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The Public Policy Doctrine: Drawing the Line Between Permissible and Impermissible Tax-Savings Clauses

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THE PUBLIC POLICY DOCTRINE: DRAWING THE LINE BETWEEN PERMISSIBLE AND IMPERMISSIBLE TAX-SAVINGS CLAUSES

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Over a half-century ago, the Fourth Circuit in Commissioner v. Procter *fashioned out of whole cloth what has become known as the public policy doctrine. This doctrine declares void certain tax-savings clauses—those clauses that taxpayers strategically use to negate the risk of additional taxes, interest, and penalties—that simultaneously undermine the ability of the Internal Revenue Service ("IRS") to enforce the tax laws and thwart the judiciary's ability to render justice.*

As taxpayers have tested the boundaries of the public policy doctrine via their continued use of select tax-savings clauses, the public policy doctrine has evolved. In this analysis, we first explore taxpayers' use of such tax-savings clauses. Next, we review the courts' responses to taxpayers' actions and critique these responses. Finally, we lay the groundwork for the institution of important reform measures in this area of the law.

We acknowledge that, in some instances, taxpayers have legitimate reasons to use tax-savings clauses. In many instances, however, reliance upon such clauses poses either a serious public policy threat whereby the very administration of the tax system is at stake or a less serious, but nevertheless important, policy concern whereby taxpayers can readily circumvent their bona fide tax obligations. A line therefore needs to be drawn between permissible and impermissible tax-savings clauses; this line must strike the appropriate balance between the taxpayers' quest for certainty and the IRS's mission to secure tax compliance.

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I. INTRODUCTION

Taxpayers usually accept those tax consequences that they anticipate and abhor those tax consequences that they consider unanticipated. To shield against the latter, many taxpayers insert so-called "tax-savings clauses" into their operative legal documents. While tax-savings clauses come in a variety of forms (e.g., formula and defined-value clauses) and are used in an assortment of different contexts (e.g., in last wills and testaments and gift assignments), they essentially declare that if an IRS audit or other event would give rise to additional tax, the transfer or transaction in question should be recast in a manner that negates or minimizes such unanticipated tax consequences.[1]

1. For excellent articles that detail the nature of various tax-savings clauses, see Scott Andrew Bowman, *McCord v. Commissioner: Defined Value Clauses Redefined?*, 33

Both the IRS and courts have had mixed reactions to taxpayers' use of such tax-savings clauses. In some contexts, the IRS has sanctioned their use;[2] in other contexts, the IRS has declared their use to be detrimental to the viability of the tax system.[3] Courts, too, have responded in a varied fashion to the use of tax-savings clauses—in some instances receptive to their use,[4] and not so in others.[5]

Identifying the demarcation line between the permissible and the impermissible use of tax-savings clauses is not easy. However, this identification is important in order to protect our nation's fiscal resources. This analysis explores taxpayers' use of such clauses and how the IRS has responded to their use, revealing both sides' competing agendas. On the one hand, taxpayers want to secure the most favorable tax outcome possible and often insist upon a nontaxable "do over" of sorts if they run afoul of governing law for whatever reason. On the other hand, the IRS harbors a twofold concern: (1) the agency does not want to waste its limited audit resources upon those taxpayers who are allowed ex post to reverse or change course; and (2) it fears that sanctioning the use of tax-savings clauses will embolden taxpayers to take aggressive tax return positions without the downside financials risk of additional tax, interest, and penalties.

Section II discusses the *Commissioner v. Procter*[6] decision—a pioneering case that involved a taxpayer's use of a tax-savings clause—followed by a discussion of its progeny. Section III details the *Wandry v.*

ACTEC J. 169 (2007); Wendy Gerzog, *Not All Defined Value Clauses Are Equal*, 10 PITT. TAX REV. 1 (2013).

2. *See, e.g.*, Rev. Proc. 64-19, 1964-1 C.B. 682 (sanctions the use of formula marital deduction bequests); Treas. Reg. § 25.2702-3(b)(1)(ii)(B) (sanctions defining the annuity amount in terms of a percentage of the finally determined fair market value of the assets transferred to the grantor-retained annuity trust); Treas. Reg. § 1.664-2(a)(1)(iii) ("The stated dollar amount may be expressed as a fraction or a percentage of the initial net fair market value of property irrevocably passing in trust as finally determined for federal tax purposes."); Treas. Reg. § 25.2518-3(c) (sanctioning the use of formula disclaimers).

3. *See, e.g.*, Rev. Rul. 86-41, 1986-1 C.B. 300 (The IRS refused to permit two different valuation-adjustment clauses that pertained to putative real estate transfers. The first clause instructed that the donee would transfer back to the taxpayer that portion of the real estate necessary to make the value of the gift $1,000, and the second clause required that the transferee pay to the transferor cash equal to the value of the property in excess of $1,000. The IRS premised its disallowance on the fact that each transfer was subject to an impermissible condition subsequent, namely, an IRS audit.); Rev. Rul. 65-144, 1965-1 C.B. 442 (held void a tax-savings clause that provided substantial modification of trust terms (subsequent to an IRS audit) to the extent necessary to qualify a transfer made into trust for the gift tax charitable deduction under Code § 2522).

4. *See infra* Section II.B.2.

5. *See infra* Section II.B.1.

6. Comm'r v. Procter, 142 F.2d 824 (4th Cir. 1944).

Commissioner[7] decision and its possible profound effect upon tax-savings clause usage. An analysis of existing case and administrative law leads to the conclusion that reforms are in order. In Section IV, this analysis presents criteria upon which tax-savings clauses should be evaluated and proposes various administrative reforms and judicial approaches that would elucidate this otherwise opaque area of the law. Finally, Section V concludes.

II. TAX-SAVINGS CLAUSES AND THEIR HERITAGE

Tax-savings clauses did not come about by accident. To the contrary, almost since the inception of the income tax, taxpayers have sought ways to insulate themselves from tax consequences they could not anticipate. In a perfect world for taxpayers, tax-savings clauses would enable taxpayers to get to the exact "line" of paying the least possible tax resulting from a transaction or transfer and not a penny more. However, finding the "Holy Grail" of the perfect tax-savings clause that would achieve this goal has proven elusive.

In Section A, we discuss *Commissioner v. Procter*,[8] a case that many commentators contend was the first detailed judicial examination of a tax-savings clause. In Section B, we examine *Procter*'s progeny and how it has shaped the evolution of tax-savings clauses and the demarcation line between those tax-savings clauses that courts have ruled to be permissible and those that are not.

A. Commissioner v. Procter

In *Procter*, the taxpayer's grandfather established two trusts, one inter vivos and the other testamentary.[9] The corpus of the inter vivos trust was $928,593.70, and the value of the testamentary trust was $961,552.68.[10] The taxpayer, aged thirty-six, was entitled to receive (i) the corpus of the first trust upon the death of his mother, aged sixty-three, and (ii) the latter trust in the event that he survived his mother and attained the age of forty.[11] Unrelated to the two trusts, the taxpayer apparently was greatly indebted to his mother; as a result, the taxpayer issued demand notes to his mother equal to $686,300.03 (i.e., the amount of his debt), secured by the taxpayer's remainder interest in the two trusts established by his grandfather.[12]

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7. Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (2012).
8. *See Procter*, 142 F.2d at 824.
9. *Id.* at 825.
10. *Id.*
11. *Id.*
12. *Id.*

Several years after the grandfather's trusts were formed and funded and the taxpayer became indebted to his mother, the taxpayer established a trust for the benefit of his two children.[13] The taxpayer funded this newly established trust with his remainder interest in the two trusts established by his grandfather.[14] Once the actuarial computations of the taxpayer's remainder interest in his grandfather's trusts and his mother's security interest therein were each taken into account, the taxpayer averred that his assignment to fund the newly established trust did not result in the imposition of gift tax.[15] Furthermore, the taxpayer took the position that even if there were a putative gift tax due, the following tax-savings clause embedded in the terms of the newly established trust negated the imposition of such tax:

> Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, 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, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be 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 Frederic W. Procter free from the trust hereby created.[16]

The IRS disputed the taxpayer's assertion that there was no attendant gift tax associated with the taxpayer's assignment; furthermore, the IRS claimed that the aforementioned tax-savings clause was ineffectual.[17]

In its first leg of analysis, the United States Court of Appeals for the Fourth Circuit devised a methodology to compute the amount, if any, of the taxpayer's gift.[18] Any gift would be valued by determining the taxpayer's present interest in both of the trusts established by his grandfather, subtracted by the debt owed to the taxpayer's mother.[19] The Fourth Circuit then remanded the case back to the Tax Court for a ruling consistent with these computational instructions.[20]

In the second leg of its analysis, the Fourth Circuit examined whether the taxpayer's tax-savings clause would come into play to negate that

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13. *Id.*
14. *Id.*
15. *Id.* at 826.
16. *Id.* at 827.
17. *Id.* at 825.
18. *Id.* at 826.
19. *Id.*
20. *Id.* at 828. On remand, the amount of the taxable gift was determined to be $166,400.58; and, after applying the then-specific exemption of $40,000, a gift tax in the amount of $10,566.07 was deemed due and owing. 4 T.C.M. 359 (1945).

portion of the assignment, if any, that might give rise to a taxable gift.[21] Given the absence of any provision in the Internal Revenue Code ("Code") addressing the use of such a clause, the Fourth Circuit was forced to create out of whole cloth a rule that tax-savings clauses of this nature violated public policy. It delineated three reasons why this clause (and, presumably, those sharing similar characteristics) would not be allowed to stand.[22] First, were the application of this clause upheld, it would undermine IRS enforcement efforts (i.e., any time the agency devoted its limited resources to collecting tax, such efforts would be for naught).[23] Second, the enforcement of this clause would undermine justice as it would require courts "to pass upon a moot case"[24] (i.e., if the court were to rule that there was a taxable gift, the gift theoretically would be undone; yet because the donees were not party to the court action, this ruling would not be enforceable upon them). Third, enforcement of this clause would cause the court to render a declaratory judgment, which the Fourth Circuit held was beyond its jurisdiction.[25]

The three aforementioned concerns articulated by the *Procter* court have formed the backbone of what commentators now commonly refer to as the public policy doctrine.[26] This doctrine declares that taxpayers'

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21. *Id.* at 827.

22. *Id.* Almost since the advent of the income tax, courts have pondered the role of public policy in making statutory interpretations. Indeed, there are pre- and post- *Procter* cases that examine whether business deductions should be disallowed in those instances where such deductions might harm the general welfare. *See, e.g.*, Great N. Ry. Co. v. Comm'r, 8 B.T.A. 225 (1927), *aff'd*, 40 F.2d 372 (8th Cir. 1930) (penalties for violating statutes and regulations held not deductible from railway company's net income as operating expenses); Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958) (upheld the disallowance of deductions claimed by taxpayers for fines and penalties imposed upon them for violating state penal statutes because to allow a deduction in those circumstances would have directly and substantially diluted the actual punishment imposed). But the U.S. Supreme Court has also made clear that use of the public policy doctrine should be restricted. *See, e.g.*, Tank Truck Rentals v. Comm'r, 356 U.S. 30, 35 (1958) (finding that the "test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction"); Lilly v. Comm'r, 343 U.S. 90, 97 (1952) (finding that the "policies frustrated must be national or state policies evidenced by some governmental declaration of them"); Comm'r v. Heininger, 320 U.S. 467, 473 (1943) (only where the allowance of a deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct" should a court uphold the disallowance of such a deduction).

23. *Procter*, 142 F.2d at 827.

24. *Id.*

25. *Id.* at 827–28.

26. *See, e.g.*, Jeffrey G. Sherman, *'Tis a Gift to Be Simple: The Need for a New Definition of "Future Interest" for Gift Tax Purposes*, 55 U. CIN. L. REV. 585, 633–34 (1987) (explaining the *Procter* decision and its public policy concerns).

clauses and actions that endanger the public's well-being are not sanctioned under the Code and are therefore disallowed.[27] Because this doctrine was judicially created, however, courts have been circumspect in not overstepping their bounds—a point that the United States Supreme Court affirmed in *Commissioner v. Tellier*.[28] In *Tellier*, a taxpayer was criminally charged for his illegal security-trading activities.[29] The issue that the Supreme Court had to address was whether the taxpayer could deduct the legal expenses associated with his criminal defense under Code Section 162 (which permits the deduction of "ordinary and necessary" business expenses).[30] The IRS claimed that public policy concerns—i.e., the deductibility of such legal expenses might foster criminal behavior—prohibited such deductibility.[31] The Supreme Court, however, admonished the IRS and ruled to the contrary; it pointed out that construing statutory law in accordance with public policy concerns should be done sparingly[32] and, as applied to deductions, should only be employed when the danger to the public is severe and immediate.[33]

Going forward, in light of the *Tellier* decision, if the IRS was to invoke the public policy doctrine (including attacking tax-savings clauses), the agency would have to demonstrate with specificity how the public might be endangered and the grave risks at stake. Vague and undocumented concerns simply would not suffice. The message of the Supreme Court was clear: the IRS was at liberty to invoke the public policy doctrine to challenge a taxpayer's position, but the agency would only prevail if the fundamental fabric of the tax system was in jeopardy of being tattered.

In the section that follows, with the *Procter* and *Tellier* decisions in mind, this Article investigates why the IRS prevailed in some cases involving tax-savings clauses and why taxpayers were successful in others.

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27. For an excellent exposition of the public policy doctrine, see Note, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 108 (1962).

28. Comm'r v. Tellier, 383 U.S. 687 (1966).

29. *Id.* at 687.

30. *Id.* at 688.

31. *Id.*

32. *Id.*; *see* Richardson v. Mellish, 130 Eng. Rep. 294, 303 (Ex. 1824) (Burrough, J.)) ("Public policy is a very unruly horse, and when once you get astride it you never know where it will carry you. It may lead you from the sound law. It is never argued at all, but when other points fail."), *quoted in* E. ALLAN FARNSWORTH, CONTRACTS 326 (3d ed. 1999).

33. *Tellier*, 383 U.S. at 694.

B. *The Progeny of* Procter

In their decisions, judges often remind their readers that the practice of tax is filled with unexpected and nettlesome land mines and complexity.[34] The financial ramifications for running afoul of these land mines and such complexities are often significant: taxpayers face potential additional tax, interest,[35] and penalties;[36] and tax practitioners must endure potential financial penalties[37] and professional liability exposure.[38] In light of these financial stakes, legal documents are often infused with prophylactic measures that are specifically designed to safeguard against such unanticipated tax outcomes.

