Pierre v. Commissioner, 133 T.C. No. 2
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Transfers of Interests in Single-Member LLC Treated as Transfers of Interests in the Entity Rather Than as Transfers of Proportionate Shares of the Underlying Assets (Without a Discount)

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Synopsis

Gifts and sales of interests in a single-member LLC to two trusts (12 days after the LLC was created) are treated for federal gift tax purposes as transfers of interests in the entity (with the possibility of discounts) rather than as transfers of proportionate shares of the underlying assets owned by the LLC, even though the single-member LLC is treated as a disregarded entity pursuant to the check-the-box regulations. This conclusion came from a rather divided Tax Court (with 10 judges joining the majority and 6 judges dissenting).

Basic Facts

(1) Mother wanted to provide for her son and granddaughter, but was concerned about keeping her family's wealth intact. A plan was developed for her to fund an LLC and make transfers of interests in the LLC to trusts for her son and granddaughter.

(2) On July 13, 2000, Mother organized a single-member LLC. She did not elect to treat the LLC as a corporation for federal tax purposes by filing Form 8832, so by default it was treated as a disregarded entity.

(3) On September 15, 2000, Mother transferred $4.25 million in cash and marketable securities to the LLC.

(4) Twelve days later, on September 27, 2000, Mother transferred her entire interest in the LLC to two separate trusts, one for her son and one for her granddaughter. This happened in two steps. First, she gave a 9.5% interest to each trust. Then she sold a 40.5% interest to each trust for a secured note, with the face amount determined by an appraisal that applied a 30% discount (although a mistake in valuing the underlying assets resulted in a 36.55% discount.)

(5) Mother filed a gift tax return for 2000 reporting the gifts. The IRS took the position that the transfers made by gift and sale should be valued as a proportionate share of the underlying assets (without a discount).

Issue

"The issue to be decided is whether certain transfers of interests in a single-member limited liability company (LLC) that is treated as a disregarded entity pursuant to sections 301.7701-1 through 301.7701-3, Proceed. & Admin. Regs., known colloquially and hereinafter referred to as the check–the-box regulations, are valued as transfers of proportionate shares of the underlying assets owned by the LLC or are instead valued as transfers of interests in the LLC, and, therefore, subject to valuation discounts for lack of marketability and control." (A separate opinion will address "(1) Whether the step transaction doctrine applies to collapse the separate transfers to the trusts and (2) the appropriate valuation discount, if any.")

Holding

"[T]ransfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC."

Analysis of Majority:

(1) IRS Position. Mother elected to treat the LLC as a disregarded entity separate from its owner "for federal tax purposes" under the check-the-box regulations. Regulation §301.7701-3(a) provides that "[w]hether an organization is an entity separate from its owners *for federal tax purposes* is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." (emphasis added) Because the LLC is treated as a disregarded entity, the transfers of interests in the LLC should be treated as transfers of cash and marketable securities, i.e., proportionate shares of the LLC's assets, rather than as transfers of interests in the LLC for purposes of valuing the transfers to determine federal gift tax liability.

(2) Taxpayer Position. State law, not federal tax law, determines the nature of a taxpayer's interests in property transferred and the legal rights inherent in that property interest. Under New York law, a member has no interest in specific property of the LLC. Accordingly, the transfers of interests in the LLC were properly valued as interests in the LLC with appropriate lack of control and lack of marketability discounts.

(3) Historical Gift Tax Valuation Regime. The U.S. Supreme Court has clarified that the federal gift tax is constitutional as an excise tax rather than a direct tax (which must be apportioned proportionately by population) because it is a tax on the power to give property to another. "A fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights." The conclusion to be drawn from the general principles is that "there was no State law 'legal interest or right' in [the LLC assets] for Federal law to designate as taxable, and Federal law could not create a property right in those assets. Consequently, pursuant to the historical Federal gift tax valuation regime, petitioner's gift tax liability is determined by the value of the transferred interests in Pierre LLC, not by a hypothetical transfer of the underlying assets of Pierre LLC."

