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This article discusses the recent Tax Court decision in *Pierre* and the effect for gift tax purposes of an entity's classification made under the check-the-box regulations. The court was split on what those regulations mean when they stated that an entity is to be disregarded "for federal tax purposes."

Pierre v. Commissioner[1] examines whether a donor's gifts of entity interests in a single-member limited liability company that she elected to treat as a disregarded entity under the check-the-box regulations will be recharacterized as transfers of LLC assets. The *Pierre* opinion covered only this issue; a separate opinion will address the application of the step transaction doctrine and the amount of the valuation discounts, if any.[2]

In 2000 a wealthy friend gave Suzanne Pierre, a New York resident, $10 million in cash. She then organized Pierre Family LLC, but did not elect to have the entity taxed as a corporation for federal tax purposes. Eleven days later, she created two trusts, one for her son, Jacques, and the other for her granddaughter, Kati. Almost two months after creating the trusts, the taxpayer contributed $4.25 million, consisting of cash and marketable securities, to her family LLC. Twelve days later, she gave all of her interests in her family LLC to the two trusts.

The taxpayer filed her gift tax return valuing her transfers with discounts attendant to a transfer of LLC interests.[3] Examining her returns and denying her those discounts, the government determined that the taxpayer's gifts were of the underlying assets of the LLC.

Both the taxpayer and the government agree that the LLC is a valid separate entity from the taxpayer under New York law and that the LLC is disregarded under the check-the-box regulations "for federal tax purposes."[4] However, the taxpayer maintains that "for Federal gift tax valuation purposes, State law, not Federal tax law, determines the nature of a taxpayer's interest in property transferred and the legal rights inherent in that property interest"[5] and that under New York law an LLC member has no interest in specific property of the LLC. The government, however, contends that because the entity is ignored for federal tax purposes under the check-the-box regulations, the taxpayer has transferred cash and stock to the trusts.[6]

The court first described what it called the "Federal gift tax valuation regime," citing the regulation defining fair market value[7] and the Supreme Court cases *Bromley v. McCaughn*[8] and *Morgan v. Commissioner*.[9] The court relied on *Bromley* for the axiom that the gift tax is an excise tax rather than a direct tax[10] and on *Morgan* for the principle that state law creates property rights and interests, and federal tax law defines their tax treatment.[11]

The court elaborated by stating that "the interest was created by State law, respected by the Court, and taxed pursuant to the Federal estate and gift tax provisions."[12] The court held that the taxpayer did not have a property interest in the LLC's underlying assets and therefore she had transferred her only property interests in the entity under state law — her LLC interests themselves — to the trusts.

The court proceeded to explore whether the check-the-box regulations should alter its conclusion. On this point the court explained that those regulations were created to "simplify the classification of hybrid entities"[13] by allowing a business entity to "elect to be classified as an association or to be disregarded as an entity separate from its owner"; if no election is made, a domestic eligible entity with a single owner is treated as identical

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[1]*Pierre v. Commissioner*, 133 T.C. No. 2 (2009), *Doc 2009-19089*, *2009 TNT 162-4*. Judge Wells wrote the majority opinion of the court and was joined by Judges Cohen, Foley, Vasquez, Thornton, Marvel, Goeke, Wherry, Gustafson, and Morrison.

[2]*Id.* at 3, n.3.

[3]She contends that both lack of control and nonmarketability discounts apply to value the gifts of LLC interests. *Id.* at 7. She also maintains that the government bears the burden of proof on factual issues, but, as the court explained, the only issue in this opinion was decided as a matter of law. *Id.* at n.8.

[4]*See* reg. section 301.7701-1(a)(1), -3(a), and -3(b).

[5]*Pierre*, at 6.

[6]*Id.* The government states that "petitioner made gifts equal to the total value of the assets of Pierre LLC less the value of the promissory notes she received from the trusts."