In this section of the analysis, we catalog controversies between the IRS and taxpayers involving tax-savings clauses, bifurcating our analysis into: (1) those cases in which the IRS prevailed; and (2) those cases in which taxpayers prevailed.[39]

1. The IRS Prevailed and Voided the Use of a Tax-Savings Clause

There are several cases in which the IRS was able to convince courts that a tax-savings clause should either be ignored or voided. In chronological order, the three most important cases are: (a) *Harwood v. Commissioner*;[40] (b) *Ward v. Commissioner*;[41] and (c) *Estate of McLendon v. Commissioner*.[42]

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34. *See, e.g.*, Peracchi v. Comm'r, 143 F.3d 487, 488 (9th Cir. 1998) ("We must unscramble a Rubik's Cube of corporate tax law to determine the basis of a note contributed by a taxpayer to his wholly-owned corporation."); O'Bryan v. Comm'r, 75 T.C. 304, 306 (1980) ("Like many simple rules, the rule contained in section 642(h)(2), when applied to a concrete set of facts, creates an enigma.").

35. I.R.C. § 6601 (2006).

36. *Id.* §§ 6651–64.

37. *Id.* § 6694.

38. *See generally* Jay A. Soled, *Tax Shelter Malpractice Cases and Their Implications for Tax Compliance*, 58 AM. U. L. REV. 267 (2008) (explaining how tax practitioners face potential liability claims if their clients are audited and bear additional tax, interest, and penalties).

39. To date, the majority of adjudicated cases involve transfer tax issues. However, as tax-savings clauses grow in popularity, we anticipate that future disputes will encompass other areas of tax law.

40. Harwood v. Comm'r, 82 T.C. 239 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986).

41. Ward v. Comm'r, 87 T.C. 78 (1986).

42. Estate of McLendon v. Comm'r, 66 T.C.M. (CCH) 946 (1993), *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995).

a. Harwood v. Commissioner

In *Harwood*, taxpayers had gifted limited partnership interests into trusts established for the benefit of their children.[43] The Tax Court's first task was to ascertain the fair market value of these gifted limited partnership interests.[44] After the court conducted this valuation analysis, it had to determine the validity of a tax-savings clause.[45] The clause required the trustees to issue a promissory note to the taxpayer donors equal to the difference between the contributed property's reported value for gift tax purposes and the property's actual fair market value if the two following conjunctive conditions were both met: (i) a final determination that the contributed property to the limited partnership exceeded $400,000; and (ii) "in the opinion of the [a]ttorney for the trustee a lower value is not reasonably defendable."[46]

In analyzing the tax implications associated with the use of this tax-savings clause, the Tax Court examined whether these conjunctive conditions had both been met.[47] Because the fair market value of the limited partnership interests was determined to be $1,278,826.50, which was well in excess of the reported $400,000 value, the first condition was obviously met.[48] The second condition, however, was not satisfied because the attorney for the trustee apparently believed that the reported value was defendable.[49] This latter point was evidenced by the fact that the trustee had not issued a promissory note equal to $878,826.50 (the contributed property's fair market value of $1,278,826.50 less its reported value of $400,000) to the taxpayer donors who had made the trust contribution.[50]

In analyzing the effect, if any, of the tax-savings clause, the Tax Court distinguished the facts of this case from those found in *Procter*.[51] It pointed out that the structure of the *Harwood* tax-savings clause was different from the tax-savings clause used by the taxpayers in *Procter*.[52] In particular, the effect of the *Procter* tax-savings clause would have been to undo a portion of the initial transfer (i.e., after the court decision was rendered, a portion of the property theoretically was supposed to be returned to the donor).[53] In contrast, in *Harwood*, if the tax-savings clause took effect, it was designed

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43. *Harwood*, 82 T.C. at 239.
44. *Id.* at 242.
45. *Id.*
46. *Id.* at 248.
47. *Id.* at 273.
48. *Id.* at 274.
49. *Id.* at 273.
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*

to come into play immediately after a property appraisal was made or the IRS had conducted an audit—not after a judicial decision was rendered.[54] Here, because the trustee did not issue a promissory note to the taxpayer donors (which might have negated the putative additional gift), the tax-savings clause was ineffectual.[55] The Tax Court therefore issued a narrow ruling based upon the facts before it, holding that the tax-savings clause in question was a nullity, skirting the larger issue regarding its validity.[56]

b. Ward v. Commissioner

In *Ward*, the Tax Court was confronted with facts similar to *Harwood*. The taxpayers had transferred interests in a closely held business to their children, and the Tax Court was called upon to ascertain the fair market value of such interests and the validity of a tax-savings clause.[57] After a lengthy discussion of the numerous factors that shape the fair market value of closely held business interests, the Tax Court reached the conclusion that the per share value reported for gift tax purposes ($2,000 for all tax years involved) was below that of the actual fair market value per share ($2,207 for 1979, $2,288 for 1980, and $2,295 for 1981), and hence there was a potential gift tax deficiency.[58]

Despite the Tax Court's valuation finding, the taxpayers argued that they should nevertheless prevail and that no gift tax should be assessed.[59] The taxpayers first asserted that they had intended to transfer $50,000 to each of their sons rather than a specific number of shares.[60] The Tax Court did not find this argument persuasive insofar as the gift tax return specifically referred to the transferred shares rather than a specific dollar amount.[61] Second, the taxpayers argued that a tax-savings clause that was part of the transfer documents negated the taxable gift.[62] More specifically, the taxpayers pointed out that while they had transferred twenty-five shares of company stock to each of their children, they reserved the right to revoke a part of each gift if it was "finally determined for gift tax purposes" that the fair market value of each share exceeded $2,000.[63]

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54. *Id.*
55. *Id.* at 275.
56. *Id.*
57. Ward v. Comm'r, 87 T.C. 78 (1986).
58. *Id.* at 109.
59. *Id.* at 109–10.
60. *Id.*
61. *Id.* at 110. *See also* Knight v. Comm'r, 115 T.C. 506 (2000) (rejecting the taxpayer's argument based on a tax-savings clause in light of the taxpayer's indication on the gift tax return that shares had been gifted rather than a defined-value amount).
62. *Id.*
63. *Id.* at 110 n.10.

The Tax Court found this power to revest the company shares in the taxpayers problematic for two reasons. First of all, it was far from clear if this revesting power would ever take effect; in particular, the court was confident that had the IRS not conducted an audit, the activation of this provision would have remained untapped.[64] More troubling to the court, however, was the fact that even if it upheld the clause's validity, "the Commissioner has no power to compel the donor to reclaim a portion of the property."[65] Put differently, in the aftermath of the court's decision, the donees of the property (namely, the taxpayers' children) might simply have refused to return the property, thus rendering the opinion of the Tax Court a nullity. In accordance with *Procter*, the Tax Court determined the tax-savings clause to be deemed void rather than have its holding become an exercise in judicial futility.

c. Estate of McLendon v. Commissioner

The facts of *McLendon* are remarkably similar to those of *Harwood* and *Ward.* Once again, the Tax Court was called upon to value closely held business interests and to decide the validity of a tax-savings clause. In *McLendon*, the taxpayer was stricken with a deadly form of cancer.[66] In light of his severe illness, in return for a private annuity, the taxpayer sold family partnership interests to his son and the trustee of a trust established for the benefit of his daughters.[67] The Tax Court first went through the difficult exercise of determining the actual fair market value of the interests that were sold by the taxpayer in exchange for the private annuity.[68] The Tax Court concluded that the fair market value of the transferred assets greatly exceeded the annuity purchase price, thus triggering a possible gift tax exposure.[69]

In anticipation that the IRS might make a valuation challenge, the taxpayer had inserted a tax-savings clause into the purchase agreement.[70] The clause essentially declared that if the IRS or Tax Court arrived at a different fair market value than the one used for computation of the private annuity amount, the purchase price would be adjusted by the difference.[71]

64. *Id.* at 111.
65. *Id.* at 113.
66. Estate of McLendon v. Comm'r, 135 F.3d 1017 (5th Cir. 1998).
67. *Id.*
68. *Id.* at 1019.
69. For example, were the fair market value of the transferred assets $500,000 and the fair market value of the private annuity $100,000, the potential gift tax exposure would be on $400,000 ($500,000 less $100,000).
70. *Estate of McLendon*, 135 F.3d at 1019.
71. *Id.*

In the taxpayer's opinion, application of this clause would negate the imposition of any gift tax.[72]

After reviewing the outcomes in both *Procter* and *Ward* and distinguishing the presented facts from those found in the *King* decision (see below),[73] the Tax Court summarily dismissed the tax-savings clause as being null and void.[74] The reasons for its holding closely echo the *Ward* decision. The Tax Court first declared that "it makes little sense to expend precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render the issue moot."[75] The Tax Court then added that "our determination that the private annuity agreement resulted in a taxable gift is not directly binding on [the donees] who are not parties to this case. Consequently, there being no assurance that the terms of the adjustment clause will be respected . . . ."[76] The Tax Court did want to be placed in the uncomfortable position of rendering a decision that did not result in the imposition of gift tax and could be blithely ignored by the donees who had been directly enriched by the transfer.[77]

In each of the foregoing cases, the common denominator was the cautionary nature of the judiciary. If the taxpayers in these cases prevailed, the transfer of virtually any difficult-to-value asset would be accompanied by some sort of tax-savings clause or agreement seeking to undo unforeseen gift tax exposure arising from an IRS audit. The *Harwood*, *Ward*, and *McLendon* courts rejected this loophole: if a transfer was made and the reported gift was inaccurate, the taxpayers were going to have to bear the concomitant transfer tax consequences and associated valuation risks of gift giving. Effectively, under these decisions, no tax-savings clause or agreement could shield taxpayers from taking aggressive transfer tax valuation-reporting positions.

2. The Taxpayer Prevailed and the Use of a Tax-Savings Clause Was Upheld

The *Procter* decision had a chilling effect upon taxpayers attempting to use tax-savings clauses. Indeed, the *Procter* holding pertaining to the

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72. *Id.*

73. King v. United States, 545 F.2d 700 (10th Cir. 1976).

74. Estate of McLendon v. Comm'r, 66 T.C.M. (CCH) 946 (1993).

75. *Id.*

76. *Id.*

77. *See, e.g.*, Estate of Focardi v. Comm'r, 91 T.C.M. (CCH) 936 (2006) (taxpayers inserted a tax-savings clause into a grantor retained annuity trust that declared void a spousal interest were that interest later deemed to be nonqualified under the Code and associated Treasury regulations; the Tax Court ruled that such a clause was null and void, "and we give it no respect").

validity of a tax-savings clause was not cited by a reported case for another quarter of a century.

This section of the analysis again catalogs court controversies between the IRS and taxpayers, but this time explores cases in which taxpayers prevailed. In chronological order, the four most important cases are as follows: (a) *King v. United States*;[78] (b) *McCord v. Commissioner*;[79] (c) *Estate of Christiansen v. Commissioner*;[80] and (d) *Petter v. Commissioner*.[81]

a. King v. United States

After *Procter*, the next case to examine the validity of a tax-savings clause was *King v. United States*.[82] In *King*, the taxpayer sold 1,600,000 shares of closely held stock, valued at $1.25 per share, to trusts that he had established for the benefit of his children.[83] In the stock purchase agreement, there was a "price adjustment clause" declaring that the price per share would be upwardly or downwardly adjusted if the IRS determined that a higher or lower price was appropriate.[84] Upon audit, the IRS declared that the actual fair market value price per share was $16 (twelve times higher than the dollar figure reported by the taxpayer), resulting in a $14.75 per share gift ($16 - $1.25) to the trusts—a total taxable gift of $23,600,000 (1,600,000 × $14.75).[85]

The United States Court of Appeals for the Tenth Circuit had to consider whether the tax-savings clause in the stock purchase agreement should be upheld.[86] In its decision, the Tenth Circuit was impressed by the district court's factual finding that the taxpayer intended that the trusts pay full and adequate consideration for the stock (i.e., there was an absence of donative intent on the taxpayers' part), "and that the [tax-savings] clause was a proper means of overcoming the uncertainty in ascertaining the fair market value of the stock."[87] The Tenth Circuit then distinguished this tax-savings clause from the clause in *Procter*.[88] The tax-savings clause before the court did not "attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees was made to reconvey the stock to

78. *King*, 545 F.2d at 700.
79. McCord v. Comm'r, 461 F.3d 614 (5th Cir. 2006).
80. Estate of Christiansen v. Comm'r, 130 T.C. 1 (2008).
81. Estate of Petter v. Comm'r, 98 T.C.M. (CCH) 534 (2009), *aff'd*, 653 F.3d 1012 (9th Cir. 2011).
82. *King*, 545 F.2d at 700.
83. *Id.* at 704.
84. *Id.* at 703–04.
85. *Id.* at 704.
86. *Id.* at 703.
87. *Id.* at 705.
88. *Id.*

King or to cancel the notes in anticipation of an unfavorable valuation ruling."[89] Put another way, when the taxpayer sold the stock to the trusts, the transaction was complete because ownership of the stock had vested in the donee.[90] If, upon audit, the IRS found the sales price for the stock was too low, the purchasing trust would have to pay more for the stock; or if the IRS found that the reported sales price was too high, the taxpayers could demand to be reimbursed.[91] In upholding the tax-savings clause's validity,[92] the Tenth Circuit did not seem bothered by the fact that after the IRS audit was conducted and the court's decision was rendered, the taxpayer and the trustee of the trust could conspire to ignore the court's holding (which is apparently what happened).[93]

b. McCord v. Commissioner

Notwithstanding the issuance of the *King* decision, several courts considered its holding suspect.[94] Furthermore, taxpayers attempting to employ tax-savings clauses were met with crushing defeats in *Harwood*,[95] *Ward*,[96] and *McLendon*,[97] casting doubt on the utility of tax-savings clauses in general. The United States Court of Appeals for the Fifth Circuit then rendered a decision in *McCord v. Commissioner*,[98] which, despite not

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.* at 706.

93. Another unstated factor that may have played a pivotal role in the court's pro-taxpayer decision was that by the time the *King* case was adjudicated, the company whose shares had been sold in return for the private annuity had gone bankrupt. King v. United States, 545 F.2d 700, 703 (10th Cir. 1976). It is likely that holding the taxpayers liable for gift tax on the initial transaction seemed palpably unfair to the court. *See, e.g.*, Ward v. Comm'r, 87 T.C. 78, 115 (1986) ("It appears that the taxpayer and the trusts made no attempt to make a price adjustment, but the adjustment would have been an empty formality, since the trust corpus—shares in the corporation, which was bankrupt by the time of trial—was worthless.").

