WHITE & CASE

Use of Formula Clauses for Income Tax Advantage

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In early 1985, Nestlé Holdings Inc. (Nestlé US), a first-tier wholly owned subsidiary of Nestlé S.A. (Nestlé Switzerland), acquired Carnation Co. and made an election under section 338 for that acquisition.[1] Under section 338, Nestlé US would obtain a step-up in the tax basis of Carnation's assets.[2] Nestlé US retained an appraisal firm, which valued Carnation's intangible assets at $425,630,700, and on April 30, 1985, Nestlé US sold those intangible assets to Nestlé Switzerland for that amount. The IRS disputed Nestlé US's valuation of the intangible assets acquired from Carnation and asserted that the correct value was much lower. Ultimately, the Tax Court held that the correct value of the Carnation intangible assets was $219,482,000, and this was held to be Nestlé US's tax basis in the assets after the section 338 election. But recall, Nestlé US had sold the assets to Nestlé Switzerland for $425,630,700. Thus, the Tax Court concluded that Nestlé US had realized a taxable gain of $206,148,700. The Second Circuit disagreed with the Tax Court's valuation method and remanded the case on that ground, but it agreed that Nestlé US had realized a taxable gain based on the difference between $425,630,700 and the fair market value of the Carnation intangible assets.

Nestlé argued what to many of us seems like common sense, which is that if a parent company buys an asset from its wholly owned subsidiary for more than it is worth, the excess is really just a capital contribution from the parent to the subsidiary. If the IRS were adjusting the purchase price under the authority of section 482, that indeed would be the likely treatment of the excess.[3] Both the Tax Court and the Second Circuit rejected Nestlé's argument, holding that such treatment would constitute a retroactive change in the form of the transaction and that the taxpayer must be held to its chosen form.

Could Nestlé have achieved a better result if the sale agreement between Nestlé US and Nestlé Switzerland had a clause in it providing that if the value of the Carnation intangible assets were determined to be less than the purported value, the excess would be treated as a contribution to capital by Nestlé Switzerland to Nestlé US? In other words, could the parties under a simple formulaic adjustment clause have eliminated the possibility of the IRS producing a taxable US gain by prevailing on a valuation argument? It is important in framing the issue to realize that if such a formula clause were respected, the IRS would have no clear incentive to challenge Nestlé's valuation. Put another way, an IRS auditor of Nestlé US's 1985 tax return would not generate even a dime of taxable income by adjusting the valuation of the transferred assets. Therefore,

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1. The facts come from *Nestlé Holdings v. Commissioner*, T.C. Memo. 1995-441 , *aff'd and remanded*, 152 F.3d 83 (2d Cir. 1998)
2. *See* section 338(b).
3. *See* reg. section 1.482-1(g)(3)(i).

the likely result of the formula clause is that Nestlé's position on valuation would prevail because it would not be challenged by the IRS on audit.[4]

This report will consider the foregoing question and some related questions, all having to do with clauses that attempt, by formula, to solve what would otherwise be an income tax problem or eliminate what would otherwise be a tax risk. First, however, it is useful to detour through an area of estate and gift taxation in which those clauses have been used and, on varying facts, upheld and disregarded. The detour will be lengthy, not because estate and gift taxation is a topic of this report, but because that is where the law is. Then I will cover some of the issues that are raised by the applicable law and apply also in the income tax world. Finally, this report will cover the possible application of formula clauses in several specific income tax areas.

I. Formula Clauses in Estate and Gift Tax Cases

A. The Original Defined Value Clause

In *Procter*,[5] an old gift tax case, the taxpayer made a gift to his children under a trust indenture that contained the following formulaic language:

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 in trust 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 Frederic W. Procter free from the trust hereby created.[6]

The formula fixed the definition of the property that was transferred by reference to a defined value as finally determined. I will refer to such a formula as a "defined value clause."

The IRS disagreed with the taxpayer's valuation of the underlying property and assessed a gift tax, ignoring the taxpayer's attempt to avoid that result with the defined value clause. The Fourth Circuit agreed, stating that the taxpayer made a present gift based on what he thought the value was and that his attempt to limit the value by formula was really a condition subsequent. Further, the Fourth Circuit held that the defined value clause is void on public policy grounds. Finally, the Fourth Circuit noted the possibility of whipsaw; the Tax Court could apply the defined value clause to reduce the transferred interest from the viewpoint of taxation, but then the donees, not being parties to the tax suit, might later enforce the full gift despite the Tax Court's decision.

A condition subsequent can be defined as a happening that terminates an interest in property and causes a reversion. Put differently, a condition subsequent refers to an event that brings an end to something else. The Fourth Circuit's conclusion in *Procter* that the formula creates a condition subsequent arises fairly easily from the language used by the taxpayer, which stated a current intention regarding the property that was transferred and arguably stated that a reduction in the transferred property occurred when there was a final court judgment. The Fourth Circuit viewed the possibility of an after-the-fact final determination of value as creating the potential for a portion of the transferred property to revert to the transferor. The court's whipsaw concern also seems driven by the possibility that the thing that was legally gifted could be viewed separately from the valuation conclusion. Both of those problems could be eliminated, or at least mitigated, by a different wording of the language of transfer, so that the operative transfer was of a fixed quantum of value (corresponding to the gift tax exemption) to which there would never be an adjustment but on which subsequent facts – such as a determination of value – might shed light.

The public policy grounds are the most interesting. The Fourth Circuit gave three reasons why the formula clause is void because of public policy. First, it would discourage the collection of tax by the IRS because the only effect of an attempt to enforce the tax would be to defeat the gift and thereby avoid the tax. Second, the formula clause would obstruct the administration of justice by requiring the courts to decide a case that is moot and contains no tax controversy, which would amount to nothing more than asking the court for a

4. If one assumes that Nestlé would have made the section 338 election anyway, Nestlé had an incentive to put as high a value on the intangible assets as possible. That is because the sale of the intangible assets to Nestlé Switzerland would produce no taxable gain in the United States, and the greater the value of the intangible assets, all other things being equal, the greater the royalty that it could be justified for Nestlé US to pay Nestlé Switzerland for future use of the intangible assets. That royalty would shift income from the United States to Switzerland.

5. *Commissioner v. Procter,* 142 F.2d 824 (4th Cir. 1944), *rev'g* 2 T.C.M. 429 (1943).

6. *Id.* at 827.

declaratory judgment on valuation.[7] Finally, the court perceived a circularity problem with its jurisdiction in the sense that the only way there could be a final judgment of the court is if it rendered an opinion on tax liability, and because the effect of honoring the formula clause would be no tax liability, the judgment of the court could never be a final judgment on a tax matter.[8]

The circularity problem presumably also could be eliminated, or at least mitigated, by different language in which the trigger is not a court judgment per se, but rather an abstract notion of true value, with the final court judgment being a dispositive opinion on that value. For example, the language could say simply that the trigger is any of a list of determinations, including a redetermination by the parties, determination by an appraiser, and so on, with all of them being trumped by an IRS determination, and with all of the foregoing being trumped by a court determination. The first two public policy points, however, are not easily addressed by different language or fixed by a different approach.

B. Defined Consideration Clauses

King[9] presented an easier case than *Procter*, because the formula in *King* adjusted the consideration for what was transferred rather than what was transferred in the first place. I will refer to this as a "defined consideration clause." In *King*, the taxpayer sold corporate stock to trusts for his children under agreements that provided:

However, if the fair market value of The Colorado Corporation stock as of the date of this letter is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the same manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service.[10]

Tax returns were filed valuing the stock at $1.25 per share, but the IRS determined that the stock had a value of $16 per share and assessed a gift tax on the difference. The IRS relied on *Procter*, but the Tenth Circuit in *King* saw the distinction and held that there was no gift. It is easy to see why the structure in *King* does not have as much of a "heads I win, tails you lose" flavor to it as the structure in *Procter*. In *King*, the transaction itself was not adjusted — just the price — and there were real consequences to the price adjustment.[11] There was no condition subsequent in *King*; in other words, there was no circumstance in which property was transferred and then later a portion of it was transferred back. But one could argue (and the IRS did argue) that the public policy issues in *King* are the same as in *Procter* — that the adjustment clause in *King* neuters the IRS in its ability to collect a gift tax and therefore deters administrative enforcement of the gift tax laws.[12] However, one could infer (and the Tenth Circuit did infer) a benign motive for the formula in *King* — ensuring full and fair consideration. That motive is harder to infer in *Procter*. In the end, the Tenth Circuit relied on the perceived motive of the taxpayers in upholding the formula adjustment provision.