[7]*See* reg. section 25.2512-1(b) (incorporating the hypothetical willing buyer/willing seller concept).

[8]280 U.S. 124 (1929).

[9]309 U.S. 78 (1940).

[10]*Pierre*, at 9.

[11]*Id.*

[12]*Id.* at 10.

[13]*Id.* at 13.

to that owner.[14] According to the court, the regulations merely clarified whether an entity should be taxed as a corporation or as a partnership and were not intended to affect how a transfer of a validly formed LLC should be taxed for federal gift tax purposes.

The court distinguished the government's precedents as not material to *Pierre*. *McNamee v. Dept. of the Treasury* dealt with whether a single-owner LLC was required to pay the entity's withholding taxes and therefore was not on point regarding gift taxes.[15] Both *Shepherd v. Commissioner*[16] and *Senda v. Commissioner*[17] examined the sequence of the donor's funding of the family entity and the donor's gifts of entity interests to determine whether the donor had made an indirect gift. Finally, the court also rejected the taxpayer's reliance on *Mirowski v. Commissioner*[18] although the court noted in *Mirowski* that its holding did not preclude a single-member LLC from qualifying for the bona fide sales exception in section 2036, which would be the result if the government's position was upheld in *Pierre*.[19]

Essentially, the court viewed the check-the-box rules narrowly, as a means of *classifying* the LLC for tax purposes. The court rejected the principle that the regulations define the property interest the taxpayer transferred for federal gift tax purposes:

> To conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be 'manifestly incompatible' with the Federal estate and gift tax statutes as interpreted by the Supreme Court.[20]

The court referred to sections 2701-2704 as examples of congressional limitations to correct valuation abuses and stated that a regulation should not be used to change precedent or what it called "the federal gift tax valuation regime."[21] The court concluded that the taxpayer had transferred LLC interests and not the underlying property of the LLC.

Judge Cohen, in her concurring opinion,[22] explained how she, as author of *Med. Practice Solutions, LLC v. Commissioner*,[23] which followed *McNamee*, agreed with the majority that those cases were classification cases applying the check-the-box regulations in the employment tax context unlike *Pierre*, which involved valuing LLC interests that the owner gave as gifts to her family. While the regulations might be used to identify the transferor (the LLC or the owner) to determine who is liable for gift tax, the issue in *Pierre* involved the transfer by the owner of LLC interests.[24] Judge Cohen agreed with the majority that the regulations should be narrowly applied: "A targeted solution to a particular problem should not be distorted to achieve a comprehensive overhaul of a well-established body of law."[25] Judge Cohen said the regulation was ambiguous because it contained the language "for federal tax purposes" rather than "for *all* Federal tax purposes," and the majority's interpretation was compatible with section 7701(a) limitations and valuation principles.[26]

In the first of two dissenting opinions, Judge Halpern disagreed both with the majority's approach and its conclusions.[27] The regulations explain the consequence of disregarding a single owner LLC as separate from its owner: "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."[28] Thus, for all tax purposes, the LLC's activities are treated the same as those of a sole proprietorship.[29] The taxpayer's argument ignores the regulation's activities instruction and that a sole proprietorship lacks any separate identity from its owner. Judge Halpern explained that treating the transfer of an interest in a single-member disregarded entity as a transfer of an interest in the entity's assets is compatible with the willing buyer/willing seller valuation regulation,[30] which may be applied by "considering the LLC's property . . . as the property petitioner transferred when she transferred interests in the LLC."[31]

Judge Halpern cited several examples of how the government's position in *Pierre* has been consistent for the last 10 years.[32] He said that while the rulings concerned sales for income tax purposes, "the difference between a sale and a gift is a difference in degree, not in kind."[33] Moreover, in *McNamee,* while state law protected the appellant from his LLC's liabilities, the federal regulations allowing him to waive that shield to benefit from escaping the double taxation of a corporate entity classification extended to his employment tax liabilities. Thus, Judge Halpern interpreted *McNamee* as holding that

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[14]Reg. section 301.7701-3(a) and (b)(1)(ii).

