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Estate Planning Update Summer 2023 - Don’t Look a Gift Horse in the Mouth—but Make Sure the Price Is Right

A recent gift tax case, which settled before trial, illustrates the tax-saving potential of gifts and sales to family trusts—and also some cautions about the risks involved. In 1994, after securing loans from family and friends, brothers Chris and Robin Sorenson opened a sandwich shop called "Firehouse Subs" as a tribute to growing up in a family of firefighters. Eventually the business expanded, and by 2014, they owned 27 restaurants, had 823 franchisees and saw more than $500 million of annual sales per year companywide. In light of their good fortune, Chris and Robin decided to leverage their lifetime gift tax exemption (then $5.34 million) and transfer some of their interests in the business. On December 31, 2014, Chris and Robin each created a grantor trust and gifted $5 million of nonvoting stock to their respective trusts using a defined value clause, made famous by a tax court case known as *Wandry v. Commissioner*, T.C. Memo 2012-88. A *Wandry* clause is essentially a formula permitting a taxpayer to determine a gift's fair market value for federal gift tax purposes by referencing a fixed-dollar amount rather than a fixed quantity of property. In this case, company shares having an appraised fair market value of $5 million were transferred to a trust. However, the gift document provided that if the IRS ultimately determined the fair market value of the stock was higher, the number of shares gifted would be adjusted in order to ensure that the amount gifted had a value of $5 million when taking into account the increased valuation. In determining the value of the interests being gifted, the brothers relied on an appraisal that valued each nonvoting share at $532.79 as of December 31, 2014. This valuation resulted in a transfer of 9,385 nonvoting shares to each brother's trust, subject to later adjustment under the *Wandry* formula. When filing their respective 2014 gift tax returns, the brothers disclosed the use of the *Wandry* formula for calculating the gifts and acknowledged that the number of shares ultimately transferred may be adjusted once the value was finally determined for federal gift tax purposes. On March 15, 2015, each brother sold 5,365 nonvoting shares to his trust. In determining the sale price, they used the December 31, 2014 appraisal of $532.79 per nonvoting share, for a sale price of just under $3 million. The brothers did not use a *Wandry* clause for the sales and did not choose to report the sales on their 2015 gift tax returns. The IRS audited the 2014 and 2015 gift tax returns. The IRS refused to recognize the *Wandry* clause in the 2014 gifts. The IRS supported its position by pointing at particular facts, including that the trusts were shown as the owners of the gifted shares in business records, distributions were made on that basis, the trusts never agreed to transfer shares back to the brothers in the event of an audit adjustment and the trusts never transferred any shares back to the brothers (because the business was sold). The IRS also claimed *Wandry* was wrongly decided. The IRS also argued that the appraisal of the shares as of December 31, 2014, was too stale for use in determining the price for the March 15, 2015 sales—a mere two-and-a-half months later. The IRS assessed a total of $18 million of gift tax and penalties against each brother. The brothers brought the case to the Tax Court. On November 15, 2021, while the case was pending, the business was sold for $1 billion, which resulted in each trust receiving $153 million. In 2022, the IRS and the brothers reached a settlement prior to the case being heard by the Tax Court. The brothers and the IRS agreed to a value per nonvoting share that fell between the brothers' valuation and the IRS' valuation (but closer to the IRS' valuation), resulting in an ultimate gift tax liability of $6,516,045 and penalty of $251,605 per brother. Considering the amount ultimately received by the trusts on the sale of the business, this represented a great deal for the brothers. Perhaps the IRS will be satisfied with the capital gains tax on the 2021 sale. There are several lessons we can take away from this case:

- Current valuations should be used for all transfers. Valuations that are stale, even by a few months, may be challenged.
- When using *Wandry* clauses, properly drafting the gift documentation is not enough. Pay careful attention to documenting the potential for adjustment in corporate records and trust records.
- The IRS may still challenge *Wandry* clauses on public policy grounds.
- When considering the use of *Wandry* clauses, weigh the advantages and disadvantages. If the *Wandry* clauses had been enforced in this case, payment of gift tax would have been avoided, but the adjustment would have resulted in less money in the trusts and more money remaining in the brothers' estates. In this case, paying rather than avoiding the gift tax resulted in a better deal for the brothers.

If you have any questions about gifting of simple or complicated assets, please contact your Day Pitney estate planning attorney.