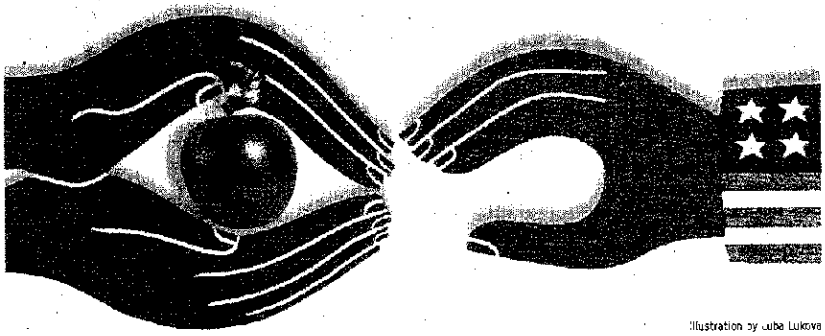

Illustration by Luba Lukova

TAX REPORT | By Laura Saunders

IRS Loses a Gift-Tax Battle

Wealthy taxpayers who want to make large gifts to family members recently got good news: A federal appeals court affirmed a popular technique to sidestep gift taxes.

The decision, *Estate of Petter v. Commissioner,* was published in August by the Ninth Circuit in San Francisco. It joins earlier rulings on related issues by the Eighth and Fifth circuits. All the cases originated in Tax Court, but appeals go to the federal circuit court in which the taxpayer lives.

"These decisions make it easier for senior family members to transfer hard-to-value assets to heirs and charity with reduced gift-tax risk," says John Porter of Baker Botts in Houston, who argued all the cases. These and other victories have made him a rock star in the staid trust-and-estates bar.

The Internal Revenue Service declined to comment on the case.

The techniques affirmed by the Petter case are especially relevant now, says estate attorney Howard Zaritsky of Rapidan, Va. With asset values low and the estate- and gift-tax exemption slated to snap back to $1 million in 2013 from its current $5 million level, many are considering making large gifts.

But there is a hitch: valuations. These are always an issue with large gifts, especially with real estate or a business. What if the IRS challenges an estimate and wants more gift taxes? Many taxpayers are loath to write a check, and some don't have ready cash. Petter offers a solution.

Anne Petter was a Washington state teacher who died in 2008. In 1982 she inherited United Parcel Service stock from an uncle who was among the company's first investors. In May 2001, when the top gift- and estate-tax rate was 55%, she held $22 million of stock.

Estate planners advised Ms. Petter to transfer all the UPS stock to a limited-liability company. Then she both gave and sold units of the LLC to two of her children in 2002.

Why do this? In the eyes of the law, putting stock into an LLC lowers its value when units are given away or sold. That's because no one member of the LLC owns a controlling interest in it, and units can't easily be traded. This strategy also allowed Ms. Petter to retain some control. Being charitable, she also gave units to a local nonprofit with a donor-advised fund.

Ms. Petter claimed that putting the stock in the LLC entitled her to a 51% discount from its market value on the transfers made to her children. The IRS challenged that, and the two parties ultimately settled on a 36% discount.

The crux of the case: Was gift tax due once the discount dropped to 36% from 51%? Because each LLC unit had a smaller discount than Ms. Petter first assumed, it took fewer units to reach the gift-tax exemption, which was $1 million at the time. The revised discount also raised the price of the units her children bought.

As a result, some LLC units transferred by Ms. Petter weren't covered either by the gift-tax exemption or the amount her children paid her. The IRS said she owed gift tax on the transfer of these units. But she had specified that in such a case they would bounce to her IRS-registered charity—with no gift tax due.

The IRS didn't like that one bit, because it meant the penalty for an exaggerated discount was simply a donation to a charity, not a check to Uncle Sam.

"The government said if Ms. Petter prevailed, it had no incentive to audit," says Carlyn McCaffrey, an attorney at McDermott, Will & Emery in New York. The IRS's real fear, says retired tax expert Tom Ochsenschlager, is that without audits, taxpayers could "get away with murder on valuations."

The courts sided with Ms. Petter, giving a lift to taxpayers and charities, if not the IRS.

Some experts hope the decision can be broadened to include a spousal trust or perhaps a grantor-retained annuity trust benefiting heirs instead of a charity.

Others warn that the IRS has the power to change its own regulations to invalidate Ms. Petter's strategy. Mr. Zaritsky's advice: "Taxpayers interested in these transactions should do them soon."

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