(4) Check-the-Box Regulations Merely Intended to Cover Classification of Entities. The "Kintner Regulations," in place since 1960, addressed the classification of entities for federal tax purposes and they became "unnecessarily cumbersome to administer." To simplify the classification of hybrid entities, such as LLCs, the check-the-box regulations were promulgated. Regulation §301-7701-1(a)(1) provides:

> "The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners *for federal tax purposes* is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." (Underlined emphasis supplied by court; italicized emphasis added).

Regulation §301.7701-3(a) provides that

> "[a] business entity … can elect its classification for federal tax purposes as provided in this section. An eligible entity … with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner." (Emphasis supplied by court).

"There is no question that the phrase 'for federal tax purposes' was intended to cover the classification of an entity for Federal tax purposes, as the check-the-box regulations were designed to avoid many difficult problems largely associated with the classification of an entity as either a partnership or a corporation…"

Section 7701, which is the underpinning of the check-the-box regulations, defines entities for purposes of the Internal Revenue Code, but §7701(a) makes clear that the definitions in that section apply "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." In any event, §7701 does not make clear whether an LLC falls within the definition of a partnership, a corporation, or a disregarded entity taxed as a sole proprietorship.

(5) Check-the-Box Regulations Do Not Alter Historical Federal Gift Tax Valuation Regime. The issue is whether the check-the-box regulations require disregarding a single-member LLC, validly formed under state law, in deciding how to value and tax a donor's transfer of an ownership interest in the LLC under the federal gift tax regime. The IRS suggested several precedents for ignoring state law restrictions. None of those precedents are applicable. McNamee v. Dept. of the Treasury, 488 F.3d 100 (2d Cir. 2007) held that state law cannot abrogate the federal employment tax obligations of the owner of a disregarded entity under the check-the-box regulations; it did not hold that an entity is to be disregarded in deciding what property interests are transferred under state law. Similarly, Littriello v. United States, 484 F.3d 372 (6th Cir. 2007) and Med. Practice Solutions, LLC v. Comm'r, 132 T.C. No. 7 (March 31, 2009) merely involved the classification of a single-member LLC for purposes of liability for employment taxes, not transfers of interests in a single-member LLC for gift tax purposes. Shepherd and Senda held that a transfer of assets to a partnership already owned by other partners (or where it cannot be determined whether the contribution preceded the transfer of partnership interests) may represent an indirect gift to the other partners. That is distinguished from the current situation in which the taxpayer clearly contributed assets to the LLC before transfers of ownership interests in the LLC to the trusts.

(6) Conclusion. Congress has enacted several provisions that explicitly disregard valid State law restrictions in valuing transfers (§§2701 and 2703), but when Congress has determined that the "willing buyer, wiling seller" and other valuation rules are inadequate, it expressly has provided exceptions to address valuation abuses (see

chapter 14 of the Code). By contrast, Congress has not acted to eliminate entity related discounts for LLCs or other entities generally, or for single-member LLCs specifically.

> "In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC."

The reviewed majority opinion, written by Judge Wells, was joined by nine other judges (Cohen, Foley, Vasquez, Thornton, Marvel, Goeke, Wherry, Gustafson, and Morrison).

Brief Overview of Concurring and Dissenting Opinions

(1) Concurring Opinion by Judge Cohen. The check-the-box regulations were a targeted substitute to the complexity of the Kintner regulations, and a targeted solution to a particular problem should not be distorted to achieve a comprehensive overhaul of a well-established body of law.

The majority opinion does not disregard the plain meaning of the phrase "for federal tax purposes" in the check-the-box regulations. First, the regulation does not provide that an entity is disregarded "for all federal tax purposes," but the regulation implements a statute that by its terms applies except where "manifestly incompatible with the intent" of the Internal Revenue Code. "The language of the regulation requires a determination of which 'federal tax purposes' are implicated and whether a given purpose might be manifestly incompatible with the Internal Revenue Code." Second, the statement that an entity will be "disregarded as an entity separate from its owner" is ambiguous and the regulation must be interpreted in light of the other principles of the Internal Revenue Code, including the historical valuation principles. The IRS's proposed application of the regulation is manifestly incompatible with those principles.

The majority opinion does not involve the issue of deference to the Commissioner's interpretation of a statute. Nothing in the check-the-box regulations or in the cases cited requires disregarding a "single–owner LLC where, as is the case here, to do so would be 'manifestly incompatible' with the intent of other provisions of the Internal Revenue Code."

