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This article discusses *Linton*, a district court decision about a family limited liability company, indirect gifts, and the step transaction doctrine.

The moral of *Linton v. United States*[1] is that disaster looms for achieving desired family entity discounts when all significant events are performed in one day, especially when they occur without meticulous care.

According to the limited liability company agreement, William Linton formed WLFB Investments, LLC (WLFB LLC) on November 7, 2002. The agreement gave him and his wife, Stacy, the power over the everyday business of the LLC, and it restricted transfers to nonfamily members.[2] On January 22, 2003, Linton transferred 50 percent of the LLC to his wife. Also on January 22, he executed a quitclaim deed transferring undeveloped real property to the LLC, and authorized the transfer of stocks, municipal bonds, and cash to the LLC. As managers of WLFB LLC, the Lintons signed ''An Assignment of Assets'' agreement concerning those transfers.[3]

Also, on January 22, 2003, the Lintons and Mr. Linton's brother James, who was appointed trustee, executed undated separate trusts agreements and ''Gift of Percentage Interest in WLFB Investments, LLC'' documents (Gift Documents), in connection with the Lintons' transfers to their four children. According to its terms, the trusts were irrevocable and effective when property was contributed to the trust. The trust documents also stated that ''the Grantors have transferred percentage interests in the WLFB Investments LLC'' for their children's benefit when they signed the trust agreement, and that James as trustee acknowledged having received the property. According to the Gift Documents, the children's trusts each received an 11.25 percent LLC interest from each parent, so that the trusts collectively owned 90 percent of the LLC.[4]

In his deposition, Mr. Hack, the attorney who had prepared the documents, stated that several months after the documents were executed, he inserted January 22, 2003, as the date on all of the documents. In that deposition, he also contended that the dates of the trust and the transfers of the LLC interests to the trusts should have been January 31, 2003. Linton emphasized in his own deposition that the reason for executing all of the documents, and for all of the transfers, was to achieve lack of marketability and minority discounts to lower his and his wife's transfer tax liabilities.[5]

On audit, denying the taxpayers both a nonmarketability discount and a minority discount for taxable gifts that they made to their children, the government increased the size of their taxable gifts respectively for William from $725,548 to $1,587,988 and for Stacy from $724,000 to $1,520,440. The Lintons sought a partial refund of gift taxes.[6]

The district court granted the government's motion for summary judgment.[7] The court explained that a contribution of property to a partnership is treated as an indirect gift to the partners when, instead of increasing the transferor's capital account by the full amount of the contribution, the other partners' capital accounts reflect a proportionate enhanced value because of a transferor's contribution.[8] The court reviewed the Tax Court's conclusion in *Shepherd v. Commissioner*[9] that the transfers of property to a partnership, which was not formed until the next day, had occurred at the same time so that the transfers constituted indirect gifts of the underlying property interests.[10] The court contrasted *Shepherd* with *Estate of Jones v. Commissioner*[11] and *Gross v. Commissioner*,[12] and distinguished the latter cases, in which the taxpayers successfully argued that the transferor had transferred partnership interests to his children. In both

[1] 638 F. Supp.2d 1277 (W.D. Wash. 2009), *Doc 2009-15152*, *2009 TNT 126-15*.
[2] *Id.* at 1281.
[3] *Id.* at 1278-1279. William signed as assignor and they both signed as managers of WLFB LLC. *Id.* at 1279.

[4] *Id.* at 1279-1280.
[5] *Id.* at 1280.
[6] *Id.* at 1278.
[7] *Id.* The court also denied the taxpayers' cross-motion for partial summary judgment and dismissed the taxpayers' complaint, with prejudice. *Id.* at 1278 and 1290.
[8] *Id.* at 1282.
[9] 115 T.C. 376 (2000), *Doc 2000-27642*, *2000 TNT 209-15*.
[10] *Linton*, 638 F. Supp.2d at 1282-1283.
[11] 116 T.C. 121 (2001), *Doc 2001-6611, 2001 TNT 45-12*.
[12] *Gross v. Commissioner,* T.C. Memo. 2008-221, *Doc 2008-20847*, *2008 TNT 190-17*. *See* Wendy C. Gerzog, ''*Gross*: FLP Sequence and Its Consequence,'' *Tax Notes*, Dec. 1, 2008, p. 1075, *Doc 2008-23927*, or *2008 TNT 232-81*.

