Linton v. U.S., U.S. Dist. Ct. W.D. Washington, Cause No. C08-227Z (July 1, 2009)

Contributions of Property to LLC and Gifts of LLC Interests on the Same Day Resulted in Application of Indirect Gift and Step Transaction Doctrines to Eliminate Any Discounts for Gift Tax Purposes

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Synopsis

The court found factually that undeveloped real property, cash, and municipal bonds were contributed to an LLC on the same day that gifts of LLC interests were made to a trust (also created on that same day for the donor's children). (Despite factual testimony as to the intended dates of the gifts, the trust agreement itself stated that the gifts of LLC interests to the trust were made "[a]t the time of signing of this Agreement" and the trust agreement was signed on the same date as the date of the contributions.) In a gift tax refund action, the court upheld the government's motion for summary judgment, finding that no discount should be allowed with respect to the LLC interests. The gifts constituted indirect gifts of the underlying assets (the facts are particularly similar to those in *Senda* where the contribution and gift occurred on the same day and the facts did not make clear which occurred first).

The most significant impact of this case is its analysis of how the step transaction doctrine applies to gifts of partnership or LLC interests. Although not necessary to grant the government's motion for summary judgment, the court also added that the step transaction would apply. The *Holman* and *Gross* cases were the first cases (both decided by Judge Halpern) to address the application of the step transaction doctrine in this context. Even though various commentators have criticized the analysis in *Holman* and *Gross*, the court's analysis followed the same general approach as in the *Holman* and *Gross* cases. The court repeated all three of the alternative tests for the step transaction doctrine that were mentioned in *Holman* and *Gross* and concluded that all three tests would apply. The court's reasoning regarding especially the last two tests was very broad and might leave open an argument by the IRS in future cases that the step transaction doctrine could apply to gifts of partnership or LLC interests made long after the time that the entities are funded. 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. The court specifically observed that the assets involved in this case (real property, cash, and municipal bonds) were not as volatile as the assets involved in *Holman* and *Gross*.

Basic Facts

(1) H created an LLC in November 2002.

(2) On January 22, 2003, H gave 50% of his percentage interest in the LLC to W.

(3) *On the same day*, H signed documents transferring assets, including undeveloped real property, cash, and municipal bonds to the LLC.

(4) Furthermore, o*n the same day*, H and W signed trust agreements for their four children, providing that the agreements were "entered into effective upon contribution of property to the Trust," and stating further the "[a]t the time of signing of this Agreement, the Grantors have transferred percentage interests in the WLFB Investments, LLC… to the Trustee …."

(5) Finally, *on the same day* H and W signed gift assignments collectively assigning 90% of the LLC interests to the trusts for their children. The gift assignment documents were not dated when they were signed, but their lawyer later filled in January 22, 2003 on the gift assignment documents.

(6) H testified in a deposition that his "team of experts" suggested creating the LLC and stated that between 40 and 49% discounting would be allowed for gifts of the LLC interests based on the blend of assets being considered. Based on that, H "just did some back math to figure out how much money to put into the LLC."

(7) H and W filed gift tax returns reporting gifts of about $725,000 each (after applying discounts), but the IRS concluded that no discounts should be allowed and that the gifts by each were about $1.5 million. (The opinion does not state the discount claimed by the donors, but the gift amount

claimed on the returns reflected discounts of about 52-54% of the gift amounts claimed by the government.)

Analysis and Observations:

(1) Dispute as to Intent. The court allowed testimony by the donors and their attorney regarding the intent with respect to the timing of the transactions. However the court concluded that the testimony only reflected that the donors did not date the trust agreements or gift documents, and that the dates added by the attorney may been incorrect as a result of a scrivener's error. However, the taxpayers cannot by parol evidence contradict the express language of the trust and the gift documents, and they explicitly indicate that the gifts to the trusts occurred before or with the signing of the trust agreements, which undisputedly took place on January 22, 2003.

(2) 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 regulation does not directly address partnership or LLC contributions, and the court concludes in that context that "the distinguishing factor for gift tax purposes is whether the donating partner's contribution of property was apportioned among the other partners or was attributed only to the donor's own capital account." If the contribution is apportioned directly among the other partners' capital accounts, the contribution is treated as an indirect gift to the other partners.

The court analyzes three separate types of factual circumstances.

a. Partnership Transfers Preceded Contributions. In *Shepherd,* 115 T.C. 376 (2000), the donor's sons owned partnership interests before land was contributed to the partnership. "[B]ecause the contributions of property were allocated, pursuant to the partnership agreement, to the taxpayer's and his sons' capital accounts according to their respective partnership shares, and because each son would be entitled upon dissolution of the partnership to receive payment of the balance in his capital account, the taxpayer had made indirect gifts to the sons."

b. Contributions Preceded Partnership Transfers; Contributions Allocated to Contributor's Own Capital Account. In *Estate of Jones,* 116 T.C. 121 (2001), the decedent and his children contributed to several partnerships, with the contributions being allocated to their respective capital accounts. Subsequently that same day, the decedent gave limited partnership interests to his children. (The facts were clear that the gifts occurred *after* the contributions, even though they were made the same day.) The court refused to treat contributions made by the decedent as indirect gifts to his children, based on their subsequently donated partnership interests, because his contribution was originally allocated to his own capital account.

