Cannon Insights
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Taxes—IRS Loses LLC Case Involving LLC, IDGT, and Defined-Value Clause

Estate freezes involving family limited liability companies (LLCs), intentional defective grantor trusts (IDGTs), and charitable giving are often discussed, but real-life situations in which these techniques are elegantly combined rarely reach the public eye except in a court of law. A recent court case, *Estate of Petter v. Commissioner*, lays the facts bare, provides insight into how the IRS might attack such techniques along, and illustrates how advisors can insulate clients from a successful attack.

The Facts

The facts of this case are complicated. Here's the gist:

- Anne Petter received a large inheritance of UPS stock;
- In an effort to minimize impending estate taxes in the event of her own death, she formed two trusts (family trusts), one for each of her children, with essentially identical terms. She also formed a family LLC (Petter LLC) and transferred her UPS stock to it in return for membership interests.
- Next, she transferred, via a transfer documents, enough LLC units to the family trusts so that the *dollar value* equaled the remaining balance of her lifetime exemption amount created by the unified credit (one-half of the remaining exemption to each trust). In order to determine the number of units to transfer to the trust, the membership units were appraised by a professional appraiser who discounted their value to about 59 percent of the value of the underlying assets (UPS stock). The discount was largely attributed to lack of marketability of the LLC units due to transfer restrictions in the LLC operating agreement.
- She also sold additional LLC units of a defined dollar amount to the trusts via an installment note, based on the valuation previously obtained. The amount sold to the trust represented 90 percent of the value of all assets held by the trust. The trusts were designed as IDGTs so that the sale would not generate a taxable gain to the seller/grantor.
- In addition, Mrs. Petter made gifts to two charities of a defined dollar amount utilizing the remaining LLC units and claimed an income tax charitable deduction based on the their appraised value.

- The transfer documents contained a *reallocation clause*, which provided, essentially, that should the IRS determine a higher gift tax value for the LLC units (a smaller discount), the number of units gifted and sold to the trusts would be reduced to equal the defined dollar value specified and the units not passing in trust would transfer to the charities.

The litigation that gave rise to the 9th Circuit's eventual decision in this case began when on audit the IRS in fact attached a higher value to the LLC units than Mrs. Petter's appraiser—the IRS allowed only about a 25 percent discount.

From the IRS's perspective, this higher valuation had two significant gift tax consequences:

- **First, it meant that the Mrs. Petter had underreported the value of the units transferred as gifts to the trusts and, accordingly, that her gifts exceeded the unused portion of her lifetime unified tax exemption.**
- **Second, it meant that the shares sold to the trusts were sold for "less than full and adequate consideration," and thus were transferred partly by sale and partly by an additional gift (about $2 million) to each trust, computed by deducting the price of the installment notes from the fair market value of the shares transferred.**

Additionally, the IRS concluded that the defined-dollar formula clauses were void as against public policy and refused to allow Mrs. Petter to take an additional charitable deduction for the value of the additional units that would pass to the foundations following the upward valuation. As a result of its audit, the IRS issued a notice of tax deficiency for $2,115,797.

Mrs. Petter filed suit in tax court seeking a redetermination of the value of the LLC units. However, shortly before the case went to trial, Mrs. Petter and the IRS settled on a higher valuation amount—about a 30 percent discount. This caused approximately 9,000 units to be diverted from the trusts to the charities for which Mrs. Petter claimed an additional charitable deduction.

After a trial, the tax court determined that Mrs. Petter was entitled to an increased charitable deduction based on the value of the additional LLC units transferred to the charities. Specifically, the tax court held that the dollar formula and reallocation clauses used to effect the additional transfers were not void as against public policy and that the foundations' receipt of additional units was not subject to a condition precedent:

"[i]f, as of the date of the gift, a transfer for charitable purposes is dependent upon the performance of some act or of the happening of a precedent event in order that [the transfer] might become effective."

Holding and Rationale

As both the tax court and the appeals court noted, the IRS's argument is nothing new. There has been a long line of litigation around when certain gifts are subject to a prohibited "condition precedent." In general, the law distinguishes between clauses that condition a contribution on the occurrence of an event (such as an IRS audit and reevaluation) and those which merely adjust the amount of a gift after the gift has been made.

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In the words of the 9th Circuit:

"Contrary to the IRS's argument, the Taxpayer's transfer documents do not make the additional transfers of LLC units to the foundations dependent upon the occurrence of an IRS audit. Rather, the Taxpayer's transfers became effective immediately upon the execution of the transfer documents and delivery of the units. The only possible open question was the value of the units transferred, not the transfers themselves."

The court goes on to say:

"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 Moss Adams 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 to which the foundations were entitled was capable of mathematical determination from the outset, once the fair market value was known."

Bottom Line

The case is a tribute to the careful planning and drafting undertaken by Mrs. Petter's estate planning attorney. The attention to detail in no doubt favorably affected the outcome of this case. The planner:

- Combined a defined-value clause with a reallocation clause that clearly avoided the condition precedent trap;
- Obtained a professional appraisal of the LLC units; and
- Properly flied the gift tax returns and fully disclosed the nature of the underlying transactions.

The combination of these actions assured that the gifts in trust resulted in no gift tax payable, that the sale to the trust would not be re-characterized as a part-gift, part-sale transaction, and that an additional charitable deduction was available for additional LLC units contributed to charity.

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