

## Wandry Revisited

August 22, 2022

2022-8

### A. Introduction

*Wandry v. Comm'r*, T.C. Memo. 2012-88, was discussed on pages 10765-10770 of the April 2012 issue of Practical Drafting. The court approved the use of a defined value provision in determining the amount of a gift. The provision stated:

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 [stated in the transfer documents].

The IRS issued an Action on Decision, 2012-46 IRB 543, towards the close of 2012 disagreeing with the result.

Cases involving another defined value provision have been docketed with the Tax Court, *Robin Sorensen v. Comm'r*, Docket Nos. 24797-18 and 20285-19, and *Chris Sorensen v. Comm'r*, Docket Nos. 24798-18 and 20284-19. The IRS is contending again that use of a defined value provision (like the one in *Wandry*) in an irrevocable stock power should be rejected. This provision states:

[A] specific number of nonvoting shares in FIREHOUSE RESTAURANT GROUP, INC., a Florida corporation (the "Company"), that have a fair market value as finally determined for federal gift tax purposes equal to exactly \$5,000,000. The precise number of shares transferred in accordance with the preceding sentence shall be determined based on all relevant information as of the date of transfer in accordance with a valuation report that will be prepared by the Dixon Hughes Goodman, LLP ("DHG"), Jacksonville, Florida, an independent third-party professional organization that is experienced in such matters and appropriately qualified to make such a determination. However, the determination of fair market value is subject to challenge by the Internal Revenue Service ("IRS"). While the parties intend to initially rely upon and be bound by the valuation report prepared by DHG, if the IRS challenges the valuation and a final determination of a different fair market value is made by the IRS or a court of law, the number shares transferred from the transferor to the transferee shall be adjusted accordingly so that the transferred shares have a value exactly equal to \$5,000,000, 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 court of law.

In effect, the IRS is asking the Tax Court to overrule *Wandry*. Pre-Trial Memoranda have been filed by the parties. The amounts involved are large and include penalties for gift tax valuation misstatements.

### B. Facts

The Pre-Trial Memorandum of the respondent contains a "Summary of Facts" which includes the following:

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Robin Sorensen and Chris Sorensen (petitioners) are brothers and founders of the restaurants known as Firehouse Subs. The brothers opened the first Firehouse Subs in Jacksonville, Florida in 1994. In 1995, petitioners created Firehouse Restaurant Group, Inc. (FRG) as a Florida corporation, which elected to be taxed as an S corporation under §1362(a) of the Internal Revenue Code. FRG was headquartered in Jacksonville, Florida, and operated and franchised Firehouse Subs restaurants, which specialize in sub sandwiches. FRG also provided financing to franchisees through its subsidiaries.

By the end of 2011, there were over 500 Firehouse Subs in the United States, over 90% being franchises, that served about 700,000 customers per week, and grossed over \$285,000,000 in system wide sales. By the end of 2014, Firehouse grossed over \$550,000,000 in system wide sales and was projected to gross \$667,000,000 in system wide sales for 2015.

As of December 31, 2014, FRG operated 27 restaurants and had 823 franchises across 43 states and Puerto Rico. FRG operated on a 52/53-week fiscal year and was managed by petitioners. As of December 31, 2014, Robin Sorensen served as President of FRG, and Chris Sorensen served as Vice-President and Secretary of FRG. FRG was financially successful, as shown by its healthy growth and increasing operating margins from fiscal year ended December 27, 2009 (revenue totaling \$34,519,997 and operating margin of 21.44%) to fiscal year ended December 27, 2015 (revenue totaling \$81,135,198 and operating margin of 27.83%).

#### 2014 Transfer of FRG Stock

As of December 21, 2014, FRG had 9,000 voting shares issued and outstanding. The shareholders of FRG were as follows:

| <u>Shareholder</u>        | <u>Shares % Interest</u> |        |
|---------------------------|--------------------------|--------|
| Robin's Living Trust      | 3,200                    | 35.56% |
| Chris's Living Trust      | 3,200                    | 35.56% |
| <i>Other Shareholders</i> | 2,600                    | 28.88% |

**Total 9,000 100.00%**

On December 28, 2014, FRG was recapitalized, dividing the shares into tranches of voting stock and nonvoting stock. After the recapitalization, the shareholders of FRG stock were as follows:

| <u>Shareholder</u>        | <u>Voting</u> | <u>Nonvoting</u> | <u>Total</u> | <u>% Interest</u> |
|---------------------------|---------------|------------------|--------------|-------------------|
| Robin's Living Trust      | 3,200         | 28,800           | 32,000       | 35.56%            |
| Chris's Living Trust      | 3,200         | 28,800           | 32,000       | 35.56%            |
| <i>Other Shareholders</i> | 2,600         | 23,400           | 26,000       | 28.88%            |

