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Now is an appealing time to make large gifts: The values of many assets remain low, and federal gift and estate tax exemptions are scheduled to fall back to $1 million in 2013 from their current $5.12 million threshold. (Individual states have their own exemption rules and amounts.)

On the other hand, IRS challenges to the valuation of transferred assets could result in unexpected gift taxes. The good news is that a Ninth U.S. Circuit Court of Appeals tax case, *Estate of Anne Y. Petter v. Commissioner*, favored a taxpayer who'd implemented a gifting strategy to avoid additional taxes from an IRS revaluation: the charitable freeze.

HANDLE WITH CARE

In 1982, Anne Petter inherited a large amount of stock in United Parcel Service from an uncle who was one of the company's first investors. By May 2001, she held $22.6 million in UPS shares, and she transferred all of the stock to a limited liability company (LLC). She subsequently both gave and sold units in the LLC to trusts set up for her two children.

To minimize gift taxes, Petter coupled the gifts to her children with simultaneous gifts of LLC units to two charitable foundations. This strategy is known as a charitable freeze. It's designed to ensure that, if the IRS successfully challenges a taxpayer's valuation of a gift, the amount by which the gift was undervalued doesn't go to the IRS as gift or estate tax but to one or more charities named by the taxpayer in the transfer documents.

Petter's transfer documents included a dollar formula clause that assigned to the children's trusts a number of LLC units worth a specified dollar amount that was equal to the amount of her unused lifetime gift tax exemption. It assigned the remainder of the units to the charities. The documents also contained a reallocation clause, which obligated the trusts to transfer additional units to the charities if the IRS later determined that the value of the units the trusts received as gifts exceeded the specified dollar amount.

WHAT'S THE NEXT MOVE FOR THE IRS?

The ruling of the Ninth U.S. Circuit Court of Appeals in *Estate of Anne Y. Petter v. Commissioner* (see main article) was consistent with a 2009 Eighth Circuit decision, *Estate of Christiansen v. Commissioner*, regarding Internal Revenue Code Section 2522 regulations. However, the IRS still could make a public policy argument against charitable freezes.

In *Petter*, the agency argued to the U.S. Tax Court that the dollar formula clauses used to effect additional transfers to the charities were against public policy, but it didn't raise the issue on appeal after the Tax Court rejected the argument. Further, the IRS could move to change the regulations. The Ninth Circuit expressly invited the U.S. Treasury Department to amend its regulations if it's troubled by the consequences of the court's decision.

DECLARED VALUE

On her 2002 tax return, Petter reported no gift tax liability on her transfers of LLC units. Because of transfer restrictions on the units, her valuator had applied a generous discount to the value, reflecting their lack of marketability. An IRS audit subsequently determined that the units had been undervalued. As a result, the gifts put her over her lifetime gift tax exemption.

Petter and the IRS eventually settled the valuation issue by stipulating the value of the units. Under the terms of the reallocation clauses, the charities received additional units, but the IRS refused to allow a charitable gift tax deduction on those units. The U.S. Tax Court disagreed, and the IRS appealed that ruling.

READING THE FINE PRINT

Section 2522 of the Internal Revenue Code prohibits charitable deductions if, "as of the date of the gift, a transfer for charitable purposes is dependent upon the performance of some act or of *the happening of a precedent event* in order that [the transfer] might become effective." (our italics) The IRS argued that Petter's transfer documents made the additional charitable gifts subject to the "happening of a precedent event" — an IRS audit that determined that the reported value of the LLC units was too low.

The Ninth Circuit, however, found that the transfer documents didn't contain such a condition precedent. The documents didn't make the additional transfers of LLC units to the charities dependent on the occurrence of an IRS audit. Rather, the transfers became effective immediately upon the execution of the transfer documents and delivery of the units.

The charities were always entitled to receive a predefined number of units (the difference between a specific number of units and the number of units worth a specified dollar amount), which the documents expressed as a mathematical formula. The formula had one unknown: the value of an LLC unit at the time the transfer documents were executed. Nevertheless, that value was a constant, so both before and after the IRS audit the charities were entitled to receive the same number of units.

To minimize gift taxes, Petter coupled gifts to her children with simultaneous gifts of LLC units to two charitable foundations.

