INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 31, 2002

Number: **200245053**
Release Date: 11/8/2002
Index (UIL) No.: 2511.00-00; 2512.00-00
CASE MIS No.: TAM-118335-02/CC:PSI:B4

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Date 1 =
Taxpayer =
Spouse =
Family Trust =
Year 2 =
Date 2 =
Partnership =
Child 1 =
Child 2 =
Child 3 =
F =
A =
B =
C =
D =
E =
X =
Date 3 =
Appraisal =

Y =

ISSUE:

Is the provision in the Sale and Purchase Agreement, that provides for the subsequent adjustment of the percentage interest in the limited partnership subject to the transfer, effective for gift tax purposes under § 2511 of the Internal Revenue Code?

CONCLUSION:

The provision in the Sale and Purchase Agreement is not effective for gift tax purposes under § 2511. Therefore, the gift tax consequences of the transaction are determined without regard to any adjustment in the partnership interest transferred that is required under the clause.

FACTS:

On Date 1, Taxpayer and Spouse established Family Trust, a revocable trust, and designated themselves as co-trustees. Under the terms of Family Trust, the trust assets are divided into two trusts, Trust A and Trust B. The trust agreement states that Spouse and Taxpayer each transferred to Trust A and Trust B, respectively, that individual's separately-held property or that individual's undivided one-half interest in property held by the spouses as tenants in common. Under the terms of Trust B, during Taxpayer's life, the trustees are directed to pay to Taxpayer so much of the net income and principal of the trust as she may elect to withdraw. At Taxpayer's death, if Spouse has predeceased Taxpayer, the Trust B corpus is to be distributed to the children of Spouse and Taxpayer in equal shares. In Year 2, Spouse died and Taxpayer became sole trustee of Trust B.

On Date 2, Taxpayer as Trustee of Trust B of Family Trust (Trust B), and Taxpayer's three children, Child 1, Child 2, and Child 3, formed Partnership. The Partnership agreement states that Taxpayer as Trustee of Trust B transferred $F ($A in cash, $B in publicly traded securities, and $C in real estate) in exchange for a 0.85 percent general partnership interest and a 99 percent limited partnership interest. Child 1, Child 2, and Child 3 each transferred $D in cash (of which roughly $E was gifted to each child by Taxpayer) in exchange for a 0.05 percent general partnership interest.

Also on Date 2, the following transactions occurred. Taxpayer created Irrevocable Trust for the benefit of Taxpayer's lineal descendants. Taxpayer is designated as trustee. The trust provides that during the term of the trust, trust income and principal is to be distributed in such amounts and at such times as the trustee deems appropriate for the health, support, maintenance or education of any of taxpayer's descendants selected by the trustee. The Taxpayer's children are granted the right to substitute property in exchange for trust assets of equivalent value.

As trustee of Trust B, Taxpayer assigned a 0.1 percent limited partnership interest in Partnership to herself as trustee of Irrevocable Trust. In addition, Taxpayer, as trustee of Trust B, executed a Sale and Purchase Agreement (Sales Agreement) pursuant to which Taxpayer as trustee of Trust B (Seller) sold to herself, as trustee of Irrevocable Trust (Purchaser), a fractional share of the 98.9 percent limited partnership interest in Partnership owned by Trust B. Sales Agreement describes the fractional share subject to the sale as follows:

> The numerator of such fraction shall be the Purchase Price, and the denominator of such fraction shall be the fair market value of [the 98.9 percent limited partnership interest]. The fair market value of [the 98.9 percent limited partnership interest] <u>shall be such value as finally determined for federal gift tax purposes based upon other transfers of limited partnership interests in the Partnership by Seller as of [Date 2],</u> in accordance with the valuation principles set forth in Regulation Section 25.2512-1 as promulgated by the United States Treasury under Section 2512 of the Internal Revenue Code of 1986, as amended.

(Emphasis added.) Under the Sales Agreement, the "Purchase Price" is defined as the value determined by an appraisal of the 98.9 percent limited partnership interest made as soon as practicable after Date 2.

In payment of the "Purchase Price," Taxpayer as trustee of Irrevocable Trust executed a promissory note in the amount of $X (identified in the note as the Purchase Price under the Sales Agreement) with interest at the rate of 6.2 percent compounded annually. Interest is payable annually and the note principal is due 9 years less one day after Date 2. The note may be prepaid in whole or in part at any time within the term.

Under a security agreement, the promissory note was secured by all of Irrevocable Trust's interests in Partnership, whenever acquired by the trust. Child 1, Child 2, and Child 3 executed a guarantee, guaranteeing payment on the note.