Jones and *Gross*, the donor's gifts affected only the transferor's capital accounts and did not enhance the other partners' interests.[13]

In *Linton,* the government maintained that the facts were most like those in *Senda v. Commissioner*,[14] in that the significant events occurred on the same date or that the order of incidents was uncertain. In *Senda,* wherein the sequence of events (that is, partnership formation and property transfers) was unclear, the Tax Court held that the transfers were indirect gifts.[15] Although originally undated, the pertinent documents in *Linton* were all later dated on January 22, 2003. While the court agreed to consider the taxpayers' parol evidence for purposes of the motion for summary judgment, what controlled here was ''the express language of these documents [that] establishes that the Trusts were created and the gifts were made on January 22, 2003.''[16]

In response to the taxpayers' suggestion that the trusts were ineffective on January 22, 2003, because they lacked a trust res, the court held that any type of property may be the subject of a trust and that the res was the partial interests in the LLC ''which existed and were contributed to the Trusts at or before the signing of the Trust Agreements on January 22, 2003.''[17] On that date, the LLC owned both undeveloped real property transferred by quitclaim deed and securities transferred as reflected in the Assignment of Assets document. According to the *Linton* court, moreover, the taxpayers' argument supporting their contention of no trust res conflicted with their statements offered to bolster their argument about the purported sequence of events.[18]

Essentially, the taxpayers failed to prove that the transactions were of LLC interests and were not ''indirect gifts to the Trusts of pro rata shares of the assets conveyed to the LLC.''[19] The court concluded that on January 22, 2003, the trusts were valid and the taxpayers gave the partnership interests to the children's trusts so that, like in *Shepherd* and in *Senda,* the transfers of assets occurred either before or at the same time as the transfers of LLC interests.

Alternatively, applying the step transaction doctrine, the *Linton* court found that the taxpayers made indirect gifts to the children's trusts. Under that doctrine, a court can compress a series of steps to view them as one transaction. Courts apply several different tests to consider the appropriate application of the doctrine[20]; however, the *Linton* court held that under any of those tests, the taxpayers made indirect gifts. Although the appropriateness of the step transaction doctrine is usually a factual issue, the court concluded that there would not be much utility in holding a trial to determine the legal issues when the evidence was unchallenged.[21] Therefore, under *Penrod v. Commissioner*,[22] the court held as a matter of law that the step transaction doctrine applied.[23]

Unlike in *Holman v. Commissioner*[24] or *Gross*,[25] two cases in which the Tax Court refused to apply the step transaction doctrine, the *Linton* court stated that there was no passage of time producing an ''independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another.''[26] In *Holman*, the Tax Court held that a six-day delay between the two transactions suggested that ''the taxpayers bore a 'real economic risk' that the value of an LP unit could change.''[27] Likewise, in *Gross*, the Tax Court emphasized the interval of 11 days between the two events. In *Linton*, by contrast, there was no indication of a gap between the two transactions and, therefore, no showing of a ''real economic risk.'' The taxpayers failed to submit any evidence ''concerning the fluctuations, if any, in the prices of the various securities at issue on a daily basis during the period in question.''[28] Also, the two transactions would never have occurred

[13]*Linton,* 638 F. Supp.2d, at 1283.

[14]433 F.3d 1044 (8th Cir. 2006), *Doc 2006-436*, *2006 TNT 5-12*. *See* Gerzog, ''Return to *Senda*: Order Determinative for FLP Discounts,'' *Tax Notes*, Feb. 13, 2006, p. 791, *Doc 2006-1385*, or *2006 TNT 30-40*.

[15]*Linton,* 638 F. Supp.2d, at 1283-1284.

[16]*Id.* at 1285.

[17]*Id.* at 1286.

[18]*Id.* at 1287:

> Plaintiffs also contend that the transfer of securities was effective on January 22, 2003, when Mr. Linton executed the Assignment of Assets in favor of WLFB LLC. Although plaintiffs make this argument for another reason, namely in an effort to show that the contribution of securities to the LLC occurred prior to the gifts of LLC interests to the Trusts, having advanced this position, plaintiffs will not be heard to challenge whether WLFB LLC had assets, or whether percentage interests in WLFB LLC constituted adequate trust res, on January 22, 2003.

