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Dear Clients and Friends:

A recent Ninth Circuit case provides new planning opportunities for persons who wish to combine family entity planning with charitable giving. Such planning can be advantageous for taxpayers who contemplate making significant gifts to charities and to their children, but who also want to avoid uncertain gift tax consequences. The recent case confirmed a method to give interests in family entities to succeeding generations and charities in a manner that fixes the tax liability irrespective of any subsequent IRS audit.

Petter (the senior generation) was willing to transfer LLC interests to charities and to her two children provided she did not pay any gift tax. The Petter Family LLC contained publicly traded securities. Anne transferred membership interests pursuant to a formula. The children received membership units equal in value to one-half of Anne's gift tax exemption, and the charities received the balance. Each child was obligated to transfer LLC units to the foundation if the final gift tax value (e.g. after audit) exceeded the exemption.

Anne obtained appraisals and provided them to the charities. The charities' counsel participated actively in the valuation process. The charities then executed gift agreements with Anne, and received the calculated number of membership interests, based upon the appraised value. The gifts to the charities qualified for a charitable deduction, and Anne reported net taxable gifts equal to her exemption.

Anne's gift tax return was audited. The taxpayer and the government agreed that the value for each LLC interest was approximately 39% higher than the appraised value. Each child promptly transferred units to the respective charities in order to limit Anne's taxable gifts to her exemption based on that increased value. The government sought to impose a gift tax on Anne for the increase in value, without regard to the transfer to the charities.

If Anne had structured the transaction so that her children would return to *her* interests whose value upon audit exceeded her gift tax exemption, Anne would have paid tax on the amounts actually gifted, irrespective of the returned interests. Instead, the gift agreements signed by Anne's children and the charities increased the gifts to the *charities*. Anne claimed an additional gift tax charitable deduction for the "excess" units that the children were obligated to transfer to the charities. The Tax Court held that Anne was entitled to a gift tax charitable deduction for those additional excess units, and the Court of Appeals agreed.

The key to the taxpayer victory was a well drafted gift agreement. The Tax Court made note of the concessions that the charities had obtained in connection with the gift agreements. The Court of Appeals



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reviewed the provisions of those agreements in detail, concluding that the contractual formula established the amount of the gift from the time they were signed. Anne's children transfer of the excess units to the charities was simply a performance of those contractual duties.

Anne incurred no tax liability because she had structured the transaction to provide that the charities would receive any additional LLC interests. She was able to transfer a set amount of membership interests, while fixing her gift tax liability from the outset and allowing the gift tax consequences to be predicted with greater certainty. Family members might thereafter redeem or reacquire the charities' membership interest in the family entity, keeping ownership of the entity within the family, benefiting the donor's family and her favorite charities, all the while having certainty as to the gift tax consequences.

The form of gift agreement and formula clause approved in this case may be used in a variety of planning contexts. A donor may use a formula clause to limit the amount of her lifetime gift tax exemption to be applied to specified gifts. A donor may use a formula to divide gifts between children and grandchildren and to fix the amount of her generation-skipping transfer tax exemption that would be applied to particular gifts. A donor may even be able to structure the transaction to have a spouse, rather than charities, be the remainder beneficiary of a proposed gift.

If this planning is of interest, please call so that we can discuss its particular applicability to your planning circumstances and goals.

Very truly yours,

HARTOG & ASSOCIATES, INC.