

Taxes—Step 1, Step 2, Step 3

Here's a common scenario.

Mom and Pop form a family limited liability company (LLC) and contribute assets to the entity. In exchange for the transferred assets, Mom receives a fifty percent interest; Pop receives the same. A few days following creation of the entity and the contribution of assets thereto, Mom and Pop transfer the LLC interests to younger-generation family members, or trusts established on their behalf. Due to lack of control and restrictions on transferability of the LLC interests, a qualified appraiser concludes that valuation discounts of as much as 40 or 50 percent are available for federal gift tax purposes.

Everyone lives happily ever after!

It makes a great tale and a good example for illustrating how certain concepts work, but as any experienced Advisor knows, the devil is in the details.

A recent case, *Linton v. United States*, No. 09-35681 (9th Cir. 2011) (per curiam), *Doc 2011-1458*, *2011 TNT 15-27*, *aff'g in part, rev'g in part*, and *remanding* 638 F. Supp.2d 1277 (W.D. Wash. 2009), *Doc 2009-15152*, *2009 TNT 126-15*, illustrates the pitfalls that exist when details are overlooked. It also illustrates the dangers involved when several professionals work independently without one of them coordinating their activities.

The Ugly Facts

The Lintons' LLC was formed in November 2002. On January 22, 2003, they **signed and dated** several documents (a quitclaim deed, an assignment of assets, and letters authorizing security transfers and cash to the LLC). Several other documents (trust agreements for their children and gift documents of 11.25 percent of their LLC interests to each child's trust) were **signed but not dated**. The letters authorizing the stock transfers were received by one investment firm on January 24, which made the transfers between that day and January 31, and by another investment firm, which apparently effected the transfers between January 24 and 29.

Two or three months later, the Linton's attorney inserted the date January 22, 2003, on all undated documents. However, both the attorney and the Lintons' accountant later testified in their depositions that the correct date was really January 31, 2003. Also, the LLC's 2003 income tax return, prepared by the accountant, indicated that the Lintons' contributions were first credited to their individual capital accounts and then subsequently to their children's trusts'

capital accounts. Furthermore, each of the taxpayers' 2003 gift tax returns, prepared by the attorney, specified gifts of LLC interests occurring on January 31, 2003. The first row of the LLC's "Membership Interest Ledger," prepared by the attorney and containing no dates, showed Mr. Linton as owning 100 percent of the LLC when he contributed real estate and portfolio assets and as transferring 50 percent of his LLC interest to his wife; subsequent rows of

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the ledger listed the taxpayers' transfers of LLC interests into their children's trusts. A valuation report, prepared by the accountant, showed the LLC interests were transferred on January 31, 2003.

District Court

The IRS effectively disallowed the valuation discounts claimed by the Lintons (they had claimed a 47 percent lack of marketability and lack of control discount) with respect to the transfer of the LLC interests to or for the benefit of the children.

Much to the chagrin, no doubt, of the Lintons and their advisors, the district court granted summary judgment in favor of the IRS. Relying on the express language of the trust agreements and gift documents, the judge concluded that the correct date for the trust creation and gifts was January 22, 2003, and that the contributions of assets to the LLC occurred simultaneously with, or subsequent to, the gifts to the Lintons' children's trusts.

The court also applied the step transaction doctrine to conclude that under any of the three tests of that doctrine, the taxpayers made indirect gifts of the underlying assets in the LLCs, observed that the taxpayers "made no affirmative decision to delay the gifts and no evidence suggested the trust res was exposed to real economic risk during the alleged interim between the contributions to the LLC and the gifts of the LLC interests to the children's trusts."

The Lintons appealed.

The Appeals Court

The Ninth Circuit court of appeals was more generous to the Lintons and their advisors than the district court.

Although the Ninth Circuit agreed that the sequence of the Lintons' contributions of cash, stock, and real property to their family LLC and the transfer of LLC interests to their children's trusts

determined the nature of their gifts (LLC interests or underlying assets), the appellate court remanded the case because, in its view, there were genuine factual issues about the sequence of the transactions that could not be decided by summary judgment.

Furthermore, the Ninth Circuit disagreed with the district court on its application of the step transaction doctrine. The appeals court applied all three tests of that doctrine to the stipulated facts before it and found that none of the tests required it to collapse the formation of the LLC and the gifts on the interest into a single transaction.

The district court granted summary judgment in favor of the IRS. Relying on the express language of the trust agreements and gift documents, the judge concluded that the correct date for the trust creation and gifts was January 22, 2003.

What's Next?

In granting summary judgment, the district court gave considerable weight to the fact that the LLC was formed on January 22 and the gift documents were executed the same day. The district court apparently found the attorney's "after the fact" testimony that the Lintons actually intended to make the gifts on the 31st to be less than convincing.

On remand, the district court will consider and weigh all the evidence to determine when the Lintons formed the LLC and when they expressed donative intent. There is a good chance, however, that the court will reach the same conclusion it originally reached, leaving the Lintons with a gift tax bill and their advisors with egg on their faces.

Bottom Line

The Lintons would have been better served by greater attention to detail and better coordination among advisors.

The IRS does not favor valuation discounts in family gifting transactions. Failure to unambiguously document the sequence of events makes it easy for the Service to disallow the discounts by asserting that an "indirect gift" of the underlying assets occurred.

In transactions of this nature, the sequence of events should be as follows:

1. The LLC or FLP should be formed and dated;
2. Subsequently, the gift documents should be dated and executed; and
3. Finally, the gifts should be implemented and the date thereof documented.

A reasonable amount of time should expire between the steps to evidence economic substance.

Furthermore, in transactions of this nature, which usually require the services of more than one professional, there should be agreement among the professionals at the outset as to who has overall responsibility for coordinating the proper sequencing of events. This agreement should be reached before the fact, not after the fact.

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