94. *Ward*, 87 T.C. at 116 ("The factual findings supporting the holding in *King* are open to question." (footnote omitted)); Harwood v. Comm'r, 82 T.C. 239, 271 n.23 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986) ("We question whether the buyer's willingness to pay whatever amount the IRS determined the stock to be worth evidences an arm's-length transaction. If anything, it tends to show that the trustee did not bargain at arm's length with the trust grantor, since the trustee evidently did not care what price it paid for the stock, but cared only that no gift tax be incurred by the grantor–seller.").

95. *Harwood*, 82 T.C. at 239.

96. *Ward*, 87 T.C. at 78.

97. Estate of McLendon v. Comm'r, 66 T.C.M. (CCH) 946 (1993).

98. McCord v. Comm'r, 461 F.3d 614 (5th Cir. 2006).

directly addressing the validity of these clauses, paradoxically led to their acceptance in later Tax Court decisions.

By way of background, the taxpayers in *McCord* established a limited partnership, McCord Interests, Ltd. ("MIL"), for estate planning reasons.[99] In return for partnership interests, the husband and wife taxpayers contributed $12,294,384 (or $6,147,192 apiece) to MIL.[100] Marketable securities comprised approximately 65 percent of the value of the contributed assets with real estate comprising approximately 30 percent of the value of the contributed assets.[101]

Using an assignment agreement, the taxpayers then assigned their MIL limited partnership interests using a formulaic approach.[102] The taxpayers' children and trusts established for the benefit of the taxpayers' grandchildren (noncharitable beneficiaries) were to receive gifted interests having an aggregate fair market value of $6,910,933.[103] If the fair market value of the gifted MIL interests exceeded this dollar threshold, the Shreveport Symphony, Inc. ("SS") was to receive a portion of the gifted interest having a fair market value equal to such excess up to $134,000.[104] After the prior two allocations, any remaining undistributed MIL interests were to pass to the Communities Foundation of Texas, Inc. ("CFT").[105] Because of their tax-exempt status, assignments to the latter two distributees would qualify for the unlimited gift tax charitable deduction.[106]

By inserting this formula clause, the taxpayers aspired to cap the amount of their taxable gift at $6,910,933.[107] More specifically, even if the IRS was to challenge the reported fair market value of the MIL interests that were assigned to the noncharitable beneficiaries, the audit would not produce any additional transfer tax.[108] Instead, any excess value determination by the IRS would result in additional MIL interests passing from the noncharitable beneficiaries to the charitable beneficiaries (SS and CFT), thereby qualifying for the gift tax charitable deduction.

Several months after the taxpayers assigned their MIL interests, the assignees of the gifts (both charitable and noncharitable) entered into a "confirmation agreement."[109] In this agreement, each party agreed to a putative value of the MIL interest assigned by the taxpayers and, based

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99. *Id.* at 616.
100. *Id.*
101. McCord v. Comm'r, 120 T.C. 358, 361 (2003).
102. *McCord*, 461 F.3d at 618.
103. *Id.*
104. *Id.*
105. *Id.* at 619.
106. I.R.C. § 2522 (2006).
107. *See McCord*, 461 F.3d at 618.
108. *Id.* at 618–19; *see* I.R.C. § 2522 (2006).
109. *McCord*, 461 F.3d at 618.

upon that valuation determination, allocated percentage interests in MIL that were to pass to noncharitable beneficiaries SS and CFT.[110] Upon audit, among other things, the IRS challenged the reported fair market value of the MIL interests that were assigned as well as the tax-savings formula clause that appeared to neutralize the tax effect of any upward valuation adjustment.[111]

The IRS prevailed in Tax Court.[112] As is typical in cases involving transfers of closely held business interests, the court initially attempted to ascertain the fair market value of MIL interests by addressing the intricacies of minority and marketability discounts and the accuracy of each party's professional experts.[113] After this lengthy discussion, the court arrived at a significantly higher fair market value for the MIL interests than the taxpayers' reported value.[114] Using this higher valuation, the Tax Court then declared that the donor taxpayers were liable for additional gift tax based upon the MIL percentage interests that were allocated to the noncharitable beneficiaries pursuant to the confirmation agreement.[115] In ruling for the IRS, the Tax Court majority did not find it necessary to address the application of the tax-savings clause and the *Procter* decision.[116] Because the tax-savings clause in question did not use the phrase "as finally determined for gift tax purposes,"[117] the Tax Court majority apparently concluded that the court's determination of value could not affect the amount passing to charity.[118] As a result, the taxpayer could not use the clause to negate the IRS deficiency.[119]

Judge Foley, in a strong-worded dissent, sided with the taxpayer.[120] He maintained that the defined-value clause used in *McCord* was different from the condition-subsequent clause used in *Procter* and *Ward* and that its failure to include the "finally determined" phrase was inconsequential.[121] In Judge Foley's view, the *McCord* clause had to be read as if it contained the proper phraseology.[122] Judge Foley also suggested that because the confirmation agreement was executed after the date of the gift, it could not

110. *Id.*
111. *Id.* at 621.
112. McCord v. Comm'r, 120 T.C. 358 (2003).
113. *Id.* at 373–95.
114. *Id.* at 395.
115. *Id.* at 404.
116. *Id.* at 424–25.
117. *Id.* at 397.
118. *Id.*
119. *Id.* at 403.
120. *Id.* at 416 (Foley, J., dissenting).
121. *Id.* at 420, 424.
122. *Id.*

be taken into account based on the inveterate gift tax principle that post-gift events are not relevant to the question of value.[123]

Relying almost entirely upon Judge Foley's dissent, the Fifth Circuit reversed the Tax Court and thereby laid the groundwork for later taxpayer-friendly opinions.[124] Like Judge Foley, the Fifth Circuit applied the tax-savings clause, finding that the charities would be entitled to receive all value in excess of the amount stipulated in the gift documents.[125] More specifically, the taxpayers had given each noncharitable donee a specific dollar amount via a "defined value" clause.[126] The designated dollar amounts to the noncharitable beneficiaries were to be funded with MIL interests—which were admittedly difficult to value—but, in the opinion of the Fifth Circuit, not a single dollar more than $6,910,933.[127]

On the basis of this finding, the Fifth Circuit ruled in the taxpayers' favor and capped the taxpayers' gift tax exposure at the dollar figure stipulated in the gift document.[128] As such, the IRS proposed deficiency was invalidated.[129] Unlike Judge Foley, however, the Fifth Circuit did not reach the *Procter* issue (namely, whether the public policy doctrine would render the operative tax-savings clause void); instead, it explicitly noted that the IRS had not pressed this argument on appeal.[130] (Parenthetically, of course, this suggests that the Fifth Circuit contemplated that, in future cases involving a defined-value tax-savings clause, the IRS would be free to pursue this argument.)

c. Estate of Christiansen v. Commissioner

Several years after the *McCord* decision, the Tax Court echoed Judge Foley's dissent in *Estate of Christiansen v. Commissioner*[131] by beginning to express skepticism toward *Procter* and the IRS position that tax-savings clauses should generally be ignored. The *Christiansen* taxpayer had died, bequeathing her estate to her daughter.[132] Under the terms of the taxpayer's will, if her daughter disclaimed all or part of her inheritance, 75 percent of

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123. *Id.* at 417; *see, e.g.*, Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929) ("[T]he value of the thing to be taxed must be *estimated* as of the time when the act is done." (emphasis added)).

124. McCord v. Comm'r, 461 F.3d 614, 632 (5th Cir. 2006).

125. *Id.* at 628.

126. *Id.* at 624.

127. *Id.* at 632.

128. *Id.* at 628.

129. *Id.* at 632.

130. *Id.* at 631.

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

132. *Id.* at 2.

her disclaimed assets would pass to a charitable lead trust (in which the daughter was the remainder beneficiary) and 25 percent of such disclaimed assets would pass to a charitable foundation.[133]

Upon the taxpayer's demise, the daughter timely disclaimed the entirety of taxpayer's estate but for the sum of $6,350,000.[134] Under the terms of the taxpayer's will, the balance of her estate was to pass to the charitable lead trust and a charitable foundation, and it was claimed that each of these bequests qualified for the estate tax charitable deduction.[135]

The IRS subsequently audited the taxpayer's estate.[136] After investigating and challenging the reported gross estate value of $6,512,223.20, the IRS and estate agreed that the estate's actual gross value was instead $9,578,895.93 (approximately 50 percent larger than the taxpayer's initial reported value).[137] Because the taxpayer had retained $6,350,000 and disclaimed the balance of her mother's estate, the reevaluation of the decedent's estate meant that the charitable lead trust and the charitable foundation were entitled to additional assets (i.e., the difference between $9,578,895.93 (the revised fair market of the estate) and $6,350,000 (the value of the disclaimed assets)).[138] In the estate's opinion, the additional sums that would pass to the charitable beneficiaries would give rise to an augmented estate tax charitable deduction.[139]

The IRS demurred.[140] First, the IRS pointed out that the value of any asset passing to the charitable lead trust would not qualify for the estate tax charitable deduction.[141] Citing Treasury Regulation Section 25.2518-2(e)(3), the IRS averred that the disclaimer that the taxpayer had issued in favor of the charitable lead trust was not qualified because the taxpayer possessed a contingent remainder interest in the trust.[142] More specifically, the Code and Treasury regulations did not permit taxpayers to disclaim any property in which they have retained an interest therein.[143] On this point, the Tax Court agreed.[144] Nevertheless, the taxpayer contended that the following tax-savings clause embedded in the terms of the disclaimer qualified the disclaimed assets for the estate tax charitable deduction:

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133. *Id.* at 4.
134. *Id.* at 5.
135. *Id.* at 6.
136. *Id.*
137. *Id.* at 7.
138. *Id.*
139. *Id.*; *see* I.R.C. § 2055(a) (2006).
140. *Estate of Christiansen*, 130 T.C. at 7.
141. *Id.* at 8.
142. *Id.* at 9–10; Treas. Reg. § 25.2518(e)(3) (1988).
143. *Estate of Christiansen*, 130 T.C. at 9; Treas. Reg. § 25.2518(e)(3) (1988).
144. *Estate of Christiansen*, 130 T.C. at 13.

> [To] the extent that the disclaimer set forth above in this instrument is not effective to make it a qualified disclaimer, [the taxpayer's daughter] hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer within the meaning of section 2518 of the Code.[145]

The taxpayer's position was that this tax-savings clause affected a disclaimer of the contingent remainder interest that had precluded the taxpayer from securing the estate tax charitable deduction.[146] The Tax Court nevertheless held this tax-savings clause ineffectual.[147] On the one hand, if its decision gave effect to this clause, the disclaimer would not be timely (i.e., because the Tax Court decision was being issued several years after the decedent's death, it failed to meet the permissible nine-month time frame to be qualified).[148] On the other hand, if this tax-savings clause was construed to be effective retroactively, in accordance with Code Section 2518(b), the disclaimer would still not be qualified because it would have failed to have properly identified the disclaimed property (i.e., the nonqualified trust remainder interest).[149]

Having failed on the first issue (namely, qualifying the disclaimed assets passing to the charitable lead trust for the estate tax charitable deduction), the taxpayer next sought to qualify the additional funds flowing to the charitable foundation for the estate tax charitable deduction.[150] In her disclaimer, the decedent's daughter had inserted another protective tax-savings clause, namely, that the fair market value of the disclaimed property would be as "such value . . . finally determined for federal estate tax purposes."[151] Citing to *Procter*, the IRS claimed that this clause was void as contrary to public policy.[152]

Ruling in the taxpayer's favor, the Tax Court did not find the IRS's argument to be persuasive on four different grounds. First, citing to *Tellier*, the Tax Court pointed out that in construing statutory language, the public policy doctrine should be employed sparingly.[153] Second, the effect of upholding this tax-savings clause would increase the amount of funds that would pass to charity, something that public policy generally favored.[154] Third, the court differentiated this case from *Procter* insofar as that case

145. *Id.* at 5.
146. *Id.* at 13.
147. *Id.*
148. *Id.*; I.R.C. §§ 2046, 2518 (2006).
149. I.R.C. § 2518 (2006); *Estate of Christiansen*, 130 T.C. at 13.
150. *Estate of Christiansen*, 130 T.C. at 14.
151. *Id.* at 15.
152. *Id.* at 18.
153. *Id.* at 16.
154. *Id.* at 16–17.

sought to undo a transfer whereas the contested phrase in *Christiansen* would simply reallocate property passing from the decedent between and among the decedent's daughter, the charitable trust, and the foundation.[155] Finally, the court contended that there were many safeguards already in place (e.g., the fiduciary role that estate executors play under state law, the oversight role that a state's attorney general is supposed to undertake to protect against misappropriated charitable assets, and the IRS's ability to impose sanctions against charitable institutions that engage in self-dealing) to ensure that the court's ruling, once rendered, would not be ignored even by those parties who were not named in the litigation.[156]

d. Petter v. Commissioner

In *Petter v. Commissioner*,[157] the Tax Court extended the scope of the pro-taxpayer analysis in *Christiansen* and once again held in favor of the taxpayer. In *Petter*, the taxpayer formed a limited liability company funded with publicly held United Parcel Service ("UPS") stock for the admitted purpose of trying to diminish the value of her intended gifts to her children (i.e., by transferring her interests in a limited liability company rather than in publicly traded stock, the taxpayer could avail herself of valuation discounts).[158] The taxpayer then gifted some of her limited company interests to trusts established for the benefit of her children and sold other shares to trusts that were likewise established for her children.[159]

In the case of the gift, the taxpayer employed the following formula approach: she assigned to her children a dollar value for her remaining unused applicable exclusion amount (i.e., the amount that could pass free of transfer tax) to be funded with interests in the limited liability company, with the balance of the assigned stock, if any, to pass to a charitable organization (the latter transfer intended to qualify for the gift tax charitable deduction).[160] In the case of the shares that were sold, a similar clause was used.[161] This clause provided that the number of shares passing to the trust would be equal in value to the amount of the note (i.e., the purchase price), with the balance of the shares passing to charity.[162] The reason for each of

155. *Id.* at 17.

156. *Id.* at 17–18.

157. Estate of Petter v. Comm'r, 98 T.C.M. (CCH) 534 (2009), *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

158. *Estate of Petter*, 98 T.C.M. (CCH) at 535; *see, e.g.*, Estate of Erickson v. Comm'r, 93 T.C.M. (CCH) 1175 (2007) (acknowledging the valuation benefits associated with establishing family limited partnerships and transferring interests held therein).