Taxpayer as trustee of Trust B and as trustee of Irrevocable Trust executed documents acknowledging the assignment and assumption of assignment of the 0.1% limited partnership interest and of the fractional interest subject to the Sales Agreement. In addition, all of the general partners executed documents acknowledging the assignments, and accepting Irrevocable Trust as a substituted limited partner with respect to the two assignments. With respect to the Sales Agreement, these documents refer to the assignment of "a fractional share of Assignor's 98.9% interest as a Limited Partner in the Partnership."

On Date 3, Taxpayer as trustee of Trust B and as trustee of Irrevocable Trust, along with the general partners of Partnership, executed "Agreement Regarding Limited Partnership Interest" (The Agreement). The Agreement provides that it is effective as of Date 2, the closing date of the sale of the limited partnership interest. The Agreement states that by virtue of an appraisal of Partnership received on Date 3, the parties reached a "tentative agreement" regarding the percentage interest assigned by the seller to the purchaser pursuant to the Sales Agreement. The Agreement states:

> [T]he parties hereto agree that the Assignment effected a transfer of a ninety-eight and nine tenths percent (98.9%) limited partnership interest in the Partnership from Seller to Purchaser, and that the books and records of the Partnership shall reflect this Agreement.
>
> The parties acknowledge that this Agreement is subject to modification if within the statute of limitations applicable to the Assignment it shall be determined that the Assignment actually conveyed a different percentage than that set forth above. The parties agree that if there shall be such a determination, the ownership interests in the Partnership and distributions previously made from the Partnership shall be adjusted.

Taxpayer's timely filed Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) reporting the transfer of the 0.1 percent limited partnership interest in Partnership. Schedule A, Part I, Item 1 reports the transfer of a 0.1 percent limited partnership interest with a value of $W. The return states that this value represents a pro rata portion of the total Y value of the assets of Partnership on the date of transfer, to which pro rata portion a discount was applied by the appraiser due to lack of marketability and minority interest.

On Schedule A, Part I, in Item 2 of the gift tax return, Taxpayer also reported the Date 2 sale to Taxpayer as trustee of Irrevocable Trust of "a limited partnership interest in [Partnership] having a value of [X]" in exchange for a promissory note with a face value of X. The return states that the sale "did not constitute a gift because the value of the Promissory Note equaled the value of the partnership interest sold."

LAW AND ANALYSIS:

Section 2511 of the Internal Revenue Code provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(g) of the Gift Tax Regulations provides that donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor.

Section 2512 of the Code provides that, if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property transferred exceeded the value of the consideration received shall be deemed a gift.

Section 25.2512-8 provides that transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth.

In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), the taxpayer created trusts for the benefit of his children and transferred to the trusts remainder interests in certain trusts created by his grandfather. The taxpayer's trust indenture contained the following provision:

> 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 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 [the settlor] free from the trust hereby created.

The Fourth Circuit characterized this provision, which effectively voided that portion of the transfer determined to be subject to gift tax, as "a device" that was contrary to public policy. The court noted that the provision discourages the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift. Further, the effect of the provision would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the provision was effective, then upon a decision that the gift was subject to tax, the court rendering the decision would then have to conclude that the transfer was not a gift and therefore not subject to tax. Finally, the effect of the provision, if valid, would be to void a court's final judgment. That is, the provision only becomes operative after the court enters a final judgment determining that the transfer is subject to gift tax. At that point, the provision, which was necessarily before the court, purports to revoke the gift, thereby voiding the judgment. The court also noted that a court decision regarding the tax consequences of the transaction would not be binding on the donees of the transfer who would not be a party to the tax litigation. Thus, they might enforce the gift notwithstanding a court decision. The Fourth Circuit concluded that the efficacy of a provision that involves "this sort of trifling with the judicial process" could not be upheld. Accordingly, the court held that the savings clause was void for gift tax purposes, and the gift tax consequences of the transfer were determined without regard to the savings clause. Commissioner v. Procter, 142 F.2d at 827. See also, Rev. Rul. 65-144, 1965-1 C.B. 442.

The Tax Court reached a similar conclusion in Ward v. Commissioner, 87 T.C. 78, (1986). In Ward , a husband and wife transferred 25 shares of stock in a closely held corporation to each of their three sons. The donors and donees executed a gift adjustment agreement providing that if it should be finally determined for federal gift tax purposes that the fair market value of each share of stock transferred exceeded or was less than $2,000, the number of shares transferred would be increased or decreased so that the maximum number of shares transferred by each donor to each donee would have a total value of $50,000. The court noted that, as was the case in Procter, if the condition was given effect, there would be no incentive for the Commissioner to challenge the value of the gift. The court noted:

> Furthermore, a condition that causes a part of a gift to lapse if it is determined for federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency, involves the same sort of "trifling with the judicial process" condemned in Procter. If valid, such condition would compel us to issue, in effect, a declaratory judgment as to the stock's value while rendering the case moot as a consequence.

