TAX COURT CASE UPDATE

FCG Valuation Case E-Flash

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Citation:

Suzanne J. Pierre v. Commissioner, T.C. Memo 2010-106, May 13, 2010.

Overview:

In *Pierre v. Commissioner*, 133 T.C. No. 2 (2009), the Tax Court determined that transferred interests in a single-member LLC (disregarded for federal income tax purposes) were transfers of member interests rather than direct transfers of the marketable securities owned by the LLC.

In its ruling, the Tax Court concluded that the step doctrine applied to the simultaneous gift and sale transfers of interests in the LLC. Additionally, the Tax Court determined that discounts for lack of control and lack of marketability totaling 35.6 percent were applicable to the transferred 50 percent member interests.

The Facts:

Suzanne Pierre was a wealthy widow when she received a $10 million cash gift from a friend in 2000. As she was 85 at that point, Ms. Pierre was concerned about the estate and income tax implications of the gift. Accordingly, Ms. Pierre began to formulate an estate tax plan through her financial advisor to meet the income needs of herself, her only son, and her only granddaughter. In particular, Ms. Pierre was concerned with preserving familial wealth through estate and gift tax avoidance. She wanted tax-free income and wanted to be able to transfer her wealth, tax-free, to her descendants.

In July 2000, Ms. Pierre established Pierre Family, LLC, of which she was the sole member. Eleven days later, she created a trust for her son and a separate trust for her granddaughter. In September, she transferred $4.25 million of her personal funds to the LLC. Her personal living expenses were appropriately segregated from the LLC. Twelve days after funding the LLC, Ms. Pierre gifted 9.5 percent member interests to each trust. Simultaneously, she sold 40.5 percent member interests to each trust in exchange for secured promissory notes. After the transfers, each trust received a 50 percent member interest, 9.5 percent as a gift and 40.5 percent through a purchase.

Although the trusts' purchase notes were executed, no principal was paid over the subsequent eight years. Furthermore, distributions from the LLC were the only source of funds for interest payments made by the trusts.

The LLC's bookkeeper recorded the gifts and sales as unified transactions. He subsequently revised his entries and recorded them as separate gifts and purchases. However, his explanation for doing so was not accepted by The Court.

The LLC was managed by a nonmember manager (its bookkeeper and Ms. Pierre's estate planning attorney), its investments were managed by an outside financial manager, it held regular meetings, and it kept meeting minutes.

Ms. Pierre properly reported each 9.5 percent gift on Form 709. She argued that each of the four transactions (the gift and the sale to each trust) were for independent business purposes and should not be collapsed under the step transaction doctrine. Although Ms. Pierre listed several non-tax reasons for the formation of the LLC, she failed to present non-tax reasons for dividing the gift and sale transfers.

The IRS contended that Ms. Pierre intended to transfer 50 percent interests to her son and granddaughter. As a result, splitting the transactions could only have been for tax avoidance purposes.

Conclusion:

The Tax Court sided with the IRS on the step transaction doctrine and determined that 50 percent member interests had been transferred. In particular, The Court cited the timing of the transactions (all occurring on the same day), Ms. Pierre's voluntary and rapid forfeiture of her member interests, and her stated desire to avoid gift taxes as compelling facts in the determination for the IRS. Additionally, the Tax Court gave significant consideration to the bookkeeper's description of the transaction for each trust as one transaction (rather than a gift and a sale).

In its determination of the fair market value for the transferred 50 percent interests, the Tax Court allowed discounts for lack of control and marketability. The Court accepted the testimony of the taxpayer's expert who opined that the discount for lack of control should be reduced modestly for a 50 percent non-controlling interest versus a minority interest (which had been valued for the tax return). The Court reduced the discount from 10 percent to 8 percent.

Initially, Mrs. Pierre requested a discount for lack of marketability of 30 percent. However, at trial, her expert determined that a 35 percent DLOM was appropriate. The IRS challenged the 35 percent discount but did not contest the 30 percent figure. Therefore, the Tax Court accepted the 30 percent discount for lack of marketability.