Pierre v. Commissioner: The Aggregation of Interests in Estate and Gift Tax Planning

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In Pierre v. Commissioner,[1] *the Service prevailed in its argument to apply the step transaction doctrine. However, the Service did not contest the use of a 10 percent lack of control discount and a 30 percent lack of marketability discount, which resulted in a combined valuation discount of 36.55 percent. However, in* Pierre*, the application of the step transaction doctrine to aggregate two separate transactions (one gift transaction and one sale transaction per trust) into one transaction led to a decrease in the effective valuation discount from 36.55 percent to 35.6 percent. The reason for this change was not due to the application of the step transaction doctrine, but to the trial testimony of the taxpayer's valuation expert. In this review of the* Pierre *decision, and more specifically in this review of the application of the step transaction doctrine, we consider two questions: (1) what is the step transaction doctrine and (2) if the step transaction is invoked, what types of transfers could trigger a difference in valuation discounts greater than the results in Pierre?*

Introduction

In 2000, Suzanne J. Pierre received a $10 million cash gift from a wealthy friend. In order to preserve family wealth, she contacted a financial planner to help develop an estate and gift tax plan.

The financial planner worked with two estate planning attorneys to develop the plan. The plan involved the transfer of $4.25 million of cash and marketable securities in order to take advantage of valuation discounts for transfer tax purposes. In order to achieve the estate and gift tax planning objectives, Ms. Pierre formed a limited liability company.

On July 13, 2000, Ms. Pierre formed the single-member Pierre Family, LLC ("Pierre LLC" or "the Company"). Ms. Pierre was a New York State resident. As such, she chose to form the Company under New York state law.

At inception, the Company designated manager was Ms. Pierre. Later, one of the estate planning attorneys was appointed the Pierre LLC manager. The Pierre LLC operating agreement indicated that the Company manager had the ability to make controlling decisions.

On September 15, 2000, Ms. Pierre transferred the $4.25 million in cash and marketable securities to Pierre LLC.

On September 27, 2000, Ms. Pierre transferred all Pierre LLC membership interests in four separate transactions. The transactions included gifts and sales of membership interests to two trusts: (1) the Jacques Despretz 2000 Trust and (2) the Kati Despretz 2000 Trust. First, gifts of 9.5 percent membership interests, which had a fair market value of $256,168, were made to each trust. Moments after the gifts, sale of 40.5 percent membership interests, which had a fair market value of $1,092,133, were made to each trust.

Ms. Pierre engaged a valuation professional to estimate the fair market value of a one percent ownership interest in Pierre LLC. As part of his analysis, the valuation analyst concluded that (1) a 10 percent discount for the lack of control (DLOC) and (2) a 30 percent discount for the lack of marketability (DLOM) were appropriate.

The valuation analyst combined the DLOC and the DLOM to arrive at a combined valuation

discount of 36.55 percent.[2] The application of the 36.55 percent discount resulted in the fair market value of a 1 percent membership interest in Pierre LLC, on a nonmarketable, noncontrolling interest basis, of $26,965.

The two sales of 40.5 percent membership interests to the trusts were transacted at the fair market value of $1,092,133 per 40.5 percent membership interest. In return, Ms. Pierre received promissory notes bearing interest at 6.09 percent and payable in ten annual installments. The notes were secured by the 40.5 percent ownership interests held by the trusts.

Subsequently, in order to satisfy the interest payments that were due on the notes, Pierre LLC made annual distributions to the two trusts. The trusts in-turn paid Ms. Pierre interest. In the eight years following the transactions, neither of the two trusts paid Ms. Pierre any principal payments on the notes.

The Service challenged the Pierre LLC transfers. The outcome of this tax dispute is summarized in the following Tax Court opinions: (1) *Pierre v. Commissioner of the Internal Revenue Service*,[3] ("Pierre I") and (2) *Pierre v. Commissioner of the Internal Revenue Service*,[4] ("Pierre II").

Pierre I

The Service took exception to the form in which Ms. Pierre transferred the Pierre LLC membership interests. This was primarily due to the fact that the Company was a single-member LLC, and it was not considered a corporation for federal income tax purposes.[5]

Therefore, the Company was considered a disregarded entity for federal income tax purposes pursuant to Section 301.7701-1 through Section 301.7707-3 of the Procedure and Administration Regulations (better known as "check-the-box" regulations).

