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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2918

Date: 08-Nov-21
From: Steve Leimberg's Estate Planning Newsletter
Subject: Paul Hood: Fifth Circuit Affirms Tax Court in Nelson, A Defined Value Gift Case

"In this ten-page gift tax Fifth Circuit opinion, issued on November 3, 2021, the Fifth Circuit panel unanimously affirmed Tax Court Judge Pugh's decision in favor of the IRS on an attempted defined value gift and a defined value sale. The three-judge panel (Judges King, Smith, and Haynes) heard oral argument on October 5, 2021. Given that it took the panel less than 30 days from oral argument to decide the case on appeal, it must not have been a very difficult case for the unanimous panel. Tax Court Judge Pugh had held that the donors transferred percentage interests instead of specific dollar amounts, distinguishing Wandry. Paul Hood covered the Tax Court's decision in Nelson in Steve Leimberg's Estate Planning Newsletter 2801. Additionally, Jonathan G. Blattmachr, Mitchell M. Gans and Vanessa L. Kanaga covered the Tax Court's Nelson decision in Steve Leimberg's Estate Planning Newsletter 2802."

Paul Hood provides members with commentary on the Fifth Circuit's opinion in *Nelson v. Commissioner*. Members who wish to learn more about this topic should consider joining Paul and **Bob Keebler** in their exclusive LISI Webinar titled "**Those Ten Missing Words: What Advisors Need to Know Now about Defined Value Gift/Sale Clauses after the Fifth Circuit Affirms Nelson**" on November 12th at 2:00PM ET. Click this link to learn more: Paul/Bob

Now, here is Paul's commentary:

EXECUTIVE SUMMARY:

In this ten-page gift tax Fifth Circuit opinion, issued on November 3, 2021, the Fifth Circuit panel unanimously affirmed Tax Court Judge Pugh's decision in favor of the IRS on an attempted defined value gift and a defined value sale. The three-judge panel (Judges King, Smith, and Haynes) heard oral argument on October 5, 2021. Given that it took the panel less than 30 days from oral argument to decide the case on appeal, it must not have been a very difficult case for the unanimous panel.

Tax Court Judge Pugh had held that the donors transferred percentage interests instead of specific dollar amounts, distinguishing Wandry. Paul Hood covered the Tax Court's decision in Nelson in *Estate Planning Newsletter 2801* Additionally, Jonathan G. Blattmachr, Mitchell M. Gans and Vanessa L. Kanaga covered the Tax Court's Nelson decision in *Estate Planning Newsletter 2802*.

FACTS:

In the Tax Court, the issues for decision were: (1) whether the interests in Longspar Partners, Ltd. (Longspar), transferred by gift on December 31, 2008, and January 2, 2009, transferred by installment sale, were of fixed dollar amounts or percentage interests and (2) the fair market values of those interests.

Longspar was formed on October 1, 2008, as a Texas limited partnership based in Midland, Texas. It was formed as part of a tax planning strategy to (1) consolidate and protect assets, (2) establish a mechanism to make gifts without fractionalizing interests, and (3) ensure that WEC remained in business and under the control of the Warren family. Mr. and Mrs. Nelson are Longspar's sole general partners, each holding a 0.5% general partner interest (together holding a 1% interest in Longspar as general partners) and 99% as limited partners.

The biggest asset of Longspar was a 27% interest in a holding company that in turn held the stock of several operating subsidiaries, the business of which was primarily in two areas: oil field service and being the dealer of Caterpillar in just about the entire state of Oklahoma and much of west Texas.

Just three months after its formation, Mrs. Nelson made two transfers of limited partner interests in Longspar to a trust. The first transfer was a gift on December 31, 2008. The Memorandum [*11] of Gift and Assignment of Limited Partner Interest (memorandum of gift) provides:

> *[Mrs. Nelson] desires to make a gift and to assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.*

Petitioners structured the second transfer, on January 2, 2009, as a sale. The Fifth Circuit, in a footnote, noted that the petitioners didn't include the second transfer as a gift on the gift tax return filed in connection with the firsttransfer The Memorandum of Sale and Assignment of Limited Partner Interest (memorandum of sale) provides:

> *[Mrs. Nelson] desires to sell and assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment * * *.*

Neither the memorandum of gift nor the memorandum of sale contained clauses defining fair market value or subjecting the limited partner interests to reallocation after the valuation date. In connection with the second transfer, the trust executed a promissory note for $20 million (note).

