Pierre v. Commissioner, T.C. Memo. 2010-106
(May 13, 2010) — " Pierre II"

Gifts and Sales of LLC Interests Moments Apart to Same Donee Aggregated for Valuation Purposes Under Step Transaction Doctrine; 35.6% Combined Discounts Allowed For Transfers of 50% Interests in LLC Containing Cash and Marketable Securities, But IRS Produced No Valuation Expert and Did Not Contest 30% Marketability Discount

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Synopsis

In Pierre I (133 T.C. No. 2, August 24, 2009) the Tax Court (in a 10-6 decision) held that 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.

In this subsequent case (Pierre II) addressing two bifurcated issues, the court determines (1) that the step transaction doctrine applies to aggregate the gifts and sales made to each trust (50% combined interest transferred to each trust) for valuation purposes (although this determination had the negligible effect of merely reducing the lack of control discount from 10% to 8%), and (2) that a combined 35.6% lack of control and lack of marketability discount is appropriate in determining the value of the 50% combined interest transferred to each trust. The taxpayer had one appraisal for the gift tax return and a separate expert testifying at trial. The IRS did not produce any valuation expert, and apparently did not even contest the availability of a 30% lack of marketability discount.

The significance of the case is the potentially far-reaching nature of the court's step transaction analysis rather than the actual result of the case. The court gave four reasons for applying the step transaction doctrine in this case: (1) Same day transactions; (2) no lapse of time between gift and sale transactions; (3) intent of making transfers without gift taxes, and (4) poor documentation. The rationale that the taxpayer intended to transfer all of the LLC without paying gift taxes could potentially apply to a variety of structured estate planning transactions.

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. 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. (The Pierre II facts said that the plan was to "transfer the $4.25 million of cash and marketable securities to an entity so that the gifts would be subject to valuation discounts for transfer tax purposes.")

(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. Moments later, she signed documents to sell a 40.5% interest to each trust for a 6.09% note "payable in 10 annual installments" secured by the 40.5% LLC

interests sold to each trust. The face amount of the notes was determined by an appraisal that applied a 36.5% discount. Pierre I stated (apparently mistakenly), that the appraiser applied a 30% discount, but "because of a mistake in valuing the underlying assets, a discount of 36.55 percent was used…" Pierre II instead states that the appraiser applied a 10% lack of control and 30% lack of marketability discount, "for a 36.55-percent cumulative discount." (A 10% lack of control and 30% lack of marketability discount would produce a combined seriatim discount of exactly 37% [i.e., 90% x 70% = 63% value, representing a 37% discount]. Perhaps the difference between 37% and 36.55% is due to some mistake in valuing the underlying assets.)

(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), which the IRS lost in Pierre I, that the gift and sale to each trust should be aggregated for valuation purposes under the step transaction doctrine, and that the discounts should be reduced.

(6) After the gift/sale transaction on September 27, 2000, the LLC made distributions each year to the two trust members that allowed them to make interest payments on the notes. No principal payments were made in the eight years from the date of the sale to the date of the trial.

Issues

As summarized in Pierre I, this separate opinion addresses: "(1) Whether the step transaction doctrine applies to collapse the separate transfers to the trusts and (2) the appropriate valuation discount, if any."

Holdings

(1) Step Transaction Doctrine Applies. The step transaction doctrine applies to collapse the 9.5% gift and 40.5% sale, made within moments of each other, to each separate trust for valuation purposes, and to treat the transfers as an aggregate transfer of a 50% interest in the LLC to each trust.

(2) Discount. An 8% lack of control and 30% lack of marketability discount was allowed, representing a combined discount of 36.5%; the IRS produced no valuation expert and apparently did not contest the applicability of a 30% lack of marketability discount.

Analysis

(1) Burden of Proof. Taxpayer argued that the IRS bears the burden of proof because she produced credible evidence and met the other requirements of §7491(a). The court said that it could "determine factual issues on the weight of the evidence, however, unless there is an evidentiary tie." It found no such evidentiary tie, so the burden of proof was irrelevant. [OBSERVATION: This approach would seem to

make the burden of proof relevant in very few valuation cases, where there is almost never an evidentiary "tie."]