The Service argued that the federal income tax status of the entity, as a disregarded entity pursuant to the check-the-box regulation Section 301.7701-3(a), is a matter of federal income tax law, not local law.

Therefore, Pierre LLC was not a recognized entity, and its membership interest transfers were transfers of the Company underlying assets and not transfers of Pierre LLC membership interests.

By suggesting that the transfers of Pierre LLC membership interests should be treated as transfers of the Company underlying cash and marketable securities, the Service was suggesting that no valuation discounts should be allowed in the transactions.

The petitioner (Ms. Pierre) argued that state law, and not federal tax law, is the determinate of a taxpayer's interest in a property. And, the Company was formed under New York law. And, in New York, a limited liability company (LLC) member has no interest in the specific property of the LLC, the transferred interest was Pierre LLC membership interests and not the Company property.

In Pierre I, the Tax Court ruled (10 judges for the majority decision and 6 dissenting) that the Pierre gifts and sales were of Pierre LLC membership interests and not transfers of the Company underlying assets.

After the decision in Pierre I, two issues remained unresolved:

1. whether the step transaction doctrine applied to the gift and sale transfers
2. if so, whether the lack of control and the lack marketability discounts used by the taxpayer valuation expert were appropriate

The Step Transaction Doctrine

In general, the step transaction doctrine is used to collapse transfers when it is apparent that a transaction embodies form over substance principles. It treats a series of formal steps as a single transaction if the steps are in substance integrated, interdependent, and focused on a particular result.

The step transaction doctrine (the "doctrine") is a judicially developed concept primarily used in income tax matters. More specifically it is considered as it relates to corporate restructurings and corporate transactions.

The courts have typically applied the following three tests to determine if the step transaction doctrine should be invoked:

1. the end result test
2. the mutual independence test
3. the binding commitment test

The end result test is the most used test to determine the applicability of the doctrine. The end result test invokes the doctrine if a series of formal steps appear to be prearranged parts of a single transaction to arrive at an ultimate result. In general, this test considers the apparent intent of the taxpayer.

The mutual independence test invokes the doctrine if the steps are so interdependent that legal relations created by one transaction would be meaningless without the completion of the series of transaction steps.

The binding commitment test invokes the doctrine when at the time of the first transaction step there is a binding commitment to take a later step.

In Pierre II, the Tax Court cited the following court cases regarding the application of the step transaction doctrine to gift and estate tax transactions: (1) Commissioner v. Clark,[6] (2) Holman v. Commissioner,[7] (3) Gross v. Commissioner,[8] (4) Senda v. Commissioner,[9] (5) Estate of Cidulka v. Commissioner,[10] and (6) Shepard v. Commissioner.[11]

The Tax Court found that the application of the step transaction doctrine is well established and expressly sanctioned to be used in the area of gift tax where intra-family transactions occur.

Pierre II

The Service argued that the four transactions (i.e., one gift transaction to each trust and one sale transaction to each trust) were really two transactions (i.e., one 50 percent transaction per trust).

The Service argued that the only reason that the taxpayer separated the two transactions into four transactions was to avoid gift tax. Therefore, the step transaction doctrine applied.

Ms. Pierre argued that the four transfers had independent business purposes to preclude the four transactions from being collapsed. To support this position, several nontax reasons for establishing Pierre LLC were specified. However, no nontax reasons for splitting the transfers between gifts of ownership interests and sales of ownership interests were offered.

The petitioner also argued that the Service bears the burden of proof since she produced credible evidence and met the other requirements of Section 7491(a). However, on this point the Tax Court concluded that it could "determine factual issues on the weight of the evidence, however, unless there is an evidentiary tie."

The Tax Court found no evidentiary tie, and, therefore, the burden of proof was irrelevant to the proceeding.

In Pierre II, the Tax Court concluded that the doctrine applied. Therefore, the four gift and sale transactions should be aggregated into two transactions.

The Tax Court listed the following reasons as to why the gift and sale transactions should be aggregated:

1. The transactions occurred on the same day.
2. No time elapsed between the gift and the sale.
3. The taxpayer intended to transfer her entire interest without paying gift tax as evidenced by the decision not to pay any principal on the notes over an eight-year period.
4. The Company provided contradictory evidence because of poor documentation. This documentation included a notation, by the Company manager, to record the transactions in the Pierre LLC journal and general ledger. The notation stated, "to reflect gift transfer by Suzanne Pierre to J. Despretz Trust and K. Despretz Trust."