Harwood[13] involved taxpayers who tried to follow the approach that had been blessed in *King*.[14] The taxpayers formed trusts for their children and transferred 8.89 percent limited partnership interests in a family partnership to the trusts. The trust agreements contained the following language:

In the event that the value of the partnership interest . . . shall be finally determined to exceed $400,000 for purposes of computing the California or United States Gift Tax, and in the opinion of the Attorney for the trustee a lower value is not reasonably defendable, the trustee shall immediately execute a promissory note to the trustors in the usual form at 6 percent interest in a principal amount equal to the difference between the value of such gift and $400,000. The note shall carry interest and be effective as of the date of the gift.

7. The court's strong view on this subject is shown by a passage quoted by it from an early Supreme Court opinion:
And any attempt, by a mere colorable dispute, to obtain the opinion of the court upon a question of law which a party desires to know for his own interest or his own purposes, when there is no real and substantial controversy between those who appear as adverse parties to the suit, is an abuse which courts of justice have always reprehended, and treated as a punishable contempt of court. *Lord v. Veazie*, 8 How. 251 at 255, 49 U.S. 251 (1850) at 255.
Procter, 142 F.2d at 827.

8. In a classic Catch-22 formulation, the Fourth Circuit said: "To state the matter differently, the condition is not to become operative until there has been a judgment; but after the judgment has been rendered, it cannot be operative because the matter involved is concluded by the judgment." *Id.*

9. *King v. United States*, 545 F.2d 700 (10th Cir. 1976).

10. *Id.* at 704.

11. There is no evidence in *King* that the trusts actually paid the increased purchase price under the formula driven by the IRS determination, but the Tenth Circuit relied on the trial court's finding that the trusts intended to pay the purchase price adjustment.

12. In the case of *King*, this argument fails if one takes the long view and recognizes that the gift tax and the estate tax operate in tandem. The value that escaped gift tax in *King* remained in the taxpayer's hands and thus was potentially subject to estate tax at the taxpayer's death.

13. *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986).

14. *King* was decided on November 19, 1976, and the *Harwood* transactions were undertaken on December 29, 1976.

The Tax Court viewed *Procter* as inapplicable because it read the "finally determined" trigger as not dependent on a finding of the court, but then held *King* inapplicable because the final determination had apparently never happened and the note had never been issued.[15] The Tax Court concluded that the defined consideration clause had no effect on the value of the gift. It thus held that the IRS could adjust the value of the property and assess a gift tax on it.

C. Variations on Defined Value Clauses

Two years later, in *Ward*,[16] the Tax Court addressed more directly the issue presented by *Procter*. The taxpayers in *Ward* gave 25 shares of stock of a corporation to each of their three sons under an agreement that contained the following defined value clause:

FUTURE ADJUSTMENT. Each party hereto agrees that if it should be finally determined for Federal gift tax purposes that the fair market value of each share of capital stock of the Corporation exceeds or is less than $2,000.00 an adjustment will be made in the number of shares constituting each gift so that each Donor will give to each Donee the maximum number of full shares of capital stock of the Corporation, the total value of which will be $50,000.00 from each Donor to each Donee and a total of $150,000 from each Donor to all Donees. Any adjustment so made which results in an increase or decrease in the number of shares held by a stockholder of the Corporation will be made effective as of the same date as this Agreement, and any dividends paid thereafter shall be recomputed and reimbursed as necessary to give effect to the intent of this Agreement.

The taxpayers argued that the adjustment clause reflected an intent to give a specific value of property rather than a specific number of shares and that the 25 shares reported on the gift tax returns were merely "representative of the value" that they intended to give. The court's adverse conclusion was signaled by its reading of the adjustment clause as amounting to a "power to revoke a part of each gift." The court first concluded that there was a completed gift of the 25 shares and that the fact that some of the shares might come back was of no consequence. This follows the *Procter* conclusion that the adjustment was a condition subsequent. Because the final determination trigger could be based on a finding of the Tax Court, the court concluded that the condition was contrary to public policy on the grounds that it obstructed justice by requiring the courts to pass upon a moot case and thereby issue a declaratory judgment, which is not its role to issue. More importantly, the Tax Court said it found "highly persuasive" the other public policy reason from *Procter*: that upholding the formula would frustrate the IRS's enforcement of the gift tax.[17]

D. IRS Position on Formula Clauses

The IRS's general position on formula clauses is evident from its litigating position in the foregoing cases. That position was solidified in Rev. Rul. 86-41, 1986-1 C.B. 300, which considered two gift situations -- basically the facts of *Procter* and *King*. In the *Procter*-like facts, which concerned a clause that adjusted what was transferred and was triggered by an IRS determination of value (a defined value clause), the IRS made a point of stating in the facts that under local law, the adjustment clause operated as a condition subsequent and thus, according to the IRS, its trigger would "reconvey" what had originally been conveyed. The revenue ruling described the *King*-like situation as identical except that there was no reconveyance and an IRS determination of value simply triggered a requirement that the transferee pay for the excess value -- that is, a defined consideration clause. For both scenarios, the IRS stated as a conclusion, rather than as a fact, that:

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.

Not surprisingly, the IRS concluded under the *Procter*-like facts that the formula clause is disregarded for gift tax purposes.[18] Somewhat surprisingly, without any analysis, the IRS said the factual difference in the *King*-like situation is irrelevant. The IRS's ultimate conclusion in Rev. Rul. 86-41 is that a formula clause will be disregarded in any situation in which a donor transfers property under terms that

15. This fact is similar to what the *Procter* court feared when it noted the possibility of whipsaw, and it is the same fact that was ducked by the *King* court.

16. *Ward v. Commissioner*, 87 T.C. 78 (1986).

17. The court viewed *King* as easily distinguishable, stating that "the adjustment clause in *King* operated to insure that no unintended gift was made, but the agreement here purports to retroactively alter the amount of an otherwise completed gift." *Id.* at 116.

18. The IRS cited Rev. Rul. 65-144, 1964-1 C.B. 442, in which it had previously used *Procter* to ignore a savings provision in a trust agreement calling for the revocation of trustee powers to the extent necessary to make a gift of a charitable remainder deductible for federal tax purposes. Rev. Rul. 65-144 clearly positioned the savings provision as a condition subsequent and, citing *Procter*, determined it to be void and ineffective in law on public policy grounds.

provide for a recharacterization of the transaction depending on the IRS's valuation of the property for gift tax purposes.

E. Adjustment of Recipient Based on Formula

One can safely assume that a trusts and estates lawyer in the late 1980s would have been hesitant to advise her client to rely on a formula clause to adjust a gift to a defined value based on a valuation by the IRS or a court. But what about a defined value clause that simply diverts the gift to another recipient instead of adjusting the fact that a gift was made? That clause, which I will call a "defined value diversion clause," was the situation in *McCord*,[19] in which the taxpayers in 1996 gave interests in a family limited partnership to several recipients under a single assignment agreement.

The assignment agreement in *McCord* contained a formula clause under which the taxpayers' children and trusts for their benefit each received partnership interests having an FMV of a specified amount, with any excess value going to one charity up to another specified amount of value and any residual value going to a second charity. The assignment agreement was unclear on the process by which the value was to be determined, and there was no specific trigger tied to a valuation in a tax matter or to any other event.[20] Rather, the assignment agreement simply stated that the FMV as used in the defined value clause is the price at which the partnership interest would change hands, as of the date of the assignment agreement, between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. The opinion is not entirely clear, but it appears that the taxpayers argued that because the assignment agreement defined FMV in a manner that closely tracks the applicable definition for federal gift tax purposes,[21] the assignment agreement effected a transfer that was determinable only by reference to the value as finally determined by the court for gift tax purposes. It appears that the IRS argued, citing *Procter*, that the formula clause was against public policy and therefore invalid. The Tax Court majority held for the IRS but managed to avoid addressing its argument that the defined value clause violated public policy. *McCord* was reversed in the Fifth Circuit, which vehemently disagreed with the approach applied by the Tax Court majority but similarly managed to avoid addressing the merits of the defined value waterfall, even though it followed that waterfall in its ultimate holding. In the end, it is hard to get much out of *McCord* other than the idea that a defined value clause that diverts gifted value to another recipient, rather than adjusting the total of what was gifted, is an easier case.

Beginning in 2008, several courts directly addressed formula clauses which, based on a subsequent value determination, diverted property to another recipient rather than adjusting the fact that the property was transferred in the first place. In *Christiansen*,[22] the beneficiary of an estate that consisted largely of interests in two FLPs executed a disclaimer of a portion of the estate. Under the decedent's will, the disclaimed portion of the estate passed to a charitable trust and a charitable foundation. The disclaimer was drafted so that the beneficiary disclaimed that portion of the estate equal to a fraction, the numerator of which was the FMV of the estate minus $6.35 million, and the denominator of which was the FMV of the estate. The effect of this defined value diversion clause was that the beneficiary received the first $6.35 million of value, and all excess value went to the charities. The disclaimer went on to say that the FMV of the estate was:

the price at which the [estate] would have changed hands on [the date of death] between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of [the federal estate tax law], as such value is finally determined for federal estate tax purposes.

