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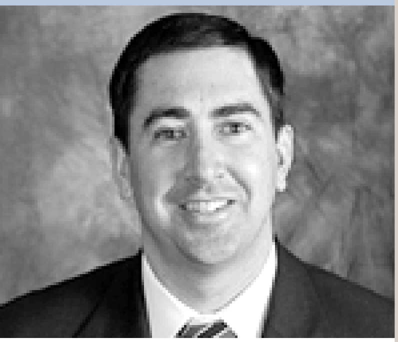

R. Scott Brace, Jr. is a Manager in Empire's Rochester, NY office, and is an Accredited Senior Appraiser of the American Society of Appraisers, designated in Business Valuation. He holds an MBA from SUNY Buffalo and has over fifteen years of business valuation and portfolio management experience.

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PETTER V. COMMISSIONER[1] UPHOLDS DEFINED VALUE CLAUSES

By R. Scott Brace, Jr., ASA

In Petter v. Commissioner, the Tax Court rejected the IRS's public policy arguments against defined value clauses, or formula allocation clauses, and upheld a taxpayer's use of formula allocation clauses. The Commissioner argued that the formula allocation was void because it was contrary to public policy. The Tax Court found that the formula allocation clause did not violate public policy and allowed the tax payer charitable deductions in the year of original transfers (rather than in a later year when the reallocation was made) for the full value that ultimately passed to two charities (based on values as finally determined for gift tax purposes).

Overview: Anne Petter inherited a large amount of stock and established a limited liability company to hold the stock (the "LLC"). At formation, Ms. Petter was sole owner of the LLC. In March 2002 Ms. Petter transferred units representing a fixed dollar amount to two trusts established for the benefit of her children (the "Trusts"), and made unit gifts to two charities (the "Charities"). The documents outlining the transfers indicated that if the value of the units initially received by the Trusts was finally determined for federal gift tax purposes to exceed the fixed dollar amount intended to be transferred to the Trusts, then the trustees would transfer the excess units to the Charities. The Charities similarly agreed to return excess units to the Trusts if the value of the units initially received was determined for federal gift tax purposes to be less than the fixed dollar amount intended to be transferred.

In April 2002 a formal appraisal of the LLC units was conducted, and units were reallocated among the Trusts and the Charities based upon the terms of the transfer documents. In August 2003, Ms. Petter filed a gift tax return detailing the transfers, which included the transaction documents that detailed the reallocation provisions.

Upon its audit of Ms. Petter's gift tax return, the IRS took the position that the formula allocation clause would not be respected for tax purposes even if additional units were allocated to the Charities. Consequently, the IRS did not allow any charitable deduction for the reallocated units. Ms. Petter subsequently filed a petition with the Tax Court.

Ms. Petter passed away while the action was pending and the matter was taken up by her Estate. The Estate and the Commissioner agreed that the value of the LLC units were higher than first reported, which triggered the obligation to reallocate more units to the Charities. The Commissioner and Ms. Petter also eventually agreed to apply a discount of approximately 34% to the value of the LLC's units, and the primary issue then became whether the Commissioner was correct in refusing to respect the formula allocation clauses on public policy grounds.

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Conclusion: The Commissioner argued that Ms. Petter actually gave the Trusts a particular number of LLC units. The Tax Court responded that the plain language of the documents showed that Ms. Petter made transfers to the Trusts of an ascertainable dollar value, not a specific number of units in the LLC.

The Tax Court stated that it was confident that the gift to the Charities was made in good faith, and was in line with Congress's overall policy of encouraging gifts to charities. Further, the Tax Court did not share the Commissioner's fear that such gift structures would have taxpayers using charities to avoid tax. The Tax Court indicated that the formulas used by Ms. Petter do not cause severe and immediate frustration of the public policy in favor of promoting tax audits.

The Tax Court found that Ms. Petter's transfers, when evaluated at the time she made them, amounted to gifts of an aggregate and set number of units, to be divided at a later date based on appraised values. Further, the formula clauses used to affect the transfers were not void as contrary to public policy, and that there was no overarching public policy against these types of arrangements (formula allocation clauses) in the first place. Additionally, the Tax Court held that the gift tax charitable deduction is allowed in the year of the original transfer, rather than in a later year when the reallocation was made after the value for federal gift tax purposes was finally determined. The Tax Court found this appropriate because, "regardless of what might trigger a reallocation, [Ms. Petter's] transfer could not be undone by subsequent events".

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