The Tax Court found that nothing of tax-independent significance occurred in the moments between the gift transactions and sale transactions.

The Court found, in Pierre II, that the particular result of the four steps was focused on avoiding gift tax. In other words, the transactions appear to have failed the end result test.

Application of Valuation Discounts

In conjunction with the transactions, a valuation professional was engaged to estimate the fair market value of a 1 percent membership interest in Pierre LLC.

In conducting his analysis, the valuation analyst selected a 10 percent DLOC and a 30 percent DLOM. The valuation analyst used the combined DLOC and DLOM of 36.55 percent to estimate the fair market value of the gifts, which were presented on the Form 709 gift tax return filing.

Ms. Pierre hired a different valuation analyst to provide testimony in Tax Court. This valuation analyst applied a 10 percent DLOC and a 35 percent DLOM. However, during the trial, Ms. Pierre advocated for the application of the 10 percent DLOC and the 30 percent DLOM.

After determining that the step transaction doctrine applied, the Tax Court relied on the taxpayer's testifying valuation expert to estimate the DLOC that would be applicable for a 50 percent ownership interest in Pierre LLC.

The valuation expert stated that "he had not valued a 50-percent Pierre LLC interest . . . a 50-percent interest would allow a member to block the appointment of a new manager . . . the discount would be modestly reduced to as low as 8 percent."

The Tax Court decided to allow the 30 percent DLOM. This is because the Service did not present a valuation expert to argue the merits of applying a lower DLOM.

Therefore, the Tax Court allowed a combined DLOC and DLOM of 35.6 percent. This concluded combined valuation discount represented a 0.95 percent decrease from the 36.55 percent combined discount that was originally used by the taxpayer.

Facts and Circumstances that May Exacerbate Valuation Differences

In Pierre II, the total value difference resulting from the change in the combined valuation discount was only $40,375 ($4,250,000 × 0.0095). Of course, if the principal amount used to fund the Company was greater than $4.25 million, the valuation difference, based on the 0.95 percent adjustment, would be greater.

Notwithstanding the valuation change due to a greater amount of underlying capital, valuation differences due to the application of the step transaction doctrine may be exacerbated by prerogatives of ownership control that result from collapsed transactions.

Qualitative factors, as discussed below, should be considered when addressing the fair market value of ownership interests that result from collapsed transactions.

By definition, the holder of a noncontrolling ownership interest lacks the perquisites of ownership control, and has little or no voice in company affairs.

The following list provides examples of some of the more common prerogatives of ownership control:

1. Select the management of the company.
2. Determine management compensation and perquisites.
3. Set investment policy and change the course of company business.
4. Acquire and/or liquidate company assets.
5. Borrow funds on the behalf of the company.
6. Liquidate, dissolve, sell, or recapitalize the company.
7. Declare and pay distributions.

A willing buyer contemplating the purchase of a noncontrolling ownership interest would consider the disadvantages arising from a lack of control. Therefore, one would not expect a willing buyer to purchase a noncontrolling ownership interest except at a discount from its pro rata share of the controlling entity value.

However, if by the application of the step transaction doctrine, a greater number of ownership control attributes are realized than initially contemplated, a new analysis of the DLOC is necessary to estimate the fair market value.

In Pierre II, the only difference, as identified by the taxpayers testifying valuation expert, was that a 50 percent ownership interest could block the appointment of a new Pierre LLC manager. According to the testifying valuation expert, the ability to block the appointment of a new manager would only modestly reduce the DLOC.

It is possible that if the step transaction doctrine is invoked in certain transactions, a transfer of an ownership interest of 50 percent or more may result. In such transactions, the application of a DLOC may not be appropriate. Only a careful analysis of the specific ownership rights, as outlined in the company operating agreement, can provide insight as to how the increase in the transferred ownership interest impacts the valuation discount.

Summary and Conclusion

In Pierre I, the Service challenged the use of valuation discounts, albeit not directly, through their claim that the Company was not recognized as a corporation under federal income tax law, and, therefore, the taxpayer transferred the Company underlying assets rather than Pierre LLC membership interests.

As such, the Service:

1. reasoned that the underlying assets were not subject to valuation discounts and
2. did not engage a valuation expert to argue the merits of the valuation discounts used in the Pierre LLC transactions.

