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Linton Reversed: Indirect Gifts and The Step Transaction Doctrine

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The Ninth Circuit recently reversed the district court's summary judgment in favor of the government in *Linton* on the issues of indirect gift and the applicability of the step transaction doctrine. The circuit court's analysis focused on the taxpayers' donative intent. With that emphasis, the Ninth Circuit remanded the case to the district court to determine the sequence of the relevant transactions.

Taxpayers William and Stacy Linton have won a reversal of the summary judgment the district court granted in favor of the government and have had their case remanded to district court.[1] On its motion for summary judgment, the government contended that the taxpayers made an indirect gift of the transferred assets, rather than gifts of limited liability company interests, and that the step transaction doctrine applied. Although the Ninth Circuit agreed with both parties that the sequencing of the taxpayers' contributions of cash, stock, and real property to their family LLC and their transfer of LLC interests to their children's trusts determined the nature of their gifts,[2] the appellate court remanded the case because there were genuine factual issues about the sequence of the transactions that could not be decided by summary judgment.[3]

The circuit court laid out the following dates and events about the relevant transactions. The Lintons' LLC was formed in November 2002. On January 22, 2003, they signed and dated several documents (a quitclaim deed, an assignment of assets, and letters authorizing security transfers and cash to the LLC), but only signed without dating several others (trust agreements for their children and gift documents of 11.25 percent of their LLC interests to each child's trust). The letters authorizing the stock transfers were received by one investment bank on January 24, which made the transfers between that day and January 31, and by another investment firm, which apparently effected the transfers between January 24 and 29.[4]

Two or three months later, the taxpayers' attorney, Richard Hack, inserted January 22, 2003, on all undated documents. Both he and the Lintons' accountant, who worked for Moss Adams LLP, testified in their depositions that the correct date was January 31, 2003. Also, the LLC's 2003 income tax return, prepared by Moss Adams, indicated that the Lintons' contributions were first credited to their individual capital accounts and then to their children's trusts' capital accounts, and that each of the taxpayers' 2003 gift tax returns, prepared by Hack, specified gifts of LLC interests occurring on January 31, 2003.[5] The first row of the LLC's "Membership Interest Ledger," prepared by Hack and containing no dates, showed Mr. Linton as owning 100 percent of the LLC when he contributed real estate and portfolio assets and as transferring 50 percent of his LLC interest to his wife; subsequent rows of the ledger listed the taxpayers' transfers of LLC interests to their children's trusts. A share valuation report, prepared by Moss Adams, showed the LLC interests were transferred on January 31, 2003.

Relying on the express language of the trust agreements and gift documents, the district court

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[1]*Linton v. United States*, No. 09-35681 (9th Cir. 2011) (per curiam), *Doc 2011-1458*, *2011 TNT 15-27*, *aff'g in part*, *rev'g in part*, and *remanding* 638 F. Supp.2d 1277 (W.D. Wash. 2009), *Doc 2009-15152*, *2009 TNT 126-15*. (All pinpoints are to page numbers in the PDF version of the Ninth Circuit opinion in the *Tax Notes Today* database.)

[2]*Id.* at 1222.

[3]Although the government also questioned the Lintons' asserted valuation discounts for their gifts of LLC interests (they had claimed a 47 percent lack of marketability and lack of control discount), the valuation issue, however, was not addressed in the appeal because the summary judgment in favor of the government on the indirect gift issue rendered the valuation discount issue immaterial. *Id.* at 1225, n.2

[4]*Id.* at 1223-1224.

[5]Courts, however, have noted that after-the-fact evidence, such as tax returns and reports, is undependable and not considered very probative. *See, e.g.*, *Senda v. Commissioner*, 433 F. 3d 1044, 1049 (8th Cir. 2006), *aff'g* T.C. Memo. 2004-160. *See* Wendy C. Gerzog, "Return to *Senda*: Order Determinative for FLP Discounts," *Tax Notes*, Feb. 13, 2006, p. 781, *Doc 2006-1385*, or *2006 TNT 20-40*.

held that the correct date for the trust creation and gifts was January 22, 2003, and that the contributions of assets to the LLC occurred simultaneously with, or subsequent to, the LLC interest gifts to the Lintons' children's trusts.[6] The district court also applied the step transaction doctrine to conclude that under any of the three tests of that doctrine, the taxpayers made indirect gifts of the underlying assets in the LLCs and observed that the taxpayers ''made no affirmative decision to delay the gifts and no evidence suggested the trust res was exposed to real economic risk during the alleged interim between the contributions to the LLC and the gifts of the LLC interests to the children's trusts.''[7] According to the Ninth Circuit, however, neither party was entitled to summary judgment because the record did not establish the date of the gift of the LLC interests.[8]

