ELECTRONICALLY REPRINTED FROM MARCH 2022

TRUSTS & ESTATES

By **William H. Frazier, ASA**

Defining Value in a Formula Gift Clause

Nelson provides further instruction

There's something for nearly everyone in the U.S. Tax Court and the U.S. Court of Appeals for the Fifth Circuit opinions in *Nelson v. Commissioner.*[1] Most notably, the cases highlight a dispute over the efficacy of defined value language in gift transfer documents. In this regard, *Nelson* joins a long list of such cases.[2] From a valuation standpoint, the Tax Court dealt with a wide range of issues, including the valuation of holding companies, minority interest discounts and discounts for lack of marketability.

Nelson provides estate planners with further instruction as to how the courts construe the drafting of defined value clauses (DVCs) in gift transfer documents. The most important objective of the DVC is to fix the dollar amount of equity gifted while allowing the percent to change if the appraised value were later found to be incorrect. A major revelation of *Nelson* is that, even when the intent of the document drafters is clear, failure to define value and when it's fixed render the key terms of the transfer instruments inoperative. The decision also describes the role played by appraisers in qualifying or disqualifying the functionality of these clauses.

While the Tax Court explored many valuation issues, the Fifth Circuit didn't review any of these issues. The Tax Court's discussion about the valuation of holding companies is unique and worth exploring further. It's also worth noting that, with respect to the lack of marketability discounts, the Tax Court preferred the work of the Internal Revenue Service's expert because it was found to be more thorough and included quantitative models.

William H. Frazier is managing director, valuations services, at Weaver in Dallas

Disputed Value

The value disputed in this case is derived from Warren Equipment Co. (WEC), a Delaware holding company owning 100% of the stock of Warren Cat, a Caterpillar equipment dealership in West Texas and Oklahoma, which made up 51% of WEC's combined value. WEC also owned several other companies providing equipment and services to the oil and gas exploration and production industry. CSI, which manufactures natural gas-powered compressors equipped with Caterpillar gas engines, comprised 40% of WEC's value.

On the valuation date, 27.7% of the stock of WEC was held by Longspar Partners, Ltd. (Longspar), a Texas limited partnership. Mary Nelson and her husband Jim Nelson each held a 50% general partnership interest for a combined 1% of Longspar. Mary also owned 93.88% of Longspar as a limited partner. Various trusts held the balance of the interests. WEC stock comprised 99% of Longspar's net asset value (NAV).

On Dec. 31, 2008, Mary made a gift such that $2.096 million in limited partnership interests were to be transferred to the Nelson 2008 Descendants Trust (the Trust). On Jan. 2, 2009, she sold, via a note, partnership interests having a fair market value (FMV) of $20 million. (Both transfers used a valuation date of Dec. 31, 2008.) The final values were to be determined within 90 days by appraisals to be performed by Barbara Rayner (WEC) and Roy Shrode (Longspar).

When the IRS challenged the appraisals as underestimating FMV, the taxpayers asserted the position that, even if the IRS' determined values held, the transfers were of dollar amounts, not fixed

percentages of Longspar. Accordingly, while the percentage interests transferred would decrease, the dollar amount would remain constant. Thus, the taxpayers would owe no additional taxes. But the IRS claimed the defined value mechanism the taxpayers used was defective and, in fact, the transfer was for a fixed percent of Longspar, not a fixed dollar amount.

The IRS and the taxpayers agreed that the transfers were complete once Mary executed the transfer instruments parting with dominion and control over the interests. But they disagreed over whether Mary transferred Longspar partnership interests of $2.096 million and $20 million or percentage interests of 6.14% and 58.65%.

Proposed Settlement

A proposed settlement was negotiated but never finalized. On the basis of these settlement discussions, the taxpayers amended Longspar's partnership agreement to record the Trust's limited partnership interest in Longspar as 38.55%, instead of the 64.79% indicated by the amounts transferred in the gift and sale transactions. The IRS, ignoring the proposed settlement, filed notices of deficiency in 2013 based on the undervaluation of the Longspar interests transferred in 2008 and 2009.

Formula Clause

The taxpayers argued at trial that the court should construe the transfer clauses as transferring dollar amounts rather than percentages. They argued that their language and intent were to imitate the formula clauses upheld in *Succession of McCord*, *Estate of Petter* and *Wandry v. Comm'r.*[3] As evidence of intent, they cited their settlement discussions with IRS Appeals and subsequent adjustments to reflect changes in valuation based on those discussions.