The estate filed a tax return valuing its assets at about $6.5 million, with the consequence being that almost all of the estate passed to the beneficiary. The IRS challenged the valuation, and the parties ultimately stipulated to an increase in value of more than $3 million.[23]

The IRS maintained that the disclaimer was invalid except for the small disclaimed amount, which was based on the original valuation, and it assessed estate tax on the increase in value. This was the case even though the lawyer for the estate testified at trial that if the disclaimer were upheld by the Tax Court, he would ask the probate court to approve an additional distribution to the charitable beneficiaries based on the results of the Tax Court case. The IRS

19. *McCord v. Commissioner*, 120 T.C. 358 (2003) , *rev'd*, 461 F.3d 614 (5th Cir. 2006) .

20. The assignment agreement said that any dispute regarding allocation among assignees would be resolved by arbitration.

21. *See* reg. section 25.2512-1.

22. *Christiansen v. Commissioner*, 130 T.C. 1 (2008) , *aff'd*, 586 F.3d 1061 (8th Cir. 2009) .

23. These figures illustrate the public policy concern with discouraging the IRS from proposing an audit adjustment to a taxpayer's valuation. The stipulated value of about $9.6 million presumably represents a highly plausible value of the estate, and the value of about $6.5 million that was reported by the estate was presumably at the low end of the plausible range. If it is clear that a defined value diversion clause like that in *Christiansen* is permissible, the IRS may not expend the effort to assert and prevail on the higher valuation, and instead by default may end up accepting the lower valuation.

argued that the formula clause amounted to a condition subsequent that had no effect on the taxation of the estate, and that it was void as contrary to public policy. The Tax Court disagreed with the first argument, saying that "resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future." The Tax Court dismissed the public policy argument, noting that there is also a public policy argument for charitable giving. The Tax Court viewed *Procter* as inapplicable because the pertinent disclaimer did not undo a transfer, but only reallocated the property among the transferees, and thus the court's decision would not be moot. Finally, the Tax Court noted that the personal representative of an estate will have fiduciary obligations that act as a check on what the IRS viewed as an unbridled incentive to low-ball the valuation of the estate's assets.

The Eighth Circuit affirmed the Tax Court's decision for many of the same reasons. The Eighth Circuit gently chided the IRS for its argument that upholding the defined value diversion clause would create a moral hazard and an incentive for executors to undervalue their estates:

First, we note that the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws. . . . Second, we find no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns.[24]

In 2009, in *Petter*,[25] the Tax Court faced a similar formula in the context of a part gift/part sale rather than a disclaimer of a bequest. The taxpayer gifted, and sold for notes, interests in an FLP,[26] and the transfers were both to trusts for her children and to two charities. The pertinent documents fixed the total number of partnership units to be transferred to all recipients, then stated that the trusts for the taxpayer's children would receive the number of units that is worth a specified amount, with the further provision that if the value of the units received by the children's trusts is "finally determined for federal gift tax purposes to exceed the [specified amount, the trust will] transfer the excess units to [the charities] as soon as practicable."[27]

The Tax Court viewed *Petter* as presenting the same issues and requiring the same conclusion as *Christiansen.* The Tax Court again made it clear that *Procter* is inapplicable to a situation in which a defined value formula allocates property among recipients but does not change the total property that is transferred to all recipients – that is, a defined value diversion clause. The Tax Court dismissed the IRS's policy concerns, saying that because of the different interests of the recipients, it was not issuing a mere declaratory judgment on a moot issue. The court also viewed the different interests of the recipients as eliminating any potential for abuse.[28] The Tax Court dismissed the IRS's argument to the effect that formulas are allowed only if it explicitly says so.[29]

Petter was handled differently in the Ninth Circuit, which declined to address "the government's numerous public policy concerns" or otherwise to address *Procter*. The IRS had apparently abandoned its policy arguments but did not drop the argument that the defined value clause operated as a condition subsequent. The IRS basically argued that units were transferred on the day of the gift and then would be transferred back when there was a final determination of value, and that the transfer back could not be recognized.[30] The Ninth Circuit did not see it that way at all. Rather, in the view of the Ninth Circuit, everyone's rights were locked in by formula on the date of the gift -- the charities received a set number of partnership units, even though they did not then know what that number was, and there were no contingencies to that fact. When an upward valuation caused the charities to receive additional units that they would not have received under the original valuation, this "in no way grants the foundations rights to receive additional units; rather, it merely ensures that the foundations receive those units they were already

24. *Christiansen*, 586 F.3d at 1064.

25. *Petter v. Commissioner*, T.C. Memo. 2009-280 , *aff'd*, 653 F.3d 1012 (9th Cir. 2011) .

26. The entity was a limited liability company, but references herein to partnerships will include LLCs treated as partnerships for federal tax purposes.

27. The documents for the sale portion of the transfer had the final determination language but did not include the phrase "for federal gift tax purposes."

28. One interesting part of the Tax Court's *Petter* decision concerns the taxpayer's introduction of several other examples in the world of estate and gift taxation in which similar formula clauses are blessed. The examples are all diversion examples. They are thus highly relevant to *Petter* but less relevant to defined value cases that do not involve defined value diversion clauses.

29. *Hendrix v. Commissioner*, T.C. Memo. 2011-133 , is another case with facts similar to *Christiansen* and that the Tax Court viewed as presenting the same issues and requiring the same conclusion as *Christiansen*.

30. The IRS focused on the deduction, for gift tax purposes, for the portion of the gift that went to the charities and argued that under reg. section 25.2525(c)(3)(b)(1), the final determination acted as a condition precedent to the gift becoming effective, and thus prevented a charitable deduction on the gifting date. This is the same condition subsequent issue; it is just looked at from a different point in time. A similar rule exists for the deductibility of a charitable gift for estate tax purposes. *See* reg. section 20.2055-2(b)(1).

entitled to receive."[31] The court noted that but for the IRS audit, the charities would not have obtained additional units, yet it held that this practical reality does not mean that the charities' rights to additional units were contingent for their existence on the IRS audit. Put a different way, the Ninth Circuit viewed the formula as fixing the answer on the date of the gift even when an input in the formula (value) was not yet known and would later be determined by a third party.

Note that the Ninth Circuit in no way rested its conclusion on the distinction made by the Tax Court that a finite and known amount was gifted and that the variable related only to the identity of the recipients. Rather, the Ninth Circuit did not see a requirement that the number of units that were gifted be known. It was enough in the court's view that a formula existed that, with subsequent input would yield the number of units. Although the Ninth Circuit did not address *Procter*, the reader will notice that the Ninth Circuit's analysis is inconsistent with *Procter* and would likely result in the formula transfer in *Procter* being viewed as not a condition subsequent.

F. The Defined Value Clause Revisited

In 2012, in *Wandry*,[32] the Tax Court addressed facts very close to those of *Procter*. The taxpayers in *Wandry* formed an FLP, and in 2004 they made gifts to their children of units in that partnership. The gifts were phrased as "a sufficient number of my Units . . . so that the fair market value of such Units for Federal gift tax purposes shall be" specified amounts per donee. The gift documents went on to provide:

Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). 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, 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 Tax Court stated, as a factual conclusion, that the only gifts the taxpayers ever intended to give were of dollar amounts equal to their federal gift tax exclusions. The Tax Court said that at all times the taxpayers understood and believed that the gifts were of a dollar value, not a specified number of units. The court noted that the taxpayers had been advised by their tax attorney that under no circumstance would units be returned to them, but rather if a subsequent determination revalued the membership units that were granted, it was only the capital accounts of the partnership that would be adjusted through accounting entries to conform to the actual gifts. Schedules that were attached to the taxpayers' gift tax returns, however, converted the dollar amounts of gifts into percentage interests in the partnership (2.39 percent for the taxpayers' children) based on the taxpayers' valuation.[33] The IRS argued that the taxpayers had admitted that the transfers were of fixed percentage interests, rather than of dollar amounts of value, in the schedules attached to the gift tax return and by the effect of the accounting entries in the partnership's capital accounts. The court rebuffed those arguments, reemphasizing its perception of the taxpayers' intent. The court said that the tax return schedules reflected only what the taxpayers' accountant had calculated, rather than what the taxpayers intended, and that the capital accounts were not dispositive.[34]

The IRS also argued, citing *Procter*, that the adjustment clause is a condition subsequent to completed gifts and void as contrary to public policy. It is here that the Tax Court opinion in *Wandry* gets interesting. The Tax Court relied on *Petter*, but not its own opinion in *Petter*, or at least most of that opinion. Rather, the Tax Court slavishly followed the Ninth Circuit opinion in *Petter* even though an appeal in *Wandry* would lie to the Tenth Circuit. The Ninth Circuit in *Petter* had ignored the easy distinction from *Procter* and had instead gone straight to the view that a formula that was fixed on the day of the gift but depended on a future determination of value was still a fixed determination on the day of the gift. This then led the Tax Court in *Wandry* to the same conclusion as the Ninth Circuit

31. *Petter,* 653 F.3d at 1019.