**Total 9,000 81,000 90,000 100.00%**

On December 31, 2014, the Robin Sorensen Living Trust, with Robin Sorensen acting as trustee, transferred 9,385 nonvoting shares of FRG stock to an irrevocable trust named the Robin O. Sorensen Family Trust dated December 31, 2014. Likewise, the Chris Sorensen Living Trust, with Chris Sorensen acting as trustee, transferred 9,385 nonvoting shares of FRG stock to an irrevocable trust named the Chris R. Sorensen Family Trust

dated December 31, 2014. The parties have stipulated that the December 31, 2014 transfer was a gift. See First Stipulation of Facts (First SOF) ¶¶23-24. After the gifts, the shareholders of FRG stock were as follows:

| <u>Shareholder</u>        | <u>Voting</u> | <u>Nonvoting</u> | <u>Total</u>  | <u>% Interest</u> |
|---------------------------|---------------|------------------|---------------|-------------------|
| Robin's Living Trust      | 3,200         | 19,415           | 22,615        | 25.13%            |
| Robin's Family Trust      | 0             | 9,385            | 9,385         | 10.43%            |
| Chris's Living Trust      | 3,200         | 19,415           | 22,615        | 25.13%            |
| Chris's Family Trust      | 0             | 9,385            | 9,385         | 10.43%            |
| <i>Other Shareholders</i> | 2,600         | 23,400           | 26,000        | 28.88%            |
| <b>Total</b>              | <b>9,000</b>  | <b>81,000</b>    | <b>90,000</b> | <b>100.00%</b>    |

This chart matches FRG's stock ledgers, which show each of petitioners' respective Irrevocable Family Trusts owning 9,385 nonvoting shares of FRG as of December 31, 2014.

Petitioners' respective Irrevocable Family Trust agreements state that, once property is transferred to the Irrevocable Family Trusts, the trustees have dominion and control over the property to manage, sell, pledge, dispose, "or otherwise deal with any trust assets of any kind...in such manner and on such terms without limit as the Trustee may deem advisable..." See First SOF ¶¶18-19, Exhibit 8-J, p. 15 and Exhibit 9-J, p. 16. The agreements also include a section specifically pertaining to "Closely-Held Businesses," and state that the fiduciaries appointed within the Irrevocable Family Trusts have "every right with respect to stock in any closely-held corporation." See First SOF ¶¶18-19, Exhibit 8-J, p. 24, Exhibit 9-J, p. 25. Such rights include, but are not limited to, the right to sell or transfer closely held corporate stock. See First SOF ¶¶18-19, Exhibit 8-J, p. 24, Exhibit 9-J, p. 25.

Respondent's Statement of Facts also provided

As of December 31, 2014 and March 31, 2015, the valuation dates, FRG was a successful and growing business. For FRG's fiscal years ended December 27, 2009 through December 28, 2015, FRG's revenues grew at an average rate of 15.45% and more than doubled from December 27, 2009 to December 28, 2014. FRG's revenue for its fiscal year ended December 28, 2014 was \$72,924,781. During this same period, FRG's operating income more than doubled from December 27, 2009 to December 28, 2014, and FRG's operating income almost tripled from December 27, 2009 to December 27, 2015.

FRG made distributions during the six-year period preceding petitioners' gift transfers on December 31, 2014 in the amount of \$95,428,145, which is \$27,000,000 more than DHG's Return Appraisal's valuation of FRG as of December 31, 2014. Such distributions were not unusual, as shown by FRG's distributions for the following six-year period totaling \$110,039,981, which is \$42,000,000 more than DHG's Return Appraisal's valuation of FRG as of December 31, 2014. FRG's distributions for its tax year ended December 27, 2009 through its tax year ended December 27, 2020 total \$205,468,126.

