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INCOME TAX MEMORANDUM

TO: CPAs, Clients & Associates

FROM: David L. Silverman, Esq.
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DATE: April 2, 2010

RE: Business Succession Planning Involving Family Members

In Pierre v. Com'r, 133 T.C. No. 2 (8/4/09), a sharply divided Tax Court with five dissenting judges held that a single member LLC, though ignored for income tax purposes, must be respected as a separate entity for gift tax purposes. [Susan J. Pierre formed Pierre Family, LLC, a single-member LLC, on July 13, 2000. On September 15, 2000, she transferred $4.25 million in cash and securities to the LLC. On September 27, she gave 19 percent of her LLC membership interest to two trusts and sold 81 percent of her interest to those two trusts in exchange for a promissory note. Discounts of 30% were taken for lack of control and lack of marketability. A gift tax return was filed.]

On examination, the IRS disallowed the discount and asserted a deficiency, arguing that the LLC should be ignored for gift tax purposes, and that the membership interests gifted and sold should instead be treated as transfers of cash and marketable securities for which no discounts were available. The promissory notes evidencing the sale of LLC interests were therefore insufficient in amount, causing the “sale” to be part unreported taxable gift. The gift of the membership interests, although reported, was also undervalued. These undervaluations resulted in a deficiency.]

The first issue was nature of the property interest transferred. The taxpayer argued that state law rather than federal law determines the nature of a taxpayer’s transferred ownership. Under NY LLC Law 601, a membership interest in an LLC is personal property, and a member has no interest in specific property of the LLC. The Tax Court agreed, observing that “a fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights.” Under New York law, the taxpayer did not possess a property interest in the underlying assets of Pierre, LLC. Consequently, gift tax liability was properly determined by the value of the transferred interests in the LLC, rather than by the value of the underlying assets.

The Tax Court then summarily disposed of the IRS argument that the LLC should be ignored for gift, as well as income, tax purposes: “If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond classifying the LLC for tax purposes. The regulation would require that Federal law, and not State law, apply to determine property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. . .To conclude that because an entity elected the classification rules. . .the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be ‘manifestly incompatible’ with the Federal estate and gift tax statutes as interpreted by the Supreme Court.”

The dissent argued that (i) “the plain language of the regulations requires Pierre LLC to be ‘disregarded as an entity separate from its owner’”; (ii) federal law, in the form of check-the-box regulations, determines the nature of the property rights and interests transferred; and that (iii) that such an interpretation was not “manifestly incompatible with the gift tax statutes.”

Although Pierre reinforced the proposition that single-member LLCs are indeed entitled to valuation discounts, those entities, while useful for income tax purposes, are sometimes less than perfect for other legal purposes, since there is a temptation — as clearly evidenced by the dissenting opinion in this case — to ignore the LLC for other legal and tax purposes as well. The problem encountered in Pierre would not have arisen had a multi-member LLC been utilized. Of particular interest is that in other respects, the taxpayer was astute: an independent valuation appraiser was retained to compute the appropriate discounts, and LLC formalities were observed.

¶ The 5th Circuit recently held that the transfer of assets owned by Linda Evans and the Estate Robert C. Evans, Jr., to a limited partnership following a Tax Court judgment constituted a fraudulent transfer under the Texas Fraudulent Transfer Act. Since the United States was not bound by state statutes of limitations in fraudulent conveyance actions, the statute's four-year limitations period was inapplicable. U.S. v. Evans, No. 08-51054, (August 18, 2009).

¶ In Estate of McCoy, TC Memo, 2009-61, the decedent's will and trust provided that specific bequests were to be paid from the residuary estate. Different definitions of "residuary" in the governing instruments created ambiguity over the tax clause. The estate apportioned all estate taxes to the specific bequests, rather than to the marital bequest. Although the IRS argued that the marital share was the proper source of payment, the Tax Court ruled that unless the will clearly provides otherwise, the state apportionment statute controls. Since Utah's apportionment statute equitably apportions taxes to property that generates the tax, no estate tax was imposed on the marital bequest.

¶ In Bennett v. Com'r, TC Memo 2008-251, the IRS rejected the taxpayer's offer in compromise even though the amount offered was ten times that which the IRS determined it could currently collect. The taxpayer, who had failed to file for five years, and had rejected an IRS counteroffer, argued that the IRS abused its discretion, since IRS guidance provides that an offer should be accepted when "it reasonably reflects collection potential." Noting that the regulations do not compel the IRS to accept any particular offer, the Tax Court concluded that "guidelines are in the end just that."

¶ It is well settled that a settlor's interest in a domestic asset protection trust ("APT") is excluded from the bankruptcy estate under §§541(c)(2) and 548(e) of the Bankruptcy Code. Will distributions of income or principal from the trust become part of the bankruptcy estate? The answer appears to be no. To be included in the bankruptcy estate, a domestic APT distribution must satisfy two requirements under §541(a)(5)(A): First, the debtor's receipt or entitlement to receipt must occur within 180 days after the filing of the bankruptcy petition. Second, the receipt must arise from a "bequest, devise, or inheritance." Since an APT is an inter vivos trust, it is doubtful that any distribution would satisfy these requirements. Therefore, a trustee in bankruptcy could not likely reach assets distributed from an APT.

¶ Since the IRS imposes greater scrutiny on transfers and discounts involving family entities, the lack of substantial nontax reasons for forming these entities may predispose these transfers to later examination. Estate of Jorgensen, T.C. Memo, 2009-66, illustrates the danger of ignoring case law, formalities, and proper maintenance when utilizing family entities for estate planning. Discounts of 35% were taken on gifts without obtaining an independent discount appraisal. The partnership bank account was used to make cash gifts to family members and to pay personal expenses. Partnership formalities were not followed, since a requirement that distributions be pro rata was ignored. The son borrowed money for personal expenses. Non-tax reasons for forming the limited partnerships were lacking. The Tax Court concluded that the use of a significant portion of partnership assets to discharge the taxpayer's obligations evidenced a retained interest in the assets of the partnership.