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Suzanne J. Pierre, Petitioner v. Commissioner of Internal Revenue Service, Respondent, T.C. Memo 2010-106, Dated May 13, 2010.

The Facts:

In the first Pierre case, Pierre v. Commissioner, No. 753-07, dated August 24, 2009 ("Pierre I"), the Court found that Ms. Pierre's single member LLC, the Pierre Family LLC ('the LLC"), was not a disregarded entity for gift tax valuation purposes under the "check the box" regulations of sections 301.7701-1 through 301.7701-3, Procedural & Administrative Regulations. As such, transfers of an interest in the LLC are treated as transfers of an LLC interest and subject to discounts for lack of control and marketability, rather than as transfers of proportionate shares of the LLC's underlying assets.

In this case, the Court was asked to decide two issues; (i) whether the step transaction doctrine applies to collapse Ms. Pierre's separate gift and sale transfers into transfers of two fifty-percent (50%) interests in the LLC; and (ii) whether the discounts for lack of control and marketability reported by Ms. Pierre should be reduced.

The Arguments:

Ms. Pierre argued that the four transfers (two gifts of 9.5% member equity interests and two sales of 40.5% member equity interests) of her entire interest in the LLC each had independent business purposes which preclude the transactions from being collapsed under the step transaction doctrine. Ms. Pierre provided several non-tax reasons for establishing the LLC but did not provide any non-tax reasons to support splitting the gift transfers from the sale transfers. The IRS argued that it was always Ms. Pierre's intention to transfer a fifty-percent (50%) interest in the LLC to each of the trusts established for the benefit of her son and granddaughter, and that Ms. Pierre only split the transfers to avoid paying gift tax. In addition, the IRS argued that the gift and sale transactions should be collapsed and treated as disguised gifts of 50% member equity interests to each trust to the extent their values exceeded the value of each trust's promissory note.

The Findings:

The Court agreed with the IRS on the step transaction issue for several reasons. The Court pointed out that Ms. Pierre had given away her entire interest in the LLC in the time it took to sign four separate documents, which all occurred on the same day. In addition, the record indicated that it was Ms. Pierre's intention to transfer her entire interest in the LLC to the trusts without paying any gift taxes. The Court found it compelling that Ms. Pierre's attorney, Mr. John Reiner, had recorded the transfers at issue as two gifts of fifty-percent (50%) interests in the LLC in his journal and ledger and that he had used these records to prepare the LLC's tax return. Although Mr. Reiner later testified that he had discarded these records due to inaccuracies, the Court found it difficult to disregard Mr. Reiner's original entries. Furthermore, the Court pointed to the fact that no principal payments had been made on either loan during the eight years in question, while the LLC continued to make yearly distributions to the trusts so that they could make the yearly interest payments on the loans. In addition, the Court found that nothing of tax independent significance occurred between the gift and sales transactions. The Court indicated 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. As such, the Court determined that Ms. Pierre had indeed transferred two fifty-percent (50%) interests in the LLC.

In regard to the determination of applicable lack of control and marketability discounts, the petitioner initially claimed a 10% discount for lack of control and 30% for lack of marketability (for a 36.55% cumulative discount). At trial, petitioner called upon an expert from Management Planning, Inc. ("MPI") who concluded that the appropriate discounts were 10% for lack of control and 35% for lack of marketability (for a 41.5% cumulative discount). The IRS did not introduce an expert at trial because of their position that gifts were of the underlying assets in the LLC. After discussing each discount in turn, the Court determined that a lack of control discount of eight-percent (8%) and a thirty-percent (30%) discount for lack of marketability were warranted on the transfers of the two 50% LLC member equity interests. The slight reduction in the minority interest discount from 10% to 8% occurred because the Court indicated that in valuing a 50% member equity interest, the owner of this interest could block the appointment of a new manager that previously the 9.5% minority interest valued could not. The IRS argued that the 35% lack of marketability discount utilized by the expert from MPI was too high, but failed to argue that the 30% lack of marketability discount actually applied in valuing the member equity interest in the LLC was inappropriate. Thus, the Court found that a 30% lack of marketability discount was appropriate.

Parting Thoughts:

While the step transaction decision was a victory for the IRS, the discounts were clearly a victory for the taxpayer. Regarding the step transaction, I expect that the decision may have been different if:

1. Mr. Reiner had not recorded the transfers at issue as gifts of two 50% member equity interests in the journal and ledger used to prepare the tax return but instead had shown them as a gift of a 9.5% equity interest and sale of a 40.5% equity interest. As seen in so many cases, a detailed paper trail can make a difference.

2. There had been some time elapse between the gift and the sale. For example, the 12 day period between funding of the LLC and transfer was deemed sufficient to not apply the step transaction doctrine in the initial Pierre decision. Thus, it might have made a difference to separate the gift and sale transactions by another period of time.

3. Principal payments had been made on the notes. The case states that the notes were initially set up to be payable in 10 annual installments and an interest rate of 6.09%. The fact that no principal payments had not been made in the first eight (8) years of the notes did not bode well for the taxpayer.