Estate and Business Planning for the Farm and Ranch Family - Use of the LLC (Part 2)

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Overview

In Part One earlier this week, I focused on the use of a single-member limited liability company (LLC) as part of the estate/business/succession plan for the farming and ranching operation. As noted in Part One, a single-member LLC is often used to hold general partner interests in the farming general partnership so that federal farm program payments can be maximized and achieve liability protection. Also, noted in Part One was that a single-member LLC can be a "disregarded entity." That means that the entity is disregarded as an entity separate from its owner if the owner does not have limited liability.

For a single-member LLC that is a disregarded entity, what does the single-member of the LLC own? Is it the interest in the LLC or the underlying asset(s) of the LLC? If the entity is respected as an entity separate from its owner, can valuation discounts for the owner's interest in the entity be achieved for federal estate and gift tax purposes? If so, that's a big planning (and tax saving) opportunity.

How a single-member LLC as a disregarded entity is treated for federal estate and tax purposes – it's the topic of today's post.

Valuation Concepts – In General

The answer to the question of what an owner of a single-member LLC owns makes a difference as far as the valuation of the interest owned is concerned because of the possible effect of valuation discounts. Those discounts are for lack of control and minority interest. With a single-member LLC, there is no discount for lack of control – the single-owner has full control. But, as a privately held business, a discount for lack of marketability might be available if the LLC is respected as an entity.

The value of an asset for federal gift and estate tax purposes is "fair market value." That's defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts." *Treas. Reg. §§20.2031-1(b); 25.2512-1; Rev. Rul. 59-60, 1959-1 C.B. 237.* State law controls the determination of what has been transferred in the valuation process.

Under the "check-the-box" regulations, a business entity that is not classified as a corporation is a "domestic eligible entity" and, without an election, is "[d]isregarded as an entity separate from its owner if it has a single owner." *Treas. Reg. §301.7701-3(b)(1)(ii).* Under Treas. Reg. §301.7701-1(a) and 301.7701-2(c)(2), an entity with a single member is disregarded as an entity separate from its owner "for federal tax purposes." That definition raises two questions: 1) What does "for federal tax purposes" mean? Does it mean federal income as well as federal transfer (estate and gift) taxes?; and 2) does it bar the use of the "willing buyer/willing seller" valuation rule? In 2004, the IRS shed some light on the first question when it ruled that although a disregarded entity is not recognized for federal income tax purposes, the entity exists under state law and state law controls the owner's rights and economic interests. *Rev. Rul. 2004-88, 2004-2*

C.B. 165. In 2009, the full Tax Court answered both questions and defined the interest owned by a single-member LLC owner.

The *Pierre* Case

In *Pierre v. Comr., 133 T.C. 24 (2009)*, the petitioner received a $10 million gift in 2000. Later that year, she created a single-member LLC in accordance with New York law and transferred cash and marketable securities to it worth about $4.25 million. She held 100% ownership of the LLC and did not file an election with Form 8823 to be treated as an association taxable as a corporation. Thus, the LLC was a disregarded entity. Twelve days after funding the LLC, the petitioner transferred her entire interest in the LLC to trusts established for the benefit of her son and granddaughter. She accomplished that by gifting a 9.5 percent interest in the LLC to each trust and then by selling a 40.5 percent interest in the LLC to each trust in exchange for promissory notes with a face amount of slightly over $1 million each. In valuing the transfers for gift tax purposes, her valuation expert applied a 30 percent discount to the value of the LLC's underlying assets (which turned out to be 36.5% for gift tax purposes due to an error in valuing the underlying assets). The petitioner filed a federal gift tax return (Form 709) reporting the taxable value of the gift to each trust in accordance with the valuation expert's report. The IRS issued a notice of deficiency on the basis that the gifts should have been treated as gifts of proportionate shares of the LLC's assets rather than transfers of interests in the LLC. As such, as 100% owner of the LLC's assets, no discount was appropriate. The IRS took the position that the entity was the check-the-box regulations meant that the LLC was to be disregarded as an entity separate from the petitioner – they were one in the same.

The petitioner claimed that NY state property law governed for transfer tax purposes rather than federal tax law. Under NY law, the LLC was not to be disregarded. Rather, upon the LLC's formation, NY law created an interest in the LLC that was distinguishable from the petitioner. The LLC became the petitioner's personal property that held legal title to the assets that the entity contained. Indeed, the NY LLC statute stated that, "A member has no interest in the specific property of the limited liability company." *N.Y. Limited Liability Company Law Section 601.*

The full Tax Court, in a 10-6 decision, agreed with the petitioner and determined that "for federal tax purposes" was limited to federal income tax and that the petitioner owned an interest in the LLC rather than the underlying assets of the LLC. As such, the willing buyer/willing seller valuation test applied to valuing the transferred interests which could then carry out any applicable valuation discounts. The Tax Court pointed out that "state law defines and federal tax law determines the tax treatment of property rights and interests." *See also Morgan v. Comr., 309 U.S. 78 (1940); United States v. National Bank of Commerce, 472 U.S. 713 (1985); Knight v. Comr., 115 T.C. 506 (2000).* The Tax Court also concluded that the check-the-box regulations don't define property interests. Instead, they merely allow the election of specific tax treatment for federal tax purposes, and that the Congress did not specifically disallow valuation discounts in the context of single-member LLCs – they aren't listed in I.R.C. §§2701-2704 along with other transactions that can't claim valuation discounts. Thus, the petitioner's gift tax liability was to be determined by the value of the transferred LLC interests rather than by a hypothetical transfer of the underlying assets of the LLC.

In a second Tax Court opinion in the case, the Tax Court noted that the petitioner made the gifts and sales on the same day. *Pierre v. Comr., T.C. Memo. 2010-106.* Thus, the court treated them as a single part-gift/part-sale transaction. That had the effect of reducing the lack of control discount slightly (from a claimed 35 percent to 30 percent) because the combined 50% gift/sale to each transferee could block the appointment of a new manager under the LLC operating agreement. The petitioner also couldn't come up with any non-tax reasons for separating the transfers into gifts and sales.

Conclusion

The *Pierre* case is important because, as full Tax Court opinion, it provides strong support for the proposition that the asset to be valued for transfer tax purposes is the LLC interest and not the property that the LLC holds. Planning and valuation opportunities are possible based on that notion. A single-member LLC holding a farmer's general partnership interest in a farming operation can be structured to obtain valuation discounts when the interest is gifted to a member of the subsequent generation as well as at death. That makes the cost of intergenerational transfers of farming interests less which will be even more important if the federal estate and gift tax exemption level declines from its present level.

In a post next week, the concepts discussed in this two-part series will be applied to a family farm operation engaged in an intergenerational transfer.