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Joanne M. Wandry and Albert D. Wandry, Donor, Petitioner vs. Commissioner of Internal Revenue, T.C. Memo 2012-88, Filed March 26, 2012.

The Facts:

Albert and Joanne Wandry formed the Wandry Family Limited Partnership ("Wandry LP") in 1998, contributing cash and marketable securities to the partnership. The Wandry's spoke to their tax attorney regarding the gift tax consequences of making transfers of limited partnership interests to their children and grandchildren. The Wandry's were advised they could transfer interests by using their annual gift tax exclusions of $11,000 per donee and additional gifts in excess of their annual exclusion of up to $1 million for each Mr. and Mrs. Wandry.

In January of 2000 the Wandry's began gifting Wandry LP partnership interests to their children and grandchildren. The Wandry's tax attorney advised that the exact value of the partnership interests transferred would not be known until a later date, after the gifts had been made and a valuation of the assets had been performed. The Wandry's were advised to transfer a specific dollar amount instead of partnership interests and that gifts should be transferred as of either December 31 or January 1 of the year so that a midyear closing of the books would not be required.

In April of 2001, the Wandry's started a new family business and on August 7, 2001, the Wandry's formed Norsemen Capital, LLC ("Norseman"). By 2002, all of the Wandry LP assets were transferred into Norseman.

On January 1, 2004, Albert and Joanne Wandry each transferred gifts of $261,000 to each of their four children and $11,000 to five grandchildren. The gifts were determined based on a formula that stated 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".

The Wandry's hired an independent appraisal firm to determine the value of the Norseman interests. The firm determined the value of a 1% membership interest in Norseman to be

$109,000. Using this value, the Norseman capital accounts were adjusted and the Form 709 was filed for Mr. and Mrs. Wandry. Mr. and Mrs. Wandry each reported total gifts of $1,099,000 which equated to a transfer of Norseman interests to each child of 2.39% and to each grandchild of 0.101%.

The Arguments and Findings:

The IRS audited the Wandry's returns in 2006 and valued the respective interests at $366,000 and $15,400. However, prior to the start of the trial, the parties stipulated the value of the children's interests to be $315,800 and the value of the grandchildren's interests to be $13,346.

The IRS argued that the completed gifts of Norseman interests were in excess of the exclusion amounts and that gift tax and interest was payable. The IRS argued that the gifts were of specific interests in Norseman (2.39% and 0.101%) and not gifts of a specified dollar amount. The IRS pointed to the fact that the description of the gifts on the gift tax returns indicated the specified interests and the Norseman capital accounts had been amended to reflect the specified interests. The IRS also argued that the adjustment clause was a "condition subsequent" that did not reduce the gift value to the applicable exclusion limit.

After review of each of the IRS's arguments, the Court determined that the description of the gifts did not show a specific intent to gift a percentage of Norseman, but instead showed the intent to gift $261,000 to each child and $11,000 to each grandchild. The Court also determined that the capital accounts were "unofficial and unreliable" because the capital accounts and the K-1s were not clear and did not control the gifted items and were deemed immaterial. Lastly, the Court determined that the gift documents did not state the specific percentages gifted. Under the Estate of Petter v. Commissioner, T.C. Memo 2009-280, a formula clause of indicating a specific value to family with a gift over to charity of excess amounts was upheld. The Court indicated that in the Wandry case, while there is no gift of excess value to charity like in Petter, the formula clause does not create a condition subsequent "to take property back" based on the valuation. The formula has only one unknown, the value of Norseman at the time of the transfer. Furthermore, while that value was unknown, it was a constant as the parties had agreed on the value. The Court determined that "it is inconsequential that the adjustment clauses reallocated membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to "take property back. Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman's value. The clauses at issue are valid formula clauses."

Parting Thoughts:

This was a big win for the taxpayer as the Court resoundingly rejected the IRS's three arguments against value defined clauses. As a valuation expert, I was disappointed that there was no discussion as to what adjustments the IRS made to the value of Norseman (likely in the reduction of valuation discounts taken by the appraiser) which increased the value of Norseman that the taxpayer stipulated to. Also, please note that the exact gifting document wording used in this case is included in the full write-up issued by the Tax Court – so it is worth checking out.