(2) Step Transaction Doctrine. The taxpayer gave several nontax reasons for establishing the LLC (despite the court's statement of the facts that the entity was created "so that gifts would be subject to discounts"). However, the taxpayer gave no nontax reason for splitting the gift transfers from the sale transfers.

(a) General Principles. The court outlined the step transaction doctrine and held that it can apply to collapse transfers for gift tax valuation purposes:

"The step transaction doctrine embodies substance over form principles. It treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. See Commissioner v. Clark, 489 U.S. 726, 738 (1989). Where an interrelated series of steps is taken pursuant to a plan to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole Holman v. Commissioner, 130 T.C. 170, 187 (2008), affd. __ F.3d __ (8th Cir., Apr. 7, 2010); Gross v. Commissioner, T.C. Memo. 2008-221. The step transaction doctrine is 'well established' and 'expressly sanctioned' and may be applied in the area of gift tax where intra-family transactions often occur. See Senda v. Commissioner, 433 F.3d 1044, 1049 (8th Cir. 2006) (citing Commissioner v. Clark, supra at 738), affg. T.C. Memo. 2004-160.

"It is appropriate to use the step transaction doctrine where the only reason that a single transaction was done as two or more separate transactions was to avoid gift tax. Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149 (collapsing decedent's transfer to family members of minority interests in closely held stock with his same-day sale/redemption of his remaining stock in the corporation in exchange for a note). We have applied the step transaction doctrine to aggregate a taxpayer's two separate same-day transfers to a partnership of undivided 50-percent interests in land to reflect the economic substance of the transaction. See Shepherd v. Commissioner, 115 T.C. 376, 389 (2000), affd. 283 F.3d 1258 (11th Cir. 2002). We have also collapsed a taxpayer's separate same-day steps of funding a partnership with the taxpayer's gifts of partnership interests where, at best, the transactions were integrated and, in effect, simultaneous. Senda v. Commissioner, T.C. Memo. 2004-160, affd. 433 F.3d 1044 (8th Cir. 2006)."

(b) Application of General Principles to Facts. Whether several transactions should be considered integrated steps of a single transaction is a question of fact. The court listed four reasons for concluding that the gift and sale were "integrated steps of a single transaction."

(i) They happened the same day.

(ii) No time elapsed other than "the time it took four documents to be signed."

(iii) The taxpayer "intended to transfer her entire interest in [the LLC] without paying gift tax." The court found that the taxpayer "had primarily tax-motivated reasons for structuring the gift transfer as she did." The court noted that no principal payments had been made on the notes despite the passage of eight years, and that the LLC made annual distributions so the trust could make the annual interest payments. "Consequently, she transferred $4.25 million of assets within Pierre LLC without paying any gift tax. Petitioner intended not just to minimize gift tax liability but to eliminate it entirely."

(iv) Poor documentation — each trust's capital account in the LLC's journal and ledger were recorded with the notation "to reflect gift transfer by Suzanne Pierre to J. Despretz Trust and K. Despretz Trust" rather than distinguishing the gift and sale transactions. Those records were used to prepare the LLC's tax return. The attorney testified that he later discarded these records because they contained inaccuracies. The court responded: "We do not so easily ignore [the attorney's] contemporaneous description of the transaction."

(c) Conclusion Regarding Step Transaction. "We find that nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions. We also find that the gift transactions and the sale transactions were planned as a single transaction and that multiple steps were used solely for tax purposes. Accordingly, we hold that petitioner made a gift to each trust of the 50-percent interest in Pierre LLC to the extent the interest exceeds the value of the promissory note executed by the trust.

(3) Valuation.

(a) Taxpayer's Position. The appraisal attached to the gift tax return (and that was used to support the sale amount) used 10% lack of control and 30% lack of marketability discounts. A different expert testified at trial, and he used 10% lack of control and 35% lack of marketability discounts. However, the taxpayer did not "advocate" for more than a 30% marketability discount (in addition to a lack of control discount).