[15]*McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007), *Doc 2007-12575*, *2007 TNT 101-13*.

[16]*Shepherd v. Commissioner*, 115 T.C. 376 (2000), *Doc 2000-27642*, *2000 TNT 209-15*, *aff'd*, 283 F.3d 1258 (11th Cir. 2002), *Doc 2002-5259*, *2002 TNT 42-16*.

[17]*Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006), *Doc 2006-436*, *2006 TNT 5-12*. *See* Wendy C. Gerzog, "Return to *Senda*: Order Determinative for FLP Discounts," *Tax Notes*, Feb. 13, 2006, p. 791, *Doc 2006-1385*, or *2006 TNT 30-40*.

[18]*Estate of Anna Mirowski v. Commissioner*, T.C. Memo. 2008-74, *Doc 2008-6681*, *2008 TNT 60-8*. *See* Gerzog, "Tax Court FLP Confusion: *Mirowski*," *Tax Notes*, July 21, 2008, p. 263, *Doc 2008-14927*, or *2008 TNT 141-30*.

[19]*Pierre*, at 18-19, citing *Mirowski* at 56.

[20]*Pierre*, at 20 (emphasis in original).

[21]*Id.* at 21.

[22]Judges Wells, Foley, Vasquez, Thornton, Marvel, Goeke, Wherry, and Gustafson joined in this opinion. *Id.* at 30.

[23]*Med. Practice Solutions, LLC v. Commissioner*, 132 T.C. No. 7 (2009), *Doc 2009-7255, 2009 TNT 60-18*.

[24]*Pierre*, at 23-24.

[25]*Id.* at 25.

[26]*Id.* at 26-30 (emphasis in original).

[27]Judges Kroupa and Holmes agreed with Judge Halpern's dissenting opinion. *Id.* at 48.

[28]*Id.* at 31-32, citing reg. section 301.7701-2(a).

[29]*Id.* at 32.

[30]*Id.* at 33, n.1.

[31]*Id.* at 34.

[32]*Id.* at 35-37, citing Rev. Rul. 99-5, 1999-1 C.B. 434, *Doc 1999-2045*, *1999 TNT 10-6*, and three letter rulings (see n.3).

[33]*Id.* at 37.

"Federal law, in the form of the check-the-box regulations, does define the property rights and interests so transferred."[34] Essentially, while *Farid-Es-Sultaneh v. Commissioner*[35] does not require the income tax provisions to be interpreted *in pari materia* with gift tax provisions, "there is nothing in the definitions in section 7701(a)(1) through (3) of 'Person', 'Partnership', and 'Corporation' that indicates that those terms should have different meanings for purposes of the income and gift tax provisions of the Internal Revenue Code."[36]

Finally, Judge Halpern construed the majority opinion as rejecting the validity of the activities instruction in the check-the-box regulations "as an invalid construction of the statute."[37] When they were approved, the check-the-box regulations represented a radical change from case law and regulatory precedent,[38] including their effective overruling of the 1935 Supreme Court case *Morrissey v. Commissioner*.[39] Because they were such a fundamental alteration from then-current law, the validity of the regulations was open to question; *McNamee*, *Littriello v. United States*,[40] and *Med. Practice Solutions Inc.* resolved that uncertainty. "If the check-the-box regulations trump Supreme Court precedent regarding the role of State law in determining entity classification for Federal income or employment tax purposes, then surely they must also supersede judicial precedent respecting State law concepts of property rights for Federal gift (and estate) tax purposes."[41]

Judge Kroupa, the trial judge in *Pierre*, wrote the second dissent.[42] This opinion began:

> The majority opinion allows an octogenarian taxpayer to give away $4.25 million in cash and marketable securities at a substantial discount in gift taxes because she put them in a limited liability company (LLC), despite a regulation telling us that "for federal tax purposes," that LLC should be "disregarded." The majority is either ignoring the plain language of the regulation or silently invalidating it.[43]