In the cases cited above, while the donees didn't know with certainty what percentage interests they would finally end up with, they did know with certainty what dollar amounts they received as of the transfer date. With a formula clause, the transaction is still closed even if a reallocation occurs. Any reallocation ensures that a specified recipient receives the percentage interests to which they were entitled.

In its deliberation over the formula clause, the Tax Court dismissed the adjustment of the Trust as a subsequent event that must be ignored. Alluding to *Comm'r v. Procter,*[4] the Tax Court held that in determining the value of the transfer, it couldn't consider subsequent events that operated to reverse a completed transfer in excess of the gift tax. On the other hand, federal courts have held as valid formulas used to limit the value of a completed transfer.

In its review of *Nelson*, the Fifth Circuit noted that while the formula clause cases might give the appearance of reopening a transaction, that's not the case. A gift is considered complete, and thus subject to the gift tax, when "the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or the benefit of another."[5]

> The chief difficulty with the taxpayers' argument was the failure of the transfer documents to properly assert that what was being transferred were dollar amounts.

The chief difficulty with the taxpayers' argument was the failure of the transfer documents to properly assert that what was being transferred were dollar amounts and that the associated percentage interests were subject to a subsequent final determination based on FMV as finally determined for federal gift and estate tax purposes. Instead, the percentage interests were tied to the amount specified by the taxpayers' appraiser (Shrode) within 90 days of the gift and 180 days of the sale.

To quote the Fifth Circuit:

> Once the appraiser had determined the fair market value of a 1% limited partner interest in Longspar, and the stated dollar values were converted to percentages based on that appraisal, those percentages were locked, and remained so even after the valuation changed.[6]

The Fifth Circuit noted that the *Nelson* transfer documents lacked crucial language describing what should happen to any additional shares that were transferred should the valuation be successfully challenged. If what was transferred were fixed dollar amounts, any increased value subsequently determined must be allocated either to a new recipient or re-allocated to the existing donees. For example, in *McCord*, *Hendrix* and *Petter*, the excess interests would go to a charity. Because this mechanism didn't exist in *Nelson*, it appeared they intended to follow *Wandry*.

> The court's analysis is flawed because it misconstrued the meaning and use of the term "holding company" in the case of WEC.

In *Wandry*, no charity was involved, rather, on revaluation, the percentage interests transferred were reallocated on a proportional basis. The potentiality for this reallocation was anticipated and provided for in the transfer documents:

> … 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.[7]

The operative language described above wasn't contained in the *Nelson* agreements. While they may have intended this, according to the Tax Court: "They are bound by what they wrote at the time."[8]

Lack of Control Discount

The taxpayers' appraiser of WEC (Rayner), using a "sum of the parts" approach, opined as to the controlling interest values of all of the WEC entities. The values were determined on a debt-free basis for each subsidiary, with debt deducted at the holding company level in determining the final value of the equity of WEC.

The skirmishes over value had to do with whether Rayner determined "controlling" interest or "noncontrolling" interest values. Rayner claimed her valuations determined controlling interests to which discounts for lack of control (DLOCs) could be applied. Mark Mitchell, the IRS' expert appraiser, disagreed, claiming the valuations determined noncontrolling interest values for which no DLOC was appropriate.

Rayner valued the 100% controlling equity interest in Warren Cat by the NAV method of the asset approach. She asserted that if control of the dealership was transferred, as was envisioned in her theoretical construct, the Caterpillar restrictions of the dealership agreement would be triggered. Those restrictions mandated that any sale of the dealership must be at NAV.[9]

Mitchell noted that Warren Cat's results indicated excess economic returns and the presence of intangible asset value. He concluded Rayner's failure to include that intangible asset value in her analysis resulted in an FMV for Warren Cat on a noncontrolling interest basis and, therefore, precluded the use of a minority interest discount. The court, however, disagreed with Mitchell's assessment, noting that it had disallowed just such an analysis of intangible asset value in two prior cases having to do with automobile dealerships.