(b) IRS Position. At trial, the IRS focused on the "disregarded entity" issue to treat the transfer as a transfer of an undivided interest in the LLC assets rather than as a transfer of interests in the LLC. The IRS offered no expert testimony on valuation. The IRS challenged certain aspects of the trial expert's report and argued that a 35% marketability discount is too high. The IRS "failed to argue, however, that the 30-percent marketability discount … is inappropriate."

(c) Lack of Control Discount. The taxpayer's valuation expert testified that he had not valued a 50% LLC interest, but if he did, he would continue to look to the rights and restrictions under the LLC agreement. He pointed out, for example, that while many control limitations would still exist, a 50% interest could block the appointment of a new manager, and he admitted that the control discount "would be modestly reduced to as low as 8 percent." The court adopted that, and reduced the lack of control discount from 10% to 8%. (Observe that all the discussion about the step transaction doctrine and treating the transfers as two 50% interests rather than four minority interests in the gifts and sales to the two trusts resulted in an almost negligible difference in the valuation.)

(d) Lack of Marketability Discount. Footnote 9 indicates that the taxpayer's expert used private placement studies, comparing the amounts that investors paid for privately placed shares of restricted stock and the prices at which the company's shares traded in open exchanges. The court cited the Holman case as authority for using this approach in valuing a limited liability entity that is an investment vehicle for marketable securities. Footnote 10 notes that the IRS argued that private placement studies before 1990 reflect a median discount of about 34% and that later private placement studies, when there are fewer restrictions on restricted stock, reflect a lower discount, as low as 13%. The court noted that the parties "disagree as to whether the decrease is relevant in valuing an interest in Pierre LLC." (For example, taxpayers typically argue that the discounts should be greater than the discounts reflected in the restricted stock studies, because they reflect a marketability restriction just for one or two years whereas the restrictions on selling LLC interests would remain indefinitely.)

The court concluded by allowing a 30% marketability discount. The court observed that the taxpayer "advocates for only the 30-persent marketability discount on which she relied" and that the IRS "failed to argue … that the 30-percent marketability discount … is inappropriate."

Observations

(1) Major Significance of Case: Another Case Following Recent Trend of Applying Step Transaction Doctrine. The application of a step transaction doctrine in the estate and gift tax area is a relatively recent phenomenon. For years, the step transaction doctrine was applied in income tax cases, and there was very little discussion of the doctrine in estate and gift tax cases. Some planners have theorized that it does not apply in estate and gift tax cases. The application of the step transaction doctrine in this case had a minimal effect — it decreased the lack of control discount from 10% to 8%. However, the increasing use of the step transaction doctrine by the IRS in court arguments and by the courts in their reasoning suggests that the step transaction doctrine may become more and more prevalent in estate and gift tax cases.

The step transaction doctrine is arising with increasing frequency. Now, it seems to be a rather commonplace argument in gift and estate tax cases (and the very broad reasoning in the Linton, Heckerman, and Pierre 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). 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. 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 context of funding an FLP and make gifts of limited partnership interests, the donees similarly end up with only restricted FLP or LLC interests rather than the hard assets, and that fact did not preclude the courts in Holman, Gross, Linton, and Heckerman (discussed below) from saying the step transaction doctrine either did apply or could potentially apply in the right fact situation.

While there may have been some uncertainty previously as to whether the step transaction doctrine applies in the estate and gift tax context — it clearly IS being applied by the courts. The question now is how far the concept will be extended in estate and gift tax cases.

Perhaps the significance of the case has best been summarized by Mil Hatcher: "Pierre II has to be viewed as the proverbial camel's nose under the tent. Beware of what follows."

Before getting bogged down in a discussion of the increasingly prevalent use of the step transaction doctrine in estate and gift tax cases and a history of the recent cases, I will highlight some of my other observations about the case, and will address the recent history of applying the step transaction doctrine further at the end of these Observations.

(2) Step Transaction Doctrine Was Not Applied to Disregard All Discounts. Footnote 1 of Pierre I indicated that there would be a separate opinion addressing "whether the step transaction doctrine applies to collapse the separate transfers to the trusts." Footnote 4 indicated that the IRS did not argue that the step transaction doctrine should be applied to disregard the LLC entirely. Instead, the IRS argued 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."