32. *Wandry v. Commissioner*, T.C. Memo. 2012-88

33. The partnership's Form 1065 would have called for beginning and ending percentage interests as well, from which one presumably could infer a gift of a percentage interest, but the Tax Court did not mention this fact.

34. The court said that "the facts and circumstances determine Norseman's capital accounts, not the other way around." There is no indication in *Wandry* that partnership units actually existed in certificate form, and the court noted that the operating agreement provided that profits and losses would be allocated in proportion to each member's capital account.

in *Petter*, which is that the formula clause worked. The Tax Court somewhat dismissively rejected the IRS's public policy arguments as old arguments that it had previously rejected in *Petter* and *Christiansen*.[35] In short, the Tax Court jumped on the Ninth Circuit bandwagon and concluded that a defined value formula clause is neither a condition subsequent nor violates public policy, and quite simply works as intended even though the formula depends on a future determination of value.

Wandry was decided on March 26, 2012. The IRS appealed *Wandry*, but then on October 16, 2012, filed a stipulation to dismiss its appeal in the Tenth Circuit.[36] Then, on November 13, 2012, the IRS issued an action on decision[37] in which it non-acquiesced in *Wandry*, emphasizing the factual difference from *Petter*. The action on decision makes it clear that the IRS views *Petter* as a completed gift even though the identity of the particular recipients may be subject to adjustment based on a subsequent determination of value and the application of a defined value clause, whereas the IRS views *Wandry* as a completed gift of a 2.39 percent interest in the partnership in which the defined value clause creates the possibility of a return of a portion of that gift in the event of a determination of a different value than the one that was used to transfer the 2.39 percent interest but does not limit the value of what was gifted in the first place.

G. The Current State of the Gift Tax Law

According to the Tax Court, a court of nationwide jurisdiction,[38] a defined value clause works.[39] In other words, if worded properly, a taxpayer can transfer property defined as a specified value (as in $10 worth of gas) rather than a specified quantum (as in three gallons of gas). The taxpayer can take an initial position on value (as in $10 worth is three gallons), but if that position turns out to be incorrect, it is only the quantum based on the correct value that was transferred.[40] The caution here is that the IRS disagrees. In the gift tax world, the fact that the IRS disagrees has less meaning than one might think, because there is a "nothing ventured, nothing gained" aspect to a defined value clause. In other words, if the clause does not work as intended, the taxpayer just has the same valuation risk that she would have if the defined value clause were not used in the first place.

35. This is not the whole truth. *Petter* and *Christiansen* both involved defined value diversion clauses, and it is in that context that the Tax Court in those cases rejected the IRS public policy arguments.

36. Stipulation to Dismiss, *Commissioner v. Wandry* (Oct. 16, 2012).

37. AOD 2012-04 .

38. In the Ninth Circuit, there is the comfort that the Ninth Circuit agrees.

39. *Wandry* is a Tax Court memorandum decision, however -- not a regular Tax Court decision.

40. In the gasoline example, if it is determined that gas is really $5 per gallon, it was only two gallons of gas that were transferred. By using a physical asset like gas as an example, I have tried to illustrate the IRS's problem with the defined value clause, which is that the recipient actually got three gallons of gas and the only way to adjust that is to give one gallon back. For an interest in a partnership, however, which is not physical, it is easier to say that the taxpayer, with hindsight, always had less than she thought.

II. Analysis of Selected Issues

Before applying some of the principles from the estate and gift tax cases to the income tax world, it is useful to pause and consider the relevant issues.

A. Disavowal of Form

In Nestlé, the case with which this report began, both the Tax Court and the Second Circuit held Nestlé to its chosen form (which did not include a formula clause), citing *National Alfalfa*.[41] In *National Alfalfa*, the taxpayer swapped debentures with a face amount of $50 for preferred stock with an FMV of $33. The taxpayer claimed a deduction for amortization of the $17 difference between the face amount of the debentures and the FMV of the preferred stock. The Supreme Court held that no deduction was allowed for such a swap. The taxpayer pointed out that if it had structured its transaction differently, issuing the debentures for cash and then using that cash to retire the preferred shares, it would have been entitled to a deduction. The taxpayer argued that it should be taxed on that alternative structure rather than the structure it chose. The Supreme Court held that the taxpayer was not entitled to a tax result that it could have achieved only by adopting an alternative form that it did not choose. The Court said that a taxpayer "may not enjoy the benefit of some other route he might have chosen to follow but did not."

If one chooses a formula clause and reflects that clause in its documentation, there should be no risk of a disavowal-of-form argument succeeding. To the contrary, the taxpayer would be following its chosen form, including the formula clause set forth in the form. There is a need, however, to carefully and consistently follow the form. For example, in *Wandry*, the IRS argued that the taxpayers, by attaching a schedule to their gift tax return showing that a specific percentage interest in the partnership had been transferred, had admitted the truth of what happened, contrary to the formula clause. The IRS did not get far with that argument in *Wandry*. In contrast, in *Knight*,[42] the taxpayers in 1994 transferred

41. *Commissioner v. Nat'l Alfalfa Dehydrating & Milling*, 417 U.S. 134 (1974).

42. *Commissioner v. Knight*, 115 T.C. 506 (2000)

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partnership interests to trusts for their children through a document that said that each taxpayer was transferring the number of partnership units that equals $300,000 in value. But the taxpayers reported on their gift tax returns that they each gave a 22.3 percent interest in the partnership (which was the interest that mathematically equated to $300,000 of value using the taxpayers' valuation). The Tax Court disregarded the formula clause, saying that the taxpayers' tax return "shows their disregard for the transfer document" and establishes the fact that their true intention was to give a 22.3 percent interest in the partnership.[43]

B. Public Policy

The Fourth Circuit in *Procter* gave three public policy grounds for rejecting the formula clause at issue in that case. One had to do with the court system. The Fourth Circuit said the formula clause, if it worked, obstructed the administration of justice by requiring the courts to make a determination of value that was moot in the sense that no tax would be collected from it. This prong of *Procter*'s public policy argument has not resurfaced much in the subsequent cases. Obviously, this concern is less of an issue in the defined value diversion cases, in which a decision on value may not affect tax liability but does affect the identity of the recipient of a transfer. In *Wandry*, which was not a diversion case, the Tax Court dismissed this public policy concern by noting that its holding affected the percentage of the partnership interest transferred under the defined value clause and that it was thus "not passing judgment on a moot case or issuing merely a declaratory judgment." The idea that the mootness of an issue introduces a public policy concern also seems intellectually unsatisfying. If there are no taxes in dispute in the particular tax years, the court may not have jurisdiction, but it does not follow that the tax planning that resulted in no taxes being due is somehow void because of public policy. Put differently, there would not appear to be any requirement in the tax law that a taxpayer plan its affairs to ensure there is a possibility of a tax deficiency, which would then give rise to court jurisdiction.

Another prong of the *Procter* public policy analysis was the Catch-22 prong, which arose from the fact that the formula clause was triggered solely by a final judgment of a court. It would seem to be relatively easy to sidestep that problem by broadening the trigger to include other determinations of FMV. This particular aspect of the *Procter* public policy concern has not been mentioned in any of the later cases.

The remaining prong of the *Procter* public policy analysis is the most serious and has resurfaced repeatedly in the subsequent cases. It is that a defined value clause, if it works, acts in some situations as a disincentive for the IRS to challenge a valuation. *Wandry* is an example of this. I view this public policy concern to be mostly a red herring. It is one thing for the IRS to note the existence of this policy issue and even, perhaps, consider proposing legislation or promulgating regulations that might mitigate the problem. It is quite another thing to argue that the policy issue requires invalidating a defined value clause. We are a nation of laws, and the IRS's job should be to enforce those laws as they are written. That enforcement may not always be easy and may not always produce revenue. The Tax Court in *Wandry* cited with approval the Eighth Circuit's statement in *Christiansen* that the role of the IRS is to enforce tax laws and not merely to maximize tax receipts.