One of the reasons Caterpillar dealerships rarely sell is that the businesses are ordinarily very profitable. Thus, the owners/operators are able to annually generate significant returns from compensation and dividends to shareholders. However, Caterpillar doesn't allow these dealers to capitalize on these "excess economic returns" when dealerships are sold because dealerships must be sold at NAV. (A very much intended inducement by Caterpillar for their dealerships to become family legacies.) Therein lies the problem for Mitchell's argument. The restriction imposed by Caterpillar

(and other equipment dealers) means a willing (or unwilling) seller is limited to NAV. According to this line of thinking, we must presume a sale to determine FMV, and, if NAV is the required methodology, the intangible asset argument becomes moot.

A better valuation approach would have been to value Warren Cat on a minority interest basis using the discounted cash flow method of the income approach. There would be no need to presume a hypothetical sale of the 100% equity interest in Warren Cat because Longspar is a 27.7% minority interest holder.

One reason the IRS may not have wanted to go down that road is that, because Warren Cat is a limited partnership, it would have drawn the issue of "tax-affecting" into the discussion. In the recent case of *Estate of Jones v. Comm'r,*[10] the IRS, to its detriment, tried to avoid tax-affecting and was soundly defeated on this issue by the taxpayer's approach, which embraced tax-affecting.

In that case, the Tax Court held that a minority limited partnership interest in a timber company that held timberlands and generated annual cashflows from timber harvesting operations must be valued *only* by the income approach because there was no likelihood of a sale or liquidation of the company. This conclusion apparently rejected even the notion of a hypothetical sale.

So, why, for a company such as Warren Cat, which is *only* an operating company, would the use of the asset approach make sense? In my opinion, it doesn't. There was another, better way to skin this cat.

The court can't be faulted for the use of the NAV-based valuation methodology in *Nelson*. This was the taxpayers' expert's approach, and neither the IRS nor its expert challenged it. This was the only evidence presented as to the value of Warren Cat. Yet another reason why appraisers shouldn't base valuation methodology on the findings of a single court case.

The Court's DLOC

There's no way to sugarcoat this. The court's analysis is flawed because it misconstrued the meaning and use of the term "holding company" in the case of WEC. As one of its reasons for rejecting Rayner's DLOC, the court said she should have used holding companies as comparables.

This suggests there's something unique about WEC's organizational structure. There isn't. Very few large businesses with multiple operations have them all held inside of one corporate entity. There is, in fact a "holding" entity owning the stock of subsidiaries. Most large, operating public companies are organized in this fashion. A better term would be "parent" company.

In investment parlance, a holding company is one that invests in the stock of companies owned and operated by others. The investments may be for control, or they may be minority interests. These investors usually seek to have an active voice in management through board representation. Think of Berkshire Hathaway or Icahn Enterprises. Their investments are opportunistic and vary widely by industry. The individual entities are usually "silos" that have little connection to one another. It's hard to imagine that one holding company could be considered comparable to another. How would you even begin to try to compare WEC to an entity of this type?

To complicate matters further, there are other types of holding companies that serve as the parent organization for a large grouping of entities that do operate together for a common purpose. If you purchase a share of Google, you're really buying stock in Alphabet, Inc., its parent holding company. Johnson & Johnson is another "holding" company. This is a distinction without a difference. These are operating companies in the same way that WEC is.

In determining its 15% DLOC, the court cited DLOCs from three prior Tax Court cases: *Litchfield v. Comm'r, Lappo v. Comm'r* and *Hess v. Comm'r.*[11] This is puzzling. The *Litchfield* and *Lappo* cases deal with small family-owned investment entities owning marketable securities and real estate.

These aren't holding companies, either. They're "investment" companies.[12] That is, these entities invest passively. In no way are they comparable to WEC. And what distinguishes these two from the myriad of other cases of family limited partnerships owning marketable securities and/or real estate?

