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Subject: **General Estate and Gift Tax Developments: May 2010**

1. **Tax Court Applies “Step-Transaction” Doctrine to Simultaneous Gift and Sale Transfers**

Major References: [*Pierre v. Commissioner, T.C. Memo. 2010-106*](#)

Prior AALU Washington Reports: 09-111; 09-99

2. **Tax Court Determines Fractional Interest Discount for Residence Transferred by Couple to Two QPRTs**

Major References: [*Ludwick v. Commissioner, T.C. Memo. 2010-104*](#)

Prior AALU Washington Reports: 09-49; 07-85; 02-67; 01-50; 00-100

MDRT Information Retrieval Index Nos.: 2500.00; 7400.021; 7400.022; 7400.024

This Washington Report summarizes a few of the more important cases and rulings in the estate and gift tax areas which were decided or reported by the courts and the Internal Revenue Service in May of 2010, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

Cases

1. [*Pierre v. Commissioner, T.C. Memo. 2010-106*](#)

The Tax Court, in a memorandum opinion, determined that the “step transaction” doctrine should be applied to collapse the simultaneous transfer, by gift and by sale, of LLC interests to the

transferor's children's trusts into a single transfer of 50 percent interests to each of them. The Court then went on to determine the appropriate discounts for lack of marketability and minority interest that should be applied to determine the value of each 50 percent interest.

The issue decided in *Pierre v. Commissioner*, 133 T.C. __ (2009) ("*Pierre I*") (see our Bulletin No. 09-111) was whether certain transfers - by gift and by sale - of interests in a single-member limited liability company (LLC) that is treated as a disregarded entity under the "check-the-box" regulations, are valued as transfers of proportionate shares of the underlying assets owned by the LLC or are instead valued as transfers of interests in the LLC, and, therefore, subject to valuation discounts for lack of marketability and control. The Tax Court determined in *Pierre I* that the single-member LLC should not be disregarded for gift tax purposes (even though it was disregarded for income tax purposes) and thus that the transfers were transfers of interests in the LLC, to which applicable discounts could be applied.

In *Pierre v. Commissioner*, T.C. Memo. 2010-106 ("*Pierre II*"), the Tax Court addressed other issues in the case (which had been bifurcated in the original decision), to wit: (1) whether the step transaction doctrine applies to collapse the transferor's gift and sale transfers into transfers of two 50-percent interests in LLC; and (2) whether the lack of control and marketability discounts the transferor reported should be reduced.

Under the facts of the case, "Taxpayer" organized the single-member Pierre Family, LLC (Pierre LLC) on July 13, 2000. Taxpayer respected the formalities of formation in the State of New York, and Pierre LLC was validly formed under New York law.

On July 24, 2000, Taxpayer created the Jacques Despretz 2000 Trust and the Kati Despretz 2000 Trust (the "trusts").

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

On September 27, 2000, 12 days after funding Pierre LLC, Taxpayer transferred her entire interest in Pierre LLC to the trusts. She gave a 9.5 percent membership interest in Pierre LLC to each of the trusts to use a portion of her then-available credit amount and her GST exemption. On the same day, she sold each of the trusts a 40.5 percent membership interest in exchange for a secured promissory note. The notes each had a face amount of \$1,092,133, an amount that was determined by an appraisal that valued a 1 percent non-managing interest in Pierre LLC at \$26,965. The appraiser determined the value of a 1 percent interest by applying a 30 percent discount to the value of Pierre LLC's underlying assets. [However, Taxpayer admitted that because of an error in valuing the underlying assets, a discount of 36.55 percent was used in valuing the LLC interest for gift tax purposes.]

Taxpayer filed a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for 2000 and reported the gift to each trust of a 9.5 percent Pierre LLC interest. She reported the value of the taxable gift to each trust as \$256,168 (determined by multiplying a 9.5 percent interest times the \$26,965 appraised value of a 1 percent non-managing interest in Pierre LLC).

On audit, the government determined that Taxpayer's gift transfers of the 9.5 percent Pierre LLC interests to the trusts were properly treated as gifts of proportionate shares of Pierre LLC assets valued at \$403,750 each, not as transfers of interests in Pierre LLC. As noted above, the government lost this argument in *Pierre I*.

In *Pierre II*, however, the government successfully argued that the same-day transfer, by gift and sale of 50 percent interests to each trust (9.5 percent to each trust by gift and 40.5 percent to each trust by sale) of interests in Pierre LLC should be collapsed, under the step transaction doctrine, from 4 separate transfers into 2 transfers of 50 percent interests in the LLC.

The “step transaction” doctrine embodies “substance-over-form” principles. Per the Court, “[i]t treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result.” A U.S. District Court applied this doctrine in *Heckerman v. U.S.*, ___ F. Supp. 2d. ___ (W.D. Wash. July 27, 2009) (see our Bulletin No. 09-99). In that case, the Court held that an indirect gift of assets contributed to a family limited partnership occurred when the contribution of the assets to the partnership and the gifts of the partnership interests to trusts for the benefit of the taxpayers’ children occurred virtually simultaneously. Therefore, no entity discount was available with respect to those assets.

