Heckerman v. U.S., U.S. Dist. Ct., W.D. Washington, Cause No. C08-0211-JCC (July 27, 2009)

Contributions of Cash to LLC and Gifts of LLC Interests on the Same Day Treated as Indirect Gifts and as Step Transaction to Eliminate Discounts for Gift Tax Purposes

August 2009
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Synopsis

This gift tax refund case is very similar to a case decided in the same federal district court (though by a different judge) earlier in July, *Linton v. U.S.* 104 AFTR2d 2009-5176 (W.D. Washington July 1, 2009). Not surprisingly, the *Heckerman* case reaches a very similar result as the *Linton* case — the court granted the IRS's motion for summary judgment eliminating any discount for gift tax purposes as to cash contributed to an LLC on the same day that interests in the LLC were transferred to trusts for the donors' children.

An oversimplification of the facts is that Parents transferred liquid assets in the form of mutual funds to an LLC and made gifts of LLC interests to trusts for their children on the same day. The IRS argued that the transfer of cash constituted an indirect gift to the trusts, and alternatively that the step transaction doctrine applied to eliminate discounts as to the cash transfers. (The IRS did not make the indirect gift or step transaction arguments as to a similar transfer of real estate made fifteen days before the assignment of LLC interests to the trusts.)

The court concluded that the transfer of cash was an indirect gift (because the taxpayer could not establish that the transfer of the mutual funds occurred before the assignment of LLC interests to the trusts.) The court also concluded that the step transaction doctrine applied, using very broad reasoning, like the *Linton* case.

The court distinguished *Holman* and *Gross* because those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts and because of the nature of the property transferred (cash rather than volatile stocks).

Basic Facts

(1) Parents sought advice for a plan to transfer property in a manner that would make their children work for their money and that would not trigger a gift tax. Based on the advice, they created two trusts for their two children and three LLCs on November 28, 2001. (There was a Real Estate LLC, an Investments LLC, and a Family LLC — which was an umbrella entity that owned all of the interests in the other two LLCs.)

(2) On December 28, 2001, Parents transferred a beach house to the Family LLC, which in turn conveyed it to the Real Estate LLC on the same day.

(3) Fifteen days later (on January 11, 2002) Parents transferred mutual funds (which the opinion consistently characterized as "cash") to the Investment LLC, and *on the same day*, transferred 49.60% interests in the Family LLC (i.e., the umbrella holding company) to the two trusts, collectively. The LLC assignment documents, and the documents admitting the trusts as members of the LLC stated that the interests were assigned "effective January 11, 2002."

(4) An appraisal was prepared reflecting January 11, 2002 as the valuation date. The appraisal concluded that a 58% discount applied to the gifts of the LLC interests.

(5) Parents claimed a 58% discount on the gift value. On audit, the IRS argued that the transfer of cash constituted an indirect gift to the trusts, and alternatively that the step transaction doctrine applied to eliminate discounts as to the cash transfers. (The IRS did not make the indirect gift or step transaction arguments as to the transfer of real estate fifteen days before the assignment of LLC interests to the trusts.) The Parents paid the assessed gift tax deficiency and sued for a refund in the District Court.

Analysis and Observations:

(1) Indirect Gift. Regulation §25.2511-1(h)(1) applies the indirect gift approach for contributions to a corporation, resulting in an indirect gift of the property to each shareholder of the corporation to the extent of his or her proportionate interest in the corporation. The same result is applied to partnerships (citing *Gross* and *Shepherd*). The taxpayer had the burden to prove that the transfer of cash to the LLC was made before the assignment of LLC interests, and the taxpayer could not meet that burden. Parents argued that the gift of LLC interests was not effective until delivery to the trustee and that the cash transfer was first allocated to Parents' capital accounts. The court pointed to various factual elements evidencing a January 11 effective date of the assignment (the Assignment document, the Admission document, the appraisal, and the refund claim [which stated that the gifts were made "on January 11, 2002, or thereafter"]). The court also noted that the taxpayers raised the "delivery" argument too late (after the audit) and that the capital account adjustments were not contemporaneous with the transfers, but were made a year or so later when the taxpayers' 2002 tax returns were prepared.

The court summarized the *Shepherd*, *Estate of Jones*, *Senda*, and *Linton* cases. The facts of this case are very similar to those of *Senda* and *Linton*, in that the transfer of assets and gift of interests in the entity were made the same day, and the taxpayers could not prove which happened first. It is not surprising that the IRS prevailed on the indirect gift argument.

Practical Planning Tip: As additional contributions are made to a partnership or LLC, the contributions should increase the percentage interests owned by the contributing partner, and the value of the additional contributions should be credited contemporaneously to that partner's capital account.

(2) Step Transaction Doctrine.

a. Legal Tests. "The step transaction doctrine 'treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.'" Unlike *Linton*, the court noted that the application of this doctrine depends on whether there are non-tax purposes of the actions:

> "The Ninth Circuit has recognized the need to balance this doctrine with the competing principle that 'anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury.' *Brown*, 329 F.3d at 671... Recognizing this tension, the Ninth Circuit has 'attempt[ed] to distinguish between legitimate "tax avoidance" — actions which, although motivated in part by tax considerations, also have an independent purpose or effect — and illegitimate "tax evasion" — actions which have no, or minimal, purpose or effect beyond tax liabilities.' *Id*."