Although noting that a completed gift for federal gift tax purposes was not based on state law characterization,[9] the circuit court said that under Washington law, a completed gift requires (1) donor intent to give (2) something capable of delivery, (3) delivery, and (4) donee acceptance, and it proceeded to review each element. The court held that the second element existed at all times during the January 2003 transactions and that delivery, the third element, involved an analysis of donor intent, the first element, and ''was at least present no later than the intent to donate.''[10] Under Washington law, the blank space might indicate ambiguity regarding the delivery date, ''especially if it determined the delivery of an LLC interest by looking for an objective manifestation of an intent to deliver.'' Finally, the court held that donee acceptance, the fourth and final element, was unquestioned by both parties.[11]

Thus, to the court, donor intent was both pivotal and unclear in *Linton*.[12] Further, Washington law does not adopt the Restatement's subjective intent test[13]; rather, Washington law determines donative intent under an objective standard, ''especially where a writing exists.''[14] The court assumed, however, that other aspects of the Restatement applied to Washington law. Under the Restatement, ''execution of a gift document, alone, is not a sufficient objective manifestation of an intent to donate.''[15] By itself, a writing does not establish donative intent at the time of the writing. Under the Restatement, that generally requires delivery to the donee,[16] and the court did not see evidence of when the taxpayers irrevocably ''put the gift documents 'beyond retrieval,'''[17] or showed they intended to make the delivery effective. The court added that after signing the documents on January 22, the Lintons left the papers with Hack, which the court suggested might indicate a lack of intent to make a gift on that date.[18] On the other hand, while Hack's testimony in deposition was ''that he later came to believe that his client would have wanted the documents to be dated January 31,''[19] Hack's belief was contravened by his other testimony that on January 22, Mr. Linton didn't know when he wanted to make the gifts effective and by Hack's inaction to make the gifts effective on January 31. Finally, again assuming Washington law reflected the Restatement, the court stated that the gifts were more likely effective in March or April, when Hack composed the minute book.[20]

Once again, the court noted that federal law does not need to adhere to state law to determine federal tax liability.[21] However, the court stated that because the record included conflicting conclusions about when the taxpayers had donative intent as required by state law, the government was not entitled to summary judgment. Although the record included the undated gift document, the court framed this issue as whether ''the accumulation of objective circumstances was or was not sufficiently complete before the LLC was funded.''[22]

Also, the circuit court reversed the district court on the application of the step transaction doctrine, under any of its three tests, as inapplicable and insufficient to the established facts.[23] The consequence of applying the step transaction doctrine is to collapse several transactions into one for tax purposes. The court discussed the three tests, any of which if satisfied would require the application of

[6]*Linton*, No. 09-35681, 1225.
[7]*Id.* at 1226, citing 638 F. Supp.2d at 1290.
[8]No. 09-35681, at 1223.
[9]*Id.* at 1228, n.3.
[10]*Id.* at 1229.
[11]*Id.* at 1230.
[12]*Id.* at 1228.
[13]*Id.* at 1231, n.4.
[14]*Id.* at 1231.
[15]*Id.* at 1232.
[16]*Id.* at 1233, n.8.
[17]*Id.* at 1233.
[18]*Id.*
[19]*Id.* at 1233-1234.
[20]*Id.* at 1234-1235.
[21]*Id.* at 1235, n.7.
[22]*Id.* at 1236.
[23]The court first acknowledged that it had grappled with whether application of the doctrine to stipulated facts is a legal or factual issue, but it said that under either standard of review, it reversed the district court on the application of the step transaction doctrine. *Id.* at 1241.

the doctrine. Preliminarily, however, the court observed that the government had not identified any ''meaningless or unnecessary step that should be ignored.''[24]

Under the end result test, a court examines whether a taxpayer's series of steps were planned to reach a desired outcome, to which a taxpayer's subjective intent would be significant, the court noted. Here, the Lintons wanted to give their children LLC interests and at the same time deny them control of the LLC or its assets. According to the court, merging the steps here would produce a win for the taxpayers; that is, to tax their gifts as gifts of LLC interests.[25] Applying the interdependence test, in which the court looks at whether the steps were so interdependent that legal consequences would depend on the completion of the entire series of events, the court compared the events in *Linton* to those in bona fide business third-party transactions and said that creating an LLC is ''a reasonable business activity.''[26] The Tax Court in *Holman*[27] said that such an activity ''was not necessarily 'fruitless' even if done in anticipation of gifting partnership interests to the taxpayers' children.''[28] As such, the taxpayers' plan did not satisfy the interdependence test. Finally, the court found the binding commitment test inapplicable because the test applies only when the series of transactions extend over several years, and all the taxpayers' actions occurred within weeks or not more than several months.

