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Single-Member LLC Respected For Gift Tax Purposes, But Step-Transaction Doctrine Applied

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- by Roger A. McEowen*

Overview

The full Tax Court, in August of 2009, knocked the IRS off its heels when the court said that a single-member LLC must be respected for gift tax purposes.[1] Such entities are ignored for federal income tax purposes - they are treated as a disregarded entity under the so-called "check-the-box" regulations. But, the court said, the entity is separate from the single-member for gift tax purposes with the result that the taxpayer in the case was not responsible for gift tax on transfer of membership interests in the LLC – she didn't have an interest in the LLC's underlying assets. The court was split - issuing four opinions (10-judge majority, 9-judge concurrence, 6-judge dissent, and 3-judge separate dissent). The Tax Court said, however, that it was reserving for another day whether the step-transaction should be applied to collapse the separate transfers and what, if any, is the appropriate amount of any valuation discount. That day has now arrived.

Facts

The taxpayer received a $10 million cash gift from a friend in 2000 when she was 85 years old and wanted a way to preserve that wealth for her son and granddaughter. She also didn't want to pay gift tax on any transfers to the son and granddaughter, didn't want to pay income tax and wanted to avoid estate tax at death. Her advisors had her invest $8 million in New York municipal bonds, and had her transfer $4.25 million of cash and marketable securities to Pierre LLC. The LLC was validly formed under New York law, and no election was made to treat it as a corporation for federal tax purposes – IRS Form 8832 was not filed. A few days later, the taxpayer formed two trusts – one for her son and one for her granddaughter. It was about two months after creation of the trusts that the $4.25 million in cash and marketable securities was transferred to the LLC. Twelve days after funding the LLC, the taxpayer transferred her entire LLC interest to the trusts – first giving a 9.5 percent interest in the LLC to each of the trusts to use a portion of the taxpayer's available estate tax credit amount and generation-skipping tax exemption, then selling each trust a 40.5 percent membership interest in exchange for a secured promissory note with a face value of $1,092,133. These transactions all occurred on the same day. The face value of the note were established by appraisal which valued a 1 percent interest non-managing interest in the LLC at $26,965 by applying a 30 percent discount to the underlying value of the LLC's assets. The taxpayer filed a gift tax return and reported the gift to each trust of a 9.5 percent interest in the LLC. The taxable gift to each trust was reported as $256,168 ($26,965 x 9.5).

IRS audited the gift tax return and issued a deficiency notice on the basis that the transfers of the LLC interests to the trusts should have been treated as gifts of proportionate shares of the LLC's assets (rather than as a transfer of LLC interests) which should have been valued at

$403,750 each. IRS also determined that the taxpayer had gifted to the trusts 40.5 percent interests in the LLC to the extent that the value of the 40.5 percent of the underlying assets of the LLC exceeded the value of the promissory notes from the trusts. IRS claimed that each of these transfers should have been valued at $629,117 after accounting for the value of the promissory notes. IRS assessed tax deficiencies of $1,130,216.11 in federal gift tax and $24,969.19 in generation-skipping transfer tax.

The Issue

There was no dispute that the LLC was validly formed and that no election had been made to treat it taxwise as a corporation. Thus, the parties agreed that the LLC was to be treated as a disregarded entity separate from the taxpayer for federal tax purposes under the so-called "check-the-box" regulations. But, the parties disagreed as to whether those regulations required that the LLC be disregarded for federal gift tax valuation purposes. IRS asserted that, because the LLC was a disregarded entity under the regulations, that the taxpayer's transfers of interests in the LLC were actually transfers of cash and marketable securities and that the gifts equaled the total value of the assets transferred less the value of the promissory notes the taxpayer received from the trusts. IRS claimed that the multiple transfers should have been collapsed into one under step-transaction doctrine, but the court refused to address that issue – noting that they would deal with it in a separate opinion. The taxpayer claimed that state law controls the nature of the taxpayer's interest in property for gift tax purposes. Thus, according to the taxpayer, state law was determinative of the nature of the interest transferred and that, under New York law, an LLC interest is personal property with the member having no interest in specific LLC property. Thus, the transfers were, the taxpayer argued, valued properly (including discounts) for gift tax purposes.

Entity Classification Regulations

The court noted that an LLC is a unique entity that has the limited liability feature of a corporation, but the pass-through tax treatment and management flexibility of a partnership, and that the tax Code doesn't clearly define what an LLC is. Before 1996, the status of an LLC depended on whether it had a "predominance" of corporate characteristics. But, that test gave way to the simplified "check-the-box" regulations in 1996 – the taxpayer just needed to check a box on IRS Form 8832 to inform IRS of the LLC's classification. If an 8832 was not filed, certain default statuses applied. For a single-member LLC, the default status is as a disregarded entity – the taxpayer and the LLC are one in the same (just like a sole proprietorship).