159. *Estate of Petter*, 98 T.C.M. (CCH) at 535.

160. *Id.* at 537.

161. *Id.*

162. *Id.*

these formula arrangements was strategic on the taxpayer's part: an IRS audit that resulted in a higher valuation of a limited liability interest would not trigger additional gift tax, but rather an augmented gift tax charitable deduction.[163]

In conducting its analysis, the Tax Court first determined the difficult-to-value limited liability interests and held such interests to be worth in excess of what the taxpayer reported.[164] The IRS took the position that, for the reasons set forth in *Procter*, the taxpayer's tax-savings clauses should be void against public policy.[165]

Nonetheless, the Tax Court upheld their validity,[166] commencing its discussion with the following declaration: "[S]avings clauses are void, but formula clauses are fine."[167] It then discussed how the taxpayer had gifted a specified dollar amount to her intended noncharitable beneficiaries and sold property at a specified dollar amount to the trustees of the trust she had established; in the Tax Court's opinion, an upward valuation determination of the the limited liability interests could not alter these salient facts.[168] The taxpayer's fail-safe mechanism whereby the balance of transferred property (i.e., beyond the stated threshold dollar amounts) passed to charity did not disturb the court.[169] To the contrary, the court pointed out that there is a congressional public policy favoring charitable giving (citing *United States v. Benedict*),[170] and the named charities would be vigilant to enforce their rights and to protect their financial interests.[171] In light of these dynamics, the Tax Court respected the tax-savings clause and held that unreported wealth would not inure to the noncharitable beneficiaries.[172] The United States Court of Appeals for the Ninth Circuit, in affirming, noted that the IRS had not made a public policy argument on appeal and therefore did not address the validity of the tax-savings clause.[173]

The common denominator in the foregoing cases was the taxpayers' strategic use of charitable beneficiaries to absorb the excess value, if any, that was produced as a result of an IRS audit, which had determined that the fair market value of the gifted or purchased assets was more than what the

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163. *Id.* at 538.
164. *Id.* at 540.
165. *Id.*
166. *Id.* at 544.
167. *Id.* at 542.
168. *Id.*
169. *Id.*
170. United States v. Benedict, 338 U.S. 692, 696–97 (1950).
171. *Estate of Petter*, 98 T.C.M. (CCH) at 542.
172. *Id.* at 543.
173. Estate of Petter v. Comm'r, 653 F.3d 1012, 1017 (9th Cir. 2011). Shortly after the *Petter* decision was issued, the Tax Court rendered an almost-identical opinion in *Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011).

taxpayers had reported. Courts have generally assumed that donations to charities constitute a public good that should be encouraged[174] and, furthermore, that charities have their own squadron of protectorates, such as independent legal counsel and state attorneys general, that advocate on their behalf.[175] Thus, all of the foregoing decisions were influenced by the fact that the tax-savings clauses in question worked to benefit charity.

In the next section of the analysis, we explore the possible implications of when a tax-savings clause directs that the difference between an asset's actual fair market value and a taxpayer's reported value flows to a noncharitable beneficiary rather than to a charitable beneficiary.

III. EXAMINING THE PERMISSIBLE BOUNDS OF TAX-SAVINGS CLAUSES

Over the past decade or so, many tax-savings clauses were structured using a charitable safety valve.[176] More specifically, if the actual fair market value of the assets gifted or purchased exceeded their reported value, the excess was to pass to entities that qualified for the gift tax charitable deduction.[177] While these tax-savings clauses sheltered taxpayers from additional gift tax exposure (depending upon whether or not they were activated), they also resulted in a diversion of financial resources from the taxpayer's family unit to charitable beneficiaries. Seeking to expand upon the success taxpayers enjoyed in the *King*, *McCord*, *Christiansen*, and *Petter* decisions, resourceful taxpayers sought to devise a tax-savings clause that could preserve wealth inside the family unit rather than cascading to charitable beneficiaries.

In Section A, we discuss *Wandry v. Commissioner*[178] and the judicial success taxpayers achieved in devising a tax-savings clause that preserved wealth inside the family unit. In Section B, we critique the *Wandry* decision and examine the profound implications it may have upon the use of tax-savings clauses and the future efficacy of IRS tax audits.

A. Wandry v. Commissioner

The facts of *Wandry* are somewhat typical of families that wish to diminish their transfer tax exposure. To avail themselves of valuation

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174. *Estate of Petter*, 98 T.C.M. (CCH) at 543 ("These features leave us confident that this gift was made in good faith and in keeping with Congress's overall policy of encouraging gifts to charities."); *see also supra* note 170 and accompanying text.

175. *See, e.g.*, *id.*

176. Peter J. Walsh, *Formula Clause Changes Taxable Gift into Charitable Donation*, 84 PRAC. TAX STRATEGIES 212 (2010).

177. I.R.C. § 2522(a) (2006).

178. Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (2012).

discounts associated with the transfer of closely held business interests,[179] the taxpayers in *Wandry* established a limited liability company and decided to capitalize upon the gift tax annual exclusion (at that time, $11,000 per donee)[180] and the lifetime gift tax exemption (at that time, $1 million).[181] The taxpayers were advised to make gifts that totaled these dollar amounts and did so by making gifts of $261,000 to each of their four children ($11,000 qualifying for the gift tax annual exclusion and $250,000 qualifying for the taxpayer's lifetime exemption) and $11,000 to each of five grandchildren (qualifying each of these transfers for the gift tax annual exclusion).[182] To fund each of the foregoing gifts, the taxpayers transferred hard-to-value membership interests in their limited liability company rather than transferring actual cash.[183]

On the advice of counsel, the husband and wife taxpayers each executed separate gift assignments.[184] These gift assignments first specified the exact dollar amounts that were to pass to each named beneficiary and declared that the funding of these dollar amounts was to be made with percentage interests in the newly established limited liability company.[185] The tax-savings clause in question was worded in a formulaic fashion; hence, the Tax Court's references to it as a "formula clause."[186] If there were an upward valuation, the savings clause instructed that there should be a corresponding diminishment of the limited liability company percentage interest to be held by each named beneficiary, with the excess reallocated back to the capital accounts of the taxpayers (i.e., the parents or grandparents of the named beneficiaries).[187]

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179. *See, e.g.*, Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, 28 VA. TAX REV. 531, 533 (2009) ("Family limited partnerships have dominated the judicial landscape in the estate and gift tax arena for nearly a decade. . . . Their principal advantage lies in the prospect of significant estate and gift tax savings generated through the exploitation of discounts used to value equity interests in closely held entities."). *See generally* Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in Its Fight Against the FLP*, 86 TAX NOTES 1461 (2000) (describing the legislative action needed to eliminate the transfer tax valuation advantages associated with the use of family limited partnerships); Leo L. Schmolka, *FLPs and GRATs: What to Do?*, 86 TAX NOTES 1473 (2000) (proposing solutions to several transfer tax loopholes, including more accurately valuing family limited partnerships).

180. I.R.C. § 2503(b) (2006).

181. *Id.* § 2010(c); *Wandry*, 103 T.C.M. (CCH) at 1473.

182. *Wandry*, 103 T.C.M. (CCH) at 1473.

183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.* at 1474.

187. The exact verbiage of the operative tax-savings clause language is as follows:

> Although the number of Units gifted is fixed on the date of the gift, that number is

In order to determine the percentage interest of the limited liability company that was to satisfy the designated dollar amount gifted, the taxpayers retained the services of an appraisal company.[188] This company determined the fair market value of each percentage interest in the limited liability company to be $109,000.[189] Consistent with this valuation, the taxpayers' children and grandchildren were to receive 2.39 percent and 0.101 percent membership interests, respectively, in the entity.[190] On their gift tax returns, the taxpayers denoted the gifts in monetary terms but also specified the percentage interest in the limited liability company that they used for funding purposes.[191]

The IRS subsequently conducted an audit of the taxpayers' gift tax returns, and together with the taxpayers agreed that the actual fair market value of a 2.39 percent interest in the limited liability company was actually $315,800 (not $261,000 as was reported), and the fair market value of 0.101 percent interest in the limited liability company was $13,346 (not $11,000 as was reported).[192] The IRS claimed that these reevaluations of the taxpayers' property triggered gift tax and that the formula clause in question was ineffectual; the taxpayers demurred.[193]

The questions before the Tax Court were threefold: first, whether the taxpayers transferred a specified dollar amount or a fixed membership percentage in the limited liability company; second, whether the limited liability company's capital accounts should control the case outcome; and

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> 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 valuation and a final determination of a different 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.

Wandry, 103 T.C.M. (CCH) at 1473—74.

188. *Id.* at 1474.

189. *Id.*

190. These percentages make sense in terms of what the taxpayers were seeking to achieve; the taxpayers had sought to gift $261,000 (i.e., 2.39 × $109,000) to each child and $11,000 to each grandchild (i.e., 0.101 × $109,000). *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

third, the effect, if any, that the formula clause would have under these circumstances.[194] The court addressed each of these questions seriatim.

First, the court examined the nature of the gift. On the one hand, the gift could be considered a fixed-percentage membership interest in the limited liability company; on the other hand, the gift could be considered a specified dollar amount.[195] If the gift were categorized as a fixed-percentage membership interest, gift tax would arise because the acknowledged fair market values of the membership percentage interests exceeded the taxpayers' annual exclusion and lifetime exemption amounts.[196] Conversely, if the gift were categorized as a specific dollar amount, no gift tax would arise because the dollar denominations were not in excess of either the annual exclusion or the taxpayers' lifetime exemption amounts.[197] After close examination, the Tax Court determined that the gifts were in the form of specific dollar amounts, not membership percentage interests, even though the gift tax return descriptions referred to membership percentage interests being transferred.[198] In the court's opinion, the controlling factor was that the taxpayers had denoted the exact dollar amounts that they were transferring to each beneficiary on the face of their gift tax returns, amounts which were consistent with the taxpayers' intentions and the written gift assignments.[199]

The Tax Court next scrutinized the IRS's argument that the capital accounts of the limited liability company should be determinative of the case's outcome.[200] More specifically, since the taxpayers' and donees' capital accounts were adjusted to reflect the percentage interests held by each as of the initial date of the gift and the limited liability company had consistently operated on this basis in terms of allocating annual gains and losses, it was too late as a practical matter to reverse course.[201] However, on the basis of prior court holdings that examined what partners in those cases actually owned rather than how profits and losses were divided between and among them,[202] the Tax Court dismissed the IRS's argument, asserting

194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.* at 1474.
198. *Id.* at 1475.
199. *Id.*
200. *Id.* at 1476.
201. *Id.*
202. The Tax Court cited to two of its decisions to support this proposition. *Id.*; *see* Offord v. Comm'r, 1961 T.C. (P-H) 871, 878–79 (1961) (capital account entries on a partnership's books were not sufficient to prove the existence of a partner); Stralla v. Comm'r, 9 T.C. 801, 819 (1947) (on the basis of facts and circumstances, partnership interests designated as belonging to certain individuals on the partnership books and records found to belong to someone else).

that "capital accounts do not control the nature of petitioners' gifts to the donees."[203]

The Tax Court then examined whether the formula clause in question could withstand judicial scrutiny. The court surveyed existing case law, bifurcating the cases into those in which such clauses were ruled invalid (e.g., *Ward* and *Harwood*) and those in which such clauses were ruled valid (e.g., *Christiansen* and *McCord*) and the rationale behind each of these decisions.[204] The Tax Court paid special attention to the *Petter* decision, which it said drew an important distinction between an impermissible *savings clause*, "because it creates a donor that tries to 'to take back property,'"[205] and a permissible the *formula clause* "because it merely transfers a 'fixed set of rights with uncertain value.'"[206]

After surveying existing case law, the Tax Court held that the taxpayers had used a permissible formula clause rather than an impermissible tax-savings clause.[207] It pointed out that the taxpayers in *Wandry* had always intended to transfer assets the value of which exactly equaled the amount of their annual exclusions and lifetime exemption amounts.[208] In seeking to fulfill their intentions, there was one unknown: the fair market value of the limited liability interests.[209] And, although the fair market value of this asset was impossible to know with certainty, the critical factor was "that [its actual] value was a constant."[210] That being the case, after the IRS audit was complete and although there was a percentage adjustment, the taxpayers had not received any property back; instead, the taxpayers and donees would now have in their possession, related back to the moment the gift was made, exactly the percentage interest each was supposed to have.[211]

In the final section of the opinion, the Tax Court addressed the IRS's public policy concerns. The Tax Court first made the general observation that invoking public policy doctrine to void a tax-savings clause should be a remedy used only sparingly and only when there may be a "severe and immediate" public policy concern.[212] Viewed from this vantage point, the Tax Court then dismissed the IRS's public policy concerns because, in the court's words, "the donees and petitioners have competing interests" that each would seek to protect.[213] Furthermore, unlike the seminal *Procter* case,

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203. *Wandry*, 103 T.C.M. (CCH) at 1476.
204. *Id.*
205. *Id.* at 1477.
206. *Id.*
207. *Id.* at 1478.
208. *See id.* at 1477.
209. *Id.* at 1478.
210. *Id.*
211. *Id.*
212. *Id.* (quoting Comm'r v. Tellier, 383 U.S. 687 (1966)).
213. *Id.*

which raised issues related to moot decisions and declaratory judgments, the court's holding in *Wandry* would engender a readjustment of partnership interest holdings and, as such, would supposedly "have significant Federal tax consequences."[214]

B. Critique of the Wandry *Decision*

For the past several years, the strategic use of valuation techniques has played a pivotal role in the estate planning process as taxpayers routinely use such procedures to minimize their transfer tax exposure.[215] *Wandry* affords taxpayers new and unprecedented opportunities to capitalize on these techniques. The question, however, is whether the Tax Court decided *Wandry* correctly. In the subsections below, we critique the three central arguments presented in *Wandry* that led the Tax Court to rule in the taxpayers' favor, namely, (1) that donors and donees have "competing interests"; (2) that partnership capital accounts are of secondary importance, and (3) that public policy concerns are not "severe and immediate."[216]

1. Argument No. 1: Donors and Donees Have "Competing Interests"

At first glance, the statement that the donors and donees have competing interests has superficial appeal. The division of money supposedly motivates people to protect their personal financial interests; among family members, theoretically, no exception applies. Upon closer inspection, however, courts routinely acknowledge that family situations are different and require special scrutiny and attention.[217] The rationale is

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214. *Id.*

215. *See* Brant J. Hellwig, *Revisiting* Byrum, 23 VA. TAX REV. 275, 278–79 (2003) ("With courts frequently sustaining combined minority-interest and marketability discounts in the range of 30–50% from proportionate value, the use of limited partnerships for estate-planning purposes is widely regarded as undermining the integrity of the estate tax." (footnotes omitted)). *See generally* Mitchell M. Gans, *Deference and Family Limited Partnerships: A Case Study*, 39 INST. ON EST. PLAN. ¶ 500 (Tina Portuondo ed., 2005); Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, 28 VA. TAX REV. 531 (2009); Louis A. Mezzullo, *Valuation of Corporate Stock*, 831-3d TAX MGM'T PORTFOLIO Worksheet 1 (2007).