The IRS did not argue 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 of Pierre I 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. In both of those cases, Judge Halpern reasoned that the step transaction concept could potentially be applied in these gift situations, but on the facts of these cases, it did not apply where there was a "real risk of economic change" between the time of funding and the date of the transfer of interests in the entity.]

(3) Importance of Correct Contemporaneous Documentation. This is another case where the documentation was viewed with considerable significance by the court. The general journal and ledger noted that the capital accounts of the donee/purchaser trusts were adjusted "to reflect the gift transfer" rather than distinguishing the gift and sale transactions. The attorney testified at trial that he later discarded those records because they contained inaccuracies, including the characterization of the transfers. The court responded: "We do not so easily ignore Mr. Reiner's contemporaneous description of the transaction."

Of course, if a mistake is made in documentation, the mistake should be corrected as soon as possible. Improper documentation at the time of a transaction does not necessarily suggest bad faith or improper motives. However, this is an example of a court placing particular significance on the way the documentation was recorded contemporaneous with the transaction.

(4) Different Expert at Trial. The taxpayer chose to use one appraiser for the appraisal contemporaneous with the transaction, to determine the number of units that were given and that were sold and to determine the sale price. Another expert was used for trial testimony, presumably someone the taxpayers' counsel believed would be good in a testifying role before the Tax Court. In this case, the appraisers were very close in their appraisals — the only difference was a 30% vs. 35% difference in the amount of the marketability discount, and the taxpayer did not press for more than the lower 30% discount at trial. There is some concern that a judge might use one appraisal to attack the other appraisal. However, this multi-expert approach is often used in valuation cases.

(5) Another Case with Substantial Discounts. When courts have reached the valuation issue in cases involving transfers of FLP or LLC interests, they almost uniformly have allowed significant discounts, even in case like this one involving an entity funded with cash and marketable securities. That happened again in this case, even though the court stated specifically in its summary of the facts that the mother wished to give her son and granddaughter $4.25 million of marketable securities, and the purpose of using the LLC was to "transfer the $4.25 million of cash and marketable securities to an entity so that the gifts would be subject to valuation discounts for transfer tax purposes." Despite that perception of the facts of the case, the court allowed substantial valuation discounts (8% lack of control and 30% lack of marketability, for a combined seriatim discount of 35.6%).

Of course, we cannot read too much into the valuation analysis by the court in light of the fact that the IRS did not present any expert testimony and apparently did not contest the 30% lack of marketability discount.

(6) How to Structure Gift/Sale Transactions to Avoid Aggregation For Valuation Purposes. To avoid aggregating gift and sale transactions for valuation purposes, the obvious response is to try to avoid the specific reasons that the court pointed to in reaching its conclusion in this case that the step transaction doctrine applied to aggregate the gift and sale assets for valuation purposes. The four factors were: (1) Same day transactions; (2) No time lapse at all in signing gift and sale documents; (3) taxpayer's intent; and (4) poor documentation.

The first two elements can certainly be addressed in planning gift/sale transactions. Ever since the Holman case, discussing that the delay of 6 days between the date of funding and the date of gifts of FLP interests prevented application of the step transaction doctrine to disregard the entity entirely for valuation purposes, planners have questioned whether a similar analysis might apply to separating the time between gift "seeding" of a grantor trust and a subsequent sale to that grantor trust. This case would suggest the wisdom of doing so. How long? Presumably the reasoning of the Holman and Gross cases would be relevant — wait long enough so that there is a real risk of a change in economic value. (However, that somehow seems to have less relevance for separating a gift and sale than for separating funding and transfers of interests in an entity —although the difference is hard to articulate, in light of the fact that it is difficult to discern the relevance of a "risk of change in economic value" in either situation.) The fourth element, poor documentation, can also be addressed in the planning stage.

