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Family LLC's in Court: Round-Up

Parents want to take the best possible financial care of their children. Sometimes their efforts come close to, or cross over, a legal line. Using family LLCs to gift assets and cash to one's children is one such place where the risk arises.

Can gift tax and income tax be equated? At an appeal a tax court panel of 15 judges were split 9-6 on preserving a family LLC for gift vs. income tax purposes. In Pierre v. Commissioner, 2009 WL 2591652 (U.S. Tax Ct.) (Aug. 24, 2009), at issue was the "check-the-box" regulations, which provide that the entity form of a single-member LLC is disregarded for federal income tax purposes. The IRS argued to extend the same regulations so that a single-member (family) LLC is ignored for federal gift tax purposes as well.

The taxpayer had formed a family LLC and two trusts for her son and grandchild. Twelve days after funding the LLC, she exchanged her entire interest for the trusts, giving each a 40.5% membership, in return for promissory notes in amounts reflecting discounts for lack of marketability and control. The taxpayer concluded that no gift tax was due. The IRS assessed deficiencies of over $1 million.

A majority of the tax court disagreed with this assessment. They found that the taxpayer did not have a property interest in the LLC's underlying assets, because New York law, under which the LLC was properly formed, recognized the entity separate and apart from her and its member, and "Federal law could not create a property right in those assets." The court went on to say that the IRS could not "overrule" the federal gift tax regime with an over-broad interpretation of the check-the-box regulations. Six of the 15-member court dissented, leaving open a strong possibility of appeal by the IRS.

Family LLC is really conduit for indirect gift. The Pierre family was more fortunate than the Heckermans, whose family LLC was found, under the step-transaction doctrine, to have been a conveyance of property to their children for the sole purpose of minimizing their tax liability. In Heckerman v. Commissioner, 2009 WL 2240326 (W.D. Wash) (July 27, 2009), the parents wanted to pass property to their young children that would make them "work for their money" without triggering a gift tax. On January 11, 2002, they transferred mutual fund investments to an LLC, owned wholly by a family LLC; transferred units in the family LLC to each of their children; signed gift documents stating that the assignments were effective on that date; provided the IRS with a document stating that the childrens' trusts were admitted as members to the family LLC, effective on that date; and provided an appraisal of the valuation of the gift transfer, also effective on that date. Some time earlier, the parents had transferred real estate to the family LLC.

The “plethora” of evidence that all the transfers (regarding the cash, not the real estate) took place on the same day led the court to agree with the IRS and conclude that the cash transfers were in reality “indirect gifts of the proportionate amount of cash…to each child’s trust.” The IRS was granted summary judgment.

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