TAX COURT CASE UPDATE

Citation:

Estate of Anne Y. Petter, et al. v. Commissioner, 108 AFTR 2d 2011-5593 (653 F.3d 1012), August 4, 2011.

Overview:

In this federal gift tax case, the 9th Circuit unanimously affirmed the Tax Court's determination that the taxpayer's defined value gift clause was enforceable under state law and was to be respected for federal gift tax purposes.

The Facts:

On the advice of an estate planning attorney, the decedent created various trusts and a family LLC. In 2002, she gifted and sold interests in the LLC to various trusts and also gave LLC units to two public charities.

The division between the charities and the trusts was accomplished via a formula. There were similar clauses in the sale and pledge documents. Both trusts actually paid their note obligations. The charities were effectively represented by separate counsel. The transfers were appraised by a qualified appraiser. The transfers were fully disclosed with all of the documentation on the decedent's federal gift tax return.

On audit of the federal gift tax return, the IRS argued for a higher unit value than that opined by the decedent's appraiser. Additionally, the IRS argued that the defined value gift clause was unenforceable and violated public policy.

At trial, the Court went through a history of the defined value gift/sale case law, beginning with *Commissioner v. Proctor* in 1944 and continuing until the 8th Circuit affirmed *Christiansen v. Commissioner* in 2010.

The Court distinguished the Petter transaction in that it was not a savings formula. He disagreed with the IRS, noting:

> The plain language of the documents shows that the decedent was giving gifts of an ascertainable dollar value of stock; she did not give a specific number of shares or a specific percentage interest in the [LLC].

With respect to the public policy argument of the IRS, the Court also disagreed, noting:

> And the facts in this case show charities sticking up for their interests, and not just passively helping a putative donor reduce her tax bill. The foundations here conducted arm's-length negotiations, retained their own counsel, and won changes to the transfer documents to protect their interests. Perhaps the most important of these was their successful insistence on becoming substituted

> members in the [LLC] with the same voting rights as all the other members. By ensuring that they became substituted members, rather than mere assignees, the charities made sure that the [LLC] managers owed them fiduciary duties.

Discussion:

On appeal, the IRS asserted that the Court ignored its argument that Treasury Regulation Section 25.2522(c)-3(b)(1) precluded the deduction for the "additional" LLC units.

With respect to the IRS's argument that the "excess units to the foundation" clause in the transaction documents left the gifts undefined when made, the 9th Circuit stated:

> We disagree. Although the reallocation clauses require the trusts to transfer excess units to the foundations if it is later determined that the units were undervalued, these clauses merely enforce the foundations' rights to receive a pre-defined number of units: the difference between a specified number of units and the number of units worth a specified dollar amount. And that particular number of LLC units was the same when the units were first appraised as when the IRS conducted its audit because the fair market value of an LLC unit at a particular time never changes. Thus, the IRS's determination that the LLC units had a greater fair market value than what [The decedent's] appraisal said they had in no way grants the foundations' rights to receive additional units; rather, it merely ensures that the foundations receive those units they were already entitled to receive. The number of LLC units the foundations were entitled to was capable of mathematical determination from the outset, once the fair market value was known.
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> Ultimately, the IRS argues that because the foundations would not have received the additional units but for the IRS audit, the additional transfer of units to the foundations was dependent upon a condition precedent. Adopting the IRS's "but for" test would revolutionize the meaning of a condition precedent.

The 9th Circuit rejected the IRS's Section 2001(f)(2) argument by pointing out that the documents did not specify the value of an LLC unit. The 9th Circuit further noted that the "court" in Section 2001(f)(2) is broad enough to include a state court, and that the foundations clearly had a right under applicable state law (Washington) to contest the valuation.

The 9th Circuit further determined that Treasury Regulation Section 25.2522(c)-3(b)(1) does not bar the charitable deduction for the units, "is consistent with" the 8th Circuit's decision in *Christiansen v. Commissioner*. The 9th Circuit also noted that the IRS had expressly abandoned its public policy arguments against defined value gifts, finding the above regulation to be clear and unambiguous.

Conclusion:

This is not the first case that has accepted the use of formula clauses although the IRS is still trying to get them banned as being against public policy.