John G. Mack, ASA, CBA
Mack Business Appraisals, LLC
26956 N. 90th Lane
Peoria, Arizona 85383
(888) 789-2401 (toll free) (623) 340-6770 (direct) (623) 476-5405 (fax)
john@mackbusinessappraisals.com
www.mackbusinessappraisals.com

Suzanne J. Pierre, Petitioner v. Commissioner of Internal Revenue Service, Respondent, No. 753-07, August 24, 2009

The Facts:

Ms. Pierre received a gift of $10 million cash from a friend in 2000. In order to provide for her son and granddaughter, Ms. Pierre established the single-member Pierre Family, LLC (Pierre LLC) on July 13, 2000, in accordance with the state laws of New York. Ms. Pierre elected not to treat Pierre LLC as a corporation for Federal tax purposes and therefore did not file a corporate return for Pierre LLC. On July 24, 2000, Ms. Pierre established the Jacques Despretz Trust and the Kati Despretz Trust for the benefit of her son and granddaughter.

On September 15, 2000, Ms. Pierre transferred $4.25 million in cash and marketable securities to Pierre LLC. Twelve days later on September 27, 2000, Ms. Pierre gifted a 9.5% interest in Pierre LLC to each of the established trusts and sold a 40.5% interest in Pierre LLC to each trust in exchange for a promissory note. Ms. Pierre filed a Form 709 gift tax return for 2000 claiming a 30% discount for lack of control and marketability on the prior transfers (which turned into a 36.55% discount because of an error in valuing the underlying assets), and so paid no gift tax on the transfers.

The IRS contested the gift tax return and asserted that no discounts were to the transfers. The IRS determined a $1,130,216.11 gift tax deficiency and a $24,969.19 generation skipping transfer tax deficiency.

The Arguments:

The IRS argued that the transfers should only be treated as transfers of the underlying assets because a single member LLC is considered a disregarded entity according to the "check-the-box" regulations. The IRS contended that Ms. Pierre made gifts equal to the total value of the assets of the LLC, less the value of the promissory notes she received in exchange.

Ms. Pierre argued that for purposes of Federal gift tax valuations, state law, not Federal tax law determines the nature of a taxpayer's interest in property transferred and the legal rights inherent in that property interest. Ms. Pierre argued that under New York state

law, a membership interest in an LLC is personal property, and a member has no specific interest in specific property of an LLC. So, Ms. Pierre argued that the transferred interests were properly valued and that appropriate discounts for lack of control and lack of marketability were applied.

The Findings:

A majority of 14 judges of the Court determined that, historically, property rights have been defined by state law. The Court determined that because "state law creates legal interests and rights" in property and Pierre LLC was recognized as a valid legal entity under New York law, the 30% discount reflected the rights and limitations of the member equity interests in the LLC. Furthermore, although the "check-the-box" regulations created a disregarded entity for income tax purposes, the Court majority determined that the state law would determine property rights. Therefore, the discounts were allowed.

However, in a dissenting opinion, Judge Halpern indicated that he and five other judges would interpret the "disregarded entity" regulations literally and would also disregard the LLC for gift tax valuation purposes.

Parting Thoughts:

I have to say I was surprised that there were six judges (including Judge Halpern) that issued a dissenting opinion. Also, lost in the disregarded entity discussion is the fact that Ms. Pierre helped her case by not putting the cart before the horse. In other words, she formed the entity and the trusts, then contributed the property and then let sufficient time elapse (12 days in this instance) before gifting/selling the interests to the two trusts for the benefit of her son and granddaughter.