In *Gross*, T.C. Memo 2008-221, the taxpayer's contributions to a partnership were allocated entirely to her capital account and she made gifts of partnership interests of 11 days later. The court refused to apply the indirect gift approach.

c. Uncertain Sequence of Events. In *Senda*, T.C. Memo 2004-160, *aff'd*, 433 F.3d 1044 (8th Cir. 2006), the transfer of partnership interests and contributions to the partnership occurred on the same day and the facts were not clear which occurred first. "Absent adequate proof of the chronology of events, the transactions in *Senda* were deemed to mirror those in *Shepherd*; the taxpayers were treated as having gifted partnership interests to their children before transferring property to the partnership, and the contributed property… constituted an indirect gift to each child."

d. Application to Linton Facts. "Because the Trusts were created, and gifts of LLC interests were made to the Trusts, on January 22, 2003, either before or simultaneously with the contribution of property to WFLB, LLC, the Court holds that this case is analogous to both *Shepherd* and *Senda*, and that the Lintons' transfers of real estate, cash, and securities enhanced the LLC interests held by the children's Trusts, thereby constituting indirect gifts to the Trusts of pro rata shares of the assets conveyed to the LLC."

(3) Observations Regarding Indirect Gift Analysis. There is no surprise or new ground broken in the indirect gift analysis. Once the court made its factual finding that the gifts of LLC interests were made before or simultaneously with the contributions, the *Senda* case (which was affirmed by the 8th Circuit Court of Appeals), directly applies to cause the indirect gift analysis to apply.

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 to that partner's capital account. (Various private rulings reasoned that merely booking additional contributions to the transferor's capital account is not sufficient. TAM 200432015 & 200212006. However, *Estate of Jones, Gross* and now *Linton* all place considerable reliance on the fact that additional contributions were first allocated to the contributing partner's capital account.)

(4) Observations Regarding Possible Argument of Ignoring Gift From H to W. Observe, that the IRS might have also argued that the initial gift from H to W and her subsequent gifts that *same day* to trusts for the children might also be treated as an indirect gift from H to the trusts for the children. Cf. Treas. Reg. 25.2511-1(h)(2,3,9) (examples of indirect transfers for gift purposes). The facts do not make clear whether annual exclusions were claimed for these gifts. From the amount of gift taxes reported on the returns, it appears that H and W had previously used all of their $1.0 million lifetime gift exemption amounts. If annual exclusions were available, the gift taxes were obviously lowered by using W's annual exclusions as well as H's. (Perhaps the IRS would have raised this issue if more than just four additional annual exclusions were at issue.)

This indirect transfer approach has also been applied in the estate tax context to determine who was the transferor of a particular transaction for estate tax purposes. For example, if A transfers cash to B, with the understanding that B will transfer property to a trust for A's benefit, A is treated as the grantor of the trust even though he never owned the property that was transferred to the trust. *Estate of Shafer v. Comm'r*, 749 F.2d 1216 (6th Cir. 1984). *See Brown v. U.S.*, 329 F.3d 664 (9th Cir. 2003)(husband made gift to wife; wife made gift to trust; husband died within three years; applied step transaction doctrine to determine that husband was the "real donor" so that §2035 applied to gift tax on transfer within three years of death). As another example, if a husband owes funds to his wife from a prior loan, but pays the funds into a trust for the wife instead of repaying her, the wife will be treated as the grantor of the trust. *Estate of Marshall v. Comm'r,* 51 T.C. 696 (1969), nonacq. 1969-2 C.B. xxvi. *See also Estate of Kanter v. Comm'r*, 337 F.3d 833 (7th Cir. 2003) (son was treated for income tax purposes as grantor of trusts purportedly established by his mother where son funded trusts).

(5) 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." Much like the analysis in *Holman*, 130 T.C. 170 (2008) and

Gross, T.C. Memo 2008-221 (2008), the court reasoned that three separate tests have been applied in determining if the step transaction doctrine applies. The court concludes that each 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, is met because the donor "executed binding Trust Agreements and Gift Documents at the same time they took the first step of contributing property to the LLC."
- 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 "undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability."
- 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 the donors "would not have undertaken one or more of the steps at issue absent their contemplation of the other integrating acts", and "[b]ut for the anticipated 40% to 49% discount in calculating gift taxes, premised on the low market appeal of WLFB LLC's structure, plaintiffs would not have contributed assets to the LLC. Indeed, the quantum of property transferred to WLFB LLC was determined solely on the basis of maximizing the tax advantages of the transaction."

