Is WANDRY a Game Changer?

In *Wandry* v. *Comm'r*, the U.S. Tax Court, in a case of first impression, paved the way for the use of defined value gift clause formulas. The taxpayers (Joanne and Albert Wandry) transferred to their children and grandchildren a defined monetary gift represented by membership interest units in a limited liability company. The amount of each gift was defined in the membership interest assignment document ("Gift Document") as follows:

"I hereby assign and transfer as gifts effective as of January 1, 2004 a sufficient number of my units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such for federal gift tax purposes shall be as follows:

1. Kenneth Wandry .....$ 261,000
2. Cynthia Wandry .....$ 261,000
3. Jason Wandry.....$ 261,000
4. Jared Wandry .....$ 261,000
5. Grandchild A .....$ 11,000
6. Grandchild B.....$ 11,000
7. Grandchild C.....$ 11,000
8. Grandchild D .....$ 11,000
9. Grandchild E.....$ 11,000"

In addition, the Gift Document included the following legend:

"I intend to have a good faith determination of such value made by an independent third party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless 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."

The IRS argued that the taxpayers transferred fixed percentage interests in the LLC that exceeded the value of the taxpayers' federal gift tax exclusion. The IRS presented four arguments to support its position and the Tax Court rejected all four of these arguments:

1. **IRS.** The gift descriptions, as part of the gift tax returns, are admissions that petitioners transferred fixed Norseman percentage interests to the donees.

   Tax Court. State law controls in determining the nature of a taxpayer's legal interest in property. The Court found that taxpayers' gift tax return description identifying membership interest percentages was not controlling because the description was derived from the Gift Document.

2. **IRS.** Norseman's capital accounts control the nature of the gifts, and Norseman's capital accounts were adjusted to reflect the gift descriptions.

   Tax Court. State law controls in determining the nature of a taxpayer's legal interest in property. The Court found that capital accounts are always tentative until a final adjudication or the passing of the appropriate statute of limitations.

3. **IRS.** The Gift Document itself transferred fixed Norseman percentage interests to the donees.

   Tax Court. The Gift Document contained a valid formula clause. A savings clause is void because it creates a donor that tries "to take property back". On the other hand, a "formula clause" is valid because it merely transfers a "fixed set of rights with uncertain value". The difference depends on an understanding of just what the donor is trying to give away. The taxpayers were not attempting to reverse a completed gift of a fixed percentage membership interest.

4. **IRS.** The adjustment clause was invalid because it creates a condition subsequent to completed gifts and is void for Federal tax purposes as contrary to public policy.

   Tax Court. There is no well-established public policy against formula clauses. In order to invoke the public policy exceptions, the frustration caused must be "severe and immediate". The Commissioner's role is to enforce tax laws, not merely to maximize tax receipts.

Formula gift clauses have been upheld in previous Tax Court cases when excess value passed to a charity. However, Wandry is significant as no charity was involved. The Tax Court provides a clear road map for drafting successful defined value gift clause formulas.

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