



Having Lost the War on Family LLC, IRS Loses the Battle on Discounts

***Pierre v. Commissioner*, 2010 WL 1945779 (U.S. Tax Ct.)(May 13, 2010)**

A wealthy widow formed a single-member family limited liability company (LLC) along with two trusts for her children. Two months later, she transferred \$4.25 million in marketable securities into the family LLC; not 12 days later, she divided her LLC interest equally between the two trusts (50/50). After her attorney advised her that she could gift a certain amount tax-free, she sold each trust a 40.5% membership interest in return for a \$1.09 million note and then gifted each 9.5%. An appraiser arrived at the note amounts after valuing a 1% interest in the LLC, including a 36% combined discount for lack of control and marketability, and the taxpayer reported the amounts on her gift tax return.

The IRS assessed over \$1 million in deficiencies, and the taxpayer appealed. In the first phase of these proceedings (*Pierre v. Comm'r*, 2009 WL 2591652)(*Pierre I*), the IRS urged the Tax Court to ignore the entity form of a single-member LLC and treat the transfer of LLC interests as transfers of the underlying stock, to be assessed at fair market value. In a split decision (9 to 6), the U.S. Tax Court sided with the taxpayer, preserving the entity form for purposes of gift tax liability. The court postponed the valuation issues, however, and in this current opinion (*Pierre II*), it also considered whether the “step transaction doctrine” would collapse the LLC and trust transfers into a single transaction.

Focus on business purpose.

The IRS claimed the family LLC served no legitimate purpose other than tax avoidance. Neither the taxpayer nor her grown son had actively managed the LLC or attended its sporadic meetings. The LLC had all but ignored the promissory notes, having distributed sufficient funds for the trusts to pay the interest but no principal. Further, at the time of funding, her attorney credited each trust’s account with 50% of the taxpayer’s original contribution, but discarded the records after filing the gift tax returns because, he later told the court, they incorrectly characterized the transfers by failing to include the four subsequent gift and sale transactions. But, “We do not so easily ignore [his] contemporaneous description,” the Tax Court said. Nor would it overlook the taxpayer’s “primarily tax-motivated reasons.” The four gift and sale transactions were planned as a single transaction and took place at virtually the same time, with no independent, intervening non-tax event. Under these circumstances, the court applied the step transaction doctrine to collapse the deal into a single transfer of 50% to each trust. As a result, the court would value the LLC transfers not by reference to the trusts but to the taxpayer. The parties agreed that under the fair market value standard, a willing buyer

would pay less for the LLC interests than for an outright purchase of the same block of securities. Given the court's collapse of the transaction into a 50/50 transfer, the taxpayer's valuation expert believed an 8% minority discount and 30% marketability were appropriate. Notably, the IRS chose not to present an expert; having lost its argument in Pierre I regarding the transfer of assets, in Pierre II it simply requested the court to reduce the taxpayer's proposed discounts. Based on the taxpayer's undisputed evidence, however, the court applied its discounts and entered judgment accordingly.

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