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The Value of Interests in Single Member LLCs

The Tax Court has handed down a taxpayer-friendly decision involving the proper valuation of an interest in a single-member limited liability company ("LLC"). In the case, the interest in the single-member LLC was transferred to trusts for the benefit of the donor's relatives. The Tax Court decided that, for gift tax purposes, transfers should be valued as transfers of LLC interest and not as transfers of the underlying assets owned by the LLC. As a result, the transfers were subject to valuation discounts for lack of marketability and control.

In this case, the taxpayer transferred cash and securities into a single-member LLC, which was treated as a disregarded entity under the check-the-box regulations. Under the check-the-box system of classifying entities for tax purposes, eligible entities may choose their federal tax classification.

Single-member LLCs that do not elect to be treated as a corporation are considered disregarded entities for federal tax purposes. As a result the disregarded entity's income, deductions, assets and liabilities are treated as those of the owner of the single member LLC and reported on the owner's income tax return.

The taxpayer in this case gifted interest in her wholly-owned LLC to trusts established for the benefit of her son and granddaughter. When valuing the interest in the LLC for federal gift tax purposes she included a large discount for lack of marketability and control and paid no gift tax on the transfers.

The IRS assessed a deficiency and took the position that because the LLC was a disregarded single-member entity, the transfers should be treated as transfer of the underlying assets for valuation purposes, thus erasing the large valuation discounts the taxpayer applied to the transfer.

The court couldn't conclude that the check-the-box regulations should be applied to disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an LLC interest. The court stated that under New York law, the taxpayer did not have an interest in the assets of the single-member LLC which was recognized under New York law as an entity separate and apart from its members.

Additionally, federal law could not create a property right in those assets. The tax court sided with the taxpayer and ruled that gift tax liability was to be determined by the value of the interests transferred not the transfer of the underlying assets of the single-member LLC.

The tax court ruling on this valuation of transfers is very significant since it provides a way to generate tax benefits through estate planning. Gifting the interest in a single member LLC allows taxpayers to discount the value of the interest transferred, which could potentially mean substantial estate tax savings.

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