[19]*Id.*

[20]The courts apply either ''(i) the 'binding commitment' test; (ii) the 'end result' test; [or] (iii) the 'interdependence' test.'' *Id.* at 1288.

[21]*Id.* at 1288-1289:

> The binding commitment test is met because plaintiffs executed binding Trust Agreements and Gift Documents at the same time they took the first step of contributing property to the LLC; as counsel for plaintiffs conceded during oral argument, these documents would have been valid after signing had they never been dated. The end result test is likewise satisfied because plaintiffs undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability, pursuant to which they crafted, with the aid of an attorney and a tax advisor, a scheme consisting of 'pre-arranged parts of a single transaction.' *** In addition, the interdependence test is met because the undisputed evidence demonstrates that plaintiffs would not have undertaken one or more of the steps at issue absent their 'contemplation of the other integrating acts.'

[22]88 T.C. 1415 (1987).

[23]*Linton,* 638 F. Supp.2d, at 1290.

[24]130 T.C. 170 (2008), *Doc 2008-11723*, *2008 TNT 103-6*. *See* Gerzog, ''*Holman*: The FLP's New Clothes,'' *Tax Notes*, Sep. 22, 2008, p. 1215, *Doc 2008-19015*, or *2008 TNT 185-23*.

[25]*Gross,* T.C. Memo. 2008-221. *See* Gerzog, ''*Gross*: FLP Sequence and Its Consequence,'' *supra* note 12.

[26]*Linton*, 638 F. Supp.2d, at 1289.

[27]*Id.*

[28]*Id.* at 1289-1290.

without "the anticipated 40 percent to 49 percent discount in calculating gift taxes."[29]

Shepherd, *Senda*, and *Jones*

In *Shepherd*, the taxpayer and his sons were partners in a limited partnership the father had previously established; then the taxpayer contributed land to the partnership, which enhanced all three of their partnership interests. Thus, the taxpayer made an indirect gift of the land to his sons, thereby denying the transfer any valuation discounts, instead of a gift of partnership interests to them.[30] Likewise, in *Senda*, the circuit court upheld the Tax Court's finding that the taxpayers had not produced sufficient evidence that their contributions of stock to two family limited partnerships (FLPs) preceded their transfer of FLP interests to their children.[31] In *Senda*, the taxpayers had depended on unreliable after-the-fact documents, such as tax returns. Likewise, the two letters faxed to their tax advisers did not conclusively determine the order of events:

> The first letter is dated the same day as the transfer of stock to the first partnership, and thus does not indicate any specific order of events. The second letter is dated two days after the second stock transfer, although the Sendas' return says they transferred the partnership interests two days earlier, the same day as the stock transfer. Significantly, the testimony of Mark Senda — that his business practice is to execute documents and transactions "as of" a certain date — undercuts the reliability of the dates on the letters.[32]

The circuit court in *Senda*, therefore, did not reverse the factual and credibility findings of the Tax Court.

In *Jones*, by contrast, the court held that the decedent had made gifts of limited partnership interests to his son and four daughters. First, he contributed assets, including real estate, to FLPs and those transfers were properly reflected in his capital accounts and did not increase any of the other partners' FLP interests. Later that same day, he transferred a large part of his partnership interests to his five children through a clear order of events that enabled the decedent's gifts to benefit from FLP discounts. "All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts."[33]

Step Transaction Doctrine

In *Penrod*, the government argued that two events, the taxpayers' purchase and sale of McDonald's stock, should be merged as one transaction, causing numerous negative tax consequences, while the taxpayers contended they were two separate and independent transactions.[34] To resolve the issue, the court considered the application of the step transaction doctrine.

In *Penrod*, the court found that there was no binding commitment to sell the stock and that at the time of the acquisition the taxpayers did not intend to sell their stock, but instead only chose to do so later because of subsequent events. Therefore, the court held that none of the three tests required the application of the step transaction doctrine, which would have combined the two steps.[35] Consequently, the court held that there was a continuity of interest as required for the acquisition of the stock to comprise a reorganization under section 368(a)(1)(A).