Ward v. Commissioner, 87 T.C. at 114. The court also noted that there was no assurance that the donors would respect the terms of the adjustment clause and actually reclaim any portion of the stock previously conveyed. Ward v. Commissioner, 87 T.C. at 114. See also, Estate of McClendon v. Commissioner, TCM 1993-459. Accordingly, the court concluded that the provision was not effective for gift tax purposes.

Finally, in Rev. Rul. 86-41, 1986-1 C.B. 300, A transferred to B an interest in a tract of income-producing realty. Under the deed, B received a one-half undivided interest in the property. In Situation 1, the deed provided that, if for federal gift tax purposes, the Service determined the value of the one-half interest was more than $10,000, then B's interest would be reduced so that its value equaled $10,000. Under local law, the adjustment clause would compel B's reconveyance of a fractional share of the property. On examination of A's gift tax return, the Service determined the date of gift fair market value of the one-half interest to be $15,000. Situation 2 addresses the same facts except that, instead of reconveying any portion of the one-half interest, B was required to pay to A consideration equal to the excess value.

The revenue ruling states that, in both cases, the purpose of the adjustment clause was not to preserve or implement the original, bona fide intent of the parties, as in the case of a clause requiring a purchase price adjustment based on an appraisal by an independent third party retained for that purpose. Rather, the purpose of the clause was to recharacterize the nature of the transaction in the event of a future adjustment to A's gift tax return by the Service. Accordingly, the revenue ruling concludes that in both situations, the adjustment clause will be disregarded for federal tax purposes.

We see no difference between the effect of the adjustment clauses at issue in Ward and Rev. Rul. 86-41, and the adjustment provision in this case. In the instant case, Spouse, as trustee of Trust B, transferred the entire 98.9 percent limited partnership to the Irrevocable Trust pursuant to the Sales Agreement and The Agreement. However, if the Service adjusts the value of the gift of the 0.1 percent limited partnership interest transferred by the Spouse on Date 2, then under the formula in the Sales Agreement, the denominator of the fraction must be adjusted, but not the numerator, thereby reducing the fractional portion of the 98.9 percent interest subject to the sale and compelling a retransfer of a portion of the 98.9 percent interest back to Trust B. Thus, we believe the case is indistinguishable from the facts presented in Ward and Situation 1 of Rev. Rul. 86-41. In all three situations, under the adjustment clause at issue, if the Service, or the courts, determined that the property subject to the transfer exceeds the value initially placed on the property by the donor, then a portion of the property sufficient to eliminate the imposition of any additional tax liability is transferred back to the transferor. As the court noted in Ward v. Commissioner, if in the instant case the condition is given effect, there would be no incentive for the Commissioner to challenge the value of the limited partnership interest subject to the sale, because any adjustment to value would be rendered moot. Similarly, any attempt by a court to opine on the value of the interests would also be rendered moot. Further, as was the case in Ward, there is no assurance that the agreement would be enforced and any excess partnership interest transferred back. [1]

---

[1]King v. United States, 545 F. 2d 700 (10th Cir. 1976) is often cited as supporting the efficacy of value adjustment clauses. The Tax Court in Ward distinguished King, on the basis that the King transactions (sales of stock to trusts for the benefit of taxpayer's children) were determined by the Tenth Circuit to have been made in the ordinary course of business at arm's length. The Tax Court questioned this factual determination, but found, in any event, that the Ward transaction was not an arm's length sale and therefore King did not apply. Ward v. Commissioner, 87 T.C. at 116. Similarly, the transaction here cannot be characterized as arms-length. Taxpayer, as trustee of both trusts was dealing with herself. There was no arm's length negotiation. Further, prior to the sale, Taxpayer transferred the Trust B assets to the Partnership,

Taxpayer argues that the clause at issue in this case is distinguishable from those presented in Procter, Ward and Rev. Rul. 86-41. As discussed above in the statement of the facts, under the formula, the portion of the 98.9 percent limited partnership interest subject to the sale will not be adjusted based on a final determination of the gift tax value of the property subject to the sale, but rather based on the finally determined gift tax value of the 0.1 percent limited partnership interest Taxpayer transferred to the Irrevocable Trust on Date 2. Thus, the Taxpayer argues that unlike the situations presented in Procter and Ward, the Service can contest the value of the 0.1 percent gift, in court if necessary. The court will not be called upon to render a moot decision, nor does the clause purport to void a judgment, because the court's decision regarding the value of the 0.1 percent gift could result in a gift tax deficiency.