Judge Kroupa explained that the effect of the check-the-box regulations is to treat the owner of a disregarded entity as the owner of LLC property; under *McNamee*, the LLC's activities are considered like those of the owner's sole proprietorship.[44]

According to Judge Kroupa, the language of the regulation plainly reads: "for federal tax purposes." Further, when Treasury has intended for a regulation to be applied solely for federal *income* tax purposes, it has so used that specific language numerous times. Had Treasury *not* wanted the regulation to apply for gift tax purposes, it could have used clear limiting language: "Tellingly, the preamble to the amended regulations states that single-owner entities 'generally would continue to be treated as disregarded entities for other federal tax purposes' after amended."[45] Moreover, the majority did not address the government's consistent treatment in its rulings for the past 10 years of an electing LLC's single-member owner as the LLC's asset owner.[46]

Judge Kroupa maintained that the majority invalidated the check-the-box regulations as applied to federal gift tax without sufficient analysis. When the pertinent statute is ambiguous, a mere statement that there is a conflicting historical gift tax regime promulgated before the applicable regulations cannot invalidate them. The Second Circuit Court of Appeals "has already held that section 7701 is ambiguous as to the Federal tax treatment of single-member LLCs."[47] Judge Kroupa wrote that these regulations determine whether the entity has an existence separate from its owner for federal tax purposes, not how the entity is to be taxed.[48]

Moreover, Judge Kroupa said the majority misstated the issue and presented a false dichotomy between an entity's classification and its valuation. The gift tax regulations do not explain how to value an interest in a single-member LLC although they do clarify how to value interests in a corporation, partnership, or sole proprietorship: "Accordingly, we must first 'classify' the entity, and only then can we 'value' its interests."[49] The check-the-box regulations elucidate the federal tax consequences of a taxpayer's election to treat the entity as identical to the owner, like in a sole proprietorship; that is, despite state law classification of the entity, the regulations allow for a different federal tax treatment. "It therefore does not matter whether Sate law recognizes an LLC as a valid entity or provides that a member has no interest in any of the specific property of the LLC."[50]

Judge Kroupa criticized the majority for diminishing the importance of both *McNamee* and *Littriello* on the ground that they are not gift tax cases: "The majority fails to recognize that the single owner's liability for employment taxes turns upon disregarding the LLC for Federal tax purposes rather than upon the identity of the taxpayer."[51] *Littriello* held that a single owner "owns all the assets, is liable for all debts, and operates in an individual

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[34] *Id.* at 42. "In other words, the Court of Appeals in *McNamee* construed the check-the-box regulations to modify the bundle of rights that Mr. McNamee enjoyed under local law and that constituted ownership of the LLC."

[35] *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812, 814 (2d Cir. 1947).

[36] *Pierre*, at 44.

[37] *Id.*

[38] *Id.* at 45.

[39] *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

[40] *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007), *Doc 2007-9567*, *2007 TNT 73-16*.

[41] *Pierre,* at 46-47.

[42] *Id.* at 49. Judges Colvin, Halpern, Gale, Holmes, and Paris joined Judge Kroupa's dissenting opinion.

[43] *Id.*

[44] *Id.* at 50.

[45] *Id.* at 52, citing REG-114371-05 (Oct. 18, 2005), *Doc 2005-21024*, *2005 TNT 200-8*.

[46] *Id.* at 53-54.

[47] *Id.* at 56, citing *McNamee*, at 107. *Pierre* is appealable to the Second Circuit.

[48] *Id.* at 57.

[49] *Id.* at 58.