216. *Wandry*, 103 T.C.M. (CCH) at 1478.

217. *See, e.g.*, Dorzback v. Collison, 195 F.2d 69, 71 (3d Cir. 1952) ("We have not overlooked the principle that transactions between husband and wife calculated to reallocate family income or reduce family taxes are subject to careful scrutiny."); Cuyuna Realty Co. v. United States, 382 F.2d 298, 300–01 (Ct. Cl. 1967) ("Claim to a debt relationship in a parent-subsidiary transaction merits particular scrutiny because the control element suggests the opportunity to contrive a fictional debt, an opportunity less present in an arms-length transaction between strangers."); United Builders Supply Inc. v. United States, 41 A.F.T.R.2d (RIA) 654, 659 (S.D. Miss. 1978) ("In cases of close relationship between the

simple: there is a vast opportunity for collusion within the family. In other words, family members ordinarily do not conduct arms-length transactions as disinterested third parties.

Consider the circumstances described in the *Wandry* decision. The taxpayers (a mother and father) transfer membership interests in a limited liability company to their descendants (their children and grandchildren).[218] From the descendants' perspective, this transfer constitutes an act of extraordinary generosity; from the taxpayers' perspective, the fact that they are shedding over a million dollars of their net worth signifies that they probably have significant assets in reserve. In light of these circumstances, there is every reason to assume that the taxpayers and their descendants will act as one, working together to achieve their mutually beneficial transfer tax–minimization goals.

Indeed, there are few plausible scenarios in which taxpayers and their descendants would manifest competing interests. The one unlikely scenario would be if the taxpayers and their descendants were to have a complete falling out while a state's statute of limitations was still open. Were this to occur, the taxpayers might invoke the gift assignment language that specified a dollar amount being transferred and assert that they had mistakenly undervalued the limited liability company interests they had gifted and that, accordingly, a portion of such interests should be reallocated to them. Even were this to happen, on the basis of several different legal theories (e.g., detrimental reliance and the doctrine of laches), the taxpayers' descendants might still be able to defeat the taxpayers' recoupment threat.

However, taxpayers and their descendants are far more likely to act collusively. Indeed, the taxpayers and their descendants would probably have discussed their common goals, including the advantages that would inure to each if the limited liability company interests were portrayed as having a diminished fair market value. By adopting this united front (i.e., acceptance of the diminished limited liability company value as the reportable value for gift tax purposes), the taxpayers and their descendants

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lessor and the lessee, . . . the Courts have always ruled that close scrutiny of the situation is appropriate in determining whether some part of the amounts designated as rentals and taken as a business expense deduction for income tax purposes were in fact disguised distribution of profits or dividends."); Diesel Country Truck Stop, Inc. v. Comm'r, 2000 T.C.M. (RIA) 1759, 1774 (1990) ("[T]ransactions between related parties are subject to close scrutiny."); Maxwell v. Comm'r, 95 T.C. 107, 117 (1990) ("In determining whether the form of a transaction between closely related parties has substance, we should compare their actions with what would have occurred if the transaction had occurred between parties who were dealing at arm's length."); Hatt v. Comm'r, 38 T.C.M. (P-H) 1293, 1304 (1969), *aff'd per curiam*, 457 F.2d 499 (7th Cir. 1972) ("The facts that Hatt was the president and majority stockholder of Johann necessitate careful scrutiny of the [employment] arrangement. . . .").

218. *Wandry*, 103 T.C.M. (CCH) at 1473.

create a "win-win" situation for the family unit: the taxpayers minimize their transfer tax burden, and their descendants are able to accumulate more wealth. The only party that is left out of the financial picture is the government.

2. Argument No. 2: Partnership Capital Accounts Are Not Controlling

One of the essential elements of partnership taxation is proper capital account maintenance (capital accounts delineate each partner's economic stake in the business enterprise).[219] Promulgated Treasury regulations addressing capital account maintenance extend over four single-spaced pages[220] and determine whether a partnership allocation has substantial economic effect—a critical element under the Code with respect to a partnership's special allocations of income and losses.[221] In the words of many commentators, proper capital account maintenance is the lifeblood of partnership taxation.[222]

In ordinary circumstances, when one taxpayer gifts a partnership interest to another taxpayer, the donor partner's capital account declines and the donee partner's capital account increases accordingly.[223] The facts in *Wandry* do not constitute an exception to this general rule. For over eight years following the date when the taxpayers' gifts were made, the limited liability company presumably conducted business, divided profits and losses, and made governance decisions based upon the taxpayers' and their descendants' putative capital accounts and ownership interests.[224] There was nothing in the record before the court to indicate otherwise.[225]

Notwithstanding the critical role that capital accounts typically play in partnership taxation, the *Wandry* court relegated their importance in determining actual property ownership. It declared that "[t]he facts and circumstances determine [the limited liability company's] capital accounts, not the other way around."[226] The court then pointed out that the governing "facts and circumstances" at issue were the taxpayers' intentions to cap the

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219. *See, e.g.*, Howard Abrams, *Taxation of Carried Interests: The Reform that Did Not Happen*, 40 LOY. U. CHI. L.J. 197, 201 (2009) ("Capital account maintenance is specified in detailed treasury regulations intended to ensure that each partner's capital account reflects the partner's economic share in the partnership.").

220. Treas. Reg. § 1.704-1(b)(2)(iv) (2012).

221. I.R.C. § 704(b) (2006).

222. *See, e.g.*, WILLIAM H. LYONS & JAMES R. REPETTI, PARTNERSHIP INCOME TAXATION 46 (2011) ("In many cases, the key to determining a partner's rights to the money and property of a partnership is the partner's capital account.").

223. Treas. Reg. § 1.704-1(b)(2)(iv)(l) (2012).

224. Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (2012).

225. *Id.*

226. *Id.* at 1476.

amount that they gifted to their descendants to specific dollar amounts.[227] While the taxpayers had mistakenly undervalued the limited liability company interests that they had gifted, the court ruled this to be immaterial.[228] The court even acknowledged the importance of state law in determining property ownership, citing the elements of a completed gift under Colorado law.[229] The court noted that these elements appeared to be met by the taxpayers on the date of the initial transfer.[230] Notwithstanding the application of state law, the court asserted that book entries cannot control "when other more persuasive evidence points to the contrary"[231] and closed its discussion on this issue by pointing out that even if the limited liability company's books were controlling, the actual records of the limited liability company were "undated and handwritten."[232] In the court's own words, "[t]he capital account ledger is unofficial and unreliable."[233]

There are three flaws in the court's capital account analysis.

First, state law controls issues pertaining to property ownership, and Colorado law would have declared the gift complete on the day it was made. This should have ended the percentage interest debate. Consider what would have happened if one or two years after the gift were made, one of the taxpayers' children had creditor issues. There is little doubt that the creditor would have been able to attach the debtor child's 2.39 percent limited liability company interest. In attempting to be shielded from creditor attacks, the debtor child would have been at a loss to argue that no attachment could occur until the IRS had conducted an audit and/or a court had determined actual ownership interests.

Second, the *Wandry* court placed undue emphasis on the fact that the IRS is at liberty to recast taxpayers' capital accounts. This ability to recast capital accounts, the court said, makes capital accounts by their nature "'tentative' until final adjudication or the passing of the appropriate period of limitations."[234] But Congress has vested the IRS, under certain circumstances (e.g., the failure by taxpayers to properly account for gains and losses), with the authority to recast capital accounts.[235] The converse is not true: taxpayers are not at liberty to readjust their capital accounts willy-nilly based upon a subsequent court decision several years after a transfer

227. *Id.* at 1475.
228. *Id.* at 1476.
229. *Id.* at 1475 (citing United States v. Nat'l Bank of Commerce, 472 U.S. 713, 722 (1985); United States v. Mitchell, 403 U.S. 190, 197 (1971)).
230. *Id.*
231. *Id.* at 1476.
232. *Id.*
233. *Id.*
234. *Id.*
235. *See generally* Treas. Reg. § 1.704-1(b)(2)(iv) (2012).

has been made.[236] It is a fundamental precept of tax law that taxpayers generally must abide by their self-described classifications and categorizations; the IRS, however, is under no similar compulsion.[237] This does not make capital accounts tentative; to the contrary, they are fixed unless and until the IRS challenges their authenticity (and, in *Wandry*, the IRS made no such challenge).[238]

Finally, taxpayers should not be afforded the benefit of doubt when they exhibit poor record keeping. The fact that the taxpayers in *Wandry* had not properly maintained their capital account ledger should not serve as an excuse for them to argue that the stated percentage interests had not technically vested with the donees. Indeed, when in doubt, taxpayers' poor record keeping practices have routinely cast a dark shadow against a taxpayer's position.[239]

3. Argument No. 3: Public Policy Concerns Are Not "Severe and Immediate"

In *Procter*, there was grave concern that a taxpayer's strategic use of a condition subsequent could fundamentally undermine the integrity of the transfer tax system.[240] The IRS echoed this concern, issuing a revenue ruling that directly attacked tax-savings clauses containing a condition subsequent.[241]

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236. *See, e.g.*, Orrisch v. Comm'r, 55 T.C. 395, 401 (1970), *aff'd per curiam in unpublished opinion*, (9th Cir. 1973) (taxpayers who ignore their capital accounts do so at the risk that the IRS need not respect their allocations).

237. Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978) ("[T]he Government should honor the allocation of rights and duties effectuated by the parties" when "there is a genuine multiple-party transaction with economic substance . . . compelled or encouraged by business or regulatory realities, . . . imbued with tax-independent considerations, and . . . not shaped solely by tax-avoidance features that have meaningless labels attached. Expressed another way, . . . the form of the transaction adopted by the parties governs for tax purposes."); Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974) ("[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not."); *accord* Gray v. Powell, 314 U.S. 402, 414 (1941) ("The choice of disregarding a deliberately chosen arrangement for conducting business affairs does not lie with the creator of the plan.").

238. Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (2013).

239. *See, e.g.*, Harker v. Comm'r, 1994 T.C.M. (RIA) 3152, 3162 ("Contentions by taxpayers who try to benefit from the fact that they kept poor records are subject to particular scrutiny.").

240. Comm'r v. Procter, 142 F.2d 824, 827 (4th Cir. 1944).

241. *See e.g.*, Rev. Rul. 86-41, 1986-1 C.B. 300 (IRS refused to permit two different valuation-adjustment clauses that pertained to putative real estate transfers. The first clause

Despite the judiciary's and IRS's attacks on tax-savings clauses that contain a condition subsequent, neither has ever elaborated upon the nature of conditions subsequent and how they differ from conditions precedent. Consider the *Black's Law Dictionary* definition of the phrase condition subsequent: "A condition that, if it occurs, will bring something else to an end; an event the existence of which, by agreement of the parties, discharges a duty of performance that has arisen."[242] A simple example illustrates a condition subsequent. Suppose a taxpayer transfers fee simple title to rent-producing property known as Blackacre to her daughter. Suppose further that the gift assignment stipulates that if the IRS or a court finally determines that the fair market value of such transfer exceeds the taxpayer's unused gift tax exemption amount (say, $5 million), the excess value, if any, must be returned to the taxpayer. If this condition subsequent were upheld (namely, there were a valuation redetermination by the IRS or a court and a transfer back of the excess portion to the taxpayer), it would function to insulate the Blackacre transfer and similarly structured arrangements from transfer tax.

Despite the judiciary's and IRS's expressed disdain toward tax-savings clauses that contain a condition subsequent, there has been tacit approval (at least on the judiciary's part) of tax-savings clauses that contain a so-called condition precedent. *Black's Law Dictionary* defines the phrase condition precedent as follows: "An act or event, other than a lapse of time, that must exist or occur before a duty to perform something promised arises."[243] Once again, the prior example can help illustrate a condition precedent. Suppose a taxpayer transfers $5 million to her daughter, and in the gift assignment declares that the gift will be funded with title to Blackacre equal to such value, allocable upon a final determination of its fair market value by a court of law or the IRS. The condition precedent to the gift being effectuated (namely, a court of law or the IRS making a valuation determination) is a necessary condition to specify with certitude the exact amount of real estate being transferred and that portion being retained. If this condition precedent were upheld (i.e., if there were a valuation redetermination by the IRS or a court and a reallocation of the excess portion to the taxpayer), it would likewise function to insulate the Blackacre transfer and similarly structured arrangements from transfer tax.

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instructed that the taxpayer would transfer back to the taxpayer that portion of the real estate necessary to make the value of the gift $1,000, and the second clause required that the transferee pay to the transferor cash equal to the value of the property in excess of $1,000. The IRS premised its position on the fact that each transfer was subject to a condition subsequent.).

242. BLACK'S LAW DICTIONARY 334 (9th ed. 2009).

243. *Id.*

Distinguishing between a condition subsequent and a condition precedent has historically proven to be a nettlesome exercise[244] and, in the area of contracts, completely abandoned.[245] Indeed, with the substitution of a few words, a condition subsequent can be transformed into a condition precedent and vice versa. This identification process has proven elusive; on numerous occasions, courts have been beset with confusion.[246] Therefore, having valuation determinations and judicial outcomes turn upon the existence of a condition precedent versus a condition subsequent is a touchstone that lacks merit. Proof of this is evident in the fact that conditions precedent and conditions subsequent almost always produce the same outcome in the tax context: taxpayers are shielded from tax, and the IRS's audit efforts are for naught.