The Company was organized in New York. New York state law provides that an LLC member is an owner of the LLC member interests not the LLC underlying assets. The Tax Court agreed that the Pierre transfers involved LLC member interests, not the underlying assets of the Company.

In Pierre II, the Service challenged the form of the four transfers to two trusts. The Tax Court found that the transactions were only focused on avoiding gift tax. Therefore, the step transaction doctrine was invoked, which resulted in the recognition of two, 50 percent membership interest gift transfers.

While the Service prevailed in Pierre II, the impact on the combined DLOC and DLOM that was used in the valuation of the transferred ownership interests was rather immaterial. The Tax Court concluded that a change in the size of the transferred ownership interest resulted in a change in the combined DLOC and DLOM of only 0.95 percent.

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The studies cited in this discussion support, quite consistently, that there exists a high correlation between the expected holding period of a security and its DLOM.

Restricted shares of public corporation stock may not (temporarily) be traded directly on a stock exchange. However, the investor has certainty that, in a relatively short time period, the trading restrictions will lapse.

The shares of stock of a closely held corporation, on the other hand, may never be traded directly on a stock exchange. The prospect of any level of efficient marketability is much lower for closely held company shares compared to restricted public company shares.

Therefore, the appropriate DLOM related to closely held corporation shares (or to similar closely held investments) is generally considered to be greater than the DLOM indicated by restricted stock studies.

Notes:

1. *Holman v. Commissioner*, 130 T.C. No. 12 May 27, 2008).
2. *Holman v. Commissioner*, 105 AFTR 2d Section 2010-721 (8th Cir. April 7, 2010) aff'g 130 T.C. 170 (2008).
3. 17 CFR 230.144 (revised April 1, 1990).
4. SEC Website: http://www.sec.gov/investor/pubs/rule144.htm.
5. On February 18, 1997, the SEC adopted amendments to reduce the holding period requirements under Rule 144 of the Securities Act from two years to one year for the resale of limited amounts of restricted securities (the amendment became effective April 29, 1997).
6. See, for example, "Restricted Stock Discounts, 1991–95," Bruce Johnson, *Shannon Pratt's Business Valuation Update*, March 1999; Rod Burkert, "Cure for Declining Discounts, Deconstruct the Studies," *Trusts & Estates*, March 2004; and Robert Reilly, "Willamette Management Associates' Discount for Lack of Marketability Study for Marital Dissolution Valuations," *American Journal of Family Law*, Spring 2005.
7. 17 CFR Parts 230 and 239, December 17, 2007.
8. John A. Menicucci Jr., "SEC Adopts Amendments to Rule 144 & Rule 145." *The Nebraska Lawyer*, April 2008.

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Valuation analysts are often engaged to value one percent ownership interests in business entities. Even though the step transaction doctrine was invoked in Pierre I and II, the difference between (1) the valuation discount applied to a 1 percent ownership interest and (2) the valuation discount applied to a 50 percent ownership interest was immaterial.

However, in other transactions where (1) the step transaction doctrine is applied and (2) the resulting transferred ownership interest has increased elements of ownership control, the decrease in the concluded valuation discount could be substantial.

Accordingly, taxpayers and their estate planners and valuation advisers should consider how owernship control changes between the two steps of a so-called step transaction.

Notes:

1. *Pierre v. Commissioner*, T.C. Memo 2010-106 (May 13, 2010).
2. Combining a 10 percent DLOC and a 30 percent DLOM results in a combined valuation discount of 37 percent. However, the appraiser made an error and applied a combined DLOC and DLOM of 36.55 percent
3. *Pierre v. Commissioner of the Internal Revenue Service*, 133 T.C. No. 2 (2009).
4. *Pierre v. Commissioner*, T.C. Memo 2010-106 (May 13, 2010).
5. Ms. Pierre filed Form 8832, Entity Classification Form, to elect not to treat Pierre LLC as a corporation.
6. *Commissioner v. Clark*, 489 U.S. 726 (1989).
7. Holman v. Commissioner, 130 T.C. 170 (2008).
8. *Gross v. Commissioner*, T.C. Memo 2008-221 (Sept. 29, 2008).
9. *Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006).
10. *Estate of Cidulka v. Commissioner*, T.C. Memo 1996-149 (Mar. 25, 1996).
11. *Shepard v. Commissioner*, T.C. Memo 2004-160 *aff'd*. 433 F.3d 1044 (8th Cir. 2006).

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