The court has never accorded deference to the Commissioner's litigating position, as contrasted to (1) contemporaneous expressions of intent when the regulations were adopted and (2) consistent administrative interpretations before the litigation.

(This concurring opinion was joined by eight other judges (all of the judges that joined the majority opinion except Judge Morrison).)

(2) Dissenting Opinion by Judge Halpern. Express language in the check-the-box regulations seems to apply. Regulation §301-7701-2(a) says that when an entity with only one owner is disregarded "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." Therefore, the LLC's activities are

treated in the same manner as those of a sole proprietorship. A sole proprietorship is generally understood to have no legal identity apart from the proprietor.

If the "activities instruction" regulation is ambiguous, it must be construed, and an agency's interpretation of its own regulation must be considered and the courts will ordinarily show deference to such construction and give it controlling weight. The government's position is consistent with the Commissioner's administrative position for at least 10 years, evidenced by Rev. Rul. 99-5, and cannot be dismissed as a mere litigating position. Rev. Rul. 99-5 treated a sale by the owner of a single-member entity of a 50% ownership interest in the entity as converting the entity to a partnership and treated the purchaser as purchasing a 50% interest in each of the LLC's assets, "which are treated as held directly by [the original single-member owner] for federal tax purposes." Granted, that addresses sales for income tax purposes, and the Commissioner has made no interpretation specifically for gift tax purposes, but "a gift is the functional equivalent of a below-market sale."

As to the deference issue, the majority opinion does not merely reject the IRS's interpretation of the regulation but actually accepts that meaning and rejects the activities instruction itself as an invalid construction of the statute. McNamee, Littriello and Med. Practice Solutions, LLC have all recognized the validity of the check-the-box regulations as applied to single-member disregarded entities.

Judge Halpern's dissent was joined by Judges Kroupa and Holmes.

(3) Dissenting Opinion by Judge Kroupa. The majority fails to apply the plain meaning of the regulation, which requires that a single-member LLC be disregarded for "federal tax purposes." The check-the-box regulations are not simply rules of classification, but apply to the entire Code. The regulations do not just apply for "federal *income* tax purposes," and the drafters could have specifically excluded gift tax from the regulations' scope had they intended to do so. The regulations consistently treat single owners who choose noncorporate status for their LLCs as holding the property of their disregarded entities.

Other guidance from the IRS treats the owner of a single-member LLC as the owner of its underlying property, including Rev. Rul. 99-5 and numerous private letter rulings (for example, such as the applicability of like-kind exchange treatment).

The majority invalidates the check-the-box regulations for federal gift tax purposes to the extent that the term "federal tax purposes" encompasses federal gift tax.

The majority opinion's reliance on the gift tax regime and valuing interests that are recognized by state law is misplaced. The regulations provide the federal tax consequences of what is, in effect, an agreement between the taxpayer and the Commissioner to treat an entity in a certain way for federal tax purposes despite the entity's state law classification. Three cases have confirmed that the owner of single-member LLC is liable for federal employment taxes even though state law provides that the owner is not personally liable for the LLC's debts. McNamee, Littriello, and Med. Practice. "Determining an owner's liability for employment taxes is as far removed from determining the owner's income tax liability as is determining the owner's gift tax liability."

The majority overlooks the broad scope of the gift tax statutes in concluding that the check-the-box regulations are manifestly incompatible with the gift tax regime. The gift tax regime includes indirect gifts (citing Dickman). Substance over form principles have been used by the courts to get to the true nature of a gift (citing Kerr, Astleford, and Estate of Murphy). The courts have also used the step transaction doctrine in the area of gift tax where intra-family transactions often occur (citing Senda and Commissioner v. Clark, 489 U.S. 726, 738 (1989)).

> "Conclusion The plain language of the regulations requires Pierre LLC to be 'disregarded as an entity separate from its owner.' Unlike the majority, I give meaning to these words. I do not minimize this language by labeling it a classification. A plain language interpretation of the check-the-box regulations must prevail. It is an interpretation of relevant regulations. It is not manifestly incompatible with the gift tax statutes."