It is interesting that the discussions of the IRS's incentive to audit the valuation of a particular transfer tend to focus on the year in question. In other words, the observation is that upholding the defined value formula means the IRS will not collect taxes in that year. This is consistent with the fact that our system of taxation, including the filing of returns, the audit of those returns, and the adjudication of disputes regarding those returns, operates on the basis of tax years. If one takes a longer view of tax revenues, however, the observation may not be true. In *Procter* and *King*, as well as in *Wandry*, the property that is deemed not to have been gifted if the defined value clause is upheld simply remains in the potentially taxable estate of the owner, and thus the IRS at some point presumably will get its tax. In other words, the defined value clause just delays the IRS collection of tax to a year subsequent to the year in which the valuation could be disputed. The courts did not discuss this endpoint in any of the cases or otherwise view this fact as mitigating the perceived public policy offense. In contrast, the defined value diversion cases involve situations in which any excess value identified by the IRS is diverted to a charity and thus is removed from the tax system. One might perversely argue that the defined value diversion cases should be more offensive -- at least to the IRS -- from a public policy standpoint, yet these cases have been accepted by the IRS and today they are viewed as almost black letter law by trusts and estates lawyers.

There are only a few instances in the income tax world in which public policy concerns have shaped a tax conclusion that one could not have reached from the applicable law. For example, courts

43. The Tax Court also said the taxpayers' contentions in court, and some of their expert's testimony, were inconsistent with the defined value clause.

have disallowed deductions for fines[44] and bribes[45] on public policy grounds. But holdings grounded in public policy are rare and not done lightly. The Supreme Court warned in 1966, in *Tellier*,[46] that the public policy that would be frustrated by allowing the contested tax result must be sharply defined and shown by a governmental declaration, and that the frustration must be severe and immediate.

It is significant that the public policy arguments in formula clause cases derive from *Procter*, a 1944 case that predated the Supreme Court's strong warning against using public policy concerns to resolve tax issues. *Ward* is the only case since then that has held for the IRS, against a formula clause, and that has cited public policy reasons, although *Ward* cited other reasons as well. The IRS won its argument in *Harwood* and *McCord*, but not on the grounds of public policy. Interestingly, the IRS in Rev. Rul. 86-41 did not rely on public policy even as it cited a prior revenue ruling, which predated *Tellier*, in which public policy grounds were used to negate a savings clause.[47] The recent action on decision in which the IRS non-acquiesced in *Wandry* similarly does not cite public policy grounds.

In short, it seems relatively clear, despite *Procter*, that public policy concerns are not enough to overcome a properly drafted formula clause. The public policy arguments are slippery and not firmly grounded in the law.

C. Conditions Subsequent

The IRS has consistently argued that defined value clauses that operate due to a later redetermination of value create a condition subsequent. The IRS's argument is that a transfer occurs based on the taxpayer's initial position on value and that a defined value clause triggered by a later redetermination of value operates as a happening that partially terminates the recipient's interest in that property and causes a reversion. If a formula clause is viewed as creating a condition subsequent, that will be fatal to the intended operation of the formula clause except in the rare circumstance in which the condition subsequent occurs within the same tax year as the transfer, in which case the rescission doctrine might apply. That is because the successful operation of the formula clause depends on the idea that the subsequent event is simply a correction of the input into a formula that governed what happened on day 1 and that while what happened on day 1 may now be viewed differently, there was never a day 2 reversion.

The absence of a condition subsequent is easiest to see in *Christiansen* and the other diversion cases. In those cases, what was transferred was precisely known at the time of the transfer, and the subsequent knowledge alters the beneficiary of the transfer, but not the fact of the transfer itself. Assume, however, that we have the more difficult case of a transfer in year 1 defined by value rather than by precisely what was transferred (for example, an interest in the partnership worth \$100x as compared with an x percent interest in the partnership) and that a redetermination of value in year 2 triggers the conclusion that a different percentage was transferred in year 1 than was actually thought at the time. Under the fixed formula analysis of the Ninth Circuit in *Petter* and the Tax Court in *Wandry*, this is not a problem and does not create a condition subsequent.

One aspect of this issue that has not been discussed in the cases is the problem that occurs if the redetermination of value occurs a few years later, when prior consequences of the initial determination must be addressed. What if the taxpayer took the position that the transfer of \$100x of value constituted a *y* percent interest in the partnership and paid tax for the next few years on that percentage of the partnership's income. Then, in year 7, say, a court concludes that the initial value was wrong and now, under the defined value clause, the taxpayer in fact owned a lesser percentage interest in the partnership during all the intervening years. Does the taxpayer amend its tax returns for the intervening years? What about the other partners in the partnership whose percentage interest is presumably altered as well? Do they also amend their tax returns? What if some of their tax years are closed? It is easy to see that the farther out the formula clause goes, the more difficult the issues that can arise if the value is altered by a final determination.[48]

The foregoing questions should not be taken to mean that the practical issues involved in a redetermination of value and an application of that redetermined value to a formula clause are always severe. There may be cases in which the practical problems are minimal, or even nonexistent. Further, the IRS has dealt with similar problems in other areas of the tax law. For example, there are complicated rules for estimating and re-estimating income

44. *Tank Truck Rentals v. Commissioner*, 356 U.S. 30 (1958).

45. *Rugel v. Commissioner*, 127 F.2d 393 (8th Cir. 1942).

46. *Commissioner v. Tellier*, 383 U.S. 687 (1966) (individual engaged in securities business allowed deduction for legal fees of unsuccessful defense of criminal prosecution of securities law violations; the IRS's public policy argument was rejected).

47. Rev. Rul. 65-144 (the IRS on public policy grounds will ignore a savings clause stating that trust provisions are automatically modified to the extent necessary to qualify the transfer in trust for the gift tax charitable deduction under section 2522).

48. The problem is diminished, as a practical matter, to the extent that the formula clause operates to chill the IRS's interest in proposing a valuation adjustment.

inclusions from installment sales.[49] There are complicated rules for reporting gains under gain recognition agreements arising from prior outbound transfers, when economic retroactivity is achieved either through the filing of an amended tax return or not, but in either case with retroactive interest.[50] Still, it is easy to see why the IRS is bothered with an interpretation of a defined value clause that can lead to amended tax returns and practical problems associated with having to change retroactively positions that were taken in prior years. It is in this sense that the condition subsequent issue almost morphs into a policy issue.[51]

There may also be a sense that at some point, enough is enough. Earnout clauses in merger and acquisition agreements present a classic situation in which formulas are routinely used and accepted by the IRS and the courts. Such a clause would typically state that if specified post-closing hurdles (often, but not necessarily, based on earnings) are met, the buyer will pay additional consideration to the seller. There is a possible analogy to the formula clauses discussed in this report in the context of an earnout paid in stock in what would otherwise be a tax-free reorganization, in which it matters whether the earnout is viewed as separate from the original transaction and thus is taxable (analogous to the IRS's condition subsequent argument in the defined value cases) or tacks back to the original transaction and thus potentially is tax free. The IRS has published guidelines on when favorable rulings will be issued in contingent stock transactions.[52] Among the requirements are that the contingent consideration must be payable within five years, that there be a ceiling on the number of additional shares that can be issued under the earnout, and that at least 50 percent of the maximum possible consideration must not be part of the earnout.[53] The reasons for these requirements are obscure, but they undoubtedly reflect some sort of uneasiness with the condition subsequent point and the extent to which a formula can be applied with after-the-fact data to create a result that is not after the fact.[54]

It seems relatively clear that the soft spot of the analysis of a formula clause is the question whether the formula clause amounts to a condition subsequent. One reason is that the answer is to some extent in the eyes of the beholder. Some of the defined value clauses in the gift tax cases were worded in such a way that it was easy to view them as creating a transfer and a reversion – that is, a condition subsequent. In fact, it takes some fairly artful drafting of a defined value clause to avoid an inference of a condition subsequent. It also seems clear from the gift tax cases that intent counts. In other words, a formula clause is more likely to withstand scrutiny if the record is clear that the purpose of the formula clause is to more accurately reflect what occurred rather than to effect an unwind. It would be prudent for a formula clause to be drafted in a way that expresses this intent.

III. Income Tax Areas of Possible Application

After discussing case law and the principles that can be distilled from that law, it is instructive to explore some possible applications in the income tax law. This is not an exhaustive list, and it is not intended as such; rather, my purpose is to illustrate the variety of situations in which the foregoing law and principles can be applied in the world of income tax.