At the same time, the circuit court also rejected the Lintons' failed gift argument that they were entitled to summary judgment because the LLC agreement only allowed their capital accounts to have been credited; thus, regardless of the order of the transfers, there was no gift and hence, no gift tax liability.[29] The court held that tax law does not depend on the formalities of title and that all concerned acted as if the taxpayers had transferred their assets beyond recall.[30]

Thus, having reversed the summary judgment in favor of the government both on the indirect gift and the step transaction doctrine issues and having affirmed the summary judgment against the taxpayers on their failed gift theory, the Ninth Circuit remanded the case to the district court to determine when the taxpayers initially and objectively showed their intent to effectuate their gifts.

Holman

Holman involved three issues: (1) whether the assets transferred to the family limited partnership were gifts of FLP interests or indirect gifts of Dell stock; (2) the value of those gifts; and (3) in determining the value of the gifts, whether the FLP agreement restrictions should be ignored under section 2703.[31]

On the indirect gift issue, the *Holman* court held that the taxpayers followed the proper order to convey a partnership interest. When the partnership was formed and the Dell shares transferred, the Holmans and the trustee of the children's trust ''received partnership interests proportional to the number of shares each transferred to the partnership.''[32] Five days later, the Holmans made gifts of their limited partnership interests. The court found that they had neither reversed that order nor simultaneously made both transfers.

Moreover, the court rejected the application of the step transaction doctrine to find an indirect gift of the stock itself to the taxpayers' children. The court interpreted the government's argument as invoking the interdependence test, but rejected the application of the step transaction doctrine. Although the court recognized that the Holmans created the FLP to make gifts of their FLP interests to their children, it declined to find that the legalities effected by the FLP agreement would have been useless without the taxpayers' 1999 gift.[33] Moreover, the court considered that the government's decision not to argue indirect gifts of the similar sequence of the 2000 and 2001 transfers may have indicated its implicit acceptance of the independent significance of those two steps.

The court distinguished *Senda v. Commissioner*[34] because the transfer of stock to the partnership in *Holman* did not occur on the same day as the gift of the partnership interests. The fact that the events of

[24]*Id.* at 1242.
[25]*Id.*
[26]*Id.* at 1243.
[27]*Holman v. Commissioner,* 130 T.C. 170 (2008), *Doc 2008-11723*, *2008 TNT 103-6*, *aff'd*, 601 F.3d 763 (8th Cir. 2010), *Doc 2010-7656*, *2010 TNT 67-11*.
[28]*Linton*, No. 09-35681 at 1241 (2011), citing *Holman*, 130 T.C. 170 at 188, 191 (2008).
[29]No. 09-35681, at 1236-1237.
[30]*Id.* at 1238.

[31]In *Holman,* the court applied section 2703 to the restrictions the taxpayers placed in paragraph 9.3 of their FLP agreement. Unlike in *Bischoff v. Commissioner,* 69 T.C. 32 (1977), and *Amlie v. Commissioner,* T.C. Memo. 2006-76, *Doc 2006-7345*, *2006 TNT 74-9*, the *Holman* court held that in contravention of section 2703(b)(1), its restrictions did not assist a bona fide business arrangement of the taxpayers; moreover, the court held in contravention of section 2703(b)(2) that they were a device to transfer property to their children for less than adequate consideration. That being the case, the partnership interests were valued without regard to a discount for the restrictions in that paragraph of the FLP agreement.
[32]130 T.C. at 187 (2008).
[33]*Id.* at 188.
[34]T.C. Memo. 2004-60, *Doc 2004-14321*, *2004 TNT 134-11*, *aff'd*, 433 F.3d 1044 (2006), *Doc 2006-436*, *2006 TNT 5-12*.

FLP formation, the taxpayers' transfers of Dell stock to the FLP, and the taxpayers' transfers of FLP interests all occurred within a week of each other did not change that result. The court emphasized that the value of the FLP interests fluctuated between November 2 and November 8, 1999, and during that period, the taxpayers shouldered the risk of a change in value. Therefore, the *Holman* court held that the taxpayers had made gifts of their FLP interests and not of the underlying assets.

Step Transaction Doctrine

In *Penrod*[35] the government argued that two events — the taxpayers' purchase and sale of McDonald's stock — should be merged as one transaction, causing several negative tax consequences, while the taxpayers contended that they were two separate and independent transactions.[36] The court considered the application of all three variations of the step transaction doctrine and 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.[37] Consequently, the court held that there was a continuity of interest as required for the acquisition of the stock to qualify as a reorganization under section 368(a)(1)(A).

