Pierre v. Commissioner, 133 T.C. 24 (2009)

The valuation of gift tax on the transfer of interests in a single-member LLC is determined by the value of the LLC interests themselves, not the underlying assets, even though the LLC is a disregarded entity for federal tax purposes under the check-the-box regulations.

Summary

The Tax Court held that transfers of interests in a single-member LLC should be valued as transfers of the LLC interests, subject to valuation discounts, rather than as transfers of proportionate shares of the underlying assets. The court reasoned that state law determines the nature of the property interest transferred, and federal tax law then determines the tax treatment of that interest. The check-the-box regulations, designed for entity classification, do not override the established gift tax valuation regime.

Facts

The petitioner, Ms. Pierre, received a $10 million gift and wanted to provide for her son and granddaughter. She formed Pierre Family, LLC (Pierre LLC), a single-member LLC, and transferred $4.25 million in cash and marketable securities to it. Shortly after, she transferred 9.5% membership interests to each of two trusts for her son and granddaughter, followed by a sale of 40.5% interests to each trust in exchange for promissory notes. Ms. Pierre valued the LLC interests by applying a discount to the underlying assets.

Procedural History

The IRS issued a deficiency notice, arguing that the transfers should be treated as gifts of proportionate shares of Pierre LLC's assets, not as transfers of interests in the LLC. Ms. Pierre challenged the deficiency in Tax Court.

Issue(s)

Whether the check-the-box regulations require that a single-member LLC be disregarded for Federal gift tax valuation purposes, such that transfers of interests in the LLC are valued as transfers of proportionate shares of the underlying assets, rather than as transfers of interests in the LLC itself.

Holding

No, because state law determines the nature of the property rights transferred, and the check-the-box regulations do not override this principle for gift tax valuation purposes.

Court's Reasoning

The court emphasized that state law creates property rights and interests, and federal tax law then determines the tax treatment of those rights, citing *Morgan v. Commissioner, 309 U.S. 78 (1940)*. Under New York law, Ms. Pierre did not have a property interest in the underlying assets of Pierre LLC. The court distinguished cases cited by the IRS, such as *Shepherd v. Commissioner, 115 T.C. 376 (2000)* and *Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006)*, noting that those cases involved indirect gifts of underlying assets, whereas Ms. Pierre transferred assets to the LLC before transferring LLC interests to the trusts. The court stated, “State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights.” The court also noted that Congress has enacted specific provisions, such as sections 2701 and 2703, to disregard state law restrictions in certain valuation contexts, but has not done so for LLCs generally. The court concluded that the check-the-box regulations, designed for entity classification, do not mandate disregarding the LLC for gift tax valuation.

Practical Implications

This case confirms that valuation discounts for lack of control and marketability can be applied to gifts of interests in single-member LLCs, even though the LLC is disregarded for other federal tax purposes. Attorneys structuring gifts using LLCs should ensure that the LLC is validly formed under state law and that the transfer of assets to the LLC precedes the transfer of LLC interests. This case clarifies that the IRS cannot use the check-the-box regulations to circumvent established gift tax valuation principles. Later cases must respect the separate legal existence of the LLC when valuing the gift of its interests, unless Congress specifically acts to eliminate entity-related discounts in this context. The case underscores the importance of carefully sequencing transactions to avoid indirect gift arguments.