A. *Nestlé*

I started this report asking whether Nestlé should have put a clause in the sale agreement between Nestlé US and Nestlé Switzerland providing that in the event that the value of the Carnation intangible assets were determined to be less than the amount paid by Nestlé Switzerland to Nestlé US for the assets, the excess payment would be treated as a contribution to capital by Nestlé Switzerland to Nestlé US. The answer seems to be yes. There would then have been no disavowal by the taxpayer of the form of its transaction, which was the basis for Nestlé's loss in both the Tax Court and the Second Circuit.[55] Further, applying the condition subsequent analysis of the Ninth Circuit in *Petter* and the Tax Court in *Wandry*, everything necessary to determine the value would be fixed on the date of the transfer, as would the formula, and the mere input of

49. Reg. section 15A.453-1(c).

50. *See* reg. section 1.367(a)-8(c).

51. The *Procter* court said: "This is clearly a condition subsequent and void because contrary to public policy." *Procter*, 142 F.2d at 827. I have interpreted that statement as two separate points, but one could just as easily focus on some of the practical problems for tax administration and view them as different aspects of a single point.

52. *See* Rev. Proc. 84-42, 1984-1 C.B. 521; Rev. Proc. 77-37, 1977-2 C.B. 568.

53. The IRS guidelines do not envision favorable rulings if the issuance of contingent stock is triggered by an IRS audit, which presumably reflects the same public policy concerns discussed in this report.

54. An earnout is a harder case because there are actual post-closing events -- *e.g.*, earnings -- that trigger a reassessment of what the value was on the closing date, whereas in the gift tax cases the only thing that occurs post closing is better or more authoritative knowledge about the value on the transfer date.

numbers into the formula after the date of transfer would not change that. Perhaps more importantly, the Nestlé facts do not involve a situation in which the formula varies what was transferred, which is what was addressed in *Wandry*. Rather, the *Nestlé* situation is more akin to *Christiansen* and the other defined value diversion cases that address the situation in which what was transferred was in fact transferred and the only variable is to whom it was transferred. In *Nestlé*, the variable is the characterization of the consideration that came back to Nestlé US in connection with the transfer — as proceeds or capital contribution — not what was transferred in the first place. Thus, with a properly drafted formula clause, Nestlé US would seem to be on fairly firm ground in the case law in arguing that it could achieve the result that it wanted, but did not get, in its own litigation.

It is important to note that there is still the issue of the IRS's lack of motivation to challenge the valuation. With the formula clause I have proposed for Nestlé, the IRS would not collect immediate tax if it challenged Nestlé's valuation, which obviously enhances the chances of Nestlé's valuation being accepted without challenge. The formula clause thus operates as a tactical edge for Nestlé and a tactical disadvantage to the IRS. How fair is this? The point, of course, is not one of fairness but of whether the tactical posture presented by the formula clause is so unacceptable that the clause should be ignored on public policy grounds. It seems relatively clear, at least in the more recent case law, that there are not sufficient public policy grounds for the IRS to object in court to the neutering effect of the formula clause in this case.

B. Other Outbound Transfers

It is useful to consider the situation of other outbound transfers of property — particularly intellectual property, for which the valuation risks can be acute. In general, the US tax law is set up to tax a US taxpayer on the built-in gain in an asset if that asset is transferred to a non-US taxpayer. Assume that a US taxpayer has put valuable intellectual property into a partnership and that a non-US subsidiary of the taxpayer is the other partner in the partnership. Assume then that the US corporation sells an interest in that partnership to the non-US partner, taking the position that the interest is worth \$100x and receiving that amount in consideration. Assume further that the sale agreement states that what is sold is a partnership interest worth \$100x, not a specified percentage interest in the partnership, and that in the event of a final determination of value, the partnership's books and capital accounts will be adjusted to reflect an acquisition by the non-US subsidiary of the appropriate percentage in the partnership that equates to the \$100x of value. Would that formula clause stand up? Like the formula that I imagined for Nestlé, there is a position here that there is no condition subsequent, because the formula is fixed on the date of transfer and the only thing remaining is to plug in the pertinent inputs. This is a harder case than *Nestlé*, however, because here the formula works to vary what was transferred, not just the characterization of the consideration received in connection with the transfer. Thus, the defined value diversion cases are not particularly relevant to this question, and it is *Wandry* itself that would be the primary authority. Given the IRS's non-acquiescence in *Wandry*, one might be nervous about undertaking this transaction.

But there are arguments other than *Wandry*. Consider, for example, an outbound transfer of property to a partnership that is contemporaneous with a cash distribution from the partnership that is treated as giving rise to a disguised sale. Under section 707(a)(2)(B), the transfer is treated as a disguised sale only to the extent of the distribution. Thus, a final determination that the value of the property that was transferred is greater than what the taxpayer said it was does not result in any greater disguised sale; rather, the excess is simply considered to be transferred to the partnership in exchange for a partnership interest. This defined value formula, which is baked into the regulations,[56] does not leave the IRS with a great incentive to challenge the value of the property that is transferred, but so what?[57] It is difficult to see how the tax law should treat a direct sale to the other partner more harshly than a disguised sale to the partnership. The same comparison can be made for a section 351 transfer with boot. The transfer is taxable only to the extent of the boot,[58] and thus there is no immediate tax incentive for the IRS to challenge the valuation. Again, this is just the way the tax law works, and it has never been thought to present public policy issues.

55. For the same reason, formula transactions would not seem to be susceptible to arguments based on the *Danielson* rule. *See Danielson v. Commissioner,* 378 F.2d 771 (3d Cir. 1967). In Danielson, the Third Circuit affirmed the Tax Court's decision to bind the taxpayers to allocations of purchase price that were set forth in closing documents. The court said that "to permit a party to an agreement fixing an explicit amount for the covenant not to compete to attack that provision for tax purposes, absent proof of the type which would negate it in an action between the parties, would be in effect to grant, at the instance of a party, a unilateral reformation of the contract with a resulting unjust enrichment." *Id.* at 775. In an agreement with a formula clause, in contrast, a party is not disavowing the form of the transaction or any particular item in the transaction agreements. Rather, the party is following that form.

56. *See* reg. section 1.707-3(f), Example 1.

57. The IRS has no immediate incentive to challenge the valuation of an outbound transfer in a non-disguised-sale situation either.

58. *See* section 351(b)(1).

C. Section 83

Section 83(a) provides that if property is transferred in connection with the performance of services and is substantially vested, the service provider must include in income the excess of the value of the property over the amount, if any, paid for that property. The property that is transferred can be difficult to value precisely. This can be particularly true for private companies, and the risk can be particularly acute to a management employee who is being asked to invest a significant portion of her net worth in the company. Can one deal with this by formula? Could the company transfer to the employee the number of shares of stock that has a value of *x*, taking the initial position that, say, 5 percent of the stock of the company has that value, but with the proviso that if it is ultimately determined that a lesser percentage has that value, it is only the lesser percentage that was transferred? Absent such a formula clause, the employee would have audit risk in the year of issue — the risk that the IRS concludes that the value of the stock that she received is greater than the amount she paid for it.[59] With the formula clause, if it is respected, the employee has no such tax risk — rather, her risk is that she received less stock than she thought she did. At first blush, this seems like a bigger risk than the tax risk, and one might ask why an employee would want to risk receiving less stock. As a practical matter, however, the IRS in this case would have no incentive to challenge the value because it would be unable to create any taxable income, and thus as a practical matter the employee probably received the stock that she thought she received but without any audit risk.[60]

This approach can be contrasted to the classic approach for dealing with valuation risk, which is for the employee to whom the property is transferred to make an election under section 83(b) when the parties are most confident that the property has little or no value or that the employee has paid full value for the property. By making a section 83(b) election, the employee includes the value of the property as income when the property is received rather than when the property becomes substantially vested. There can be considerable valuation risk for the employee, however. A section 83(b) election generally is irrevocable, and that is true even when there has been a mistake in value for the property that was transferred.[61] What is more, a section 83(b) election is made in a circumstance in which the property is not yet vested because the section 83(b) election puts the valuation risk at the most appropriate point in time to take that risk and maximizes the chance of appreciation being taxed at capital gain rates. The downside of a section 83(b) election when there is a substantial risk of forfeiture, however, is that there is no unwind of the income inclusion or other tax relief in the case of that forfeiture.[62] The use of a formula clause could, as a practical matter, eliminate an employee's valuation risk on the property subject to the section 83(b) election.

Use of a defined value clause in the foregoing section 83 context is supported by the Ninth Circuit opinion in *Petter* and by *Wandry*. But from the IRS's perspective, it would seem that the section 83 context presents the same concerns that likely caused the IRS not to acquiesce in *Wandry*. And using a formula clause in the section 83 context may involve practical difficulties in implementation. It is typically stock in a corporation that is subject to section 83. Corporate stock is usually thought of as being issued in a stated number of shares, not as a formulaic number of shares. One would need to be careful in drafting to avoid what in form is an issuance followed by a possible reversion, because that form would play into an argument by the IRS that the formula clause is a condition subsequent. The practical difficulties are less in the case of a limited liability company or partnership, in which the governing laws tend to be flexible on the types of interests that can be issued.