The more difficult unknown is the "intent" factor stated by the court: "petitioner intended to transfer her entire interest in Pierre LLC to the trusts without paying any gift taxes." If that is enough to aggregate separate steps, perhaps most gift/sale transactions would be aggregated, because the transaction is typically planned to transfer assets without paying any gift taxes, and the sale transaction is used to transfer value with paying gift taxes. However, there can be reasons for making gifts and sales of interests in the same asset beyond just avoiding the payment of gift taxes. Parents may be willing to give a certain value but want payment in return for additional transfers. Perhaps that is why the court emphasized the actual implementation of the sale transaction during the eight years following the date of the sale. The court noted that the entity made distributions each year so that the trusts could make annual interest payments, and that no principal payments were made on the note. That could be interpreted as an indication that the taxpayer did not have any purpose for making a portion of the transfer by sale rather than gift for economic reasons beyond just avoiding gift taxes.

The particularly troubling aspect of the case is that the reasoning might seem to apply if the gift and sale transactions had been separated by weeks or months. The court's conclusion was that

> "nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions. We also find that the gift transactions and the sale transactions were planned as a single transaction and that the multiple steps were used solely for tax purposes."

The court's reasoning as to the intent factor is reminiscent of the district court's reasoning in Linton that 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." Similar reasoning appeared again in Heckerman, in which the court observed that 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.'"

In many situations, parents will have a goal of transferring all of a particular asset to children and decide to make the transfer partially by sale to avoid paying large gifts taxes. The court's language might seem to apply in many of those situations to conclude that the gift and sale transactions "were planned as a single transaction and that the multiple steps were used solely for tax purposes." Could this reasoning be extended to the common plan of making a "seed" 10% gift to a grantor trust, making a subsequent sale with a 9:1 debt equity ratio, and making additional sales as the equity value of the trust increases over time and can support additional debt within the 9:1 debt-equity ratio goal? Could all of those transactions over time be aggregated for valuation purposes? (Perhaps it is best to stop referring to the gift as a "seed gift;" that may carry a connotation of a planned transaction involving both a gift and sale.)

An even more significant risk for gift/sale transactions is if the IRS argues that the entire transaction should be collapsed into a single transaction for §2036 purposes. (1) It might argue that the combined transfer is treated as a transfer for less than full and adequate consideration with a retained interest (i.e., the note payments), so that the sale portion of the transaction no longer qualifies for the "bona fide sale for full consideration" exceptions to §2035 and §2036. (2) Alternatively, Professor Mitchell Gans points out that the step transaction doctrine might be used by the IRS to help bolster a "retained interest" argument. The U.S. Supreme Court considered the predecessor to §2036 in Fidelity-Philadelphia Trust v. Smith, 356 U.S. 274, 277 (1958). The case involved an annuity-life insurance combination, and the decedent had irrevocably transferred the life insurance policy while retaining the annuity. The Supreme Court concluded that this was not a transfer with a retained interest taxable under the predecessor to §2036, observing in footnote 8 that the annuity payments were not linked to income produced by the transferred policies, and the obligation to make the annuity payments was not chargeable to the transferred property:

> "Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred

> property so as to include the property in the estate of the decedent. [Citations omitted] In these cases the promise is a personal obligation of the transferee, the obligation is usually *not chargeable to the transferred property*, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made. (emphasis added).

Professor Gans points out that if the gift/sale transactions are not collapsed, the trust has assets for making the note payments other than just the asset sold to the trust (and for which an argument could be made that the note payments constitute a retained interest), so it has harder to argue that the retained payments are "chargeable" to the property sold to the trust. However, if the gift and sale are aggregated and tested under §2036, it would be easier for the IRS to argue that the note payments are "chargeable" to the combined transferred assets since they constitute the entire trust. Another analogy would be the private annuity cases, which have generally held that transfers of assets to a trust in return for an annuity from the trust does not trigger §2036 if there are significant other trust assets for making the annuity payments than just the assets transferred in return for the annuity.

That is a huge step from what the court did in Pierre II, and perhaps the IRS will never even make that §2036 argument let alone find a court receptive to it. Query whether the risk is reduced if the initial gift is not the same asset that is being sold; it may be harder to collapse those separate transactions involving separate assets (perhaps unless the gift asset is used as downpayment for the sale transaction). However, the downside risk is so great that it makes sense to take steps to avoid the argument, to the extent possible, by delaying the sale transaction for some "appropriate" period of time after the gift.