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244. *See, e.g.*, OLIVER W. HOLMES, THE COMMON LAW 316–17 (1881) (noting the confusion underlying the distinction between "conditions precedent" and "conditions subsequent" and describing the manner in which all conditions may be seen both as precedent and subsequent); CLAUDE ROHWER & GORDON D. SCHABER, CONTRACTS IN A NUTSHELL 313 (4th ed. 1997) ("Before one gets too confused by the precedent and subsequent classifications, it might be helpful to know that in contract law there is no substantive difference between the two."); BENJAMIN J. SHIPMAN, COMMON LAW PLEADING 250 (3d ed. 1923) ("What are generally called conditions subsequent in contracts are so called with little propriety. They are in substance conditions precedent to the vesting of liability and are subsequent only in form." (quoting Professor Williston)); William V. Dorsanco III & C. Paul Rodgers III, *The Flawed Nexus Between Contract Law and Rules of Procedure: Why Rules 8 and 9 Must Be Changed*, 31 REV. LITIG. 233, 262 (2012) ("Rule 9(c) [of the Federal Rules of Civil Procedure] is flawed because it preserves the traditional but troublesome distinction between conditions precedent and conditions subsequent—a distinction rejected by the Second Restatement of Contracts."); Bryan Porter, *Bad Faith and Attorney Approval Clauses: Breach or Moot Point?*, 34 J. LEGAL PROF. 399, 401 (2010) ("The distinction between a condition subsequent and a condition precedent can be one of semantics in many instances . . . .").

245. *See* RESTATEMENT (SECOND) OF CONTRACTS § 224(e) (1981). The distinction between conditions subsequent and conditions precedent may be losing its significance in the area of future interests as well. *See* Benjamin D. Barros, *Toward a Model Law of Estates and Future Interests*, 66 WASH. & LEE L. REV. 3 (2009) (discussing an emerging view that would significantly undercut the importance of the distinction); *see also* Koontz v. St. Johns River Water Mgmt. Dist., 133 S.Ct. 2586, 2589–90 (2013) (discussing the distinction and refusing to give it significance in the context of constitutional-condition jurisprudence).

246. *See, e.g.*, Twin Fires Inv., LLC v. Morgan Stanley Dean Witter & Co., Civ. A. 00-00751-F, 2002 WL 31875204, at *24 n.18 (Mass. Super. Dec. 16, 2002) *aff'd*, 445 Mass. 411, 837 N.E.2d 1121 (2005) ("This Court recognizes, as has the Appeals Court, that the distinction between a condition precedent and a condition subsequent is often hard to understand and 'the source of considerable confusion.'" (citation omitted)); Flynn v. Hanna, 131 P.3d 844, 849 n.7 (Or. Ct. App. 2006) ("This case illustrates the confusion generated by relying too heavily on labels such as 'condition precedent' or 'condition subsequent.'"); Wash. Props., Inc. v. Chin, Inc., 760 A.2d 546, 549 n.3 (D.C. 2000) (noting that use of terms *condition precedent* and *condition subsequent* is confusing).

Consider the examples posited in this subsection pertaining to the title transfer of Blackacre. If the IRS and courts ultimately agree that its fee simple value is $7.5 million, regardless of whether a condition subsequent or a condition precedent governs, the outcome to the taxpayer is the same: she becomes a one-third tenant in common with her daughter.[247] Another way of saying the same thing but in more familiar terms is that when it comes to substance versus form debates, the former always takes precedence in tax law,[248] and by having courts focus almost exclusively upon parsing between whether particular verbiage gives rise to a condition precedent or a condition subsequent clouds issues of much greater significance (such as what the taxpayers' actual property interests were under state law).

Admittedly, there may be minor differences between a taxpayer using a condition subsequent versus a condition precedent, but the practical effects are likely to prove inconsequential. For illustration purposes, assume that the Blackacre transfer previously described above was made on January 1, 2014, and that seven years later on December 31, 2020, following an IRS audit and judicial controversy, a court of law affixes a $7.5 million fair market value related to such real estate.

For illustration purposes, we first assume that a condition subsequent is operative. On January 1, 2014, the Blackacre transfer is supposedly complete; if and when the condition subsequent is met, on December 31, 2020, a portion of that transfer is then undone. During the seven year interval between January 1, 2014, and December 31, 2020, the donee is treated as the property's owner and will enjoy and bear all of the concomitant income and deductions associated with such property ownership.

By way of contrast, we next assume that a condition precedent is operative. Until December 31, 2020, when the fair market value of Blackacre becomes fixed, the transaction is supposedly not complete (notwithstanding the fact that all of the underlying title paperwork and income tax returns by the taxpayer and her daughter will indicate that the transaction was complete on January 1, 2014). Upon learning of her valuation error, the taxpayer donor and the donee will both supposedly have to file amended income tax returns for 2014 through 2020. (These are the tax years in which the donee fallaciously reported the income and deductions related to Blackacre on her income tax returns when such income and deductions should have instead been reported on the donor's

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247. By pure happenstance, the taxpayer in the first scenario incurs transfer tax, while the taxpayer in the second scenario would not.

248. Under this doctrine, a taxpayer cannot, as a general matter, alter the tax consequences of a transaction by manipulating its form; however, the IRS is free to maintain the form chosen by the taxpayer. *See generally* William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Inability to Disavow Form*, 70 OR. L. REV. 381 (1991).

income tax returns.) In many instances, however, the filing of amended income tax returns will either be null and void because the majority of tax years in question will be closed due to the general three-year statute of limitations;[249] or, alternatively, because of the donor's strategic use of grantor trusts,[250] the need to file amended returns will be obviated.

To summarize, when the practical effects of the *Wandry* decision are distilled down to their essentials, there is no escaping the reality that the decision is largely what it contends it is not, namely, a declaratory judgment (i.e., deciding property rights between various taxpayers). Furthermore, granting free rein to taxpayers' use of tax-savings clauses likely constitutes a more immediate and severe threat to the government's coffers than the *Wandry* court acknowledges.

IV. PROPOSED REFORMS

Taxpayers routinely use tax-savings clauses in a variety of contexts.[251] The reason for this practice is evident: taxpayers want an insurance policy of sorts to shield themselves from additional tax, interest, and penalties. The IRS's concerns, however, are obvious: the unchecked use of tax-savings clauses could wreak havoc to the integrity of the tax system because taxpayers feel immunized when taking highly aggressive tax positions. Thus, the question becomes whether the courts and the Treasury Department can strike the appropriate balance between these competing interests.

Two considerations frame the way in which a balance between taxpayers' and the IRS's competing agendas may be struck. The first consideration is that the IRS can invoke the public policy doctrine, although the acknowledged viability of this doctrine turns upon whether there is a serious threat to the administration of the tax system.[252] The second

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249. I.R.C. § 6501(a) (2006).

250. *See generally* Jay A. Soled & Mitchell Gans, *Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do to Curb Aggressive Transfer Tax Techniques*, 78 TENN. L. REV. 973 (2011).

251. *See, e.g.*, C. Strobel & G. Strobel II, *Savings Clauses Can Protect Against Revalued Transfers in Family Transactions*, 14 TAX'N FOR LAW. 22 (1985).

252. *See supra* note 22 and accompanying text. In seeking to invalidate tax-savings clauses, the IRS has invoked the public policy doctrine in litigation on several occasions. To date, this approach has proved to be lackluster. *See supra* Section II.B.2. This is not a surprising outcome given the Supreme Court's rejection of the IRS's expansive use of the public policy doctrine in other contexts. *See supra* note 28 and accompanying text. Even more important, perhaps, is the agency's seemingly inconsistent stances that: (1) tax-savings clauses are so offensive to the operation of the tax system that even without any textual basis in the Code, they must be invalidated; and (2) the agency has respected clauses that serve somewhat similar functions in other contexts. *See supra* note 2.

consideration is that Congress has granted the IRS the authority to craft regulations that preserve the Code's integrity,[253] and, as long as such regulations are consistent with the Code's statutory language and are neither arbitrary nor capricious, courts will uphold them.[254] Together, these two considerations suggest that if a particular kind of tax-savings clause poses a serious public policy risk, the IRS should invoke the public policy doctrine and defeat clauses of this nature. Alternatively, if the kind of tax-savings clause in question does not pose a serious public policy risk but it nonetheless enables taxpayers to defeat their tax obligations (i.e., there is a legitimate policy concern), the IRS should craft regulations that curb the use of such clauses.

In the sections that follow, we explore how (A) the courts should refine the public policy criteria upon which the sanctity of tax-savings clauses should be evaluated; and (B) the IRS should strategically address legitimate policy concerns through administrative channels and, in particular, the crafting of Treasury regulations.

A. Refining Public Policy Criteria Used to Evaluate Tax-Savings Clauses

In its analysis of the tax-savings clauses, the *Procter* court declared that tax-savings clauses should not be upheld if they would be detrimental from a public policy perspective.[255] The *Procter* court focused upon three concerns, i.e., whether such clauses would (1) undermine IRS enforcement efforts; (2) cause courts to render moot decisions; and/or (3) trigger the issuance of declaratory judgments.[256] In this section, we examine these criteria and suggest two possible additional criteria.

To assist our examination, consider two opposite fact patterns, one involving what would undoubtedly be an impermissible tax-savings clause and another involving what would undoubtedly be a permissible tax-savings clause. Regarding the first fact pattern (impermissible tax-savings clause), suppose the sole owner of a corporation devises an employment agreement specifying that the owner/employee will receive \$10,000 annually for business-related expenses, but if the IRS conducts an audit and determines that the putative business expenses are truly personal in nature,

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253. I.R.C. § 7805(a) (2006).

254. *See* Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 710–15 (2011) (acknowledging that tax regulations are entitled to *Chevron* deference, similar to any other agency, regardless of their source of authority (i.e., unless "arbitrary or capricious," they should be upheld as valid)). *See generally* Daniel W. Graves, *Not So Special After All: How* Mayo *Granted the Treasury Unfettered Rule-Making Discretion*, 77 MO. L. REV. 283, 284 (2012) ("[T]he Court has given the Treasury Department virtually free rein in crafting new regulations and amending those regulations already in existence.").

255. *See supra* notes 21–33 and accompanying text.

256. *See supra* notes 23–25 and accompanying text.

then such expenses will be treated as deductible salary payments (rather than nondeductible constructive dividend payments). Regarding the second fact pattern (permissible tax-savings clause), suppose a taxpayer dies and her last will and testament contains the following clause:

> I bequeath an amount equal to my unused federal estate tax exemption amount to the named trustees of a bypass trust to be held pursuant to its terms and conditions; and the balance of my estate, if any, shall pass to the named trustees of a marital trust to be held pursuant to its terms and conditions.

While both of these clauses are designed to minimize each taxpayer's tax burden, under the scrutiny of the public policy doctrine—which essentially declares that tax-savings clauses that jeopardize the administration of the nation's tax system are void—the first tax-savings clause would not pass muster whereas the second clause would. This is because the first clause's sole purpose is tax motivated to shield the corporate taxpayer from IRS audit risk; in contrast, the second clause's foremost purpose is to direct appropriate trust funding.

From these two antithetical fact patterns, we examine the public policy doctrine and the criteria as set forth in *Procter*.[257] We also develop two additional criteria that future courts might consider useful in evaluating whether a particular tax-savings clause should be upheld.

The *Procter* public policy criteria have withstood the tests of time and good reason because they are logical and designed for sound administration of the nation's tax system. Consider the first criterion, i.e., whether such clauses would undermine IRS enforcement efforts.[258] If the taxpayer was able to negate such a proposed assessment vis-à-vis a tax-savings clause every time the IRS conducted an audit, then additional tax, interest, and penalties might never apply, which would eliminate the efficacies of such audits and thereby significantly erode tax compliance. Consider the second criterion, i.e., whether such clauses would cause courts to render moot decisions.[259] If the effect of a tax-savings clause is that a court's decision would be rendered moot, the clause would diminish judicial deference and constitute an unjustifiable waste of judicial resources. Finally, consider the third criterion, i.e., whether such clauses would trigger the issuance of declaratory judgments.[260] By way of background, a declaratory judgment is one where there are no factual disputes and the only relief sought is a declaration of the status or rights of the plaintiff under law.[261] In an effort to

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257. Comm'r v. Procter, 142 F.2d 824 (4th Cir. 1944).

258. *See supra* note 23 and accompanying text.

259. *See supra* note 24 and accompanying text.

260. *See supra* note 25 and accompanying text.

261. *See* BLACK'S LAW DICTIONARY 918 (9th ed. 2009) ("A binding adjudication that

curb the unnecessary use of limited judicial resources, federal courts are statutorily prohibited from issuing declaratory judgments in tax matters[262] except in limited circumstances.[263] Consistent with this prohibition, taxpayers should not be able to secure the equivalent of a declaratory judgment through the backdoor channel of using a tax-savings clause.

In determining the merits of a tax-savings clause beyond those public policy criteria enumerated in *Procter*, the judiciary should consider applying two additional criteria. First, grafted onto the public policy doctrine should be the notion that factual outcomes should not hinge upon whether the IRS conducts an audit and/or a court of law reaches a particular conclusion. The reason for this prohibition is obvious: it fosters arbitrariness in outcomes. More specifically, if the IRS conducts an audit or a court reaches a decision, a tax-savings clause putatively produces one factual outcome. Conversely, if no audit is conducted or court decision is reached, a tax-savings clause produces a different factual outcome. Such outcomes, however, should not turn upon whether an audit is conducted or judicial decision is rendered. Put differently, facts are not fluid, turning on extraneous events, and should be treated as such.[264]

In the evaluative process, there is one more public policy criterion that courts should consider enlisting. Tax-savings clauses should be more readily upheld in areas of legal rather than factual uncertainty. Taxpayers will commonly resort to tax-savings clause use because facts are unknown or an area of law is unsettled. Courts should examine this pretext for tax-savings clause usage. If facts are uncertain and this uncertainty arises, in part, due to the taxpayers' actions (e.g., taxpayers establish a closely held business enterprise to diminish the size of their taxable estates and thus cloud the value of their otherwise easy-to-value marketable securities), then tax-savings clause usage should be met with grave skepticism. Conversely, if an area of the law is uncertain and a taxpayer uses a tax-savings clause due to this legal uncertainty (e.g., whether a particular piece of property qualifies for the estate tax marital deduction), courts should give taxpayers the benefit of the doubt. Generally, taxpayers can control factual happenings, but control and mastery of the law are typically beyond them.

Noticeably absent in the existing and suggested public policy criteria set forth above is reliance upon so-called conditions precedent and conditions subsequent. This absence is for good reason: taxpayers may too easily manipulate such conditions – a manipulation that cannot be respected

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establishes the rights and other legal relations of the parties without providing for or ordering enforcement.").

262. 28 U.S.C.A. § 2201 (2010).

263. I.R.C. § 7428 (2006).

264. *See* Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148 (1974) ("[There is an] established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred.").

for tax purposes without undermining the important tax principle of substance over form. Accordingly, reliance upon them would fail to achieve the objective of protecting the public, including fellow taxpayers, the IRS, and the courts. As a way of determining the strengths or shortcomings of tax-savings clauses, Congress, the Treasury Department, and the IRS should therefore eschew criteria tied to such conditions, particularly when there are more informative criteria readily at hand.

