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When *Sommers* Are Winters: Do Blanks Denote Revocability?

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In *Sommers*, equitable apportionment altered the parties' conventional positions when the court determined whether blank spaces in the decedent's gift documents prevented completion of his gifts of limited liability company interests.

In *Sommers*,[1] the Tax Court had to decide whether the decedent made completed gifts of limited liability company interests to his three nieces on December 27, 2001, and January 4, 2002,[2] or whether the decedent retained control of the transferred property so that under sections 2035(a)(2) and 2038, the interests were includable in his estate.

The executrix argued for estate tax inclusion in order to apportion the estate taxes to the decedent's nieces instead of effectively being taxed on those gift interests herself.[3] The government argued for a higher value to the transferred partnership interests, which would have resulted in a larger gift tax liability for the decedent's estate,[4] and in a reduction in the marital deduction and the executrix's share of the estate.

The decedent wanted to transfer artwork to his nieces but did not want to incur any gift tax. In 2001 the maximum amount he could transfer under that circumstance was $675,000; however, the art was valued at $1.75 million. The decedent's attorneys suggested that the decedent and his nieces form an LLC, which would own the artwork and restrict transferability of its interests, and that the decedent make gifts of LLC interests to his nieces over at least two years.[5] As advised, the nieces hired an appraiser to value the LLC units.

The formation of the LLC, the decedent's transfers of the artwork to the LLC, and the nieces' cash purchase of the LLC interests beyond the decedent's 99 percent of the voting and 98 percent of the nonvoting LLC units all occurred at the end of December 2001.[6] On December 27, three days after the decedent and his nieces signed the LLC operating agreement, the decedent executed three gift documents, each signed by one of his nieces, accepting as donee. The documents purported to transfer LLC units, but with the number of units intentionally omitted, awaiting the appraisal figures.

In the meantime, the law firm retained the incomplete gift documents. At the end of March 2002, the firm received the appraisal, which valued the LLC at $1.76 million as of the two gift dates. Calculating the maximum number of LLC units the decedent could give his nieces free of transfer taxes, the attorneys indicated that afterwards the decedent would still retain 15.29 percent of the nonvoting interests. Unhappy with the prospect of co-owning the artwork with the decedent's second

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[1] *Sommers v. Commissioner*, T.C. Memo. 2013-8. The court ruled on both parties' motions for partial summary judgment.

[2] The government and intervenors, decedent's nieces, made that argument.

[3] At the time of his death, decedent was married, but had no children. The executrix was the sole heir and surviving spouse. Without the applicability of the New Jersey equitable apportionment statute, any additional 2001 gift taxes would diminish the decedent's estate and hence the executrix's inheritance. *See* Joseph M. Dodge et al., *Federal Taxes on Gratuitous Transfers: Law & Business* 197-198 (2011); Wendy C. Gerzog, "Equitable Apportionment: Recent Cases and Continuing Trends," 41 *(ABA) Real Prop., Prob. & Tr. J.* 671 (Winter 2007).

[4] Decedent died on November 1, 2002, within three years of making his gifts, so the amount of gift tax paid on them must be included in the estate under section 2935(b).

[5] That way, in 2001, decedent would transfer interests valued at $675,000 plus three $10,000 annual exclusions, and in 2002 or in a later year, he would transfer interests with the additional 2002 basic exclusion amount of $25,000 plus three additional annual exclusions of $10,000.

[6] On December 21, 2001, the LLC was registered in Indiana. On December 24 the decedent contributed his artwork in exchange for capital units and, with his nieces, signed the LLC operating agreement.

ex-wife (who was soon to be remarried to the decedent and who was expected to be the sole beneficiary of the decedent's estate), the nieces met with the attorney. He suggested that they pay the gift tax for the transfer of the decedent's remaining LLC interests, which would result in a net gift. They agreed.[7]

On April 11, 2002, the attorney completed the information in the gift documents — filling in the number of transferred units and making other modifications. He changed the clause containing the blank number of units to a clause that provided for ''the decedent's desire to transfer to each niece 'a number of Voting and Non-Voting capital units of the . . . [LLC] that is equal to * * * ($233,417.00) as determined by appraisal, provided that, the total amount of such units shall be composed of * * * (⅓) of Voting capital units owned by donor with the remainder of such amount consisting of Non-voting capital units of the Donor.''[8]

Regarding the 2002 gift documents, besides indicating the number of nonvoting units, the attorneys made two additional changes: (1) omitting the provision about effecting delivery of the gift by ''a duly executed transfer power representing the units, which is attached hereto as *Exhibit A*,'' and substituting a statement about the donees' agreement to pay the gift taxes and any additional applicable interest or penalties, including those later assessed; and (2) omitting the original Exhibit A. The attorneys then delivered all the gift documents to the decedent's nieces.