In *Pierre II*, however, the government had already lost the argument (in *Pierre I*) that the transfer of LLC interests to the children’s trusts should be treated as if they were transfers of the underlying assets contributed to the LLC. The steps that the government sought to “collapse” in *Pierre II* were not the funding of the LLC and the transfers of LLC interests to the children’s trust, but the simultaneous gifts and sales of those interests.

The court, in agreeing that the gifts and sales should be aggregated, noted that:

“Petitioner intended to transfer two 50-percent interests to the trusts, but she first gifted small interests in Pierre LLC to use a portion of her then-available credit and her GST tax exemption. We find that petitioner had primarily tax-motivated reasons for structuring the gift transfers as she did. She then sold interests in Pierre LLC in exchange for the promissory notes that were significantly discounted using the 36.55-percent valuation discount. No principal payments have been made on the notes despite the passage of eight years. Further, Pierre LLC has made yearly distributions to the trusts so that the trusts could make the yearly interest payments. Consequently, she transferred \$4.25 million of assets within Pierre LLC without paying any gift tax. Petitioner intended not just to minimize gift tax liability but to eliminate it entirely . . . Accordingly, we hold that petitioner made a gift to each trust of a 50-percent interest in Pierre LLC to the extent the interest exceeds the value of the promissory note executed by the trust.”

There remained to be determined the value of each 50 percent LLC interest, after taking into account discounts for lack of marketability and minority interest. Remarkably, the government did not introduce an expert’s report on the valuation of the LLC interests at trial because of its position (in *Pierre I*) that the gifts were of the underlying assets of Pierre LLC. The government merely argued, therefore (without supporting appraisals) that the taxpayer’s discounts for lack of control and marketability “should be reduced.”

In the end, the Court reduced the minority interest/lack of control discount from the taxpayer’s claimed 10 percent to 8 percent. The Court allowed to stand, however, the taxpayer’s claimed 30 percent lack of marketability discount, for an overall discount of 35.6 percent (almost equal to the discount reported on the taxpayer’s gift tax return). Therefore, despite having lost the step transaction skirmish, the taxpayer in *Pierre I* and *Pierre II* can fairly be said to have won the war.

2. *Ludwick v. Commissioner, T.C. Memo. 2010-104*

In Ludwick v. Commissioner, the Tax Court reduced the fractional interest discount attributable to the transfer of two 50 percent undivided interest in a residence owned by husband and wife to two qualified personal residence trusts (“QPRTs”) from the 30 percent discount claimed by the taxpayers to 17 percent. The IRS had claimed that the proper discount was 11 percent.

A fractional interest discount arises from the lack of control inherent in joint ownership of an asset such as real estate or artwork. Such discounts often result in reductions in the value of transferred property of 15 to 60 percent. See, e.g., *Shepherd v. Commissioner*, 115 T.C. 376 (2000), aff’d 283 F.3d 1258 (11th Cir.

2002), *rehearing, en banc, denied* 2002 U.S. App. LEXIS 14147 (2002), (*see* our Bulletins Nos. 00-100 and 02-67); *Estate of Forbes v. Commissioner*, T.C. Memo 2001-72, discussed in our Bulletin No. 01-50. The Revenue Service, however, often takes the position, sometimes successfully, that the amount of the discount should be limited to the costs of “partition” under state law. In a partition action, a court is asked to divide the property, assuming that the property is susceptible to partition, order the property sold intact, and divide the proceeds, or to split the property between the co-tenants. *See, e.g., Stone v. U.S.*, 103 AFTR 2d 2009-1379 (9th Cir. 2009), *aff’g*. 99 AFTR 2d 2007-2992, (N.D. Ca. 2007), discussed in our Bulletin Nos. 07-85 and 09-49.

The taxpayers in *Ludwick v. Commissioner* sought such a discount for their respective 50 percent undivided interests - as tenants in common - in their \$7.25 million Hawaiian vacation home. Each such interest was transferred to a qualified personal residence trust in which the transferor reserved an interest for a term of years. The remainder interest, which would vest after each term interest had expired, was reported as a gift to the taxpayer’s children.

In December 2004, “Taxpayers” Andrew and Worth Ludwick executed agreements establishing separate qualified personal residence trust arrangements. In February 2005, Taxpayers transferred their undivided interests in their vacation property pursuant to those trust agreements.

