

FCG VALUATION CASE E-FLASH

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Suzanne J. Pierre, Petitioner, v. Commissioner of Internal Revenue, Respondent

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TAKEAWAY

Footnote 10 of the court's ruling may be an indication of progress regarding appraisers' ability to properly inform the court regarding SEC Rule 144A restricted stock studies and their impact on the selection of a discount for lack of marketability ("DLOM").

Even though the Pierre court accepted the Respondent's 30 percent DLOM, some previous Tax Court rulings have relied on the Management Planning Inc. April 1997 restricted stock study's 13 percent average discount as an appropriate DLOM benchmark because it was the most recent study (note: a more current study was published in 2009, after the Pierre trial date). The Pierre court's failure to default to the 13 percent average may be an indication that experts are successfully communicating important limitations associated with the April 1997 study.

More specifically, closely-held minority interests typically have more onerous trading restrictions and longer holding periods than the restricted stocks included in the April 1997 study. Furthermore, these characteristics often are more burdensome than the ones associated with the restricted stocks analyzed in the Institutional Investors Study cited in Rev. Rul. 77-287 § 4.02, which reported discounts much larger than the April 1997 study.

Based on the preceding, appraisers who successfully communicate the differences between the often cited restricted stock studies and the subject closely-held business interest may be successful in convincing the court that the most recent SEC Rule 144A restricted stock studies do not adequately reflect the economic impact of transfer limitations associated with closely-held ownership interests.

OVERVIEW

This Tax Court Memorandum supplements *Pierre v. Commissioner*, 133 T.C. No. 2 (2009), in which the Tax Court determined that transferred interests in a single-member LLC (disregarded for federal income tax purposes) were transfers of membership interests rather than direct transfers of the marketable securities owned by the LLC.

In its ruling, the Tax Court concluded the step doctrine applied to the simultaneous gift and sale transfers of interests in the LLC. Additionally, the Tax Court determined that discounts for lack of control and lack of marketability totaling 35.6 percent were applicable to the transferred 50 percent member interests.

THE FACTS

Suzanne Pierre (the "Petitioner", or "Ms. Pierre") was already a wealthy widow when she received a \$10 million cash gift from a wealthy friend in 2000. As she was 85 at that point, Ms. Pierre was concerned about the estate tax and income tax implications of the gift. Accordingly, Ms. Pierre began to formulate an estate tax plan through her financial advisor to meet the income needs of herself, her only son, and her only granddaughter.

In particular, the Petitioner was concerned with preserving familial wealth through estate and gift tax avoidance. She wanted tax-free income and wanted to be able to transfer her wealth, tax-free, to her descendants.

In July 2000, Ms. Pierre established Pierre Family, LLC, of which she was the sole member. Eleven days later, she created a trust for her son and a separate trust for her granddaughter.

In September, the Petitioner transferred \$4.25 million of her personal funds to the LLC. Her personal living expenses were appropriately segregated from the LLC.

Twelve days after funding the LLC, Ms. Pierre gifted 9.5 percent member interests to each trust. Simultaneously, she sold 40.5 percent member interests to each trust in exchange for secured promissory notes. In summary, each trust received a 50 percent member interest, 9.5 percent as a gift and 40.5 percent through a purchase.

Although the trusts' purchase notes were executed, no principal had been paid over the subsequent eight years. Furthermore, distributions from the LLC were the only source of funds for interest payments made by the trusts.

The LLC's bookkeeper recorded the gifts and sales as unified transactions for each of the trusts. The bookkeeper subsequently revised his entries and recorded them as separate gifts and purchases. However, his explanation for doing so was not accepted by the court.

The LLC was managed by a nonmember manager (its bookkeeper and Ms. Pierre's estate planning attorney), its investments were managed by an outside financial manager, it held regular meetings, and it kept meeting minutes. The authors assumed the preceding was interpreted as evidence that the LLC was being operated for legitimate business purposes.

Ms. Pierre properly reported each 9.5 percent gift on Form 709. However, she failed to report the gift to her granddaughter's trust as a direct skip for GST purposes.

The Petitioner argued that each of the four transactions (the gift and the sale to each trust) were for independent business purposes and should not be collapsed under the step transaction doctrine. Although Ms. Pierre listed several non-tax reasons for the formation of the LLC, she failed to present non-tax reasons for dividing the gift and sale transfers.

The IRS contended that Ms. Pierre intended to transfer 50 percent interests to her son and granddaughter. As a result, splitting the transactions could only have been for tax avoidance purposes.

CONCLUSION

The Tax Court sided with the IRS on the step transaction doctrine and determined that 50 percent member interests had been transferred. In particular, the Court cited the timing of the transactions (all occurring on the same day), Ms. Pierre's voluntary and rapid forfeiture of her member interests, the Petitioner's stated desire to avoid gift taxes as compelling facts in the determination for the IRS. Additionally, the Tax Court gave significant consideration to the bookkeeper's description of the transaction for each trust as one transaction (rather than a gift and a sale).

In its determination of the fair market value for the transferred 50 percent interests, the Tax Court allowed both discounts for lack of control ("DLOC") and lack of marketability. The Court accepted the testimony of the Petitioner's expert who opined the DLOC should be reduced modestly for a 50 percent non-controlling interest versus a minority interest (which had been valued for the tax return). The Court reduced the DLOC from 10 percent to 8 percent.

Initially, the Petitioner requested a DLOM of 30 percent. However, at trial, the Petitioner's expert determined a 35 percent DLOM was appropriate. The IRS challenged the 35 percent discount but did not contest the 30 percent figure. Accordingly, the Tax Court accepted the 30 percent DLOM.

COMMENTS

Although her estate plan was sloppily executed, the Petitioner was able to justify significant discounts for transfers of 50 percent interests in a single-member LLC holding only marketable securities.

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