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# The Right Formula: Gifts of Difficult-to-Value Assets

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Twice within the last 10 years, wealthy taxpayers have felt particular pressure to pare down the sizes of their taxable estates as a result of expected changes in the federal lifetime exemption amount (the amount that a taxpayer can gift or die with without incurring gift or estate tax). In 2012, taxpayers feared that the federal lifetime exemption amount would return to $1 million from $5,120,000, leading to a high level of year-end gift giving in 2012. In early 2013, Congress acted to extend the higher exemption. Now, taxpayers similarly fear that the generous almost $12 million federal lifetime exemption amount ($11.58 million for gifts made or decedents dying in 2020 and $11.7 million for gifts made or decedents dying in 2021) will be reduced (a popular expectation is that it may be reduced by half) as a result of the Democrats' control of the presidency, Senate and House of Representatives. Taxpayers who do not make use of the full federal lifetime exemption amount now fear that they may never have the opportunity to do so again.

Individuals who are flush with cash and marketable securities may find the decision to gift easy: They likely know how much they have gifted in the past and therefore how much remains of their exemption. They can easily match the amount of cash they are giving to their remaining lifetime exemption. Similarly, with marketable securities, the mean between the high and the low on the date of their gift is the amount of the exemption they use. If they want to reach their remaining lifetime exemption exactly, they can make up any difference with cash.

There may be reasons, however, why wealthy individuals may not want to use cash or marketable securities to make gifts. They may not have sufficient liquid assets to gift the full exemption amount and still live in the style to which they are accustomed. Alternatively, or in addition, available valuation discounts for difficult-to-value assets may allow them to leverage their remaining exemption by gifting such assets instead of cash or marketable securities.

When individuals gift assets that must be appraised, the amount of the gift is uncertain, however, and they can end up giving more away than they intended. First, they must wait for the appraisal to be prepared until they know what portion of the asset they can give away while remaining under the available exemption amount. Second, even after the appraisal is made and they can determine the portion of the asset that has a value equal to the remaining exemption amount, the Internal Revenue Service may challenge that valuation. If, for example, a taxpayer gifted in 2020 60% of her interest in XYZ Corporation, a closely-held business, assuming the value of such 60% interest was $11,580,000 based on an appraisal by a qualified appraisal, and the IRS audits the taxpayer's gift tax return and determines that the 60% interest was in fact worth $13,000,000 at the time of the gift, the taxpayer will owe gift tax on $1,420,000 (the difference between $13,000,000 and $11,580,000).

Although paying gift tax may actually be efficient from a wealth-planning perspective, it is not uncommon for taxpayers to be averse to doing so. While the nominal federal gift tax rate is the same as the nominal federal estate tax rate, the effective gift tax rate is about half of the effective estate tax rate. This is because the gift tax is tax exclusive, meaning the tax is levied only on the amount transferred by gift, while the estate tax is tax inclusive, meaning the tax is levied on the amount passing to a decedent's beneficiaries through the estate plus the amount of the estate tax itself. Further, the assets an individual gifts may appreciate substantially before the individual's death, so that the amount removed from the individual's estate is actually greater than the amount of the gift. Finally, for New Yorkers, a gift that is made more than three years before death entirely escapes New York estate tax (and there is no New York gift tax). On the other hand, many individuals prefer to defer taxes. They may not have the cash available to pay the gift tax.

Fortunately for those who want to gift difficult-to-value assets-out of necessity or the desire to leverage a gift-they can find comfort in court rulings that would approve of them gifting such assets by formula, thereby insuring that the amount they gift is not so great that it exceeds the lifetime exemption and produces a gift tax or so small that it is less than they wish to gift to maximize use of their lifetime exemption. While the IRS will often challenge formula clause gifts, court rulings over the years provide some guidelines for individuals to structure a formula gift that will withstand judicial scrutiny.

One of the early cases often relied-upon by the IRS to challenge formula gifts is Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944). In Procter, the court found a provision in a document of transfer that would take back from the gift "the excess property hereby transferred which is deemed by [a] court to be subject to gift tax" to be impermissibly subject to a condition subsequent and to be contrary to public policy on several grounds. A number of fairly recent cases have distinguished Procter.

In Wandry v. Commissioner, T.C. Memo. 2012-88, the Tax Court distinguished Procter and other cases and allowed a formula clause gift. The taxpayers in Wandry executed gift documents that assigned and transferred as gifts, a certain number of units in a limited liability company "so that the fair market value of such Units for federal gift tax purposes shall be as follows:" with specific dollar amounts listed next to the intended beneficiaries. The gift documents went on to say that if, after the number of gifted units is determined based on an independent appraisal of the units, the IRS or a court of law finally determines a different value, the number of gifted units were to be adjusted accordingly "so that the value of the number of Units gifted to each person equals the amount set forth …" The Wandry court determined that the gift was not subject to a condition subsequent, but rather was always of a specified dollar amount. A few cases in the years prior to the Wandry decision similarly recognized defined value gifts, but the gifts in those cases provided that excess value would go to charity and so the court's reasoning relied in part on public policy generally favoring charitable giving (See, e.g., Estate of Christiansen v. Comm'r, 130 T.C. 1 (2008) and Estate of Petter, 98 TCM 534 (2009), the excess value was transferred to charity.)

Courts continue to review defined value clauses, and recent decisions have been consistent with the reasoning and decision of Wandry. In a 2020 case, Nelson v. Comm'r., T.C. Memo 2020-81, June 10, 2020), for example, although the Tax Court rejected that the taxpayer transferred a specific dollar amount, the court did not reject the formula gift approach. Instead, it appears that the reasoning for the court's rejection of the specific formula in this case was that the transfer documents did not reference the fair market value as finally determined for gift tax purposes but rather as determined by an appraiser.

A lawyer advising a client seeking to make a defined value gift should review case law to understand the nuances of when such a gift is likely to succeed. Two of the key components of such a gift should be that (1) the taxpayer consistently treats the gift as one of a specific dollar amount- in the transfer documents, on the gift tax return, and in communication with the IRS, and (2) the value of such gift in the transfer documents should be given with reference to the value as finally determined for federal gift tax purposes.

While it remains challenging to predict the timing and magnitude of changes to the federal lifetime exemption amount, effective estate planning strategies, including lifetime gifts, can provide substantial tax benefits whether exemptions decrease in the near future or not. When the lifetime gift involves a difficult-to-value asset, a wellcrafted defined value gift clause, consistently applied throughout all facets of the transaction, can lessen the likelihood of unexpected and unwanted gift tax liability.

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