In June 2002 the decedent claimed he had not made a completed gift of the artwork to his nieces, and that claim went to arbitration as required by the LLC agreement. The decedent died on November 1, 2002, but in September 2005 the arbitrator ruled that although the decedent may have switched his largesse to his second wife, the decedent knew that he was making a gift to his nieces and that his intention was embodied in the 2001 and 2002 gift documents. According to the arbitrator, the decedent irrevocably transferred the artwork to his LLC and then gave all his LLC interests to his nieces. The arbitrator's award, plus attorney fees, was confirmed in 2007 by a final judgment from the Marion Superior Court and affirmed in 2008 by the Indiana appellate court.[9]

In 2007, claiming that the gifts were revocable when made and thus includable in the decedent's estate when he relinquished his power within three years of his death, the decedent's executrix instituted an action in the Superior Court of New Jersey, seeking to have the decedent's nieces reimburse the estate for their proportionate share of estate taxes under the New Jersey apportionment statute. As an alternative, seeking rescission and reformation, the executrix maintained that because of the blanks left in the gift documents, the gifts were made not in 2001 but in 2002 when the attorneys completed the documents, indicating the nieces' agreement to pay all applicable gift and estate taxes and any penalties and interest on their gifts.[10]

The New Jersey court held that the decedent ''made a valid irrevocable transfer of the twelve pieces of artwork to the LLC in December 2001; he thereafter made valid, irrevocable gifts in December 2001 and January 2002 of all his capital shares of the LLC to his nieces. The gift[s] were complete and irrevocable by Dr. Sommers and, subsequently, irrevocable by the Estate of Dr. Sommers.'' The court then dismissed the executrix's first claim without prejudice as the apportionment issue was not ready for a determination, but dismissed with prejudice her remaining claims.[11]

The Tax Court first reviewed the standards for the application of collateral estoppel and issue preclusion. In *Peck*,[12] it had enunciated five requirements for issue preclusion: The issue in the later claim must be identical to the one in the earlier claim; a court of competent jurisdiction must render a final judgment; collateral estoppel is available against the parties to the prior judgment; the issues must have been litigated, resolved, and essential to the earlier decision; and the critical facts and law must be the same as those applicable in the earlier

[7]''Mr. Kaltenmark opined that, as a net gift, the 2002 transfer would reduce the 2002 gift tax obligation, and he estimated that the tax on that gift would be $88,000 split three ways by the nieces. The nieces decided to follow Mr. Kaltenmark's suggestion that they pay the 2002 gift tax.'' T.C. Memo. 2013-8, at 13. *See* Dodge et al., *supra* note 3, at 63-64.

[8]According to the court, the figure provided was one equal to the then-applicable basic exclusion amount plus three annual exclusions, although, as the court noted, that should have meant three gifts of $235,000. T.C. Memo. 2013-8, at 14, n.6.

[9]*See Sommers v. Sommers*, 898 N.E.2d 1234 (Ind. Ct. App. 2008).

[10]Alternatively, the executrix sought a reformation that would have produced the same results as her second argument. She asserted a fourth position based on contract law and promissory estoppel that required the nieces to pay all the pertinent transfer taxes, a fifth argument based on mutual mistake that results in rescission of the gifts, and a sixth claim seeking reformation of the LLC units transferred so that the gifts were limited to those transferrable tax free.

[11]In February 2009 the court entered that decision as its final judgment. The following year, the Appellate Division of the Superior Court of New Jersey affirmed.

[12]*Peck v. Commissioner*, 90 T.C. 162, 166-167 (1988), *aff'd*, 904 F.2d 525 (9th Cir. 1990).

case.[13] In its analysis, the court looked at whether the Indiana and New Jersey courts would apply issue preclusion under those circumstances.[14]

The Tax Court concluded that the Indiana arbitrator's finding that the transfers were valid gifts was a determination that they were irrevocable and absolute, and consequently were both completed gifts under the regulations,[15] and not a retained power under section 2038.[16] The court held that that finding thus satisfied the *Peck* requirements of issue identity and application of the same legal principles. Likewise, the court held that the New Jersey litigation made the same conclusions. Also, the Tax Court held that the findings that the 2001 and 2002 gifts were valid and complete gifts under both Indiana and New Jersey law were essential to both states' determinations. It therefore held that the executrix was collaterally estopped from contending otherwise in the instant litigation.

The Tax Court also analyzed the issue without the application of collateral estoppel and dealt with the taxpayer's position that by leaving the blank spaces in the gift documents, the gifts themselves were necessarily incomplete under section 2038. Although the donor and donees did not know the precise number of transferred LLC units on December 27, 2001, and January 4, 2002, because they had not received the valuation report by those dates, the parties had agreed to the transfers' completion. The court stated that "the parties' intent with respect to the blanks was to have [the decedent's attorneys] carry out the terms of the original agreement, not to grant decedent the right to alter, amend, revoke, or terminate it." When the appraisal indicated a higher LLC unit value, the donees agreed to accept that liability in order to allow the donor to avoid paying gift tax for the 2002 gift. Despite that, the court held that "the modification and other (nonsubstantive) modifications to the 2001 and 2002 gift documents carried out the parties' original agreement; they did not alter or amend it."