Court's Rationale

On the issue of whether the "check-the-box" regulations applied in the gift tax realm, IRS argued that valid state law restrictions applicable to the transferred interests were to be ignored when determining the nature of the interest being transferred. IRS cited cases holding that a single-member owner of an LLC was responsible for paying withholding taxes on the LLC's employees. But, the majority noted that those cases didn't hold that the LLC entity is to be disregarded in deciding the nature of LLC interests being transferred for gift tax purposes. Instead, prior case law supported the taxpayer's argument that state law is determinative of the nature of the property interest transferred. Here, the sequence of the gifts was critical. The taxpayer first gifted cash and marketable securities to the LLC and at a time when the trusts were not members of the LLC, and then transferred LLC interests to the trusts. In that instance, state law controls the nature of the interest transferred, and the court cited other cases that had reached that conclusion based on cases involving similar gift sequences. So, calculating the gift tax became a simple, three-step process – (1) determine the nature of the transferred interest under state law; (2) determine the fair market value (including appropriate discounts) of the transferred interest; and (3) calculate the gift tax due on the transfer. The "check-the box" regulations don't control how the nature of the interest in the entity is to be determined for gift tax purposes – they control the tax treatment of the entity, not the

donor of interests in the entity. They are only entity classification regulations. The majority opinion stated that "to conclude that because an entity elected the classification rules set forth in the check-the-box regulations, the long established Federal gift tax valuation regime is overturned as to single-member LLCs would be "manifestly incompatible" with the Federal estate and gift tax statutes as interpreted by the U.S. Supreme Court."

Future of Discounting Entity Interests

Step transaction doctrine. The Tax Court noted that they were only ruling on the validity of the "check-the-box" regulations as applied to the gifting of the interests in the LLC. They noted that they would address in a separate opinion whether the step transaction doctrine applied to collapse the separate transfers to the trusts and the appropriate valuation discount, if any. That's a key point. Recently, two Federal District Courts have applied the step transaction doctrine to eliminate discounts of LLC gifted LLC interests. In *Linton v. United States,*[2] the court provided a good discussion of the components of the step transaction doctrine. The court noted that the doctrine is comprised of three tests: (1) the binding commitment test applies if, at the time the first step of the transaction is entered into, there is a binding commitment to undertake a later step; (2) the end result test is satisfied if there is a series of formally separate steps that are pre-arranged parts of a single transaction intended from the outset to reach the ultimate result; and (3) the interdependence test is met if, based on the objective facts, the steps of the transaction were so interdependent that the legal relations created by a single transaction would have been fruitless without a completion of the series of transactions. In *Linton*, while there was some question as to whether the gift of LLC interests occurred at the same time as the funding of the LLC, the court went on to address the application of the step transaction doctrine as if the gifts occurred after the LLC was funded. The court determined that all three tests of the step transaction doctrine were triggered such that the taxpayer had, in effect, made indirect gifts to the trusts for the taxpayer's children. The court determined that the taxpayer had failed to raise an issue of material fact concerning the taxpayer's subjective intent, the contemplated sequence of transactions or the manner in which the events actually unfolded.

> **Note:** On January 21, 2011, the U.S. Circuit Court of Appeals for the Ninth Circuit reversed the trial court's award of summary judgment to the government.[3] The court held that a question of fact remained as to *when* the gifts to the taxpayers' children were effective under state law.

In another opinion by the same court, *Heckerman v. United States,*[4] the taxpayer created an LLC and funded it with property and cash. The taxpayer then transferred minority shares of the LLC to trusts for his minor children, and claimed a valuation discount to reflect the minority interests that were transferred. The trusts were established on the same day that the LLC was formed, and the transfer of LLC interests to the trusts was made on the same day that the LLC was funded. The IRS claimed that the taxpayer's contribution of cash to the LLC should be treated as an indirect gift to the children under the step transaction doctrine. The court agreed. The court reasoned that both the end result test and the interdependence test were satisfied. The taxpayer had the subjective intent to transfer property to the children while minimizing tax liability, and the LLC wouldn't have been funded with cash except for the discount that could be derived on subsequent transfer to the children. While the court did not find that the binding commitment test had been satisfied (there was no evidence that the taxpayer had a legally binding commitment to either transfer the cash or carry out the gifting of the LLC interests), they noted that the U.S. Circuit Court of Appeals for the Ninth Circuit has not required the binding commitment test to be satisfied before the step transaction doctrine can be applied.[5]

But, the Tax Court has provided a roadmap for successfully avoiding the application of the step transaction doctrine. In *Holman v. Comr.,*[6] the court held that the gift of FLP interests was not

an indirect gift to the taxpayers' children. Six days had elapsed between the funding of the LLC with shares of stock and the transfer to the children. During those six days, the stock was heavily traded in a volatile market and the taxpayers bore economic risk of a substantial change in value. Accordingly, the court did not apply the step transaction doctrine to the transfers and the gifts of the FLP interests were valued after the application of minority and marketability interests.