As a practical matter, the fact that the gift and sale transactions happened in Pierre within "moments" of each other (as noted in the court's conclusion) may have been an especially important factor in the court's decision. (Indeed, there was no hint that the court would have been receptive to applying the step transaction doctrine to the funding of the LLC and the subsequent gifts and sales made 12 days later even if the IRS had made that argument.)

Summary of Structuring Suggestions.

- Plan some time delay between the gift and sale transactions.
- If the client intends to limit the amount of gifts for economic reasons (i.e., the client is not willing to relinquish more value than a desired amount) and to make further transfers only as sales that will not deplete the client's assets, document that intent.
- To every extent possible, focus on the economics of the separate sale transaction, and implement the sale transaction in a way as to

give credence to the sale transaction, including making principal payments on the note over time, and not having the seller immediately turn around and make gifts of the note payments back to the purchaser (that did not happen in Pierre). The case indicates that the note was "payable in 10 annual installments." It did not say whether there were to be equal amortized payments or annual principal payments each year and the sellers failed to meet their payment obligations under the notes. In any event, the court went out of its way to observe that no principal payments were made on the notes over the eight years after the sale — suggesting that the taxpayer was not overly concerned with receiving payments from the sale transactions.

- Do not refer to the gift as a "seed" gift.
- If consistent with the client's intent, give and sell different assets. (Of course, there could be no aggregation for valuation purposes if there are different assets, but more importantly, using different assets may help thwart a §2036 argument by the IRS.)

(7) No Aggregation of Interests Received by Multiple Recipients. The IRS is foreclosed from arguing that transfers to multiple transferees should be aggregated for valuation purposes because of Rev. Rul 93-12. Not surprisingly, it appears that the IRS did not even raise that as an issue in Pierre. Even in the highly unlikely event that the IRS were to try to make a step transaction argument to aggregate transfers to multiple donees, the step transaction reasoning in Pierre does not require aggregation of interests given to multiple donees on the same day. Typically a parent will have reasons other than just reducing taxes for making gifts to more than one recipient. In Pierre, the taxpayer wanted to benefit both her son and her granddaughter. Indeed, in Pierre the court recognized the interests conveyed to the separate trusts for her son and granddaughter and viewed the aggregated gift/sale transaction to each trust as conveying a 50% interest.

(8) Recent History of Applying Step Transaction Doctrine.

a. Cidulka and Shepherd. The court cited several older cases, Cidulka and Shepherd in its step transaction doctrine analysis. However, neither of those cases refers to the step transaction doctrine. Cidulka and Shepherd both involve situations of ignoring separate transactions made on the same day for purposes of determine the value of a gift to the donee on that day. In Cidulka, a father made gifts to his son of minority interests in a corporation, but on the same day, the father's remaining shares in the corporation were redeemed. Not counting the father's shares that were redeemed, the shares given to the son on that day constituted a majority of the corporation's shares and the court concluded that the shares that were given to the son should be valued as a majority controlling interest. While there were two separate transactions (the gift and the redemption), the effect was just how the gift to the son would be valued; there were not two different transfers that were aggregated for valuation purposes by treating them as a single transfer. There was no discussion of the "step transaction doctrine."

Similarly, in Shepherd parents transferred all of their interest in certain land to a non-existent partnership, and the court treated the transfer as a transfer of 25% to each of their two sons. A detail that is buried in the facts of that case is that the parents deeded the land to the partnership using two separate deeds conveying 50% each to the partnership on the same day. The court had no trouble ignoring the fact that two deeds were used in making the transfer on that day instead of just one deed.