D. Profits Interests

A profits interest in a partnership is an interest that on the date that it is issued would not give the holder a share of the proceeds if the partnership's assets were sold at FMV and the proceeds were then distributed in a complete liquidation of the partnership.[63] Put simply, a profits interest entitles the holder to profits earned or appreciation that occurs after the date that it is issued, and not to anything that has occurred before. A service provider who receives a profits interest generally does not have to treat the receipt of that interest as a taxable event.[64] Consider the relatively simple case of a private equity partnership formed to acquire all the stock of a C corporation, when the corporation is the partnership's only asset. The partnership's only profit is therefore likely to be gain on

59. The issuer would typically get an increased compensation deduction for any additional income that is taxed to the employee. In some circumstances, that fact can mitigate the systemic effect of the IRS adjustment. But many issuers have tax losses and cannot use an additional compensation deduction, and the fact that the issuer gets a tax benefit does not help the employee unless there is a gross-up or other indemnitylike arrangement between them.

60. A protective section 83(b) election might be advisable on the chance that the formula clause is considered to amount to a substantial risk of forfeiture.

61. *See* reg. section 1.83-2(f).

62. Section 83(b)(1) so provides.

63. Rev. Proc. 93-27, 1993-2 C.B. 342

the sale of the corporation when the private equity investors exit their investment.[65] A service provider at the time of the formation of the partnership can be granted a profits interest defined as *x* percent of the total profit on the sale of the corporation. Because the corporation was acquired that day in an arm's-length transaction, an interest in all the appreciation is by definition a profits interest. What if an individual becomes a service provider on the first day of year 2, it is desired that the service provider receive an interest in appreciation after that date, and that the partnership interest qualify as a profits interest? This requires knowing the FMV of the corporation on that day, and that is not an easy thing to know or something that can be established with certainty. Further, if the new service provider gets a profits interest defined by reference to appreciation above *$y*, thought to be the value on the first day of year 2, and the IRS ultimately determines that the value is greater than *$y*, the consequence is that not all of the partnership interest qualifies as a profits interest and the "in the money" value of the partnership interest is thus taxable to the manager.[66] Can a formula clause be used to remedy that problem? What if, instead, the profits interest is defined formulaically – 100 percent of the appreciation over what is finally determined to be the FMV on the first day of year 2 until the employee has been allocated an amount equal to *x* percent of the appreciation over *$y*,[67] and then *x* percent of subsequent appreciation. It would seem that this formula solves the problem. And as a practical matter, of course, it would remove any incentive of the IRS to dispute the value of the partnership at the time that the partnership interest was issued.

Use of a formula clause in the foregoing profits interest context somehow does not seem objectionable. It does not seem to have condition subsequent problems, and it is not even clear that there are policy issues, even from the IRS's perspective. What policy issues there are may have more to do with the tax treatment of profits interests, and with the characterization of what constitutes a profits interest, than with the use of the formula. Objections can arise, however, in more complicated examples, particularly in an example in which the profits interest entitles the holder to a specified portion of annual profits of an operating business and tax returns have already been filed based on allocations that were premised on the taxpayer's valuation. That example presents the specter of amended tax returns being required in the event of a subsequent redetermination of value, in order to achieve the taxpayer's intent while starting with a different value.

E. Transfer Pricing

Section 482 authorizes the IRS to make adjustments to a taxpayer's transfer pricing to clearly reflect income. It does not authorize taxpayers to make adjustments to their own prior transfer pricing. The applicable regulations contain one exception, in which a taxpayer is allowed to file its tax return reporting transfer pricing that is different from the prices actually charged during the tax year.[68] The regulations emphasize that section 482 grants no other rights to a taxpayer to apply section 482. But what if a taxpayer sells goods to a related party not for a specified price but for a price as is finally determined to clearly reflect income under the principles of section 482? Such a formula clause might go on to provide for a hierarchy of final determinations, with a final determination by a court as the highest determination, but perhaps a determination by the IRS as an intermediate point and a determination by a nationally recognized transfer pricing adviser as the first point. That formula, if it worked, would allow a taxpayer to adjust its transfer pricing after the fact, and after the tax return had been filed, based on pricing determinations of an expert. There would appear to be nothing in section 482 to prevent that formula pricing from being respected.[69] The IRS redetermination of transfer pricing could take place many years later, and there would obviously be the problem of intervening tax returns that were filed based on the original transfer price. As a practical matter, however, that problem might not arise. That is because a formula that automatically adjusts a US taxpayer's transfer pricing based on an IRS redetermination would mean that the IRS would collect no tax dollars from proposing a redetermination, and it may as a practical matter mean that there is no subsequent redetermination by the IRS.

64. *Id*. Similar treatment is proposed to be applicable, on an elective basis, to the safe harbor partnership interest described in a proposed revenue procedure included in Notice 2005-43, 2005-1 C.B. 1221 .

65. To simplify the example, I am ignoring the possibility of dividends and other interim distributions.

66. There is even the possibility under a literal reading of Rev. Proc. 93-27 that the IRS does not bifurcate the partnership interest into a profits interest and a capital interest but instead views the entire partnership interest as a single interest that does not qualify as a profits interest and therefore is taxable to the service provider to the extent of its entire value.

67. This portion of the formula operates as a catch-up, and this discussion assumes that those catch-ups are generally permitted.

68. Reg. section 1.482-1(a)(3).

69. Reg. section 1.482-1(d)(3)(ii)(B)(1) provides that written contractual terms will be respected by the IRS in its transfer pricing analysis if those terms are consistent with the economic substance of the underlying transaction. If the written contractual terms are inconsistent with the economic substance of the transaction, the IRS is allowed to disregard those terms and impute terms that are consistent with the economic substance of the transaction. As much as the IRS might not like the envisioned formula clause, it would not seem that the IRS could credibly assert that the formula clause is inconsistent with the economic substance of the transaction.

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Similarly, section 482 contains a "commensurate with the income" standard under which the IRS, after the fact and with hindsight, can adjust the transfer pricing of intangible property.[70] That adjustment is not based on a redetermination of the value of the intangible property at the time, and in the year, of transfer, but rather is based on a redetermination in light of the income that the transferee earns from the transferred property in subsequent years. It is the position of the IRS that the taxpayer cannot adjust its own transfer pricing under this provision.[71] A formula clause in a contract between related parties for the use of intangible property presumably could give the parties the right to redetermine a transfer price with hindsight based on the same commensurate-with-income standard as that standard is applied by the IRS on audit. This one seems harder. There are serious condition subsequent issues, in the sense that the formula clause is being used to alter pricing that took place in the prior year, and that alteration is triggered by facts that arise in subsequent years. Moreover, this application is likely to present in spades the problem of inconsistent treatment on prior years' tax returns based on the prior valuation, and the question of how to adjust or account for that fact. And, of course, this application, like the former one, has policy concerns regarding section 482. Section 482 by its terms is a sword of the IRS.[72] Formula clauses that operate to blunt that sword are arguably inconsistent with the purpose of section 482.

F. Elections

There are several places in the tax law where elections must be made on tax returns, and it is not always an easy task to decide whether to make those elections. Optimizing some elections can require a crystal ball -- what appears to be optimal when a tax return is filed may become suboptimal in light of financial results in future years. In some cases, the tax law prohibits taxpayers from changing the elections that were made on a tax return. A question arises whether a formula can be used to get around, in effect, a prohibition on changing an election. In other words, the question is whether a taxpayer can wait and see what the future holds, and assuming that she has been smart enough to write a formula that correctly applies the future facts, cause the prior year's election to be adjusted automatically based on what occurred in the future.

For example, section 168(b)(3)(D) provides for an election to claim slower depreciation.[73] The election is made by class of property placed in service in that year, and once made, "shall be irrevocable."[74] Would it be possible for a taxpayer to make an election in year 1 that depends formulaically on its actual taxable income in succeeding years? I think not. That election would be inconsistent with the analysis of the Tax Court in *Wandry* and the Ninth Circuit in *Petter*, which depended conceptually on there being a formula driven by year 1 facts, with the only thing that occurs in year 2 being better information about what the year 1 facts were. A much more sympathetic case for upholding a formulaic depreciation election would be an election in year 1 that is adjusted automatically to be optimal should the IRS in a subsequent year increase the taxpayer's taxable income in year 1. That fact pattern seems very close to *Wandry*.