Mr. Nelson, as trustee, signed the note on behalf of the trust. The note provides for 2.06% interest on unpaid principal and 10% interest on matured, unpaid amounts, compounded annually, and is secured by the limited partner interest that was sold. Annual interest payments on the note were due to Mrs. Nelson through the end of 2017. The Longspar partnership agreement was amended on January 2, 2009 (the date of the installment sale to the trust) to reflect the trust as the holder of a 6.14% limited partnership interest in Longspar (acquired by gift) and a 58.65% limited partnership (acquired by sale).

The Nelsons retained an appraiser to value the Longspar interests that were given and sold. That appraiser in turn relied upon another appraisal of the operating companies that were included within the holding company that in turn 27% of the stock of which was held in Longspar. The valuation issues aren’t that unusual, except to note that the appraisers for both the Nelsons and the IRS weren’t really that far apart. The real issue was the efficacy of the defined value clauses in the gift and in the sale.

Longspar reported the reductions of Mrs. Nelson's limited partner interest and the increases of the Trust's limited partner interests on the Schedules K-1, attached to its Forms 1065, U.S. Return of Partnership Income, for 2008 through 2013. Longspar also made a proportional cash distribution to its partners on December 31, 2011. The Trust's portion of the cash distribution — 64.79% — was based on the appraiser's valuation.

The Nelsons filed separate Forms 709, United States Gift (and Generation-Skipping Transfer) Tax Returns, for 2008 and 2009. On their 2008 Forms 709, they each reported the gift to the trust “having a fair market value of

$2,096,000 as determined by independent appraisal to be a 6.1466275% limited partner interest" in Longspar. They classified it as a split gift and reported that each person was responsible for half ($1,048,000). They did not report the January 2, 2009, transfer of the Longspar limited partner interest on their 2009 Forms 709, consistent with its treatment as a sale.

With respect to the defined value clauses, the Nelsons relied upon Wandry v. Commissioner (covered by Paul Hood in Estate Planning Newsletter 1941, by Steve Akers in 1946, Andy Katzenstein and Scott Bowman in 1945 and by Gassman et al. in 1978) and Succession of McCord v. Commissioner, a Fifth Circuit decision (discussed in Estate Planning Newsletters 547, 551, 555, 557, 1010, 1016 and 1017). The IRS countered that the Nelsons actually gave and sold percentage interests in Longspar and not defined value transfers.

Petitioners and the Internal Revenue Service (IRS) Office of Appeals (IRS Appeals) negotiated a proposed settlement agreement, but it was never completed.

On the basis of their settlement discussions with IRS Appeals, petitioners amended Longspar's partnership agreement to record the Trust's limited partner interest in Longspar as 38.55% and made corresponding adjustments to the books for Longspar and the trust. Longspar also adjusted prior distributions and made a subsequent proportional cash distribution to its partners to reflect the newly adjusted interests.

In the August 29, 2013, notices of deficiency, the IRS determined that the Nelsons had undervalued the December 31, 2008 gift, and their halves of the gift each were worth $1,761,009 rather than $1,048,000 as of the valuation date. The IRS also determined that the Nelsons had undervalued the January 2, 2009, transfer by $13,607,038, and therefore they each had made a split gift in 2009 of $6,803,519. The Nelsons filed separate petitions in the Tax Court, which were consolidated for trial.