The Statement listed cash distributions received by the Family Trusts in 2016 through 2020 tax years as follows:

Robin O. Sorensen Family Trust      Chris R. Sorensen Family Trust

| Year | Amount of Distributions | Year | Amount of Distributions |
|------|-------------------------|------|-------------------------|
| 2016 | \$ 1,579,137.00         | 2016 | \$ 1,579,137.00         |
| 2017 | \$ 1,497,869.00         | 2017 | \$ 1,497,869.00         |
| 2018 | \$ 8,981,917.00         | 2018 | \$ 8,981,917.00         |
| 2019 | \$ 4,020,096.00         | 2019 | \$ 4,020,095.00         |
| 2020 | \$ 1,036,711.00         | 2020 | \$ 1,036,711.00         |

On March 31, 2015, Robin and Chris each sold 5,365 FRG non-voting shares to the trustees of their respective Family Trusts in exchange for \$2,858,418 from each trustee. The purchase price was based on the DHG valuation report as of December 31, 2014.

In November 2021, Restaurant Brands International, Inc. announced that it was acquiring FRG for \$1,000,000,000 in cash. The acquisition was closed in December 2021.

We have quoted from respondent's Statement of Facts because it is shorter than petitioners' Statement of Facts which contains the following:

In late 2014, the Sorensen Brothers' advisors encouraged them to transfer a portion of their ownership in Firehouse for estate planning purposes. Until that time, the Sorensen Brothers had received relatively small monetary rewards from the business that they had spent two decades building, pouring nearly all of their time, effort, and energy (and nearly every penny) into the endeavor. As a result, the Sorensen Brothers were reluctant to give up Firehouse stock for any reason, given that they had not yet had the chance to enjoy the fruits of their labors.

The Sorensen Brothers ultimately heeded advisor recommendations and decided to make gifts of Firehouse stock to their respective Family Trusts prior to the end of 2014. The decision to complete the gifts prior to the end of 2014 was driven by the timing of when these discussions and decisions occurred, coupled with general unease that the then-current \$5.34 million gift and estate tax exemption could be legislated away at any time.

In part to address the Sorensen Brothers' concerns regarding lack of rewards for their multi-year efforts, Firehouse increased and drew down on its line of credit with TD Bank to make shareholder distributions in mid-December of 2014.

Throughout their ownership of Firehouse, the Sorensen Brothers were heavily involved in the business, and they were concerned about maintaining their historical voting block. Specifically, the Sorensen Brothers always voted together on company matters, and their ownership effectively comprised a majority block (and a supermajority for certain company decisions).

### **C. Valuation**

Respondent is asserting the value of one FRG nonvoting share on the date of the gifts was \$2,076 and the date of the sale was \$2,228. Petitioners use a value of \$532 for each date.

Valuation reports were submitted by petitioners and the respondent. In a section titled "Valuation of FRG," differences in the reports were mentioned as follows:

Mr. Anderson's Rebuttal Report [Anderson is respondent's expert] lists five primary reasons for the difference between his valuation conclusions and the valuation conclusions of DHG's Return Appraisal and Mr. Rey's report as follows: 1) Tax Affecting – DHG's Return Appraisal applied a

theoretical corporate income tax, whereas Mr. Anderson's did not; 2) Discount Rates – DHG's Return Appraisal and Mr. Rey used discount rates of 26.00% and 25.7% as of December 31, 2014 and March 31, 2015, respectively, whereas Mr. Anderson used a discount rate of 13.14%; 3) Comparable Companies – DHG's Return Appraisal and Mr. Anderson used different criteria and methodologies to determine comparable companies; 4) Exclusion of EBIT Multiple – DHG's Return Appraisal did not consider EBIT multiples in its Market Approach, whereas Mr. Anderson considered EBIT multiples; and 5) Adjustment Factor – DHG's Return Appraisal used a size adjustment factor of 60% to lower its market approach value, whereas Mr. Anderson did not include a size adjustment factor.

#### D. Comments

In its Pre-Trial Memorandum, respondent asserts that the "irrevocable stock power" language intended to "adjust" the number of nonvoting shares that were transferred to the Family Trusts on December 31, 2014 is a condition subsequent and violates public policy. In making this assertion, it relies upon *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). *Procter* was also the primary case relied upon by respondent in Wandry. Each memorandum discusses other cases, including *Nelson v. Comm'r*, 17 F. 4th 556 (5th Cir. 2021), discussed in Issue 2021-8.

Our purpose in writing this article is not to form a conclusion as to the merits of the contentions of the parties. Rather, it is to alert readers to the existence of the *Sorensen* cases which should be considered by attorneys advising clients on the use of defined valuation provisions. It seems likely that if the case is not settled, an appeal will be taken to the Eleventh Circuit Court of Appeals.

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#### related professionals

Jerome J. Caulfield / Partner

D 212 238-8809

[caulfield@clm.com](mailto:caulfield@clm.com)