b. Distinguishing *Holman* and *Gross*. 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. The court recited the "real economic risk" reasoning by Judge Halpern in *Holman* and *Gross*. Because there was a real economic risk of a change in value between the time of the contribution and the subsequent gifts of partnership interests, *Holman* and *Gross* "refused to disregard the passage of time or to treat the contributions to the partnership and the subsequent gifts as occurring simultaneously pursuant to the step transaction doctrine." Based on the types of assets involved in *Holman* and *Gross*, (Dell stock in *Holman* and a portfolio of marketable securities in *Gross*) the court determined that there was a real economic risk of a change in value during the six and eleven day delays, respectively, in those cases between the date of funding and the date of the subsequent gifts of interests in the entities. The court specifically observed in *Holman* that the IRS did not make the step transaction argument with respect to a gift made two months after contributions to the partnership, thus suggesting that some appropriate delay is sufficient to avoid the step transaction argument.

In this case, the donors did not delay the gifts for some period of time after funding of the LLC. Furthermore, the court observed that there was no data concerning the fluctuations, if any, and the prices of the various securities issue on a daily basis during the period in question. The court observed that because of the assets in question (i.e., real property, cash, and municipal bonds), "plaintiffs cannot show the volatility necessary to establish a real economic risk associated with" any delay that may have existed in this case.

(6) Observations Regarding Step Transaction Doctrine Analysis.

a. <u>Dictum</u>? The indirect gift analysis by itself is sufficient to grant the IRS's motion for summary judgment ignoring LLC discounts in determining the gift amount. In that respect, the additional step transaction analysis is dictum (or is the indirect gift analysis dictum to the step transaction analysis)?

b. <u>Adopts General Approach of *Holman* and *Gross* Despite Criticism by Commentators</u>. Various commentators have criticized the approach of the step transaction analysis in *Holman* and *Gross*. The IRS's argument is that the donor makes an indirect gift of the contributed assets to the other members of the LLC in proportion to their percentage interests (without a discount attributable to the LLC). However, the children who own membership interests do not end up owning the assets. The step transaction doctrine treats a series of formally separate steps as a single transaction. Even so, in this situation the end result is that the donee-partners do not end up owning a pro rata undivided interest in the assets contributed to the LLC. That would seem sufficient to say that the step transaction doctrine does not apply. (The step transaction argument is different from the indirect gift argument, where there is a regulation providing that a transfer to an entity may be treated as indirect gifts to the other shareholders even though they do not end up owning the assets. However, if there is not an "indirect gift" under the regulation, there is no indication that the fiction in the regulation should be extended to the totally separate step transaction argument.)

Observe the significance of the first cases to rule on a particular issue. Despite the criticism that Judge Halpern's analysis in *Holman* and *Gross* has received, the first district court to address this issue applied the same general approach toward the step transaction issue in the context of gifts of partnership or LLC interests.

c. <u>Length of Delay Required Based on Types of Assets Involved</u>. Judge Halpern's analysis in *Holman* and *Gross* suggested that the amount of delay required to avoid a step transaction argument will depend on the nature of the assets contributed to the partnership or LLC. The court acknowledged in *Holman* in footnote 7 that the "real risk of a change in value arises from the nature of the Dell stock as a heavily traded, relatively volatile common stock. We might view the impact of a six-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond." Similarly, footnote 5 in *Gross* suggested that an 11-day delay might not be sufficient for certain types of assets, such as a preferred stock or a long-term Government bond.

Linton reiterates this concern, by specifically questioning whether there would be sufficient volatility over a ten day delay period to establish a real economic risk for the assets involved with this LLC, namely, real property, cash and municipal bonds. (Query why it looked at ten days? A ten-day period does not seem to appear anywhere in the facts.)

For assets with low volatility, a significantly longer delay than 6-11 days may be required to avoid the analysis of the three cases that have now considered the step transaction argument in the context of gifts of partnership or LLC interests. For non-volatile assets, delay as long as possible. Some have noted that the IRS did not make the step transaction argument for the gift made two months after the initial contribution in *Holman*, but there is no magic about even a two month delay for non-volatile assets.

Indeed, the court's analysis of the "end result test" and "interdependence test" seems to leave open a possible argument by the IRS that the step transaction doctrine could apply with respect to partnership interest transfers made long after the contribution of assets to the partnership. The court reasoned that the end result test is satisfied because the donors "undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability." That same reasoning would seem to apply to gifts of partnership or LLC interests made years after the contribution to the entity. The court's reasoning as to the interdependence test also seems to apply broadly: "But for the anticipated 40% to 49% discount in calculating gift taxes, premised on the low market appeal of WLFB LLC's structure, plaintiffs would not have contributed assets to the LLC." If that is sufficient to apply the interdependence test, the step transaction doctrine similarly might be applied to subsequent gifts made years later. (This nonsensical result seems to underscore that the reasoning of this approach to analyzing whether the step transaction doctrine applies does not seem appropriate to determine if the donor has made a gift of a pro rata portion of the assets contributed to an entity.)