B. Strategically Addressing Policy Concerns Through Administrative Channels

Admittedly, the vast majority of tax-savings clauses do not threaten the administration of the tax system and, therefore, courts will not consider them void under the public policy doctrine.[265] Such tax-savings clauses generally fall within the scope of two categories. The first category includes those clauses that the IRS acknowledges have merit and that the agency accordingly sanctions.[266] The second category includes those clauses that, although not sufficiently pernicious as to violate the public policy doctrine, function nevertheless as devices designed to thwart taxpayers' legitimate tax obligations.[267] It is this latter category that is the subject of this subsection.

As has been previously pointed out,[268] taxpayers have historically sought ways to minimize their risks of bearing additional tax, and tax-savings clauses can play a critical role in fulfilling this goal. However, there are some circumstances in which the Treasury Department should draw the line and declare that taxpayers—not the government—should bear the tax risks associated with particular transfers and transactions. It is in these circumstances that the Treasury Department should craft regulations that reassign the risk of additional taxation, interest, and penalties to taxpayers. Using one example from the transfer tax area (valuation-adjustment clauses) and another example from the income tax area (those clauses designed to preserve grantor trust status), we demonstrate this point in the subsections below.

1. Valuation-Adjustment Clauses That Seek to Eliminate Valuation Risk

The Code seeks to balance the advantages and disadvantages associated with making inter vivos gifts compared with making testamentary bequests. On one side of the ledger sheet, gifting offers a threefold advantage. First, from the moment the gift is made, any appreciation in the value of the

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265. *See supra* note 22 and accompanying text.
266. *See supra* note 2.
267. *See supra* note 2.
268. *See supra* note 208 and accompanying text.

gifted property and the income therefrom are removed from the transfer tax base.[269] Second, within limits ($14,000 in 2013), a gift can qualify for the so-called "annual exclusion" that enables taxpayers to transfer relatively large sums on a tax-free basis.[270] Third, while the gift tax is computed on a tax-exclusive basis, the estate tax is computed on a tax-inclusive basis.[271] On the other side of the ledger sheet, however, there are three distinct disadvantages associated with gift giving. First, to the extent that a transfer triggers a gift tax liability, the taxpayer is required to make an immediate payment and thereby forfeit the opportunity to use this money for income-producing purposes. Second, for income tax purposes the donee generally takes the donor's tax basis in a gifted asset[272] rather than a tax basis in the asset equal to its fair market value—the applicable rule had the asset been held until the taxpayer's death.[273] Third, in the case of hard-to-value assets (e.g., interests in a closely held business enterprise), a donor reporting such value incurs valuation risk and the possibility of bearing tax, interest, and penalties.[274]

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269. Samuel A. Donaldson, *Income Taxation of Outright Gifts, Nongrantor Trusts, Estates and Beneficiaries*, *in* ESTATE PLANNING IN DEPTH 65, 67 (2007) (an asset that balloons in value after the transfer occurs can save significant federal estate taxes); Mitchell M. Gans, *GRITs, GRATs and GRUTs: Planning and Policy*, 11 VA. TAX REV. 761, 813 (1992) (indicating that all income and appreciation accruing after a gift is made is excluded from the donor's tax base); John A. Miller & Jeffrey A. Maine, *The Fundamentals of Wealth Transfer Tax Planning: 2011 and Beyond*, 47 IDAHO L. REV. 385, 430 (2011) (post-transfer appreciation excluded from tax base).

270. I.R.C. § 2503(b) (2006). Under this provision, taxpayers may give up to $14,000 per year to as many donees as they choose without any incurring any gift tax liability. *Id.* And, for estate tax purposes, once assets are gifted, they are not included in a decedent's gross estate. *See* Rev. Proc. 12-41, 2012-45 I.R.B. 539 (determining the amount of the exclusion, based on an inflation index, to be equal to $14,000 in 2013).

271. *See* Theodore S. Simms, *Timing Under a Unified Wealth Transfer Tax*, 51 U. CHI. L. REV. 34, 35–39 (1984) (explaining and critiquing how funds used to pay the gift tax are generally removed from the transfer tax base, whereas funds used to pay the estate tax remain subject to transfer tax).

272. I.R.C. § 1015(a) (2006).

273. I.R.C. § 1014(a) (2006).

274. As a practical matter, taxpayers often choose to gift hard-to-value assets in order to achieve valuation discounts. *See supra* note 179 and accompanying text. One might question why taxpayers who gift hard-to-value assets must be required to confront this risk while taxpayers who gift easy-to-value assets need not. The answer is that in many hard-to-value cases, the valuation difficulty is self-imposed. In other words, taxpayers often establish entities (such as limited partnerships and limited liability companies) funded with easy-to-value assets (such as marketable securities) as a means to transfer those assets at deeply discounted values. *See, e.g.*, Howard M. Esterces, *Make Best Tax Use of FLPs and LLCs in Estate Planning*, 73 PRAC. TAX STRATEGIES 260 (Nov. 2004) (advocating the use of family limited partnerships and limited liability companies to diminish the value of a taxpayer's easy-to-value assets). In these instances, from a policy perspective, it makes a lot of sense to

The delicate balance described above can readily unravel if taxpayers perceive that there are opportunities to make significant lifetime gifts of hard-to-value assets without any valuation risk and the concomitant possibility of additional tax, interest, and/or penalties. As valuation-adjustment clauses eliminate valuation risk, they tip the scales heavily in favor of gifting. From a general tax policy perspective, the resulting damage to the transfer tax system is severe. It provides taxpayers with a powerful incentive to form closely held business ventures such as a family limited partnership, contribute their easy-to-value assets (e.g., marketable securities) to these newly formed entities, and then gift interests in these entities to their loved ones.[275] Due to minority and marketability valuation discounts associated with the transfer of closely held business interests,[276] the promotion of this sort of gift giving significantly jeopardizes the transfer tax base.

To date, courts have not been receptive to the IRS position that all value-adjustment clauses necessarily violate the public policy doctrine.[277] To the contrary, as discussed, taxpayers using a defined-value clause have been successful in sheltering their transfers from risks of revaluation.[278] However, the IRS is not without recourse. Consistent with the Ninth

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require such taxpayers to assume valuation risk.

275. *See* Paul L. Caron & James R. Repetti, *The Estate Tax Non-Gap: Why Repeal a "Voluntary" Tax?*, 20 STAN. L. & POL'Y REV. 153, 159–60 (2009); Wendy C. Gerzog, *Valuation Discounting Techniques: Terms Gone Awry*, 61 TAX L. 775, 789–91 (2008) (reaching the same conclusion). *See also* George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 195–204 (1977). *See generally* James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415 (1995); Walter D. Schwidetzky, *Last-Gasp Estate Planning: The Formation of Family Limited Liability Entities Shortly Before Death*, 21 VA. TAX REV. 1 (2001).

276. *See* Schwidetzky, *supra* note 275, at 11–12 (indicating that minority discounts reflect a lack of control inherent in the transferred interest, and marketability discounts reflect an "inability . . . to readily dispose of the interest . . . .").

277. In each of the cases in which taxpayers prevailed, either the IRS did not advance the public policy argument or, alternatively, the courts dismissed it. *See supra* Section II.B.2.

278. In *Ward*, the taxpayer used such a valuation-adjustment clause based on a condition subsequent, requiring the donee to return the portion of the gifted asset determined to exceed the stipulated value. Ward v. Comm'r, 87 T.C. 78, 116 (1986). In determining the amount of the gift, the court disregarded the clause. *Id.* In the more recent cases, taxpayers used a defined-value clause, the same clause that the taxpayer used in *Ward* but drafted instead as a condition precedent, gifting to the donee only that portion of the asset determined to equal the value stipulated in the transfer document. As previously discussed, the courts have found this difference in drafting to be decisive. *See supra* Section III.B. As a result, taxpayers in the more recent cases have succeeded in altering the advantage-disadvantage balance. *See supra* Section III.B.

Circuit's recommendation in the *Petter* decision,[279] to prevent taxpayers from eliminating valuation risk and from thereby altering the delicate balance between gifting and bequeathing assets, the IRS should use the authority granted to it under Code Section 7805 to promulgate regulations that eliminate this practice.

In the preamble to the proposed regulations, the IRS could explicate the balance the Code attempts to strike between lifetime and testamentary transfers. It could then explain that if the balance between lifetime gifts and testamentary transfers is to be maintained, taxpayers should not be permitted to use value-adjustment clauses to negate valuation risk. In recognition that valuation-adjustment clauses open the door for taxpayers to distort the reported value of the assets reported for gift tax purposes, the regulations should be added to existing regulations promulgated under Code Section 2512, which defines the term "value" for purposes of applying the gift tax. This would overrule the spate of recent cases in which the taxpayer prevailed,[280] thus making it clear that valuation-adjustment clauses (of whatever variety) are invalid.[281] Under such regulations, a

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279. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 713 (2011) (quoting United Dominion Indus., Inc. v. United States, 532 U.S. 822, 838 (2001)); Petter v. Comm'r, 653 F.3d 1012, 1023 (9th Cir. 2011) ("[W]e expressly invite[] the Treasury Department to 'amend its regulations' if troubled by the consequences of our resolution of th[is] case.").

280. *See supra* Section II.B.2.

281. In theory, as the IRS did in Rev. Rul. 86-41, 1986-1 C.B. 300, the proposed Treasury regulation could make reference to *Procter* and seek to codify the public policy doctrine. If the IRS adopted this approach, however, it would need to explain that, as a matter of substance, there is no difference between a valuation-adjustment clause that uses a condition subsequent and one that uses a condition precedent. In other words, the difference between these two variations is merely one of form. Again, the regulation would overrule the recent defined-value cases, but based on the public policy doctrine rather than the need to maintain the advantage/disadvantage balance. Treasury regulations crafted in this fashion, however, could prove to be more vulnerable to a challenge in court. For, as the *Wandry* court pointed out, the Supreme Court has taken a narrow view of the scope of the public policy doctrine as a general matter in tax cases. *See* Wandry v. Comm'r, 103 T.C.M. (CCH) 1472, 1478 (2012) (citing Comm'r v. Tellier, 383 U.S. 687, 694 (1966)). Thus, a taxpayer challenging Treasury regulations predicated on the public policy doctrine might well convince a court to invalidate such regulations despite the extensive deference that these regulations ordinarily enjoy. *See Mayo Found.*, 131 S. Ct. at 713 (adopting *Chevron* in the tax context and explaining its deferential approach). Moreover, as taxpayers have previously argued, the IRS's willingness to accept some tax-savings clauses, *see supra* note 2, and reject others, *see supra* note 3, might undermine the claim that such clauses are so problematic that they need to be struck down even though there is no textual basis for doing so in the Code. *See Petter*, 96 T.C.M. (RIA) at 280 (reviewing the inconsistencies in the IRS's position). Although, ordinarily, an agency's record of inconsistency on an issue does not necessarily invalidate a regulation, *see, e.g.*, Cent. Laborers' Pension Fund v. Heinz, 541 U.S. 739 (2004), it might have this unintended consequence were the IRS to invoke the

taxpayer who gifts a hard-to-value asset would not be able to eliminate valuation risk. More specifically, the regulations could provide as follows:

> Except as otherwise provided in Treasury Regulations 1.664, 25.2518 and 25.2702, a formula clause that values an asset dependent upon a determination made by the IRS or a court of law shall be void, whether the clause uses a condition-subsequent approach, a condition-precedent approach (such as a defined-value clause), or any other approach and whether or not the clause is based upon the finally determined gift tax value.[282]

Using three examples, the IRS should illustrate the application of the foregoing rule. Each example should be based on the following fact pattern: Suppose a father owns all one thousand shares of Company X, a closely held business. Suppose further that (i) the overall business of Company X is worth $1 million; and (ii) the father wishes to make a gift of Company X shares to his son worth $50,000.

The first example should be based on the *Ward* decision.[283] Suppose the father determines the value of Company X shares to be $500 per share[284] and, using a condition-subsequent tax-savings clause, accordingly gives one hundred shares of Company X stock to his son. Under the clause, if the fair market value of the gifted shares is finally determined to be more or less

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public policy doctrine.

282. In *McCord*, the tax-savings clause in question did not use the phrase "as finally determined for gift tax purposes." McCord v. Comm'r, 461 F.3d 614, 627 (5th Cir. 2006). As a result, the majority in the Tax Court did not believe that it was necessary to consider the IRS's public policy argument. *Id.* Instead, the majority concluded that the tax-savings clause did not have the desired effect of eliminating the IRS's proposed deficiency. *Id.* at 631. Put differently, if the number of shares or units passing to the noncharitable donee were not made dependent on the value as found by the court, it would be possible that the units passing to the noncharitable donee would have a greater value than the amount stipulated in the clause, thus producing a gift tax deficiency. In reversing the Tax Court, the Fifth Circuit was aware that the failure to use the "finally determined" phrase could have this effect, but construed the tax-savings clause to read as if the taxpayer had actually used the phrase. As a result, the Fifth Circuit was able to hold that the clause eliminated the deficiency. *Id.* at 627.

In future cases, on the one hand, it is possible that taxpayers will include the "finally determined" phrase in order to ensure that their tax-savings clauses have the effect of eliminating potential deficiencies; on the other hand, it is also possible that taxpayers will avoid using the phrase, as in *McCord*, in the hope that they will be able to avoid triggering application of the public policy doctrine. Accordingly, we propose that the Treasury regulations make clear that the use of such phraseology will be denied effect for tax purposes regardless of how it is drafted.

283. *See supra* note 278.

284. The father might use a minority and marketability discount of 50 percent, *see* Cooper, *supra* note 275, and the resulting share price would thus be $500 (($1,000,000 \div 1,000) \times .5$).

than $500 per share, an adjustment would occur. To illustrate, if the gift tax value were finally determined to be $1,000 per share, under the *Ward* clause, the son would be required to return half of the gifted shares to the father so that the total amount of the taxable gift would remain equal to $50,000. The example should conclude, as did the court in *Ward*, that such a condition-subsequent tax-savings clause is invalid and that the taxable gift is equal to the value of the one hundred shares, or $100,000 ($1,000 × 100).