In *Senda* the Eighth Circuit 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 was restricted to identifying the donor or donee in a gift tax case, the appellate court cited two of its opinions,[38] wherein the court maintained that its application extended to resolving the nature of the transferred property.[39] ''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.''[40]

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 but refused to conclude that ''the legal relations created by the partnership agreement would have been fruitless had petitioners not also made the 1999 gift.''[41] 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.[42] Also, the court emphasized that the value of the FLP interests fluctuated between November 2 and November 8, 1999, during which time the taxpayers bore that risk.[43]

Finally, in *Gross v. Commissioner*,[44] the government argued that the taxpayer made an indirect gift either 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.''[45]

Analysis and Conclusion

Although the Ninth Circuit repeatedly stated that a completed gift for federal gift tax purposes was not determined by state law, much of the court's opinion discusses when a gift is complete under state law.[46] For the federal gift tax, donative intent

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[35]*Penrod v. Commissioner*, 88 T.C. 1415 (1987).

[36]*Id.* at 1427. (The determination of this issue would affect the continuity of interest test required for the taxpayers' acquisition to qualify as a tax-deferred reorganization under section 368(a). Under the government's theory, the taxpayers would have had 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.*

[37]*Id.* at 1434.

[38]*Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001), *Doc 2001-16149*, *2001 TNT 112-94*. *Estate of Schuler v. Commissioner*, 282 F.3d 575 (8th Cir. 2002), *Doc 2002-5859*, *2002 TNT 46-18*.

[39]*Senda*, 433 F.3d 1044, at 1049. *See Schuler*, 282 F.3d 575, 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.

[40]*Senda*, 433 F.3d 1044, at 1049.

[41]*Holman*, 130 T.C. 170, 188 (2008).

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

[43]*Id.* at 190-191; 191, n.7, *Doc 2008-23927*, or *2008 TNT 232-81*.

[44]T.C. Memo. 2008-221, *Doc 2008-20847*, *2008 TNT 190-17*. *See* Gerzog, ''*Gross*: FLP Sequence and Its Consequence,'' *Tax Notes* Dec. 1, 2008, p. 1075, *Doc 2008-23927*, or *2008 TNT 232-81*.

[45]T.C. Memo. 2008-221, at 20, n.5.

[46]While the court recognized that Washington law differed from the Restatement position on donative intent and that Washington law placed more weight on documentary evidence,

(Footnote continued on next page.)

has very limited relevance because the focus of the inquiry is on whether there has been an unequal exchange in money or money's worth that would deplete the transferor's potential estate.[47] An analysis of donative intent for federal gift tax purposes is made only when its absence indicates a business transaction, which is exempt from the tax.[48] Completion of a gift for gift tax purposes is determined under the principles of the gift tax regulations that examine whether the donor has relinquished control over his property such that he cannot change its disposition or revest the property in himself.[49] Regarding the sequence of the two transactions involved in creating and funding a family LLC and the transfer of LLC interests in one's family members, case law such as *Senda*, *Holman*, *Gross*, *Jones*,[50] and *Shepherd*[51] requires the taxpayers to prove that the proper sequence of events has manifestly occurred.

As the district court noted, *Senda* is very similar to *Linton*. In *Senda* the sequence of events (that is, partnership formation and property transfers) was unclear; on that basis, the Tax Court held that the transfers were indirect gifts.[52] Although originally undated, the pertinent documents in *Linton* were all dated January 22, 2003, after the fact. While the district court agreed to consider the taxpayers' parol evidence for purposes of the motion for summary judgment, the lower court said that it was ''the express language of these documents [that] establishes that the Trusts were created and the gifts were made on January 22, 2003.''[53]

Thus, despite the Ninth Circuit's emphasis on donative intent and on what the taxpayers ultimately *wanted* to do (that is, to do whatever was necessary to obtain valuation discounts for their gifts), applying gift tax principles and case law precedent, *Linton* should be resolved in the government's favor.

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the court continuously assumed the application of the Restatement in describing the applicable state law. It is unclear how much Washington law reflects the Restatement as assumed by the Ninth Circuit. Of course, because a completed gift for gift tax purposes is analyzed under different criteria, it is also unclear how much of the discussion of the Restatement is determinative here in any event.

[47]Likewise, common-law principles of consideration don't apply to the federal gift tax for the same reason.

[48]*See* reg. section 25.2512-8 (''However, 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.'').

[49]Reg. section 25.2511-2. Indeed, for gift tax purposes, the identity of the donee does not need to be then ''known or ascertainable.'' *Id.*

[50]*Estate of Jones II v. Commissioner*, 115 T.C. 121 (2001), *Doc 2001-6611*, *2001 TNT 45-12*.

[51]*Shepherd v. Commissioner*, 115 T.C. 376 (2000), *Doc 2000-27642*, *2000 TNT 209-15*.

[52]No. 09-35681, 1283-1284.

[53]*Id.* at 1285.