Judge Kroupa's dissent was joined by five other judges (Judges Colvin, Halpern, Gale, Holmes, and Paris).

Observations

(1) Case of First Impression; Discounts May Be Allowed for Single-Member LLCs. The issue of how the disregarded "for federal tax purposes" regulation will be applied for gift and estate tax purposes has been an open issue since the check-the-box regulations were issued. This is the first opinion addressing the valuation issue for a transfer of an interest in a single-member LLC. It seems to be a rather close call, with six Tax Court judges joining the dissent. The dissents make interesting arguments. Nevertheless, in this case of first impression, the court decides that discounts are not automatically disallowed for federal gift tax purposes when the interests in a single-member LLC are transferred.

(2) Different Possible Approach: Focus on What Is Transferred to Hypothetical Willing Buyer. The judges obviously struggled with how the regulation saying that the entity is disregarded for federal tax purposes applies in the context of gift (and presumably estate) tax purposes. However, the regulation applies during the time that the entity is a single-member entity. For gift (and estate) tax purposes, the key is what is transferred. At the instant a transfer is made, the entity is no longer a single-member entity (unless it is transferred entirely to a single transferee). In this case, there were multiple transfers (i.e., by gift and sale) to multiple transferees. The gifts occurred first. After the initial transfers, the entity clearly was not a single-member entity, and the value of the interests subsequently sold do not seem to be affected by the regulation, which only applies to single-member entities, unless the step transaction doctrine somehow aggregates the gift and sale transactions.

In addition, the transfers in this case are to multiple transferees. Under the principles of Rev. Rul. 93-12, the transfers to each separate transferee are valued separately. In that context, the transfer to each necessarily will not be interests in a single-member LLC.

One possible way of approaching the issue is to focus on the particular interest being transferred, and whether it can possibly be treated as an interest in a single-member entity. The answer for estate tax purposes may be that it would be — that the focus would be on the single-member interest owned by the estate, rather than focusing on who are the legatees of the interest (and in particular, whether there are multiple transferees). Even for gift tax purposes, if the court applies a step transaction doctrine to join all of the different transfers into a single transfer, the issue of how the regulation applies might arise. Aside from those situations, the niceties of whether the regulation applies would be avoided under this alternate possible analysis. But — that was not the court's approach.

This suggests a planning consideration. In the event that future cases may resolve this issue differently (indeed, this was a very divided court), consider first making a transfer of a very small interest in the entity (for example, 1% or lower), in case a future court were to treat the transfer of an interest in a single-member LLC as a proportionate transfer of the underlying assets (without a discount). If the client later decides to transfer further interests in the entity, it would no longer be a single-member entity, so the regulation would not apply, unless the IRS were able to apply the step transaction doctrine. How long of a delay would be necessary to avoid the step transaction doctrine? If future courts were to apply an analysis similar to Holman, the focus might be on whether there was a real risk of an economic change in value during the intervening time period. Of course, there may be important reasons for keeping the entity as a single-member disregarded entity rather than having it convert to a partnership for income tax purposes. If that were important, the transfers would typically be made to grantor trusts, and it is not clear how the single-member LLC regulations would apply in this context if there were various transfers to a single grantor trust. During the time that the original grantor and the grantor trust each held interests in the LLC, those interests are recognized as separate ownership interests for estate and gift tax purposes, but it is not clear how the single-member entity regulations would apply for estate and gift tax purposes. On the other hand, if there were transfers to multiple grantor trusts for differing beneficiaries, it would be harder for the government to maintain that the entity is still a single-member entity for estate and gift tax purposes.

(3) Step Transaction Doctrine; Aggregation. The step transaction doctrine is arising with increasing frequency. At one time, many planners argued that the step transaction doctrine was an income tax doctrine that did not apply at all to the estate and gift tax. Now, it seems to be a rather commonplace argument in gift and estate tax cases (and the very broad reasoning in the Litton and Heckerman cases is quite troubling — suggesting that the doctrine might apply almost whenever an individual has an intent to transfer assets to children while minimizing transfer taxes).

