



TO: Clients and Friends  
FR: Michael D. Schley and  
Shannon E. Sprenger  
RE: **Recent Tax Court Ruling: Federal Gift Tax Valuation is Based on Discountable  
LLC Interest, Not Underlying Asset Value for “Disregarded” LLC**  
DATE: August 31, 2009

**SUMMARY:** A new Tax Court ruling supports the proposition that the owner of a single-member limited liability company (“LLC”) may make gifts of LLC interests that are discounted significantly from the proportionate value of the underlying assets. This confirms the validity of a technique commonly used by estate and gift planning practitioners, and generally supports the use of LLCs for family-owned properties.

**ANALYSIS:** The United States Tax Court recently held that the transfer of an interest in a single-member LLC that is treated as a disregarded entity pursuant to federal check-the-box regulations is valued as a transfer of the interests in the LLC, and not as a transfer of shares of the assets owned by the LLC for the purpose of assessing gift tax<sup>1</sup>. Transfers of LLC interests, as opposed to assets, are subject to valuation discounts to reflect the lack of marketability of the interest and to account for the level of control of the entity. These discounts can reduce the transfer’s potential gift tax assessment value<sup>2</sup>.

In the Tax Court case, *Pierre v. Commissioner of Internal Revenue*<sup>3</sup>, Susan Pierre validly formed Pierre LLC under New York law, which, like California, recognizes an LLC as an entity separate from its owner, or member. At the time Susan Pierre made the gift transfers, Pierre LLC was disregarded as an entity separate from its owner (a “disregarded entity”) for federal tax purposes under federal check-the-box regulations. The IRS contended that because Pierre LLC was a single-member LLC treated as a disregarded entity under the check-the-box regulations, her transfers of interests in the LLC should be treated as transfers of the LLC’s underlying assets.

The Tax Court disagreed. The check-the-box regulations classify how an LLC will be taxed on its income at the Federal level. For example, a single-member LLC may elect to be taxed as a

---

<sup>1</sup> As of January 1, 2009, the annual gift tax exclusion is \$13,000.00.

<sup>2</sup> Gift Tax Regulations define the “value” of property as “the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts.” Accordingly, in valuing transfers of interests in an entity such as an LLC, marketability of the interests and control of the entity are taken into account when assigning value to the interests. For example, the “street” value of a 5% interest in an LLC that is worth a total of \$100,000.00 will be less than \$5,000.00.

<sup>3</sup> 133 T.C. No. 2 (Aug. 24, 2009).

corporation or as a disregarded entity. When an LLC is taxed as a disregarded entity, any property and activities of the entity are treated as those of the owner. If no election is made, a single-member LLC is classified as a disregarded entity by default<sup>4</sup>.

According to the Tax Court, state law, not Federal tax law, determines the nature of a taxpayer's interest in property. State law also determines the type and value of property interest transferred. Once the value of the transferred property interest is determined, Federal gift tax rules are applied to the interest's value to ascertain gift tax liability. Hence, Federal check-the-box regulations apply to determine how the entity is taxed; they do not apply to disregard the LLC to determine how a donor must be taxed under Federal law on a transfer of ownership interest in the LLC.

Because California law classifies an LLC as an entity separate from its owner, an owner has no personal interest in the specific property owned by the LLC. According to this recent taxpayer-friendly decision, transfers of LLC shares should be valued as transfers of interests in the LLC, subject to marketability and control discounts, and not as transfers of a proportionate share of assets owned by the LLC.

A word of caution: The IRS frequently challenges arrangements, known generally as "family limited partnerships," that facilitate intergenerational transfers at lower estate and gift tax rates through the use of minority and illiquidity discounts. Be sure to consult with your estate planning professionals before utilizing this technique.

Please feel free to contact us for more detailed information, or if you have questions regarding gift tax or how this decision applies to your LLC.

Santa Barbara: 805-966-4100

Solvang: 805-688-9226

---

<sup>4</sup> Multi-member LLCs may elect to be classified as corporations or partnerships. If no election is made, the default classification is partnership.