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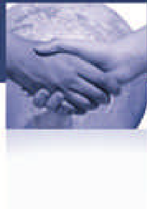
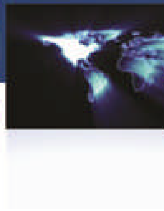

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Estate of Anne Y. Petter vs. Commissioner, T.C. Memo 2009-280, December 7, 2009.

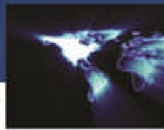
The Facts:

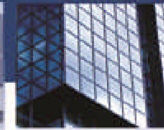
Ms. Petter was a schoolteacher in the state of Washington for her entire life. In 1982, Ms. Petter inherited several million dollars worth of stock from her uncle, who had been one of the first investors in what later became the United Parcel Service (UPS). After receiving the stock from her uncle, Ms. Petter continued to live in her same home and made plans to make gifts to charity and her children.

Ms. Petter had three children; Ms. Donna Petter Moreland, Mr. Terrence Petter and Mr. David Petter. In order to provide for her children, Ms. Petter engaged an estate planner, Mr. Richard LeMaster, who established a sophisticated estate plan to help her achieve her goals of providing a comfortable life for her children and their children, teaching Donna and Terry to manage family's assets, and give money to charity.

In 1998, Mr. LeMaster first created an irrevocable life insurance trust and Ms. Petter contributed enough to the ILIT to purchase a $3,500,000 life insurance policy with her children and grandchildren as the beneficiaries that would be used to cover any estate taxes. Secondly, a charitable remainder unitrust was established and funded with $4,000,000 of UPS stock to cover Anne's day-to-day expenses for the rest of her life through the lifetime payments of 5% per year to Ms. Petter. Third, Mr. LeMaster created the Petter Family LLC (PFLLC). Ms. Petter's intention was to fund PFLLC with UPS stock at a later date; however, in November of 1999 UPS announced plans to go public which froze her stock until after the IPO was completed. After the completion of the IPO in May of 2001, the value of Ms. Petter's UPS stock had risen to $22.6 million.

Ms. Petter funded PFLLC with 423,136 shares of UPS stock worth $22,633,545 and received in exchange 22,633,545 member units divided into three classes (approximately 452,000 Class A units, 11 million Class D units and 11 million Class T units). Eventually, the Class D units were intended for transfer to a trust for the benefit of Ms. Donna Petter Moreland, and the Class T units were intended for transfer to a trust for the benefit of Mr. Terry Petter. Ms. Petter retained the Class A units which gave her effective control of PFLLC.

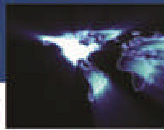


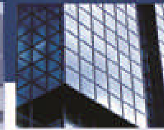


In late 2001, Mr. LeMaster setup two intentionally defective grantor trusts (IDGTs) for both the Class D and Class T units. On March 22, 2002, Ms. Petter gifted the IDGTs units intended to equal 10% of the trusts' assets; then on March 25, 2002, she sold the IDGTs units valued at 90% of trust assets in exchange for promissory notes. Ms. Petter, as a part of these transfers, also gave units to two charities – the Seattle Foundation and the Kitsap Community Foundation (both were 501(c)(3) charities). Mr. LeMaster used a formula clause dividing the units between the trusts and two charities to ensure that the trusts did not get so much that Ms. Petter would have to pay gift tax. The gift formula indicated that the gifted units to each IDT were equal to "one-half the minimum dollar amount that can pass free of Federal gift tax by reason of transfer's applicable exclusion amount". The excess of the value was to be transferred to "the Seattle Foundation ('the Foundation") as a gift to the A.Y. Petter Family Advised Fund." If a later valuation dispute with the IRS should arise, the IDGTs were required to transfer additional units to the Foundation so that the taxable gifts did not exceed the available gift exemption. Similarly, the Foundation was required to return excess units to the IDGTs if the value of the units gifted to the IDGT is determined to be less than the available gift exemption.

The installment notes from each of the IDGTs dated March 25, 2002, were for approximately $4.1 million and required quarterly payments for 20 years. All installment note payments to Ms. Petter were made by the IDGTs from the quarterly distributions paid by PFLLC to its members. Thus, the full intent of Ms. Petter was to gift as much as she could to her children and grandchildren without having to pay gift tax, and then to give the rest to charities in her community.

Mr. LeMaster obtained an appraisal from a well known area firm (Moss Adams). In determining the minority interest discount, Moss Adams compared the PFLLC to closed-end mutual funds owning domestic stock and having little or no debt in determining a minority interest discount of 13.3%. Moss Adams also determined a lack of marketability discount of 46% which was reached by averaging the marketability discount found in two studies. Thus, the result was a unit value of $536.20 per unit and the shares were allocated to the IDGTs and the charitable organizations using this value. Ms. Petter timely filed her gift tax return and reported the gifts, using her $1 million exclusion. The return was audited by the IRS who determined a significantly higher per unit value of $794.39 (later reduced to $744.74 by stipulation) per unit which significantly increased the gift to the Foundation. Mr. LeMaster and Ms. Petter figured the revaluation would trigger a reallocation of shares from the IDGTs to the charities, creating a greater charitable deduction for Ms. Petter but no additional gift tax. The IRS argued that the formula clause was invalid. Thus, if the IRS was correct, the units might still be allocated to the charities, but Ms. Petter would not get an additional charitable deduction. This would also mean that the shares sold to the IDGTs were sold for "less than full and adequate consideration", and thus were transferred partly by sale and





partly by an additional $1,967,128 gift to each IDGT, computed by deducting the price of the installment notes from the fair market value of the shares transferred.

The Arguments and Findings:

The Court was asked to decide (1) whether to honor the formula clause for the gift and the sale and (2) if it is honored, the Court also must decide when Ms. Petter may take the charitable contribution deduction associated with the additional units going to the charitable organizations.

Ms. Petter argued that Washington property laws allow a taxpayer to pass a particular dollar value of money to intended beneficiaries and because it works under state law, it should also be honored under Federal gift tax law as a transfer in 2002. The Commissioner argued that the formula clauses are void because they are contrary to public policy, which would create an increased gift tax liability for Ms. Petter.

After review of various formula and savings clauses, in Commissioner v. Procter, and Estate of Christensen v. Commissioner, the Court determined the public policy is to specifically allow formula clauses if there is a fixed gift that is not susceptible to abuse. Furthermore, since the Foundation had a fiduciary relationship with PFLLC and could police the IDGTs, the formula clause was upheld by the Court.

In regard to the timing of Ms. Petter's gift of the additional units to the charitable organizations, the Court found it relevant only that the shares were transferred out of Ms. Petter's name and into the names of the intended beneficiaries in 2002, even though the initial allocation of a particular number of shares between those beneficiaries later turned out to be incorrect and needed to be fixed. Thus, the Court viewed the gift as unconditional and immediate, and the gift was held to be effective as of March 22, 2002.

Parting Thoughts:

I found this to be a very interesting case as not many I have reviewed over the last several years have dealt with a formula clause. I'm sure many estate planners wanting to use a formula clause with their clients will use this case as a roadmap to help achieve successful results with formula clauses in the future.