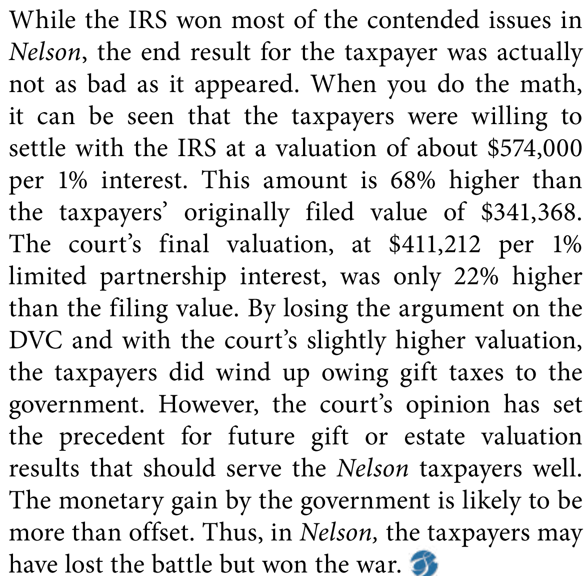
Hess is a good example, although I would note

it's not a true holding company in the strict sense I described above. It's a parent corporation with operating subsidiaries. (The same could be said for *Estate* of *Simplot v. Comm'r, Estate of Gallo v. Comm'r, Estate of Piper v. Comm'r, Estate of Mitchell v. Comm'r, Estate of Newhouse v. Comm'r* and, no doubt, others.[13])

And, finally, to strike this dead horse one more time, the Tax Court in *Estate of Jones* states: "Not all companies are apt to be characterized as simply an operating or a holding or investment company."[14]

Lost the Battle, Won the War?

While the IRS won most of the contended issues in *Nelson*, the end result for the taxpayer was actually not as bad as it appeared. When you do the math, it can be seen that the taxpayers were willing to settle with the IRS at a valuation of about $574,000 per 1% interest. This amount is 68% higher than the taxpayers' originally filed value of $341,368. The court's final valuation, at $411,212 per 1% limited partnership interest, was only 22% higher than the filing value. By losing the argument on the DVC and with the court's slightly higher valuation, the taxpayers did wind up owing gift taxes to the government. However, the court's opinion has set the precedent for future gift or estate valuation results that should serve the *Nelson* taxpayers well. The monetary gain by the government is likely to be more than offset. Thus, in *Nelson,* the taxpayers may have lost the battle but won the war.



Endnotes

1. *Nelson v. Commissioner*, T.C. Memo. 2020-81; *Nelson v. Comm'r*, 17 F.4th 556 (5th Cir. 2021).
2. *Succession of McCord v. Comm'r*, 461 F.3d 614, 623 (5th Cir. 2006); *Estate of Petter v. Comm'r*, T.C. Memo. 2009-280; *Estate of Christiansen v. Comm'r*, 586 F.3d 1061, 1062 (8th Cir. 2009); *Hendrix v. Comm'r*, T.C. Memo. 2011-133; *Wandry v. Comm'r*, T.C. Memo. 2012-88.
3. *Ibid.*
4. *Comm'r v. Procter*, 142 F.2d at 827.
5. *Nelson v. Comm'r*, 17 F.4th 556 at p. 4.
6. *Ibid.,* at p. 3.
7. *Wandry, supra* note 2, at pp. 2-3.
8. *Supra* note 5, at p. 8.
9. A valuation at net asset value implies the net value of the company's tangible assets and thus would exclude the intangible value created by the business' excess economic return above asset return rates.
10. *Estate of Jones v. Comm'r*, T.C. Memo. 2019-101.
11. *Litchfield v. Comm'r*, T.C. Memo. 2009-21; *Lappo v. Comm'r*, T.C. Memo. 2003-258; *Hess v. Comm'r*, T.C. Memo. 2003-251.
12. According to the Securities Exchange Commission definition of "investment company," *Lappo, ibid.,* certainly qualifies. Over 50% of its assets were marketable securities. *Litchfield, ibid.,* whose assets were primarily farmland, converted from a C corporation to an S corporation to avoid the corporate level 25% tax on its income which, under Internal Revenue Service regulations, was classified as passive.
13. *Estate of Simplot v. Comm'r*, 112 T.C. 130 (1999); *Estate of Gallo v. Comm'r*, T.C. Memo. 1985-363; *Estate of Piper v. Comm'r*, 72 T.C. 1062 (1979); *Estate of Mitchell v. Comm'r*, 74 T.C.M. (CCH) 872 (1997); *Estate of Newhouse v. Comm'r*, 94 T.C. 193 (1990).
14. *Supra* note 10, at p. 13.

Copyright © 2022 by Informa
For more information on use of this content, contact Wright's Media at 877-652-5295.
2308436