In the second example, the regulations should hypothesize a *Wandry*-type defined-value clause.[285] The clause should be the same as in the first example except that it should be drafted as a defined-value clause rather than as a condition-subsequent clause (as used in *Ward*). Thus, the clause would provide that the father transfers such number of all of his shares as is equal to $50,000 in value. As in the first example, the clause should be disregarded, and the father should be treated as having made a gift of $100,000 (i.e., the fair market value of the one hundred shares that he transferred). Although, at first blush, this result might seem harsh given that the father never intended to gift more than $50,000 in value, there is no principled basis upon which to distinguish the second example from the first. Indeed, to do so would be to elevate form over substance and to thereby permit taxpayers to escape the new regulation through the simple expedient of modifying the way in which they construct the clause. Just as it is necessary to eliminate condition-subsequent valuation-adjustment clauses in order to prevent taxpayers from defeating valuation risk, the same rationale applies to the use of the condition-precedent (defined-value) clauses.

Following the *Petter* fact pattern,[286] the third example should address valuation-adjustment clauses that use charitable organizations (and/or marital transfers) as a means to insulate transfers from transfer tax. The clause could, for instance, provide that the father makes a gift of one hundred shares of Company X stock to his son but that if the value of such shares exceeds $50,000, the excess is to pass to an entity that qualifies for the gift tax charitable deduction.[287] The example should conclude that if the value of the gifted shares in the closely held business interest proves to be higher, say $100,000, this amount would constitute the amount of the taxable gift. In justifying this outcome, the Treasury regulation should explain that valuation-adjustment clauses need to be ignored notwithstanding the fact that a charitable organization is a donee. The rationale for this conclusion is that while the Code does contemplate that charitable organizations will be subsidized,[288] it does not reveal an intention

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285. *See supra* Section III.

286. *See supra* Section II.A.2.d.

287. I.R.C. § 2522(a) (2006).

288. *See* Miranda Perry Fleischer, *Equality of Opportunity and the Charitable Tax Subsidies*, 91 B.U. L. REV. 601, 606–09 (2011) (discussing how a charitable tax exemption

to permit taxpayers to leverage the use of charitable organizations in order to eliminate valuation risk.

The proposed Treasury regulations set forth above should mention two additional items. First, the proposed regulations would have to make clear that while valuation-adjustment clauses would be deemed void, the IRS would continue to respect other kinds of formula clauses for enumerated policy reasons. Such formula clauses would continue to enable taxpayers to determine the amount of a decedent's marital bequest,[289] the funding of charitable trusts,[290] the funding of grantor-retained annuity trusts,[291] and the determination of a disclaimed amount.[292] Second, the IRS should explicitly

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affects a subsidy); Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX. L. REV. 283, 283–87 (2011) (explaining how exemptions for charity create a subsidy).

289. Estate planners commonly use formula clauses in order to bifurcate estates of married decedents into tax-free (marital) and non-tax-free (nonmarital) shares. *See* Rev. Proc. 64-19, 1964-1 C.B. 682. In the past, the IRS has sanctioned the use of such clauses and should continue to do so because these clauses are utilized in the testamentary setting and present no risk of upsetting the delicate balance between inter vivos and testamentary transfers.

290. The existing rigor of the rules set forth under Code § 664—designed to make sure that charity receives economic benefits commensurate with the amount of the charitable deduction taken by the taxpayer—makes it appropriate to permit taxpayers who make gifts in compliance with the section to avoid valuation risk. *See* I.R.C. § 664 (2006).

291. *See* Treas. Reg. § 25.2702-3(b)(1)(ii)(B) (2005). The legislative history underlying Code § 2702 indicates that the section was patterned after Code § 664, which authorizes the use of valuation-adjustment clauses. *See* 136 CONG. REC. 30538 (Oct. 18, 1990) ("Therefore, the committee determines that the valuation problems inherent in trusts and term interests in property are best addressed by valuing retained interests at zero unless they take an easily valued form—as an annuity or unitrust interest. By doing so, the bill draws upon present law rules valuing split interests in property for purposes of the charitable deduction."). In the future, in reconsidering formula clauses generally, the IRS may choose to revisit this regulation since taxpayers currently use it to eliminate their gift tax exposure. *But see* I.R.S. Tech. Adv. Mem. 02-45-053 (Nov. 8, 2002) (indicating that the regulations under I.R.C. § 2702 do not contemplate that taxpayers may negate their gift tax liability). Revising the regulations to invalidate valuation-adjustment clauses for purposes of I.R.C. § 2702 would not necessarily be inconsistent with the legislative history of I.R.C. § 2702 because Congress presumably did not intend to incorporate into I.R.C. § 2702 every aspect of the then-existing regulations under I.R.C. § 664.

292. The vast majority of disclaimer use is associated with testamentary dispositions. That being the case, the policy concern articulated in the regulation's preamble (namely, the balance between inter vivos and testamentary transfers) would have little or no application in this context. It may, however, be appropriate for the IRS to consider modifying the disclaimer regulations to prohibit the use of valuation-adjustment clauses in the inter vivos context. To illustrate, assume that a father wants to make a $5 million gift to his son but wants to avoid valuation risk. If the regulation we suggested is adopted, the father might make the gift and have the son disclaim any amount determined to have a value in excess of $5 million. To make certain that our suggested regulation is not gamed via the disclaimer

explain that the rationale of these proposed Treasury regulations does not rest on public policy grounds; instead, the proposed Treasury regulations rest upon the clear policy objectives inherent in Code Section 2512, namely the accurate reporting of asset values and the need to maintain the delicate balance between the advantages and disadvantages associated with lifetime gift giving.

2. Tax-Savings Clauses Designed to Preserve Grantor Trust Status

In drafting trust instruments, taxpayers commonly use grantor trust status—a status which generally enables the grantor taxpayer rather than the trust itself to be the responsible taxpayer—to achieve several tax-saving objectives.[293] If a later audit reveals that the trust in question is not entitled to this tax-favored status, the advantages associated with this status will of course be unavailable. To protect against this risk, taxpayers often insert tax-savings clauses designed to provide that the terms of the trust are to be construed in a manner designed to ensure grantor trust status.[294]

Tax-savings clauses designed to safeguard grantor trust status, however, contravene the statutory and regulatory scheme of Subpart E of Subject J of the Code (defining grantor trust status). The legislative history of this subpart makes clear that the only way a trust may be characterized as a grantor trust is if it has one of several enumerated features delineated in Code Sections 673–79.[295] Many courts have explicitly stated that this legislative history precludes the IRS from arguing that the taxpayer in question had sufficient indicia of control to render the trust grantor in nature; instead, the courts have declared that, in this realm of the law, Congress has issued specific criteria that make a trust grantor in nature and

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regulations, we would suggest an amendment to the disclaimer regulation that would deny effect to such a disclaimer clause.

293. I.R.C. §§ 671-79. *See, e.g.*, Stephen R. Akers, Jonathan G. Blattmachr & F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP. TR. & EST. L.J. 207 (2009) (explaining the tax-saving advantages associated with the use of grantor trust status).

294. Sample trust language might read as follows: "Subject to the foregoing, it is also the Settlor's intent that this trust be treated as a 'grantor trust' under §§ 671 et seq. of the Code during the Settlor's lifetime and that solely for federal and state income tax purposes, the Settlor be deemed the owner of the entire trust corpus and income at all times while the Settlor is living." Note that, in Rev. Proc. 07-45, 2007-2 C.B. 89, the IRS approved the use of a clause in a trust instrument that negated any powers or interests that would cause the trust to qualify as a grantor trust.

295. *See* H. REP. NO. 83-1337, pt. 2, at 4351–52 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017 ("It is also provided in this section [671] that no items of a trust shall be included in computing the income or credits of the grantor (or another person) solely on the grounds of his dominion and control over the trust under the provisions of section 61 (corresponding to sec. 22(a) of existing law). The effect of this provision is to insure that taxability of Clifford type trusts shall be governed solely by this subpart.").

that failure to meet these specific criteria renders the trust nongrantor in nature.[296]

In light of this legislative history and case law, the IRS would therefore be at liberty from a policy perspective to preclude taxpayers from using tax-savings clauses designed to transform otherwise nongrantor trusts into grantor trusts. Otherwise, if and when the IRS audits a trust to challenge its grantor trust status, the grantor could simply argue that under the terms of the tax-savings clause the grantor had an offending power (such as a power of substitution)[297] that ensured grantor trust status. To the extent that a sound policy rationale argues against a taxpayer's ability in the face of an IRS audit to alter tax outcomes in a unilateral fashion, tax-savings clauses of this nature should be deemed void.

Thus, akin to value-adjustment clauses, the IRS should consider using its regulatory authority to prevent taxpayers from relying on tax-savings clauses designed to ensure grantor trust status.[298] In the regulations themselves, the IRS could spell out that trust terms are to be strictly construed and that tax-savings clauses will not enable taxpayers to read in provisions into the trust instrument that are simply not present or to utilize liberal construction rules for tax-favored interpretive purposes. The effect

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296. *See, e.g.*, Estate of Goodwyn v. Comm'r, 35 T.C.M. 1026, 1040 (1976) ("Section 671 precludes attributing the income to Goodwyn on any other theory of dominion and control under the definition of gross income, including the Clifford doctrine. We interpret this limitation to mean that if Goodwyn cannot be considered as a trustee, in fact, under the statutory provisions of subpart E, he cannot be considered as such by virtue of the judicial doctrines arising from the Clifford case which Congress intended to limit through the enactment of subpart E.").

297. I.R.C. § 674(b)(4) (2006).

298. Consistent with current practice, the Treasury regulation might permit the use of a tax-savings clause where the instrument creates more than one trust and the clause simply makes clear that the problematic power does not apply in the case of one of the trusts. *See* Rev. Rul. 75-440, 1975-2 C.B. 372. In the ruling, the decedent's will had created two trusts, a trust that was designed to qualify for the estate tax marital deduction and a residuary trust that would not so qualify. *Id.* Under the will, the trustee was given a power that, if applicable to the marital trust, would render the marital trust ineligible for the estate tax marital deduction. *Id.* However, the will also contained a tax-savings clause, denying effect to any clause in the will that would render the estate tax marital deduction unavailable. *Id.* The IRS concluded that the estate tax marital deduction was valid by reason of the tax-savings clause. *Id.* In doing so, it distinguished the situation where, as in Rev. Rul. 65-144, 1965-1 C.B. 422, the instrument contains only one trust and a tax-savings clause is used to render inoperative any provision that is found problematic by the IRS or the courts. Rev. Rul. 75-440, 1975-2 C.B. 372. Parenthetically, the IRS has not consistently followed the distinction between an instrument that contains a single trust and one that contains multiple trusts. In Rev. Proc. 2007-45, 2007-2 C.B. 89, for example, the IRS approved the use of a clause negating any power that might produce a tax outcome contrary to the taxpayer's objective even where the instrument contained only one trust.

of such Treasury regulations would be that all taxpayers, whether they are subject to audit or not, would be required to abide by the same rules; no clause that is dependent on whether the taxpayer is audited should be given effect. Equity requires this kind of broad sweep. While the IRS has not previously articulated such an expansive approach, it has previously expressed its hostility to the "audit lottery" by making it impermissible for tax advisers to incorporate such considerations into the advice they give taxpayers.[299] Treasury regulations crafted to eliminate tax-savings clauses as they pertain to grantor trust status would represent an extension of this philosophy.

In a world in which all tax returns were audited, the presence of tax-savings clauses would not likely present a risk to the government that taxpayers would shortchange their tax obligations. However, in the real world, in which most tax returns are not audited,[300] tax-savings clauses often enable taxpayers to take calculated risks which come at the government's expense. It is in this latter world—the one in which we exist—that the judiciary and the IRS must be proactive.[301]

When attempting to differentiate between permissible and impermissible tax-savings clauses, the vast majority of taxpayers admittedly do not seek to stake out aggressive tax positions. Instead, they want to be compliant and are simply in need of guidance. In responding to this call for guidance, the Treasury Department should promulgate regulations (such as those recommended above) that are within the authority of *Mayo Foundation for Medical Education and Research v.*

299. *See* INTERNAL REVENUE SERV., CIRCULAR 230, § 10.34; *see also* Treas. Reg. § 1.6694-2(b) (2012). There would thus appear no impediment to using a similar approach that is aimed not merely at the tax adviser but rather directly at the taxpayer.

300. *See, e.g.*, Treasury Inspector Gen. for Tax Admin., Trends In Compliance Activities Through Fiscal Year 2010, at 38 app. IV, fig.33 (July 18, 2011) (Ref. No. 2011-30-071), *available at* http://www.treasury.gov/tigta/auditreports/2011reports/201130071fr .pdf(showing that of the 142,823,000 income tax returns filed for fiscal year 2010, only 1,581,000 were examined).

301. Consider the fact that judicial doctrines are shrouded in mystery regarding their application. This is by design: the fact that taxpayers do not know the exact line between what is permissible and what is not creates a chilling effect upon those taxpayers who wish to take aggressive tax positions. *See* 1 BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.1, at 4–27 (3d ed. 1999) (claiming that the vagueness of rules are their strength because "when the meaning of a provision is veiled by fog, taxpayers may tread more warily than when the landmarks are clearly visible"). Such judicial gloss produces an immediate benefit: Congress does not have to craft legislation on a case-by-case basis that addresses each and every existing and anticipated tax stratagem. The elimination of pernicious tax-savings clauses would have an effect similar to that of judicial doctrines, namely, making taxpayers more cautious in the tax return positions they adopt.

United States[302] and that accurately draw the appropriate line between those tax-savings clauses that are permissible and those that are not.

V. CONCLUSION

Tax-savings clauses are not going to go away anytime soon. Indeed, until the courts clarify the application of the public policy doctrine and the Treasury Department takes a more active stance in promulgating regulations that restrict their use, taxpayers will continue to test the waters, and we suspect that tax-savings clauses will become even more ubiquitous.

Among other things, this analysis makes clear that attempting to distinguish between conditions precedent and conditions subsequent and using one or the other to uphold or to nullify tax-savings clauses is a poor solution. Instead, there are other, more informative criteria that directly address public policy concerns and are far less susceptible to taxpayer manipulation. In addition, the Treasury Department is empowered to promulgate regulations that eliminate those tax-savings clauses that lack justification from a tax administration point of view. Action to clarify the differences between permissible and impermissible tax-savings clauses should be taken sooner rather than later.

If the judiciary refines the public policy doctrine and the Treasury Department adopts a more proactive approach toward crafting regulations, tax-savings clause use would be more measured. Taxpayers would continue to use tax-savings clauses to alleviate issues of uncertainty, but such clauses could no longer be used as devices to shield taxpayers from IRS audit risks and protect them from shouldering their legitimate tax burdens. Needless to say, this would be a good thing for the administration of the tax system as a whole.

302. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704 (2011).