Much like the analysis in *Holman*, 130 T.C. 170 (2008), *Gross*, T.C. Memo 2008-221 (2008), and *Linton*, the court reasoned that three separate tests have been applied in determining if the step transaction doctrine applies. The court concludes that two of those three separate tests would apply on the facts of this case.

- The "binding commitment test," based on whether there was a binding commitment to undertake the later step at the time the first step is entered into, was not met because there was no binding commitment to make gifts of interests after making contributions to the LLCs.

- The "end result test," based on whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result," is satisfied because the donors

  > "clearly had a subjective intent to convey property to their children while minimizing their tax liability, pursuant to which they crafted, with the help of their attorneys and advisors, a scheme consisting of 'pre-arranged parts of a single transaction[.]' *Penrod*, 88 T.C. at 1429. Such intent is evident in Mr. Heckerman's testimony that he and his wife 'wanted to fund the LLCs in such a way that would not trigger a gift tax.'"

- The "interdependence test" inquires whether the steps were "'so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series' of transactions." This test is met because

  > "it is clear from the record that but for the anticipated discount in calculating gift taxes, based on the low market appeal of Family LLC's structure, Plaintiffs would not have transferred the cash into Investments LLC. This is most apparent in a December 2001 email chain in which Mr. Heckerman explained to his advisors that he would determine how much cash to transfer into the LLC based on the size of the tax advantage: '[r]egarding the securities LLC, once I know how much discount I can get as a function of how much value is in this LLC, I will determine the funding of this LLC.'"

Observe that the analysis of the end result test could apply to many estate planning transactions (as discussed below). However, the analysis of the interdependence test is not as broadly stated as in *Linton*, and there may be situations in which taxpayers can establish that there are reasons for the initial transfer of assets to an LLC in addition to just getting a valuation discount.

b. <u>Distinguishing *Holman* and *Gross*</u>. The court distinguished *Holman* and *Gross* for two reasons. First, those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts. Second, because of the nature of the gifts (cash) taxpayers could not establish that there was any real economic risk that the LLC units would change in value between the time of the funding and gifting of the LLC units. (*Linton* also distinguished *Holman* and *Gross* under similar reasoning. *Linton* involved transfers of cash and municipal bonds.)

(3) <u>Observations Regarding Step Transaction Doctrine Analysis</u>.

a. <u>Non-Tax Purpose</u>. The §2036 cases invariably focus on whether there are "legitimate and significant non-tax purposes" for transferring assets to an FLP or LLC. That traditionally has not been an issue in gift tax cases. However, that may become an important issue in gift tax cases if future cases addressing this step transaction doctrine issue continue to place importance on whether there is a non-tax purpose for transferring assets to the FLP or LLC other than just getting valuation discounts. It is interesting that the *Heckerman* case specifically addressed the importance of the non-tax purpose element to balance between "tax avoidance" and "tax evasion," depending on whether there is an "independent purpose or effect" in addition to the tax savings.

b. Continued Adoption of General Analysis of *Holman* and *Gross*. Commentators have criticized the *Holman* and *Gross* analysis approach because even ignoring intervening steps in the transaction does not leave the taxpayer with making a gift of assets to donees — the donees do not actually end up with those assets but instead own an interest in an entity with substantial state law restrictions.

c. Reasoning for "End Result" Test is Very Broad. The rationale of the opinion is that the donors had a subjective intent to transfer assets to their children with minimal (or no) gift tax. If that is enough to conclude that the step transaction doctrine applies, a wide variety of estate planning transactions might be caught. That subjective intent is present with most donors.

As an example, a donor may choose to make "sliver" gifts of interests in an asset over a period of years rather than all at once. An effect is to take advantage of minority discounts as to each "sliver" gift under Revenue Ruling 93-12. Could the IRS argue that the intent is to achieve the end result of transferring the asset with minimal gift taxes, and therefore ignore the intervening sliver gifts over a number of years, and treat the transfer as being made all at once? As another example, if a client creates voting and non-voting stock and makes gifts of the non-voting stock, could the lack of control discount be ignored because the end result is to transfer the entire interest in the entity (through lifetime and testamentary transfers)? An obvious response to an attempt to apply the step transaction doctrine in that situation is that the children in fact end up with only non-voting stock after the gift. However, in the FLP context, the donees similarly end up with only restricted FLP or LLC interests rather than the hard assets.

d. Indirect Gift and Step Transaction Argument Not Made as to Real Estate Transferred Fifteen Days Before Gifts. The IRS chose not to make the indirect gift or step transaction arguments, to eliminate any discount for gift tax purposes, with respect to the transfer of real estate into the Real Estate LLC 15 days before the gift of LLC interests. In light of the reasoning of the *Linton* and *Heckerman* cases, it will be interesting to see if the IRS makes the step transaction argument for similar transfers in the future.

(4) Observations Regarding Tiered Entity Valuation. The case does not clarify the basis for the appraiser's 58% discount with respect to gifts of interests in the Family LLC (which in turn owned interests in the Real Estate LLC and the Investments LLC). If part of the reason for the discount is attributable to the fact that the underlying assets are held in subsidiary entities, the IRS may have contested the second level discount, under the same rationale as the IRS's approach in *Astleford*, T.C. Memo 2008-128. The tiered-entity discount issue was not mentioned in this case that dealt only with the motions for partial summary judgment on the specific issues included in those motions.