On their separate 2005 Federal gift tax returns, Taxpayers each reported a gift of the remainder interest resulting from the transfers in trust, claiming a 30 percent discount to the net value of 50 percent of the residence; viz, \$2,537,500 (0.70 x 0.50 x \$7,250,000). In determining the deficiencies in gift tax, the Revenue Service allowed a discount of only 15 percent, so that it computed \$3,081,250 to be the value of each undivided one-half interest that Taxpayers transferred. On brief, the government argued for a discount of no more than 11 percent, which would result in a value for each transfer of \$3,226,250.

Each of the parties presented reports by their respective experts.

Taxpayers’ expert relied on analyses of sales of undivided interests and partnership interests. The government’s expert relied on analyses of sales of undivided interests, various surveys of brokers, a review of tender offers for majority interests in public companies, and lawyers’ estimations of the cost of partition. The Court did not find the analysis of either expert convincing.

The Taxpayer’s expert “failed not only to explain how the discounts were calculated (i.e., how did he calculate the underlying fair market value?), but also to provide any measure of the variability or dispersion of his data points (e.g., their standard deviations). . . Most importantly, he did not provide any of the data; we do not know the specifics of any of the ‘undivided interest transactions.’ We have no way to know how comparable those properties were to the one here in issue.”

The government’s expert, in his direct testimony, relied in part on four sales of undivided interests between 2002 and 2007, all involving commercial property in the eastern United States. The Court observed that “[w]e are not convinced that such data tells us much about the appropriate discount for a multimillion dollar vacation home in Hawaii.”

Both experts presented additional data, but with little background substantiation.

The Court inquired of each expert at trial why a buyer of an undivided interest in the property would consider the interest worth any less than a proportional share of the fair market value of the whole property reduced by the cost to the buyer of partition; *i.e.*, the cost to end joint ownership involuntarily by a judicially mandated sale. Both experts convinced the Court that a buyer would also take into account marketability or liquidity risk; *i.e.*, “the risk of being unable to sell an asset quickly at its fair market value.” They disagreed, however, as to the size of the appropriate discount and as to whether partition would even be necessary. (It was established that the taxpayers had a right to partition under Hawaii law.)

In determining the appropriate discount, the Court summarized the standard as follows:

“ . . . [A] buyer who had a right to partition could not demand a discount greater than (1) the discount reflecting the cost and likelihood of partition and (2) the discount representing the marketability risk because, if he did, another (rational) buyer would be willing to bid more. That iterative process would drive the discount down to the discount reflecting the expected cost of partition and the marketability risk.

Accordingly, the Court concluded, “to determine the price that a buyer would be willing to pay, we must figure (1) the length of the partition process, its costs (including the cost of selling the property), and the likelihood partition would be necessary, (2) the rate of return the buyer would demand, and (3) the value of 50 percent of the property upon sale.”

The Court found that a contested partition would take 2 years to resolve (including 1 year to sell the property) and that the costs made necessary by the litigation would be 1 percent of the value of the property (that is, \$72,500). Taxpayers, however, have failed to convince the Court that partition “will always -- indeed, will often -- be necessary.” The Court determined that a buyer would expect partition to be necessary 10 percent of the time. It found that the cost of selling the property (which the sellers would bear in any case) would be 6 percent of the value of the property, or \$435,000. Finally, since the annual operating cost of the property was approximately \$350,000, the Court assumed that that a buyer of a one-half undivided interest in the property would expect to bear half of such costs, and that the buyer would expect the remaining other one-half owner to bear the other half.

With respect to the marketability risk, the Court found that a buyer would demand a return of 10 percent.

Given an assumed growth rate of 3 percent, and also assuming a 1 or 2-year time frame in which to sell the property, the Court concluded that, at the end of 1 year (if partition were not necessary) or 2 years (if it were) the property would sell for \$7,467,500 or \$7,691,525, respectively.

Applying these factors, the Court determined that the fair market value of the gift that each petitioner made in 2005 was \$3,000,089, as follows.

If Partition Is Not Necessary:					
Year	Operating Costs	Selling Costs	Sales Proceeds	Total	Present Value
1	\$175,000	\$217,000	\$3,733,750	\$3,341,250	\$3,037,500
If Partition Is Necessary					
Year	Operating Costs	Partition and Selling Costs	Sales Proceeds	Total	Present Value
1	\$175,000	\$18,125	\$0	(\$193,125)	(\$175,568)
2	\$175,000	\$235,625	\$3,845,763	\$3,435,138	<u>\$2,838,957</u>
Total					\$2,663,388

The Court then found the weighted average of the two numbers to be \$3,000,089, after finding that a buyer would expect partition to be necessary 10 percent of the time.

We noted above that, in the past, the IRS has contended, with varying degrees of success in litigation (*see, e.g., Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982)), that fractional interest discounts are either not allowable, or are limited to the costs of partition. The Revenue Service, confirmed by the Court in this case, appears to concede in *Ludwick v. Commissioner* that other factors - i.e., marketability - may

enter into the equation. The detailed roadmap for valuation of fractional interests provided in *Ludwick* may provide needed guidance in this area.

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