

## **TAX COURT CASE UPDATE**

### **Citation:**

*Estate of Sheldon C. Sommers, et al. v. Commissioner*, T.C. Memo 2013-8, January 10, 2013.

### **Overview:**

The Tax Court held that transfers of interests in a limited liability company (LLC) to family members were completed gifts for federal gift tax purposes even though the transfer documents were not completely filled in at the time they were signed, but were completed a few months later when the valuation report was completed.

### **The Facts:**

The decedent owned a valuable collection of original art by world famous artists. He had been married twice and had no children. He was survived by his second wife and by three nieces.

The decedent retained an attorney to advise him on the transfer of 12 of his works of art to his nieces without incurring any gift taxes. The art work was appraised at a value of \$1,750,000. The attorney recommended that the decedent and the nieces form an LLC to own the art and that the decedent make gifts of his interest in the LLC to the nieces over multiple years. The proposed plan contemplated making gifts of LLC units to the nieces over more than one year so the decedent could take advantage of both the increase from \$675,000 to \$700,000 in the gift tax exemption that was scheduled to take place in 2002, and multiple \$10,000 gift tax annual exclusions for each of the nieces. The plan was for the decedent to give LLC units to the nieces in 2001 in an amount not to exceed \$675,000 plus three \$10,000 annual exclusions. The decedent would transfer any remaining value of LLC units in 2002. An appraiser was retained to value the interests in the LLC.

Pursuant to the plan, in December 2001, an LLC was formed, the decedent transferred the 12 works of art, and the decedent and his nieces signed an operating agreement governing the LLC. The agreement placed restrictions on transfers of units, required unanimous member consent for many actions relating to management of the LLC and its assets, and provided that all controversies among the members had to be referred to mediation and arbitration. As of December 2001, the decedent owned 99 percent of the voting units and 98 percent of the nonvoting units in the LLC. The balance of both units was acquired by the nieces, one-third each, for cash.

In December 2001, the decedent executed three documents entitled "Gift and Acceptance of Capital Units," which provided for the transfer of an unspecified number of voting and nonvoting units in the LLC to each of the nieces. Each niece also signed the documents accepting the units transferred to her. The documents left the number of such units transferred to each niece blank.

In January 2002, the decedent and the nieces executed identical documents. As with the

December transfers, the documents left the actual number of units transferred to each niece blank. The attorney explained to the decedent that until receipt of the appraisal valuing the interests in the LLC, the number of LLC units to be transferred to each niece must be left blank; the number would be filled in based on the appraisal report so as to avoid gift tax on the transfers.

The attorney retained the signed original documents. In March 2002, the appraiser completed its valuation of the interests in the LLC. On the basis of the valuation report, the attorney computed the maximum number of LLC units to be transferred to the nieces under the original 2001 and 2002 gift documents.

In April 2002, the nieces met with the attorney and expressed their unhappiness with the outcome because, ultimately, they would be co-owners of the LLC with the decedent's wife. The attorney suggested that the decedent transfer the balance of the interests to the nieces in 2002, and that the nieces should pay the gift tax that would be attributable to the decedent's 2002 gift over the exclusion amount. The nieces chose to follow the attorney's suggestion and the attorney then completed the original 2001 and 2002 gift documents by eliminating the blanks and identifying the interests transferred.

In addition, the attorney modified the original 2002 gift document by adding a new paragraph that provided that the donee agreed "to pay the gift taxes, if any, relating to the gift of the units, including any gift taxes, penalties, and interest that may later correctly be assessed." The modifications did not affect the signature page of the document. The attorney then delivered the finalized 2001 and 2002 gift documents to the nieces. Gift tax returns were filed reporting the gifts. The decedent died in November 2002.

Upon the decedent's death, the estate argued that the 2001 and 2002 gift documents, because they were incomplete when signed, did not reflect completed gifts of the LLC units for federal gift tax purposes. Rather, the estate argued, because the 2001 and 2002 gifts were made in blank, the decedent retained the power to alter, amend, revoke, or terminate those transfers, a power that he relinquished in April 2002, by permitting the attorney to deliver the completed gift documents to the nieces.

The estate pointed to Section 2038(a)(1), which includes in a decedent's gross estate interests in property transferred where the transfer on the date of death was subject to the decedent's exercise of a power to "alter, amend, revoke, or terminate" the transfer, and to Section 2035(a), which requires the inclusion in a decedent's gross estate of property interests with respect to which the decedent relinquished, within three years of death, a Section 2038 power to alter, amend, revoke, or terminate the transfer thereof. On the basis of those two provisions, the estate argued that the LLC units transferred to the nieces remained part of the decedent's gross estate and that no gift taxes should therefore be imposed.

The IRS argued that the gifts were completed gifts in 2001 and 2002, or in the alternative, that the transfers to the nieces were completed gifts in 2002 when the blanks on the original 2001 and 2002 gift documents were filled in and the completed documents were delivered to the nieces in 2002.

**Discussion:**

The Tax Court rejected the estate's argument that the gifts were not completed gifts in the years made. The Court interpreted the 2001 and 2002 gift documents in the context of the overall agreement among the decedent and his nieces, which was for the decedent to give his LLC units to them free of any obligation on his part to pay gift tax. The Court found that the intent of the parties was that once they had received the appraiser's valuation, the blank LLC share amounts would be filled in on the basis of that valuation. The Court stated that the blanks manifested the parties' intent to have the attorney complete the gift documents consistent with their agreement that the decedent would give his LLC units to the nieces free from federal gift tax. The Court believed that the parties' intent with respect to the blanks was not to grant the decedent the right to alter, amend, revoke, or terminate it.

The Court found that when the appraiser's valuation came in higher than expected, the attorney advised the nieces that the decedent could not transfer all of his LLC units and still avoid gift tax. The Court believed that the attorney and the nieces were able to preserve the terms of the original agreement by having the nieces agree to pay the 2002 gift tax associated with the 2002 gift, and the original 2002 gift document was modified to reflect that undertaking on the part of the nieces. The Court concluded that the modification to the 2002 gift document carried out the parties' original agreement and did not alter or amend the gifts and found that the filling in of the blanks was a ministerial act of completing, not revising or abandoning, the terms of the parties' original agreement. The Court stated that one substantive change that did occur (i.e., the nieces undertaking to pay any gift tax) was required and previously contemplated as a means of satisfying the one condition that had been built into the original agreement - that the decedent not be subject to gift tax. The Court found that the decedent's acquiescence in the attorney's distribution to the nieces of the completed 2001 and 2002 gift documents in April 2002 was further evidence that those documents reflected and carried out the decedent's understanding of the parties' original agreement.

**Conclusion:**

The court concluded that the decedent made taxable gifts to the nieces in December 2001 and January 2002, and did not retain the power to "alter, amend, revoke, or terminate" those gifts within the meaning of Section 2038. Therefore, the LLC units were not includable in decedent's gross estate.