The IRS's determination that the LLC units were undervalued didn't grant the charities rights to receive additional units. It only ensured that they received those units they were already entitled to.

WORTH CONSIDERING

The *Petter* case well illustrates the benefits of the charitable freeze. If you have clients who're considering making a large gift that might become subject to IRS scrutiny, a charitable freeze is worth considering. And if you have a client whose charitable freeze has been challenged by the IRS, the Ninth Circuit's decision may help your case.

Lost earnings: Breaking down the damages calculation process

Lost earnings can be one of the more challenging categories of damages to calculate. Just as every employee is different, so too is the combination of base earnings, benefits and other factors that an expert must consider. For this reason, damages experts generally break the process into several steps.

1. IDENTIFY A BASE

The initial focus in a lost earnings claim typically rests on the employee's "base earnings" — the rate for a specific year or years from which lost earnings will be extrapolated. The facts of the case will determine whether the base earnings will use the actual earnings in the year before the injury, the projected earnings for the year the injury occurred or the expected rate of earnings for a year in the future.

Experts use several types of data to put a number on base earnings. These include:

- Employer records,
- Employee pay stubs,
- Income tax records,
- Social Security records,
- U.S. Census information, and
- Earnings of comparable employees in the industry or company.

They also may consult information related to an employee's seniority, health history or productivity declines. And experts may need to make adjustments for seasonal variations and sick pay. One-off, nonrecurring payments, such as a non-performance-based bonus, can skew base earnings, as well.

2. RECOGNIZE RETIREMENT BENEFITS

The proper amount of compensation for lost retirement benefits depends on the type of plan involved. Calculations for defined *contribution* plans tend to be fairly straightforward. Employer contributions are considered as a portion of lost earnings in the years the contributions would have been made but for the injury. Rather than projecting the postretirement benefits to be paid, the expert calculates the sum of the but-for employer contributions and the but-for earnings.

Calculations for defined *benefit* plans may require projection of the actual benefit stream following the employee's retirement. Relevant factors include years of service, salary levels, retirement date and life expectancy.

3. FACTOR IN FRINGES

Experts then consider fringe benefits, comparing the benefits received before the alleged wrong to those received after, possibly taking into account the replacement cost of the lost benefits. Individual insurance rates, for example, may be higher than those paid under a group plan.

Experts also scrutinize those benefits to which both the employer and the employee contribute. The employee's contribution is deducted from his or her lost wages, because the employee would be doubly compensated if damages were paid for the contribution *and* lost wages.

4. MAKE IT PERSONAL

Courts considering wrongful death claims may agree to offset lost earnings awards with an amount equal to the victim's personal consumption — the amount of money that wouldn't have been available to family members even if the individual hadn't suffered injury. So experts may need to include the individual's separate food, health care, clothing and entertainment expenses (but not income taxes or savings) in their damages estimate.

While past spending provides the strongest evidence for personal consumption rates, this data can be difficult to gather. Most experts rely on government studies — particularly those compiled by the U.S. Bureau of Labor Statistics — that identify the average percentages and dollar amounts of household income consumed by each family member.

5. ANTICIPATE DISPUTES

Lost earnings claims can trigger several areas of dispute — such as the effect of commissions, overtime and performance bonuses — between parties. Arguments may also arise over how to handle the plaintiff's future compensation increases, retirement age, mortality and present-value discount rates.

The extent of the employee's duty to mitigate his or her damages can raise questions as well. Defendants may argue, for example, that the employee took an unreasonable amount of time to land a new job or accepted a position at an unreasonably low rate of pay.

QUALITY IS IMPORTANT

Whether you represent the plaintiff or the defendant, the quality of your lost earnings damages estimate will play a big role in determining an award. Hire an experienced expert capable of preparing a thorough calculation that anticipates the other party's disputes and the court's objections.

How data mining helps fight the war against fraud

According to two government reports released this past fall, U.S. investigators have secured a growing number of indictments for fraud related to the wars in Iraq and Afghanistan. Their primary weapon? A new data mining system that helped uncover bribery, kickbacks and other schemes. Stateside fraud investigators can employ similar technology to discover crimes in your clients' companies.

NUMEROUS SOURCES AND TOOLS

Fraud investigators use data mining techniques to extract and analyze digital data from databases. The data is scrutinized to find anomalies, unusual trends and patterns, inconsistencies, and suspicious transactions. It can come from a range of sources, including a company's purchasing and accounts payable records; general ledger transactions; customer, vendor and employee records; access, telephone and computer network logs; and e-mail.