In *Senda*, the circuit court held that the Tax Court had properly used the step transaction doctrine to determine the character of the transferred property. The court held that the lower court's findings that the transactions were integrated and concurrent were thoroughly corroborated by the facts. While the taxpayers contended that application of the doctrine is restricted to identifying the donor or donee in a gift tax case, the appellate court cited two of its opinions, *Sather v. Commissioner*[36] and *Estate of Schuler v. Commissioner*,[37] when the court maintained that its application extended to resolving the nature of the transferred property.[38] "In sum, the Sendas' proposed limitation would be contrary to the precedent of the Supreme Court, which calls the step transaction doctrine 'well-established' and 'expressly sanctioned.'"[39]

In *Holman*, the Tax Court refused to apply the step transaction doctrine to find an indirect gift of stock to the taxpayer's children. The court interpreted the government's argument as adopting the interdependence test. The court, however, refused to conclude that "the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift."[40] The court speculated that the government's decision not to argue indirect gifts for the taxpayer's 2000 and 2001 transfers of similar sequence implicitly accepted the independent significance of the two transfer events.[41]

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[29] *Id.* at 1289.

[30] *Shepherd*, 115 T.C. at 385.

[31] *Senda*, at 1047.

[32] *Id.*

[33] *Jones*, 116 T.C. at 128.

[34] *Penrod*, 88 T.C. at 1427 (The determination of this issue would affect the continuity of interest test required for the taxpayers' acquisition to qualify as a as a tax-deferred reorganization under section 368(a). Under the government's theory, the taxpayers would have to recognize gain from the exchange of their stock in 1975. The benefits of a tax-deferred reorganization are derived from the principle "that the shareholders of an acquired corporation have not terminated their economic investment, but have merely altered its form." *Id.*).

[35] *Id.* at 1434.

[36] 251 F.3d 1168 (8th Cir. 2001), *Doc 2001-16149*, *2001 TNT 112-94*.

[37] 282 F.3d 575 (8th Cir. 2002).

[38] *Senda,* 433 F.3d at 1049. *See Schuler*, 282 F.3d at 579. In *Sather* and *Schuler*, the circuit court had applied the reciprocal trust doctrine, which it considered a variant of the doctrine of substance over form and which the Tax Court referred to as the reciprocal transaction doctrine, to deny additional annual exclusions for gifts made by the taxpayer and his brother to each other's children. *Id.*

[39] *Senda*, 433 F.3d at 1049. *See supra* note 20.

[40] *Holman,* 130 T.C. at 188.

[41] *Id.* at 189-190.

Also, the court emphasized that the value of the FLP interests fluctuated between November 2, 1999, and November 8, 1999, during which time the taxpayers bore that risk.[42]

Finally, in *Gross*, the government argued that the taxpayer made an indirect gift in fact, or under the step transaction doctrine. However, the court rejected both arguments. The court agreed with the taxpayer on the timing of the two transactions and held that the step transaction doctrine did not apply, because 11 days separated the final transfers of the transferor's stock to her FLP and her gifts of partnership interests to her daughters, and because the stocks were all, or virtually all, "heavily traded, relatively volatile common stocks."[43]

Analysis and Conclusion

Linton is a case that parallels *Senda* and underlines the importance of following the proper sequence of transfers to guarantee the receipt of valuable family LLC or FLP discounts. Estate planners need to ensure that the transferor's asset contribution is properly reflected in his capital account before the transferor makes gifts of interests in that entity to family members. To defeat the application of the step transaction doctrine, litigators need to provide evidence of economic risk existing between the two transaction dates.

A comparison between *Shepherd*, *Senda*, and *Linton* on one hand and *Holman* and *Gross* on the other, indicates that the step transaction doctrine has been applied only when the two transactions of contributing assets to the family LLC or FLP, and of effecting gifts of interests in that family entity, have occurred on the same date, and when a court alternatively finds an indirect gift in fact from the unclear or unfavorable evidence of the sequence of those two events. In sum, there is only a limited application of the step transaction doctrine in this context; courts appear to have applied the doctrine only when it has not changed the outcome of the case.

[42]*Id.* at 190-191; 191, n. 7.
[43]*Gross,* T.C. Memo. 2008-221 at 20, n.5.