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TAX COURT CASE UPDATE

FCG Valuation Case E-Flash

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Citation:

John H. Hendrix and Karolyn M. Hendrix v. Commissioner of Internal Revenue, T.C. Memo 2011-133, June 15, 2011.

Overview:

The Tax Court determined that formula clauses reached at arm's-length can be used to determine fair market value. Further, the Court decided that formula clauses are not void as a matter of public policy.

The Facts:

John H. Hendrix and Karolyn M. Hendrix ("Petitioners") and their adult daughters were the shareholders of JHHC ("JHHC"), a Texas corporation. JHHC's capital structure consisted of nonvoting and voting common stock, and it was an S corporation.

In 1999, their attorney advised them to transfer JHHC stock to their daughters (through trusts) and to a donor-advised fund at a nonprofit community foundation. A donor-advised fund permits donors (in this case, the Petitioners) to control the ultimate recipient of the donation.

The foundation's vice president and legal counsel negotiated the terms of the assignment agreement with the Petitioners. Included in the drafts of the agreement was a stipulation that a formula clause would set the number of JHHC shares transferred to the daughters' trusts and the foundation.

Also during 1999, the Petitioners engaged a business appraiser ("Appraiser") to value the company's nonvoting stock. Relying on the appraised value, the Petitioners decided to donate \$50,000 of JHHC nonvoting stock to the foundation, more than \$10.5 million of JHHC nonvoting stock to a generation skipping tax ("GST") trust, and more than \$4.2 million of JHHC nonvoting stock to an issue trust for the benefit of their daughters.

On December 31, 1999, each Petitioner, trustees of the trusts, and the foundation executed an assignment agreement irrevocably assigning 287,619.64 shares of JHHC stock to the GST and the foundation. The assignment agreement established a formula by which JHHC stock having approximately \$10.5 million of value would be transferred to the GST, and any remaining portion

was assigned to the foundation for the benefit of the Petitioners' donor-advised fund. As part of the transaction, the trusts also agreed to pay each Petitioner approximately \$9 million. Additional assignment agreements were executed on the same day. In them, each Petitioner irrevocably transferred 115,622.21 shares of JHHC nonvoting stock to the issue trusts and the foundation as tenants in common. The value of the shares transferred to Petitioners' daughters was fixed at slightly more than \$4.2 million. The agreement also directed the trusts to deliver a note of approximately \$3.6 million to each Petitioner. Any share value in excess of \$4.2 million was to be transferred to the foundation.

For both sets of assignment agreements, the transferees were responsible for the allocation of shares on a per-share basis, and the Petitioners were relieved of such responsibility. The Petitioners' attorney, acting as a representative for the trusts, retained the Appraiser to determine the December 31, 1999, value of the transferred interests. Fulfilling its fiduciary obligation, the foundation contracted an independent appraisal firm to review the Appraiser's December 31, 1999, value, and the second appraiser pronounced the value reasonable and fair. Accordingly, the December 31, 1999, value was used by the foundation and trusts to establish the fair market value of the JHHC nonvoting stock in their confirmation agreements. The Petitioners were not party to the confirmation agreements.

Discussion:

The Petitioners asserted that the formula clauses are valid because 1) they were used to fix the transferred amount of JHHC's stock, and 2) the parties to the clauses negotiated at arm's-length. The IRS disagreed, asserting the clauses were not reached at arm's-length and are contrary to public policy.

Interestingly, the Petitioners successfully shifted the burden of proof for this case under §7491(a); Rule 142(a)(2). The IRS did not dispute Petitioners' claim with respect to the formula clauses, but did so under another element of the claim, which The Court determined was moot. On another point, the Petitioners argued that the case was factually similar to *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), revg. 120 T.C. 358 (2003), and The Court agreed. Even so, the Tax Court determined that the Fifth Circuit did not rule on the specific arguments made by the IRS: "(1) The formula clauses are not the result of an arm's-length transaction or (2) the formula clauses are void as contrary to public policy."

Regarding the IRS's assertion that the formula clauses did not represent an arm's-length transaction, the Tax Court disagreed, saying:

The mere fact that the petitioners and their daughters were "close" and that petitioners' estate plan was beneficial to the daughters does not necessarily mean that the formula clauses failed to be reached at arm's length. Nor is a finding of negotiation or adverse interests an essential element of an arm's length transaction [citations omitted], although we find nothing in the record to persuade us either that the formula clauses were not subject to negotiation or that petitioners and the daughters' trusts lacked adverse interests. We also note economic and business risk assumed by the daughters' trusts as buyers of the stock (i.e., the daughters' trusts could receive less stock for their payment if the JHHC stock was overvalued) placed them at odds with petitioners and the Foundation.

Additionally, The Court found no evidence of collusion, as asserted by the IRS. Such evidence would have undermined the transaction. As to the IRS's public policy argument, the Tax Court again disagreed, saying the formula clause in the present case supports the public policy of encouraging gifts to charity. As a result,

The Court determined that the Petitioners' formula clauses were not contrary to public policy.

Conclusion:

THE TAX COURT DETERMINED THAT FORMULA CLAUSES MAY BE EVIDENCE OF A TRANSITION NEGOTIATED AT ARM'S-LENGTH AND ARE NOT VOID AS A MATTER OF PUBLIC POLICY. FURTHERMORE, THE RULING REINFORCES THE USE OF PROPERLY DETERMINED FORMULA CLAUSES IN GIFT AND ESTATE PLANNING.