

ANOTHER ATTACK ON DEFINED VALUE CLAUSES FAILS

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In the previous [posting](#) on June 23, 2011, we discussed the use of charitable lid/defined value clause planning, and how it had recently been upheld in by the Tax Court in *Hendrix*. Such planning has now successfully weathered another attack – this time in the 9th Circuit Court of Appeals in *Petter*. This time, the IRS dropped its public policy objections and focused on denial of the gift tax charitable deduction for additional amounts passing to charity by reason of a revaluation of gifted or sold property under regulations prohibiting a condition precedent to a deductible charitable gift.

In *Petter*, the taxpayer transferred UBS stock to a family LLC. She then gifted LLC units to two trusts and a charitable organization. The gift was accomplished via a transfer of a fixed number of LLC units. A formula was employed to allocate the transferred units between the two trusts and the charitable organization. The amount allocable to the trusts was intended to equal the value of the taxpayer's unused unified tax exemption. More specifically, the allocation clause allocated to each trust a portion of the LLC units equal to "one-half the [maximum] dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be \$907,820, so that the amount of this gift should be \$453,910." To the extent the value of the transferred LLC units exceeded this allocation to the trusts, such remaining LLC units from the transfer were allocated to the charitable organization. The transfer documents also provided that if the value of the units was finally determined for federal gift tax purposes to be different than as originally computed, the trusts and charitable organization would reallocate those units amongst themselves in accordance with that final determination. Subsequent to the gift, a sale of additional LLC units to the two trusts was undertaken on an installment basis. The sold units were allocated to the two trusts and another charitable organization in a similar manner.

The LLC interests were eventually revalued higher than the value used on the Form 709. This triggered additional units passing to the charitable organizations.

Generally, gifts to charities are not subject to gift tax pursuant to the gift tax charitable deduction under Code Section 2522(a). However, no charitable deduction is allowed "[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" (emphasis added). Treas. Reg. Section 25.2522(c)-3(b)(1). The IRS argued that the transfer of the additional LLC units to the charities is subject to a condition precedent within the meaning of that regulation. The condition precedent is the IRS audit that ultimately determines that the reported value of the LLC units is too low and triggers the additional transfer.

The IRS further bolstered its argument by citing Code Section 2001(f)(2). That provision provides that a value as finally determined for gift tax purposes means the value shown on the taxpayer's return unless the IRS audits and challenges the value. The IRS thus argued that under the taxpayer's formula, the value, and thus the amount passing to charity, was fixed by the value reported on the gift tax return. Any IRS action to change that value was a subsequent action, and thus a necessary precedent event, to increase what passes to the charity - thus that increase would be a prohibited precedent event to the transfer at the time of the gift.

The appellate court found that there was no condition precedent - the Taxpayer's transfers became effective immediately upon the execution of the transfer documents and delivery of the units. The only post-transfer open question was the value of the units transferred, not the transfers themselves. The court stated the "clauses merely enforce the foundations' rights to receive a pre-defined number of units...Thus, the IRS's determination...in no way grants the foundations rights to receive additional units." Similarly, the court noted "that value was a constant, which means that both before and after the IRS audit, the foundations were entitled to receive the same number of units. Absent the audit, the foundations may never have received all the units they were entitled to, but that does not mean that part of the Taxpayer's transfer was dependent

upon an IRS audit." If the charities did not agree with the reported value, they could have brought suit to determine the proper value applying the gift tax definition and thus did not need an IRS audit to get all they needed (although the court notes this was unlikely to occur).

The appellate court overcame the IRS' argument that Code Section 2001(f)(2) set the value as finally determined for gift tax purposes at the returned value, by noting that Code Section 2001(f)(2) applies to set the value as finally determined for purposes of gift only for purposes of applying Code Section 2001(f)(1) which relates to determination of values only after the period for assessment of tax has expired. Code Section 2001(f)(2) does not apply to set that value for other Chapter 12 gift tax purposes.

The decision is important for several reasons. It applies a well-reasoned and supported appellate court defeat to the IRS' condition precedent argument. Also, it may signal IRS surrender on the public policy arguments it has been asserting, per its withdrawal of those arguments from the appeal issues. Lastly, another Circuit Court of Appeal is voicing its approval of the formula clauses.

The appellate court invites the IRS to seek a change in the law if it is troubled by these clauses. One hopes that Capital Hill would resist such changes. While the clauses can be subject to abuse, for the majority of taxpayers they provide a mechanism to allow them to make full use of available transfer tax exemptions without being subject to the risk of taxes arising from challenges to a good faith valuation.

Petter v. Commissioner (9th Cir. 2011)

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