Neither of these cases applied a broad step transaction doctrine, which can have far-reaching effects in estate planning transactions beyond simply aggregating multiple transfers for valuation purposes that are made on the same day.

b. Senda (8th Circuit 2006). The Senda case sent minor shockwaves through the estate planning community in light of the Eighth Circuit's broad language applying the step transaction doctrine for estate and gift tax purposes. In Senda, the court applied the general principle that if a partner makes an additional contribution to a partnership with existing partners, the IRS will treat the contribution as an "indirect gift" of the contributed assets to the other partners, rather than as an increase in value of their partnership interests. A transfer creating a partnership and gift of partnership interests was made on the same day; it could not be determined which happened first, and the Tax Court concluded that the indirect gift principle applied. The IRS argued alternatively, that even if the court were to find that the funding occurred before the gifts of partnership interests, in which event the indirect gift theory as applied in an analogous regulation would not apply, that an "integrated transaction" approach should be applied to disallow entity level discounts. The Eighth Circuit responded to this argument by stating its view of the Tax Court's finding:

> "Immediately after concluding that they did not meet their burden of proving that the stock transfers preceded the gifts, the tax court finds: 'At best, the transactions were integrated (as asserted by respondent) and, in effect, simultaneous.' *The tax court recognizes that even if the Sendas' contribution would have first been credited to their accounts, this formal extra step does not matter."* (emphasis added). 433 F.3d 1044 (8th Cir. 2006)."

Having decided the case, the Eighth Circuit went on to consider the IRS's step transaction argument, and concluded that the doctrine applies broadly to estate and gift transactions. The court cited Sather v. Comm'r, 251 F.3d 1168, 1174 (8th Cir. 2001), which disregarded "reciprocal gifts" by reference to the step transaction doctrine (where siblings each made gifts to nieces and nephews with the overall result of increasing transfers to their own children). There is a long jurisprudence of taxing indirect gifts without reference to a step transaction doctrine. The discussion by the Eighth Circuit in Senda seemed to open the door to treating transfers to a partnership as an indirect gift of the underlying contributed assets (without a discount) even if gifts of the partnership interests were made after the funding of the partnership.

c. Holman, Gross, Linton, Heckerman. Four subsequent cases have expanded the Eighth Circuit's analysis saying that the three alternative tests that had emerged in income tax cases for applying the step transaction doctrine may conceptually apply in the context of treating transfers to a partnership and subsequent gifts of partnership interests as indirect gifts of a pro rata part of the assets contributed to the partnership. Holman, Gross, Linton, and Heckerman.

In Holman (2008), the Tax Court reasoned that the step transaction doctrine applies generally in this context, but that in the facts of that case (where the gift of partnership interests was made 8 days after funding the partnership with Dell stock) the doctrine did not apply. The court summarized the three tests that have been applied in income tax step transaction cases, and said that the IRS appeared to be arguing that the interdependence test applies, and that test requires that the legal relations created by one transaction would have been fruitless without a completion of the series. The court concluded that while the parents intended to make gifts of LP interests when they formed the FLP, it could not conclude "that the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift." The court gave two reasons for distinguishing the Senda court's conclusion that transfers to partnerships coupled with transfers of limited partnership interests to their children on the same day were "integrated steps in a single transaction." First, the transfers in this case were not made the same day. Second, there is a "real economic risk of a change in value" of the Dell stock (and the value of the LP interests). The court did acknowledge in footnote seven 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."

Gross (2008), written by the same judge (Judge Halpern) as Holman, was very similar. The opinion reiterates the test that the time delay between the date of funding and the date of the gifts must be long enough so that there is a "real economic risk of a change in value." The court concluded that 11 days were long enough where the contributions to the partnership consisted of a portfolio of "heavily traded, relatively volatile" stocks.

Linton (2009) concluded that the indirect gift doctrine applied where LLC interests were given the same day the LLC was funded. Although not necessary to grant the government's motion for summary judgment, the district court also added that the step transaction would apply. 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 "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."

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.

Heckerman (2009) was decided by the same district court (but by a different judge) as the Linton case and not surprisingly it has a very similar analysis. It concluded that the indirect gift doctrine applied where LLC interests were given the same day the LLC was funded, and also added that the step transaction would apply. The court repeated all three of the alternative tests for the step transaction doctrine that were mentioned in Holman, Gross, and Linton and concluded that all three tests would apply. Heckerman's general summary of the step transaction doctrine also suggests that the application of the 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.*"

Pierre II seemed to follow that general approach by stating that there was "nothing of tax-independent significance." That seems to be another way of saying there was no non-tax purpose for splitting the gift and sale transaction.