Footnote 1 indicates that there will be a separate opinion addressing "whether the step transaction doctrine applies to collapse the separate transfers to the trusts." Footnote 4 indicates that the IRS did not argue that the step transaction doctrine should be applied to disregard the LLC entirely. Instead, the IRS argues that the step transaction doctrine should apply to the gift and sale transfers, but "explicitly limits the proposed application of the step transaction doctrine to the events of Sept. 27, 2000." That is the date the gifts and sales occurred with the two separate trusts. Will the IRS argue that all four transactions (i.e., gift to Trust 1, sale to Trust 1, gift to Trust 2, and sale to Trust 2) should be treated as one transaction? That would involve the collapse of the multiple transactions with each transferee as well as the transactions of one transferee with the other transferee.

What if the two transferee trusts are each grantor trusts? Does that change the analysis? For income tax purposes, the grantor is treated as the owner of the assets of the grantor trust, so the owner may still be treated as the owner of the interests, but for estate and gift tax purposes, the trusts are separate legal entities and should not be deemed to be owned by the grantor of the grantor trust. Even if the trusts are grantor trusts, they should not be treated as being a single member (i.e., Mother in this case) for estate and gift tax purposes.

The IRS is not arguing that the funding of the LLC and the subsequent transfers of interests in the LLC should be treated as transfers of assets contributed to the LLC under the step transaction doctrine as discussed in the Holman, Senda, Gross, Linton, and Heckerman cases. (That would involve applying the step transaction doctrine to the events of Sept. 15-27, 2000, not just to the events of Sept. 27.) Footnote 12 specifically made the observation that the subsequent transfers were made 12 days after the funding of the LLC and that Holman had refused to apply the indirect gift analysis "where assets were transferred to a partnership 5 days before the gifts of the partnership interests." [Observe: The Holman facts indicate that the gift of partnership interests in the partnership holding Dell stock was made 6 days after funding in that case and the Gross case involved contributions of marketable securities 11 days before the transfers of partnership interests.]

The step transaction issue obviously involves an aggregation issue, as to whether transfers to multiple recipients should be aggregated. That would seem to be a very difficult argument for the IRS in light of its position in Rev. Rul. 93-12. The aggregation issue is important because if a transfer is made to a single member, even if it is treated as an interest in an entity rather than as a transfer of all of the assets, if the single member could dissolve the entity at any time under state law, the IRS would likely argue for very low (if any) discounts. If the transfers to multiple transferees are not ignored under the step transaction doctrine, it would generally no longer be possible for any single recipient to have the power to force the liquidation of the entity, so avoiding aggregation of the interests held by the separate transferees is very important.

How will the court apply the step transaction doctrine? Planners were generally very surprised with the way that the Tax Court chose to apply the step transaction doctrine in Holman (followed by Gross). If the court applies a similar analysis, i.e., whether there is a real risk of an economic change in value between the different steps in the transaction, it would seem that the gifts and sales made on the same day may be aggregated. However, that would not address combining the transfers to the separate trusts as a single transfer. If the transfers to the multiple recipients are respected, it would seem that the interests actually transferred would be entitled to entity level discounts under the reasoning of Rev. Rul. 93-12.

(4) Estate Tax Implications. The analysis presumably would be the same for estate tax purposes as to whether the interest in a single-member LLC is valued as an interest in the entity or valued at an amount equal to the value of the underlying assets. Even if the decedent is treated as holding an interest in the entity rather than the underlying assets, the IRS may argue that no discount should be appropriate if under state law the decedent could unilaterally control when the entity would be liquidated and receive the underlying assets, and could transfer that right to another single recipient. While the focus would still be valuing an interest in an entity, very low discounts may be applied if the decedent or the decedent's estate has the ability to reach the underlying assets at any time.

If that is the analysis that emerges in future estate tax cases involving interests in single-member LLCs, the primary importance of this case will be its direct application for gift tax purposes rather than possible ancillary effects for estate tax purposes.

In Mirowski, the IRS made its typical argument that the bona fide sale exception to §2036 did not apply, in part because "Ms. Mirowski sat on both sides of Ms. Mirowski's transfers" to a single-member LLC. The court rejected that argument, because it would mean that the bona fide sale exception to §2036 could never apply to the creation of a single-member LLC, and the court would not read out of the statute an exception that "Congress expressly prescribed when it enacted that statute."