G. Rescission

The tax law follows an annual accounting principle, which means that taxes are paid on the basis of tax years. In concept, the tax law can be thought of as looking at a taxpayer's financial status at the end of the tax year and then accounting for changes in that financial status since the end of the previous tax year. Rev. Rul. 80-58, 1980-1 C.B. 181, concludes that if a transaction is rescinded in the same tax year in which it occurred, and after the rescission the parties are in the same position as before the transaction (that is, the contract is unwound, the purchase price is returned, anything that was done under the contract is canceled, and so on), for federal income tax purposes the transaction will be deemed not to have occurred. In contrast, Rev. Rul. 80-58 says that rescission of a transaction in a later tax year will not negate the tax consequences of the transaction before the date of rescission. The IRS has issued a number of private letter rulings allowing rescission based on Rev. Rul. 80-58.[75]

An illustration of the application of the rescission doctrine can be seen in a letter ruling[76] in which the owners of an LLC converted it into a corporation under state law in contemplation of a planned initial public offering (IPO). When the owners decided against the public offering, they converted the corporation back to an LLC within the same tax year. The ruling confirmed that the IRS will treat the LLC as though it was an LLC for the entire tax year and that the period in which it was a corporation will have no tax effect. The rescission was respected by the IRS even though there was

70. *See also* reg. section 1.482-4(f)(2)(i).

71. *See* AM 2007-007 .

72. Section 482 authorizes the IRS to adjust transfer pricing if the IRS determines that it is necessary to clearly reflect income.

73. There are several similar elections elsewhere in section 168.

74. Section 168(b)(5). *See also* prop. reg. section 1.168-2(c)(1) and -5(e)(9).

75. Rescission is under study by the IRS, and rulings are no longer being issued. *See* Rev. Proc. 2013-3, 2013-1 IRB 113 , section 5.02(1).

76. LTR 200613027

no mistake involved in the original transaction and the parties were seeking to avoid a negative tax result, and despite that the entity was in fact a corporation for a portion of the year.

What if the conversion had taken place in year 1 under a binding contract providing that the conversion is premised on the IPO occurring by a specified date in year 2, and if it does not occur by that date, the corporation will be converted back to an LLC effective for tax purposes as of year 1? This would seem to be taking the formula clause too far. The fact that it is real under state law whether an entity is a corporation or an LLC means that it is very easy to view the conversion back to an LLC as a condition subsequent, and somewhat difficult to view the formula clause as a fixing of an answer on the date of the conversion that is only missing input in the formula – that is, whether the IPO occurs. Take a different transaction, such as the transfer in year 1 of the percentage of the entity that is worth *$x* based on the year 2 IPO price. This also does not fit easily in the analysis that supports a defined value clause, because the trigger is not a subsequent determination of the value on the day of the transfer, but a subsequent determination of value on a later date. In summary, it does seem possible to use a formula clause to allow, in effect, a rescission after the end of the year.

H. Other Areas

There are no doubt several other areas in the tax law in which a formula clause could be useful, including some areas in which the issue is not valuation. For example, a regulated investment company must in each tax year pay dividends of at least 90 percent of its taxable income.[77] But, of course, it is impossible to calculate taxable income with precision on December 31, and thus there is the possibility of inadvertently flunking this requirement. Section 855 contains an ameliorative provision under which a dividend that is declared before August 15 of the next year, and distributed soon thereafter but before the end of the next year, can be elected to be treated as paid in the preceding year for purposes of satisfying the 90 percent test. What if a RIC does not wish to rely on section 855 and prefers to declare a dividend on December 31 that is drafted in a formulaic way — that is, the amount that is necessary for the RIC to meet the 90 percent test in that year? Or what if the RIC is unsure even in August of the next year that it has calculated the preceding year's taxable income precisely enough? Can the section 855 dividend be declared by formula? It seems in both cases that it should be permissible in the tax law for a formulaic dividend to be declared. If anything, this is one of the most sympathetic cases for the use of a formula.[78] It is difficult to see any public policy grounds for disqualifying a RIC that is trying in good faith to meet the rules. And a formula based on the year's taxable income is by nature retrospective; it is difficult to view the calculation in the next year of that income as constituting a condition subsequent.

Another example may be section 956. In a fairly well known private letter ruling issued in 2007,[79] the IRS allowed a foreign partnership to specially allocate to a US partner income from a US business and US assets that would give rise to income inclusions under section 956, and to specially allocate to a controlled foreign corporation partner income from a foreign business and foreign assets that would not give rise to section 956 inclusions. There are obvious audit risks regarding the determinations of the two baskets of income.[80] If a particular item of income is allocated to the foreign partner but it is later determined that the income is effectively connected with a US business, the foreign partner would be a US taxpayer and the clean separation that supports the section 956 holding of the private letter ruling would be impaired. A formula clause could be used to adjust the income allocation between the two partners in the event of such a redetermination, so that any newfound US effectively connected income is by formula allocated to the US partner. Perhaps more importantly, the existence of the formula clause might chill the IRS's interest in proposing an audit adjustment.

IV. Conclusion

Formula clauses present difficult issues but also two opportunities. The first is the opportunity to fashion an optimal tax result even when a particular input — such as valuation — is not precisely known. The second, frankly, is the opportunity to create a disincentive for the IRS to challenge the taxpayer's position. The second opportunity can be particularly important for valuations, which are inherently soft and difficult to defend in case of a challenge.

The basic paradigm for an acceptable formula clause is a clause that operates as an equation in which the pertinent facts are input, in a situation in which the pertinent facts exist and the only thing that is missing is knowledge of what the pertinent facts are. An example is a clause that transfers *$x* worth of *y* units, with the missing input

77. Section 852(a).

78. Similar provisions in sections 857(a)(1) and 858(a) apply to REITs, and that may be even a more sympathetic case. That is because the underlying income of a REIT can be even more complex than the underlying income of a RIC, and thus the chance of being wrong may be even greater with a REIT than with a RIC.

79. LTR 200832024 .

80. The private ruling only addressed section 956. But a purpose of the structure is that all the income that is US-source or is US ECI is allocated to the US partner.

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being the value of a y unit and therefore how many y units it takes to be worth *$x*. The IRS accepts such a formula clause if there is no reversion when the value is later determined. For example, the IRS has accepted defined value diversion clauses in which *$x* worth of *y* units is transferred to party A, and the remaining *y* units are transferred to party B.[81] The IRS does not accept a classic defined value clause — that is, *$x* worth of y units is transferred — because to the IRS that clause presents a transfer today based on what is thought to be the value of a *y* unit, and then a reversion of some *y* units when one has better knowledge of the value of a *y* unit. The IRS has even said that it will not accept a defined consideration clause in which there is no reversion of the *y* units that are transferred based on what was thought to be the value, but rather the recipient has to pay for any excess value.[82]

Every situation is different, however, and it is important to consider the issues that are raised in the case law. Disavowal of form should not be a problem. In fact, a taxpayer is following its form when it applies a formula clause. Public policy concerns are worth considering but should not be dispositive for a properly drafted formula clause. This is true even when the clause operates as a disincentive to the IRS to challenge the taxpayer's position. The big issue with formula clauses is the extent to which they create a condition subsequent — in other words, the extent to which they can be viewed as a current transfer and then a future reversion when the formula operates. The condition subsequent issue is partly optics, and good drafting and a good purpose can help the optics. There is, however, a looming problem that has not been well addressed: the effective disavowal of, or need to correct, tax returns that have been filed based on the original position before the change caused by better inputs in the equation.

Finally, I want to emphasize that the case law described in the first portion of this report and the issues presented therein arise in the context of estate and gift taxation. While I believe those cases and their analysis should be applied in the income tax area as well, this conclusion is not entirely clear, and the IRS or the courts could disagree. Further, the favorable cases are very recent — *Wandry* is less than two years old — and may not constitute the last word on the subject. We should stay tuned.

81. *See* AOD 2012-04 and text accompanying note 61, *supra.*

82. *See* Rev. Rul. 86-41 and the discussion in Section I.D of this report. The IRS's position in Rev. Rul. 86-41 does not really make sense and may be inconsistent with the subsequent case law or even the IRS's litigating positions therein.

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Dantzler examines the use of formula clauses for income tax advantage in several contexts. He first discusses the estate and gift tax law concerning formula clauses and draws from it some legal principles and lessons that he applies in the income tax area. He focuses on the fact that a formula clause can remove the IRS's ability to challenge a taxpayer's valuation. He considers whether a formula adjustment clause creates a condition subsequent -- that is, a second transaction with independent tax significance. He also raises an issue that has received little attention in the estate and gift tax cases: the extent to which a formula clause requires a disavowal of positions previously taken on tax returns.