After the Tax Court's typical avoidance of IRC Sec. 7491 regarding the burden of proof shift, Judge Pugh determined that the Nelsons had given and sold percentage interests rather than having made defined value transfers. He reasoned:

> *Unlike the clause in Succession of McCord, "fair market value" here already is expressly qualified. By urging us to interpret the operative terms in the transfer instruments as transferring dollar values of the limited partner interests on the bases of fair market value as later determined for Federal gift and estate tax purposes,* ***petitioners ask us, in effect, to ignore "qualified appraiser * * * [here, their appraiser] within * * * [a fixed period]" and replace it with "for federal gift and estate tax purposes." While they may have intended this, they did not write this. They are bound by what they wrote at the time.*** *As the texts of the clauses required the determination of an appraiser within a fixed period to ascertain the interests being transferred, we conclude that Mrs. Nelson transferred 6.14% and 58.35% of limited partner interests in Longspar to the Trust as was determined by their appraiser within a fixed period.* [Emphasis added]

Judge Pugh went on to determine the value of the percentage interests transferred. He essentially split the difference, determining that Mrs. Nelson's transfers to the trust have fair market values of $2,524,983 (about a $430,000 difference) and $24,118,933 (and $4,118,933 difference), respectively. The Nelsons appealed to the Fifth Circuit.

In unanimously affirming the Tax Court, the Fifth Circuit stated:

By its plain meaning, the language of this gift document and the nearly identical sales document transfers those interests that the qualified appraiser determined to have the stated fair market value—no more and no less.

*The specific qualification added by the Nelsons separates their agreement from the formula clauses considered in other cases. Most formula-clause cases featured transfer instruments that defined the interests transferred as the fair market value as determined for federal-gift or estate-tax purposes. See Est. of Petter v. Comm'r, 653 F.3d 1012, 1015-16 (9th Cir. 2011); Est. of Christiansen v. Comm'r, 586 F.3d 1061, 1062 (8th Cir. 2009); Wandry v. Comm'r, T.C. Memo. 2012-88, 2012 Tax Ct. Memo LEXIS 89, at *4-5, nonacq., 2012-46 I.R.B. 543 (Nov. 13, 2012). Those that did not defined fair market value through reference to the "willing-buyer/willing-seller" test that is used to define fair market value in the relevant Treasury regulation. Succession of McCord, 461 F.3d at 619 (citing 26 C.F.R. § 25.2512-1 (2005)); Hendrix v. Comm'r, T.C. Memo. 2011-133, 2011 Tax Ct. Memo LEXIS 130, at *8.* ***The Nelsons defined their transfer differently; they qualified it as the fair market value that was determined by the appraiser. 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.*** [Emphasis added]

The Fifth Circuit continued:

With a formula clause, the transaction is still closed even if a reallocation occurs. That reallocation simply works to ensure that a specified recipient "receive[s] those units [he or she was] already entitled to receive." Est. of Petter, 653 F.3d at 1019. Similarly, the value of the gift existed and could be determined

at the time of the transfer. "The number of . . . units" transferred is "capable of mathematical determination from the outset, once the fair market value [is] known." Id. The reallocation clauses thus allow for the proper number of units to be transferred based on the final, correct determination of valuation.

The Nelsons did not include such a clause. Instead, the trust has already received everything it was entitled to—the number of units matching the stated value as determined by a qualified appraiser. Both parties agree with the Tax Court's conclusion that the gift was complete, and that Mary Pat parted with dominion and control, on the date listed in each transfer agreement. *On those dates, Mary Pat irrevocably transferred the number of units the appraiser determined equaled the stated values. No clause in the transfer documents calls for a reallocation to ensure the trust received a different amount of interests if the final, proper valuation was different than the appraiser's valuation. The percentage of interests was transferred on the listed dates, even if those percentages were indefinite until the appraisal was completed. Cf. Robinette v. Helvering, 318 U.S. 184, 187 (1943) (holding that a gift was complete even in the face of "indefiniteness of the eventual recipient"). The gift tax is assessed as of the date of the transfer and on the value of those percentages, whatever that value may be.* ***Simply put, while the Nelsons may have been attempting to draft a formula clause, they did not do so.*** [Emphasis added]