Similarly, in *Gross v. Comr.,*[7] the court refused to apply the step transaction doctrine to transfers to the taxpayer's daughters. The court determined that the partnership at issue was formed when the certificate of partnership was filed, that there was a subsequent transfer of stock and that, still later, the taxpayer gave the partnership interests to the daughters. Irrespective of when the limited partnership was formed, the taxpayer and the daughters formed at least a general partnership with agreed-upon terms by the time the certificate was filed and the taxpayer made stock transfers to the partnership before giving the daughters their partnership interests. Importantly, the timeframe between the transactions, the court held, precluded a finding of a single transaction.

Pierre II[8]

Application of the step-transaction doctrine. On review of whether the step-transaction doctrine should apply to the *Pierre* set of facts and the appropriate valuation discounts, the court noted that the facts compelled the application of the doctrine. The court noted that all of the transfers not only occurred on the same day, no time elapsed between the transfers. The court noted that the taxpayer gave away her entire interest in the LLC "within the time it took for four documents to be signed." In addition, the court noted that the record indicated that the taxpayer intended to transfer her entire interest gift tax free. Also, the taxpayer's lawyer recorded the transfers as two gifts of 50 percent interests in the LLC and prepared the LLC's tax return accordingly. Thus, the court concluded that the taxpayer intended to transfer two 50 percent LLC interests to the trusts, but merely structured the transaction to first gift small interests in the LLC to use a portion of her then-available credit and her GSTT exemption – a purely tax motivated reason for the transfers. The court also found that the gift and sale transactions were planned as a single transaction with the multiple steps utilized only for tax purposes. The result was, the court concluded, that the taxpayer had made a gift to each trust of a 50 percent interest in the LLC to the extent the interest exceeded the value of the promissory note that the trust executed.

Valuation discounts. On the valuation issue, the court noted that the LLC vested control with the manager (the taxpayer) and restricted the LLC members' rights to transfer their interests or withdraw. IRS didn't challenge those restrictions, but went after the level of the discounts. The taxpayer reported the transfers with a 10 percent lack-of-control discount and a 30 percent marketability discount (36.55 percent combined). However, the IRS didn't push too hard on the discount issue, and the court reduced the 10 percent lack-of-control discount to eight percent largely due to the taxpayer's expert admitting that a 50 percent ownership interest would allow the member to block the appointment of a new manager. On the marketability discount, the court sustained the 30 percent discount because the IRS didn't challenge it.

The bottom line, however, is that Pierre II provides a roadmap of how to run face first into application of the step-transaction doctrine. The case remains helpful, however, on the discount issue.

Estate tax legislation

The *Pierre* case certainly is welcome news for estate planners wanting to utilize valuation discounts via single-member LLCs for estate and gift tax purposes. But the majority opinion seemed to send a warning on that point. The majority pointed out that while Congress has enacted Code provision that negate state law restrictions in valuing transfers (I.R.C. §§2701-2704) where abuses are likely to be present, they have not eliminated discounts in the context of

entities. But that could change. The Administration appears poised to kill discounts in the context of entities. Legislation (H.R. 436) introduced by Congressman Pomeroy (D-ND) in early 2009 and supported by the Administration would eliminate valuation discounts for non-business interests in closely-held entities. The bill would essentially restore the discredited family attribution theory that was killed off by a federal court decision in 1981 and formally abandoned by the IRS in 1993. The Administration views the bill as a revenue-raiser.[9] The bill, if it becomes law, would also likely cause taxpayers to avoid making gifts (money that is not gifted would remain in the estate and be exempt from estate tax up to seven million dollars over both spouses (assuming that the Congress takes action to reinstate the federal estate tax based on the 2009 exemption levels), but gifts of entity interests to charity would be valued at fair market value).

Without a doubt, the future of discounting, and the future of the estate tax for that matter, depends on the Congress and the courts. Stay tuned.

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*Leonard Dolezal Professor in Agricultural Law, Iowa State University, Ames, Iowa and Director of the Center for Agricultural Law and Taxation. Member of the Iowa and Kansas Bar Associations and licensed to practice in Nebraska.

[1] Pierre v. Comr., 133 T.C. No. 2 (2009).
[2] 638 F. Supp. 2d 1277 (W.D. Wash. 2009).
[3] Linton, *et ux.* v. United States, No. 09-35681, 2011 U.S. App. LEXIS 1174 (9th Cir. Jan. 21, 2011).
[4] No. C08-0211-JCC, 2009 U.S. Dist. LEXIS 65746 (W.D. Wash. Jul. 27, 2009).
[5] See Brown v. United States, 329 F.3d 664 (9th Cir. 2003).
[6] 130 T.C. 170 (2008).
[7] T.C. Memo. 2008-221.
[8] Pierre v. Comr., T.C. Memo. 2010-106.
[9] The bill may not actually raise revenue. The revenue assumptions of the bill are based on assumptions that underlie the tax gap and that the 2004 estate tax exemption levels and rates would remain in effect ($1.5 million exemption and 48 percent top marginal rate) – which seems highly unlikely at the present time.