

# 'Wandry' Gift Tax Decision Adds Tool in Valuation Fight, Barring IRS Appeal

By [Diane Freda](#)

The U.S. Tax Court's landmark decision in *Wandry v. Commissioner* is widely acknowledged to have given the estate planning community the green light to transfer gifts without worrying that changes in value imposed by the Internal Revenue Service will require them to pay gift tax.

The question is for how long.

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*David Kautter, Kogod Tax Center*

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Some advisers are urging their clients to act quickly because the *Wandry* decision may not be the law of the land for long, while others are leery of rushing out to make gifts using defined value clauses that have no charity component, practitioners told BNA in June and July. For one thing, IRS has until Sept. 4 to appeal the decision, and many practitioners believe that it will.

In *Wandry v. Commissioner* ( T.C., No. 10751-09, T.C. Memo. 2012-88, 3/26/12), the Tax Court issued a memorandum opinion upholding the use of a defined value formula clause to transfer gifts of units in a Colorado limited liability company from Albert and Joanne Wandry to their children and grandchildren (58 DTR K-2, 3/27/12).

But instead of the traditional stipulation that if IRS audited the gifts and determined that the units were worth more than the Wandrys said, the excess value would go to charity so the donors could then take advantage of a charitable deduction to reduce their tax, the *Wandry* case included no charitable adjustment clause. It was the first defined value formula clause to be upheld by a court without one.

“What *Wandry* did was say it's OK if any excess amount from a change in value doesn't go to charity. It can go back to the donor,” David Kautter, managing director of the Kogod Tax Center at American University's Kogod School of Business, told BNA June 15.

In addition to lacking the usual charitable adjustment clause, *Wandry v. Commissioner* was notable in other ways. Rather than giving away a fixed number of partnership units, it transferred a fixed dollar amount that had to be converted to a number of units. In essence, *Wandry* defined the gift as whatever number of units would equal a fixed dollar amount.

## Dueling Appraisals

The *Wandry* case, as have other defined value cases, hinged on the value of the gift transferred and whether IRS would agree with the donors' stated value.

Cases involving hard-to-value assets, such as family limited partnerships and closely held businesses, usually end up being a duel between government and taxpayer appraisers, Kautter said.

“IRS's concern has been that the taxpayer low-balled the estimate of value, transferred a lot more than they should have, and now needs to pay tax on the value of what was transferred,” he said.

In 2004, the Wandrys gifted a total of \$1,099,000 in membership units of Norseman Capital LLC to their children and grandchildren to fully utilize, but not exceed, their annual and lifetime gift tax exemptions.

Their four children were each to get units equal in value to \$261,000, while their grandchildren were each to get units equal in value to \$11,000.

The Wandrys signed written gift documents that said the gifts were to be those dollar amounts and if the value of a Norseman unit, to be determined in good faith by an appraisal, was successfully challenged by IRS, then the number of units initially calculated from the appraisal would be adjusted.

The Wandrys received an appraisal that a 1 percent Norseman membership interest was worth \$109,000. Accordingly, gift tax returns were filed that reflected the dollar amount of gifts, and resulting gifts of 2.39 percent units for each child and 0.101 percent units for each grandchild.

## Units, Not Dollars Transferred, IRS Says

IRS examined the Wandrys' gift tax returns in 2006. The service increased the value of the Norseman units, determined that the number of units reflected on the gift tax returns had a value that exceeded the Wandrys' federal gift tax exclusions, and said that there was a gift tax due.

IRS argued that the gifts made by the Wandrys were the number of units reflected on the gift tax returns and not the dollar amounts in their gift documents.

The Wandrys countered that the dollar amounts were the controlling feature and that the number of units gifted to the children and grandchildren should be adjusted downward, so that the resulting value of units equaled the appropriate dollar amounts.

IRS argued that the adjustment clauses under the gift documents should be ruled void as against public policy.

The Tax Court disagreed and held that the adjustment clauses in the gift documents were valid.

“The question is what did Mr. and Mrs. Wandry transfer? And the answer is units in an entity having a specific dollar value,” John Porter, senior partner with Baker Botts in Houston, who successfully defended a number of previous defined value cases, told BNA June 22.

For years, people have searched for a way to transfer value that was not in the form of stock or membership units in a partnership, Kautter said. What they were attempting to transfer was simply a value.

## Public Policy Argument Rejected

Porter said *Wandry* is a natural extension of the analysis in *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011) (151 DTR K-2, 8/5/11); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) (218 DTR K-1, 11/16/09); and *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006) (181 DTR K-4, 9/19/06). All the cases focus on the rights being transferred under the gift documents, he said.

In *Wandry*, the Tax Court rejected public policy concerns that IRS had raised as far back as 1944's *Commissioner v. Procter*, 142 F.2d 824 (4th Cir.), and continued to raise through more recent cases involving defined value clauses. The clauses were described as a “poison pill” for the government because they discouraged tax audits, practitioners said. Even if the service challenged the value of what was being transferred, it would not raise any additional tax, the government argued, because the excess value would go to charity.

The *Wandry* memorandum opinion said the lack of a charitable component in that case did not result in “a severe and immediate public policy concern.”

Previous cases had established that in order to reject a valuation adjustment clause, the clause would have to “severely and immediately frustrate sharply defined national or state policies proscribing certain conduct.” That is a very high burden, Porter said, which in the *Wandry*'s case, worked in their favor.

“Many people didn't think this type of clause would be upheld in light of the *Procter* decision,” Porter said. “But I have questioned for a long time whether [*Procter*] is good law given that it's more than 60 years old and the landscape regarding the use of formula clauses has changed significantly since *Procter* was decided.

“It's hard for the government to argue out of one side of its mouth that formula clauses shouldn't be respected on public policy grounds, when at the same time they are being blessed and commonly used in a variety of contexts,” he added.

This includes the marital and charitable deduction areas, and in grantor retained annuity trusts, he said.

## **IRS's Next Steps**

IRS will need to rely on arguments other than merely increasing gift tax collections to be successful with the public policy argument when challenging defined value clauses such as the one involved in *Wandry v. Commissioner*, Brian Malec, an estate tax attorney in the Orlando office of Dean Mead, told BNA July 13. “The court said that the IRS role is not to maximize tax receipts but to enforce the tax laws,” he said.

Porter said he believes that IRS will challenge the case because it has challenged so many other formula cases.

In the meantime, not all advisers are rushing forward, Malec said. “There's a split among practitioners. A lot of them are going to be structuring gifts with no charitable adjustment clause without hesitation,” he said. “Others are saying 'wait a minute, this is only a Tax Court memorandum opinion. This isn't a circuit level decision,' so some still have some hesitation about it.” They are looking for a decision that will be binding in their circuit, he said.

In addition, *Wandry* is not a full Tax Court opinion but was issued by one judge, which Malec and others said carries less weight.

If IRS does not go the appeal route, it may choose to issue regulations to curb the use of the clauses instead, Malec said.

*Wandry* is another tool taxpayers who are not as charitably inclined can use, according to Porter. All taxpayers are looking for certainty with respect to the transfer tax implications of a transfer of hard-to-value partnership interests or limited liability company interests, he said. That way they can avoid the fight over value.

“They are willing to use their entire unified credit or pay some gift tax, but they would like to understand, at the time they make that transfer, what the cost will be,” he said.

He also noted that not all charitable clauses are designed to cap gifts to charity. Some have been structured to include a significant gift to charity up front, before any adjustment. In those cases, the formula using the taxpayer's own appraisal provided a significant gift to charity, and the value of the gift was increased as a result of the value adjustment.

*By Diane Freda*