[50] *Id.*

[51] *Id.* at 60.

capacity.''[52] Both circuit courts emphasized that the taxpayer had an election option, just as the taxpayer had in *Pierre*. If the taxpayer had elected to treat the LLC as a corporation, the federal tax consequences of her entity choice would have been different.[53] Even the court's own opinion, *Med. Practice Solutions*, stated that ''a single member LLC 'and its sole member are a single taxpayer or person to whom notice is given.'''[54] Judge Kroupa wrote that ''despite the majority's wish, Pierre LLC does not exist apart from petitioner for gift tax purposes, and petitioner should be treated as holding its assets.''[55]

Finally, Judge Kroupa explained the broad scope of the gift tax statutes as the Supreme Court emphasized both in *Commissioner v. Wemyss*[56] and more recently in *Dickman v. Commissioner*.[57] Yet, notwithstanding the wide coverage of the gift tax, according to Judge Kroupa, ''the majority would require Congressional action before any State law property right could be disregarded for Federal gift tax purposes,'' she wrote.[58]

Bromley, Morgan, Wemyss, and *Dickman*

Bromley is a case that deals with the constitutionality of the gift tax based on the taxpayer's argument that it was a direct tax and not apportioned in violation of the third clause of section 2 and the fourth clause of section 9 of Article I and that it lacked uniformity and deprived him of property without due process in violation of the first clause of section 8 of Article I and the Fifth Amendment.[59] *Bromley* upheld the validity of the gift tax on the basis of being an excise tax on the transfer of wealth.

In *Morgan* the Supreme Court distinguished between a special and a general power of appointment. The decision to tax the latter and not the former was based on the potential for abuse because of the latter's unlimited potential appointees. The Court analyzed the extent of rights to dispose of property under local law to distinguish between the two types of powers of appointment. Thus, the Court said, ''State law creates legal interests and rights. The federal Revenue Acts designate what interests or rights, so created, shall be taxed.''[60]

In *Wemyss* the Supreme Court held that donative intent was not required to impose the gift tax: ''Congress chose not to require an ascertainment of what too often is an elusive state of mind. . . . And Treasury Regulations have emphasized that common law considerations were not embodied in the gift tax.''[61]

Dickman emphasized the expansive sweep of the gift taxes, saying that ''the gift tax was designed to encompass all transfers of property and property *rights* having significant value.''[62] Further, the Court underlined the connection between gift taxes and income taxes: ''We are bound to effectuate Congress' intent to protect the estate and income tax systems with a broad and comprehensive tax upon all '[transfers] of property by gift.'''[63] Instead of separating gift taxes from income taxes, the Court emphasized the interconnectedness among the federal taxes.

Analysis and Conclusion

While the majority and the dissents may be described as adopting, respectively, a narrow or broad reading of the check-the-box regulations, I agree with the dissenting opinions because, although I'm not sure what is meant by ''the Federal gift tax valuation regime'' (I have never heard that term before), if there is such a separately defined system, it is much more like the characterization of the dissenters.

Although the gift tax was enacted principally to support the estate tax, Congress[64] and the Supreme Court[65] have called the gift tax the backup to the income tax system.[66] Where the two tax systems have varied, the gift tax regulations have explained that divergence. For example, the two taxes differ about the role of donative intent in their definitions of a gift. Under *Commissioner v. Duberstein*,[67] for income tax purposes, donative intent is essential for a gift under the section 102 exclusion; by contrast, for gift tax purposes, donative intent is not

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[52]*Id.*, citing *Littriello*, at 378.
[53]*Id.* at 60-61.
[54]*Id.*, at 60, citing *Med. Practice Solutions*, at 5.
[55]*Id.*
[56]*Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945).
[57]*Dickman v. Commissioner*, 465 U.S. 330, 333-334 (1984).
[58]*Pierre*, at 62.
[59]*Bromley*, at 135.
[60]*Morgan*, at 80. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), is often then cited to describe the proper regard to be given lower state court interpretations of a determination of those property interests.
[61]*Wemyss*, at 306.