Consequently, the Tax Court held that it did not have to redetermine the estate's tax liability; however, because the gifts were made within three years of the decedent's death, section 2035(b) would require the estate tax inclusion of any gift tax paid on those gifts if the court later determined that the decedent had undervalued them. Likewise, section 2001(b)(1)(B) would require an increase in the decedent's adjusted taxable gifts in the decedent's estate tax computations. Thus, the court rejected as premature the estate's motion for a redetermination of its estate tax liability.[17]

The court considered the estate's motion to find that New Jersey's apportionment statute required the decedent's nieces to pay all the estate taxes stemming from the gifts and that the estate's marital deduction should therefore not be decreased. Both the government and the nieces, as intervenors, argued that such a decision was untimely because the substantive issues of LLC unit valuation had not yet been decided. The Tax Court said that New Jersey's apportionment provision was like most states' in that it required the recipients of property included in the estate to pay their ratable share of the estate tax liability. The applicability of the New Jersey apportionment statute, the court said, must precede any determination of the amount for which the beneficiary must reimburse the estate. However, the court held that since it had found there was no gift inclusion, no amount would be apportioned to the nieces.

Finally, the court denied, as premature, the estate's motion for a decision on the question of apportionment regarding any section 2035(b) or 2001(b)(1)(B) additional estate taxes.

Analysis and Conclusion

Two aspects of *Sommers* interest me. The first is that the parties appear to be arguing their opponent's conventional position. The second is that the court grappled with whether the blanks left in the gift documents were immaterial to gift completion for gift tax purposes; however, the court did not address whether the decedent's completed gifts qualified for the annual exclusions as he had claimed.

The executrix argued that the decedent's gifts to his nieces were includable in his estate. The government contended that because the decedent did not retain a taxable "string," his gifts were complete. At first blush, those postures seem reversed. But, as the court explained, if the gifts were included in the estate, New Jersey's equitable apportionment statute would require that additional taxes relating to the earlier gifts be paid by the nieces as beneficiaries of the LLC units instead of being taxed to the decedent's surviving spouse who was also the sole beneficiary and executrix of his estate. Alternatively, if the gifts were complete, but undervalued at that time, any 2001 gift tax deficiency would likely be payable from his estate, thus reducing the executrix's (the surviving spouse's) inheritance.

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[13] *Sommers*, T.C. Memo. 2013-8, at 28.
[14] *Id.* at 29.
[15] Reg. section 25.2511-2.
[16] *Sommers*, T.C. Memo. 2013-8, at 34.
[17] *Id.* at 47-48.

The gift documents omitted the number of LLC units the decedent intended to transfer to his nieces. The Tax Court decided that the unfinished part of the document did not render the gift incomplete because the decedent had specifically authorized an agent, his attorney, to fill out those blanks with number values consistent with the decedent's intent to avoid gift tax.[18] So, under Indiana law, the arbitrator's upholding the validity of the gifts basically meant that ''the gifts were irrevocable and absolute,'' which the Tax Court extended to constitute a finding that the gift tax regulations[19] requiring the donor's transfer of dominion and control were satisfied.

Further, the New Jersey court found that the decedent's gifts transferred in 2001 and 2002 were valid and irrevocable, saying that a donor who has a clear donative intent and who entirely relinquishes ownership of his property has made a completed transfer under the gift tax regulations and cannot have retained section 2038 powers. Thus, the Tax Court applied issue preclusion to hold that the decedent's omission, coupled with a direction for the attorney to complete the document using the appraisal values with unit amounts, was consistent with the decedent's intention to transfer all the artwork equally to his three nieces without his having to pay any gift taxes.

In ruling that the gifts were complete under the gift tax regulations, however, the court also implicitly ruled that the value of the decedent's unstated number of LLC shares were ascertainable at the time of his gifts and that they thus qualified for annual exclusions. Although in keeping with the Court's defined value decisions in such cases as *Wandry*[20] and *Petter*,[21] the court did not provide an explicit explanation of how blank spaces in a gift document at the time of a completed gift can qualify for the annual exclusion. That is, when the number of shares is intentionally left blank in the gift documents, how can possession or enjoyment of the unstated number of LLC shares be obtained by any donee immediately upon the making of each *Sommers* gift?

[18]The court noted that the arbitrator commented that the decedent did not revoke the estate planning law firm's authority to complete the blanks.

[19]Reg. section 25.2511-2.

[20]*Wandry v. Commissioner*, T.C. Memo. 2012-88.

[21]*Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011). *See* Gerzog, ''Not All Defined Value Clauses Are Equal,'' 10 *Pitt. Tax Rev.* (forthcoming, article copyright 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2106008.