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Wealth transfer opportunities only get better

October 25, 2011 2:45 PM

By John Dedon



The struggling economy continues to challenge most business owners. However, for business owners who have held their ground in this economic downturn and have assets that need to be protected, the wealth transfer opportunities could not be better. An August 2011, Ninth Circuit Court of Appeals decision, *Petter v. Commissioner*, provides even more good news for business owners and their estate planning objectives. The decision also provides a shot in the arm for charities who are suffering in this economic downturn.

Prior to discussing the *Petter* case, however, let's briefly note the factors presenting the "perfect storm" for business owners and estate planning.

1. As businesses and real estate values have held steady or declined, it is an opportune time to transfer these assets at relatively low values prior to expected appreciation.
2. Assets can be transferred at discounted values for gift tax purposes. Thus, beyond the low asset values due to a stagnant economy, oftentimes another 25 percent to 45 percent discount applies for gift tax purposes.
3. Techniques used for estate planning, where assets are gifted or sold, often rely on an IRS prescribed interest rate. If the transferred assets appreciate at a greater rate than the applicable federal interest rate, the assets are removed from the business owner's taxable estate. Current IRS interest rates are historically low (e.g., under 2 percent).
4. The Obama administration, at the urging of the IRS, is asking Congress to curtail or eliminate various transfer strategies, including the use of the discounts mentioned above. Proposed law could adversely affect these strategies as soon as 2012, making the remainder of 2011 a prime time for gifting.
5. Finally, current law allows taxpayers to transfer assets worth as much as \$5 million (\$10 million for a married couple) without incurring transfer tax. This exemption amount will drop automatically to \$1 million in 2013, and there is speculation Congress may reduce it in 2012.

These advantages have been widely discussed over the last several years, particularly since December 2010, when the extension of the Bush tax cuts also allowed the \$5 million exemption amount. So what is new? What is new takes us back to the *Petter* case.

Petter is noteworthy for two reasons. The primary reason is the court's approval of a "formula clause," where the excess value in the transferred assets as ultimately determined by the IRS did not result in additional gift tax but rather a gift to charity. The result is that, rather than the IRS receiving additional gift tax, the taxpayer received a charitable deduction, thereby avoiding gift tax. Who wins? The taxpayer and charity. Who loses? The IRS. That is why the IRS challenged the use of the formula clause.

Here are the facts in Petter: Ms. Petter transferred \$22 million of United Parcel Service stock to her newly created LLC. She then gifted the stock to her daughters through the use of Intentionally Defective Grantor Trusts. ([See my previous column.](#)) The Trusts used the gifts as a down payment thereby allowing the Trusts to purchase additional LLC interests. Because an interest in an LLC was transferred, not the UPS stock itself, the taxpayer claimed a 51 percent market and minority discount. Upon audit, the taxpayer and the IRS settled for a 36 percent discount. That is the first noteworthy aspect of Petter: the IRS agreed that UPS stock, readily tradable on the stock exchange, was reduced in value for gift tax purposes by 36 percent through the use of a limited liability company.

However, that is not the primary lesson in Petter. The difference in value between the 51 percent discount claimed on the taxpayer's gift tax return and the 36 percent discount agreed to upon audit, resulted in an additional gift. According to the formula language in the transfer documents, the Trustee had to transfer the additional LLC interests to charities designated by Ms. Petter. Thus, the charitable contribution deduction eliminated the gift tax.

The IRS argued that this violated public policy and that the gift was subject to a condition precedent. However, the Ninth Circuit disagreed, approving the taxpayer's plan. The Tax Court and other federal Appeals Courts have approved similar types of formula adjustment clauses.

The bottom line: business owners can take full advantage of the exemption amounts and charitable planning knowing their family and charitable objectives will be accomplished without the payment of transfer tax. Petter also is instructive for charities and high end donors as it provides a roadmap for optimal charitable and family transfers.

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