[62]*Dickman*, at 334 (emphasis added).
[63]*Id.* at 344.
[64]Congress intended the gift tax and the income tax to have the same top marginal tax bracket to prevent the erosion of the income tax base that had been forecast by tax professionals. *See* Statement of Managers for Conference Agreement on H.R. 1836, Economic Growth and Tax Relief Reconciliation Act of 2001, 107th Cong., 1st Sess. 91. *See also infra* note 67; testimony of Lauren Y. Detzel, House Ways and Means Committee hearing, *Doc 2001-8293*, *2001 TNT 56-83*.
[65]*See, e.g., Dickman*, at 344, *Smith v. Shaughnessy*, 318 U.S. 176, 179, n.1 (1943) (''the gift tax was passed not only to prevent estate tax avoidance, but also to prevent income tax avoidance through reducing yearly income and thereby escaping the effect of progressive surtax rates''); *Est. of Sanford v. Commissioner*, 308 U.S. 39, 47 (1939) (''one purpose of the gift tax was to prevent or compensate for the loss of surtax upon income where large estates are split up by gifts to numerous donees'').
[66]Although the 2001 act repealed the estate tax in 2010, the gift tax was retained to prevent erosion of the income tax base. *See* Jonathan G. Blattmachr and Mitchell M. Gans, ''Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning,'' *Tax Notes*, Jan. 15, 2001, p. 393, *Doc 2001-1503*, or *2001 TNT 10-110*; John Buckley, ''Transfer Tax Repeal Proposals: Implications for the Income Tax,'' *Tax Notes*, Jan. 22, 2001, p. 539, *Doc 2001-2147*, or *2001 TNT 14-159*; Martin A. Sullivan, ''JCT Estimates Widespread Evasion With Gift Tax Repeal,'' *Tax Notes*, Apr. 2, 2001, p. 10, *Doc 2001-9607*, or *2001 TNT 64-10*; John Buckley, ''Estate and Gift Taxes: What Will Congress Do Next?'' *Tax Notes*, June 18, 2001, p. 2069, *Doc 2001-16894*, or *2001 TNT 117-71*. (''Retention of the gift tax is an attempt to prevent widespread income tax avoidance. The fact that the new law provides a lower gift tax exemption than estate tax exemption also is a response to potential income tax avoidance.'')
[67]*Commissioner v. Duberstein*, 363 U.S. 278, 285-286 (1960).

required for a taxable gift under section 2512 although donative intent may be an element showing that an unequal transfer is a bad bargain in the commercial realm that is not subject to gift tax.[68] The similarity between a sale in the income tax context and a gift for gift tax purposes is integral to the definition of a gift for gift tax purposes. Not requiring donative intent, a gift for gift tax purposes is an unequal exchange. Section 2512(b) defines that gift as follows: ''Where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.'' Judge Halpern's analysis relating sales for income tax purposes and gifts for gift tax purposes reflects the dollar equivalence or inequality of, respectively, a sale or a gift as defined in that statute.

In any event, the regulation is clear: ''*Pierre LLC* is to be disregarded as an entity separate from its owner '*for federal tax purposes*' under the check-the-box regulations.''[69] It is more reasonable to read those words as they plainly read rather than to parse a narrow exception for income tax purposes, especially when courts have already extended them to employment taxes, and when there is a clear kinship between income taxes and gift taxes. Once the wrapper is ignored for tax purposes, as the dissent asserted, the taxpayer transferred cash and marketable securities to her family members for no consideration in money or money's worth.

Nor are there sufficient equities on the taxpayer's side to make one question the legal reasoning of the dissents' opinions. The taxpayer is essentially saying, ''Heads I win, tails you lose.'' Although the court will address the application of the step transaction doctrine and the valuation discount in a separate opinion, the taxpayer was not unaware that this transaction was essentially a shell game.

[68]Reg. section 25.2511-1(g)(1) (''donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer''); reg. section 25.2512-8 (''a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth'').

[69]*Pierre*, at 6 (emphasis added).