On appeal, the Nelsons attempted to argue that their clear intent to minimize their gift tax liability should prevail. However, the Fifth Circuit shot that argument down, observing:

Even if the contracts are ambiguous, there are no objective facts or circumstances surrounding the transfer that

counsel a different result. *Under federal gift tax law, "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." 26 C.F.R. § 25.2511-1(g)(1) (2021). Texas contract law commands the same. URI, 543 S.W.3d at 767 ("[T]he parol evidence rule prohibits extrinsic evidence of subjective intent that alters a contract's terms. . . ."). **The evidence the Nelsons point to all concerns their SUBJECTIVE intent; we cannot look to what the Nelsons had in their minds when drafting the contracts.** Rather than subjective intent, it is "objective manifestations of intent [that] control, not 'what one side or the other alleges they intended to say but did not.' " Id. at 763-64 (citation omitted) (quoting Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London, 327 S.W.3d 118, 127 (Tex. 2010)). Objective considerations include the "surrounding circumstances that inform, rather than vary from or contradict, the contract text." Hous. Expl. Co. v. Wellington Underwriting Agencies, Ltd., 352 S.W.3d 462, 469 (Tex. 2011).*

The only objective circumstance the Nelsons can point to in support of their reading is the setting of the transfer, as part of the Nelsons' estate planning that aimed to protect their assets while also avoiding as much tax liability as possible. *See URI, 543 S.W.3d at 768 ("Setting can be critical to understanding contract language, as we found in cases involving the lawyer-client relationship and construction of an arbitration agreement." (citations omitted)); Hous. Expl. Co., 352 S.W.3d at 469 (stating that objective circumstances include "the commercial or other setting in which the contract was negotiated" (quoting 11 Richard A. Lord, Williston on Contracts § 32.7 (4th ed. 1999))). **Consideration of the estate-plan context still hews too closely to consideration of the Nelsons' subjective intent to alter the understanding of the contractual language.** For an arbitration agreement or a contract between a lawyer and a client, one can tell the setting from fully objective facts—normally, by looking at the plain text of the agreement. For the Nelsons' transfers, however,*

consideration of the estate-plan setting still requires determining what was in their minds at the time of the transfers. One would still need to determine that, in transferring assets from Mary Pat to the trust, the Nelsons had the subjective intent of minimizing their tax liability. While that might be fairly obvious, it still requires consideration of subjective intent, rather than objective facts. This goes beyond the scope of the parol evidence rule under Texas law.

Further, the fact that the language differs from other, similar contracts in the same setting is significant. This is not a case where we would be reading the contracts in line with numerous other, similar contracts that are regular parts of a given industry or setting, such as arbitration. ***To support the Nelsons' reading, we would be required to disregard significant differences between these contracts and the transfer documents used in similar cases****. That would be an improper use of facts and circumstances surrounding the contract. Cf. Hous. Expl. Co., 352 S.W.3d at 469-72 (holding that deletions from a form contract should be considered when judging the parties' intent for the agreement).* ***The fact that the transfers involved a family trust and family assets and were made in the setting of estate planning should not be used to interpret the Nelsons' intent.*** [Emphasis added]

COMMENT:

As I predicted, the Fifth Circuit easily affirmed the Tax Court's decision. In fashioning the lesson that Nelson teaches us: Never ever fail to add the "ten missing words" at the end of the defined value gift/sale clause: ***as finally determined for federal estate and gift tax purposes.***

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Paul Hood

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CITES:

Nelson v. Commissioner, T.C. Memo 2020-81, aff'd No. 20-61068 (5th Cir. Nov. 3, 2021); *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944); Knight v. Commissioner, 115 T.C. 506 (2000); *King v. United States*, 545 F.2d 700 (10th Cir. 1976); *Estate of Christiansen v. Commissioner*, 586 F.3d 1061

(8th Cir. 2009); *Estate of Petter v. Commissioner*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C. Memo 2011-133; *Wandry v. Commissioner*, T.C. Memo 2012-88.

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