Investigators wield a variety of tools, such as data search capabilities and complex algorithms. Because a one-size-fits-all approach is likely to fail, tools usually are tailored to the specific company, industry and risk areas. Investigators also typically narrow the data according to the relevant time period and computer system.

WARNING SIGNS

Data mining has proven especially successful at detecting employee fraud, such as billing schemes in which an employee causes the company to issue a payment by submitting invoices for fictitious goods or services. Inflated invoices or invoices for personal purchases also are easily detected with data mining.

Using data mining tools, investigators look for anomalies such as vendor records with missing information and vendors whose invoices are paid more quickly than average or are processed on weekends or after hours. Other signs that something's amiss include:

- Invoices with rounded amounts (which are less likely to occur naturally),
- Invoices for higher-than-average amounts,
- Sequentially numbered invoices — with no gaps — from the same vendor (which suggests no invoices have been submitted to other customers),
- Invoices with future dates,
- Vendors that consistently submit invoices just under the amount that would require payment approval by a supervisor,
- Vendors with different names that share an address, telephone number, tax identification number or bank routing number, and
- Vendors that share an address, telephone number, tax identification / Social Security number or bank routing number with employees.

Using data mining tools, investigators look for anomalies such as vendor records with missing information and vendors whose invoices are paid more quickly than average or are processed on weekends or after hours.

It's important to note that red flags don't necessarily prove that fraud is occurring — only that additional investigation is advisable. Further scrutiny is particularly important if a vendor shows up on multiple reports — for example, on both a report for rounded invoice amounts and a report for payments processed off-hours.

BEYOND DATA COLLECTION

Thorough analysis is as important, if not more so, than the collection of data. Even if it turns out that fraud hasn't occurred, data mining investigations are worth conducting because they may indicate that tighter internal controls or other antifraud measures are needed.

New model order

Federal Circuit targets e-discovery costs

Last fall, the Chief Judge of the U.S. Court of Appeals for the Federal Circuit introduced a new model order for e-discovery. While the order was developed specifically for patent cases, it's possible that it could also be adapted for less complex types of litigation in the future. Among other issues, the order addresses e-mail, search terms, and privilege and work product protections.

FIGHTING EXCESS

According to Chief Judge Rader, the "greatest weakness of the U.S. court system is its expense," and the driving factor for that expense is discovery excesses. He noted that patent cases in particular suffer from "disproportionally high discovery expenses."

To address this problem, the Advisory Council of the Federal Circuit developed and adopted the Model Order Regarding E-Discovery in Patent Cases. Rader expressed hope that it will serve as a starting point for district courts to enforce "responsible, targeted use of e-discovery in patent cases."

SIGNIFICANT PROVISIONS

The three-page order covers several critical issues. These include:

E-mail. General requests for electronically stored information (ESI) under Federal Rules of Civil Procedure 34 and 35 may not include e-mail or other forms of electronic correspondence. To obtain e-mails, parties must make specific e-mail production requests.

E-mail production requests are phased to occur only after the parties have exchanged initial disclosures and basic documentation about the relevant issues. The requests must identify the custodian, search terms and time frame. Each party's request is limited to five custodians per producing party and, further, to five search terms per custodian per party — although

the parties can agree to more. A party that requests more custodians or search terms than allowed, or agreed to, must bear the costs of additional discovery.

Search terms. Whether used to search e-mail or other types of ESI such as documents, search terms must be narrowly tailored to particular issues. Indiscriminate terms, such as the producing company's name or product name, are inappropriate unless combined with narrowing search terms that reduce the risk of overproduction. The use of narrowing criteria — for example, "and" or "but not" — is encouraged.

Privilege and work product. The inadvertent production of privileged or work product ESI isn't a waiver of privilege or protection in the pending case or any other proceeding. Mere production of ESI in litigation as part of a mass production also won't itself constitute a waiver for any purpose.

The order also provides for cost-shifting to the requesting party for disproportionate ESI production requests.

BOTTOM LINE

The Federal Circuit's model order may apply only to patent cases right now. But this isn't likely to be the last time a court recommends steps to reduce excessive discovery costs.