In this case, the gift of the 0.1 percent interest and the sale to Irrevocable Trust were part of an integrated transaction. The Taxpayer has placed an insignificant portion of the transaction at issue in order to circumvent well-established case law that has developed regarding savings clauses. We do not believe the courts would permit these decisions to be so easily avoided. For example, in Procter, under the clause at issue, the gift was revoked to the extent it was finally determined that the gift was subject to gift tax. The court determined that the savings clause "device" was contrary to public policy. It is doubtful that the court would have reached a contrary conclusion, if the gift was revoked in its entirety but for $1.00, thus creating the potential for a nominal deficiency, in the event the Service contests the matter. Such a provision would have the same effect of discouraging the collection of tax by public officials, and would constitute the same "trifling with the judicial process," as the actual clause involved in Procter. Accordingly, we do not believe the clause at issue is in any meaningful way distinguishable from those presented in Procter and Ward.[2]

Taxpayer also argues that the Service has sanctioned the use of valuation

---

with the goal of depressing the value of the assets so that Irrevocable Trust could acquire the interests at a reduced price. Taxpayer's transfer of her assets to Partnership before the "sale" and the use of the adjustment clause indicate that Taxpayer was more concerned with the transfer tax consequences of the transaction than with obtaining a reasonable price for her assets. See Harwood v. Commissioner, 82 T.C. 239, 271 n.23.

[2]In addition, as noted above, the clause becomes operative to adjust the portion of the limited partnership interest subject to the sale only if the gift tax value of the 0.1 percent limited partnership interest is adjusted. Thus, if the Service chooses not to contest the reported value of the 0.1 percent limited partnership interest (and instead focuses its resources on the sales transaction), then that value would be utilized under the formula in determining the interest subject to the sale. The formula would not require any reconveyance of the 98.9 percent limited partnership interest even if the value of the 98.9 percent interest was adjusted.

formula clauses in other situations. For example, testamentary marital deduction formula clauses pursuant to which the amount of the marital bequest (and the amount of the marital deduction allowable under § 2056) fluctuates depending on the value of the gross estate as finally determined for estate tax purposes, are widely used, in order to take maximum advantage of the marital deduction and the unified credit available under § 2010. Similarly, § 25.2702-3(b)(ii)(B) provides that the retained annuity in a grantor retained annuity trust may be a specified fraction or percentage of the initial fair market value of the trust "as finally determined for federal tax purposes." Taxpayer argues that these clauses, that adjust the value of a testamentary or inter vivos gift based on the transfer tax value of the property as finally determined, have the same operative effect as the clause at issue in this case.

However, in order for most estates to take maximum advantage of the marital deduction and unified credit, as intended by Congress, utilization of a funding formula clause (either for the marital bequest or the "credit shelter " trust) is a necessity. That is, full utilization of these benefits is dependent on the value of the testator's property as determined for estate tax purposes on the date of death or alternate valuation date. A testator cannot anticipate when he or she will die or the value of the property at the time of death. Further, in the case of certain assets, such as an interest in a closely-held business, opinions can reasonable differ as to value. It is not feasible to continuously redraft testamentary instruments each time asset values change, or to account for differences of opinion that may arise in the valuation process. Thus, utilization of a testamentary marital deduction or credit shelter valuation formula clause is the only practical way a testator can take full advantage of these Congressionally authorized benefits.

Similarly, the formula for defining a retained annuity contained in § 25.2702-3(b)(ii)(B) sanctions a practical method which, when utilized in a bona fide manner, enables a donor to take advantage of a Congressionally approved mechanism for transferring a remainder interest in trust property, in situations where assets that may be difficult to value, such as real estate or stock in a closely held business, are transferred to the trust. Further, this regulation should not be viewed as sanctioning the utilization of the formula to "zero-out" a gift, as is the case in the situation presented here. The preamble accompanying the promulgation of this regulation explicitly expresses concern regarding the use of grantor retained annuity trusts that are structured such that the value of the remainder interest (and thus, the amount of the gift) is zero or of nominal value relative to the total amount transferred to the trust. The preamble states that the Service and Treasury view these gift arrangements as contrary to the principles of § 2702. See, Preamble to T.D.8395, 1992-1 C.B. 316, 319.

We believe the legitimate and accepted uses of formula clauses as a practical way to implement Congressionally sanctioned tax benefits are in stark contrast to the situation presented in the instant case. The creation of the partnership and the use of the valuation formula clause in the sale of the partnership interests are all part of an integrated transaction the primary purpose of which is to transfer assets to the natural objects of Taxpayer's bounty at a discounted value, while foreclosing any realistic opportunity to challenge the transaction. The Taxpayer created and funded the limited partnership primarily, if not solely, to generate valuation discounts, with the goal of enabling her irrevocable trust to acquire the interests at a reduced purchase price. Taxpayer employed the formula clause as part of the transaction in an attempt to ameliorate any adverse consequences if the Service challenged the transaction and thereby to discourage any such challenge. The clause does not serve a legitimate purpose, such as ensuring that the purchase price accurately reflects fair market value. Rather, the clause recharacterizes the nature of the transaction in the event of a future adjustment to the value of the partnership interests by the Service. Under these circumstances the adjustment clause should not be effective for gift tax purposes.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.