Price v. Commissioner, T.C. Memo. 2010-2 (January 4, 2010)

Gifts of Limited Partnership Interests Fail to Qualify for Annual Exclusion

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Synopsis

Gifts of limited partnership interests by parents to their three children did not constitute present interest gifts that will qualify for the gift tax annual exclusion. There was no immediate enjoyment of the donated property itself, because the donees had no ability to withdraw their capital accounts and because partners could not sell their interests without the written consent of all other partners. Furthermore, there was no immediate enjoyment of income from the donated property (which can also, by itself, confer present interest status) because (1) there was no steady flow of income, and (2) distribution of profits was in the discretion of the general partner and the partnership agreement specifically stated that distributions are secondary to the partnership's primary purpose of generating a long-term reasonable rate of return. Perhaps most interesting is that the IRS pursued this annual exclusion argument in litigation even though there were limited donees (three, unlike the Hackl, case where there were 41 donees) and even though there were over $500,000 of actual distributions to the children from the partnership's creation in 1997 to 2002. Clearly, the annual exclusion issue is "in play" and the availability of the annual exclusion for limited partnership interest transfers cannot be assumed. Several drafting suggestions will assist in countering the court's objections.

Basic Facts

1. Before selling his closely held company, Father contributed his stock and commercial property leased to the company to a family limited partnership in 1997. The FLP sold the stock in early 1998, and the proceeds were invested in marketable securities.
2. The 1% general partner was a corporation owned by Father's and Mother's revocable trusts, with Father as president. The 99% limited partnership interests were initially held equally by Father's and Mother's revocable trusts.
3. The terms of the FLP agreement include the following:
    a. Prohibition Against Transfer. Partners cannot sell partnership interests without written consent of all partners, but a limited partner may sell its interest to another partner.
    b. Purchase Option. If there is a voluntary or involuntary assignment of a partnership interest, the other partners have an option to purchase the interest for its fair market value, determined under a procedure requiring three appraisals. There is no time limit on exercising the purchase option in the event of voluntary transfers.
    c. Distributions. Profits are distributed proportionally to all partners "in the discretion of the general partner except as otherwise directed by a majority in interest of all the partners, both general and limited." There is no obligation to make distributions to enable partners to pay their income taxes on the partnership's profits. Furthermore, the partnership agreement stated that "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments."
4. Father and Mother each made gifts of limited partnership interest to each of their three adult children in each of the years 1997-2002. In each year, the gifts by the two donors to each child exceeded $20,000 ($22,000 in 2002), and they intended that the gifts would qualify for the federal gift tax annual exclusion.

5. The partnership actually made distributions to the children as follows:

Year	Total Partnership Distributions to Children
1997	---
1998	$ 7,212
1999	343,800
2000	100,500
2001	---
2002	76,824
Total	528,336

6. The gifts were large enough that the children collectively held a majority interest in the partnership in every year beginning in 1997. The children's cumulative interests in the partnership during the three years at issue (2000-2002) were 63%, 68.1%, and 99%, respectively.

7. The opinion described the gifts reported on gift tax returns by Father and Mother in 2000, 2001, and 2002. The IRS issued a "notice of gift value determination" for the 2000 gifts. The IRS issued notices of deficiency for 2001 and 2002. Each of these notices disallowed annual gift tax exclusions, and the opinion listed deficiencies for 2001 and 2002. (It is not clear if the IRS also questioned the annual exclusion availability for gifts made in 2000.)

Issue

Do the gifts of limited partnership interests in 2000 (perhaps), 2001 and 2002 constitute gifts of present interests that qualify for the federal gift tax annual exclusion under § 2503(b) of the Internal Revenue Code ($10,000 in 2000 and 2001 and $11,000 in 2002)? (The IRS conceded that the values were properly reported even though the appraised values allowed "substantial discounts for lack of control and lack of marketability.")

Holding

The gifts of limited partnership interests do not constitute present interest gifts that qualify for the federal gift tax annual exclusion.

Analysis

1. Regulations and Supreme Court Test. The regulations give this general description of a present interest:

> "An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property." Treas. Reg. § 25.2503-3(b).

An example in the regulations provides that where a trustee is authorized in its discretion to withhold payments of income, the beneficiaries' right to receive income payments is not a present interest. Treas. Reg. § 25.2503-3(c), Ex. (1).

The U.S. Supreme Court reasoned that the donee "must have the right presently to use, possess or enjoy the property," and this "connote[s] the right to substantial present economic benefit." Fondren v. Commissioner, 324 U.S. 18, 20-21 (1945).

2. Hackl Test. The Tax Court in Hackl v. Commissioner, 118 T.C. 279 (2002), aff'd, 335 F.3d 664 (7th Cir. 2003) reasoned that the annual exclusion is available if the donee has the right to immediate use, possession or enjoyment of (1) property transferred, OR (2) income from the property. The Tax Court's test requires that under either alternative, the immediate use, possession or enjoyment must "be of a nature that substantial economic benefit is derived therefrom."

3. Taxpayer Position. The gifts constitute present interests because (1) donees can freely transfer of the interests to one another or to the general partner, (2) each donee has immediate rights to partnership income and may freely assign income rights to third persons, and (3) Hackl was decided incorrectly and in any event is distinguishable.

4. IRS Position. The interests are future interests because the partnership agreement effectively bars transfers to third parties and does not require income distributions to the limited partners.

5. No Right to Present Enjoyment of "Property."

   a. Mere Assignees. The donees were mere assignees, not substitute limited partners, because the children were not initial partners and §11.2 of the partnership agreement provided: "Any assignment made to anyone, not already a partners, shall be effective only to give the assignee the right to receive the share of profits to which his assignor would otherwise be entitled * * * and shall not give the assignee the right to become a substituted limited partner." (Emphasis supplied by court.) [Observe: It would be unusual for the partnership not to give the existing partners the ability to admit any transferee as a substitute limited partner if they so desired. Even if the partnership agreement allowed that, apparently there was no documentation that the original partners (Father's and Mother's revocable trusts and the 1% corporate general partner) formally consented to their admission as substitute limited partners.] However, even if the children were substitute limited partners, the court said its decision would not have changed because of contingences on the "receipt of economic value for the transferred partnership interests."

   b. No Withdrawal Rights. Like most partnership agreements, this agreement did not give the partners the unilateral right to withdraw their capital accounts.

   c. Transfer and Sale Restrictions. The primary reason the court gave for refusing to find that the donees had an immediate substantial right to enjoyment of the property was because of transfer and sale restrictions in the partnership agreement.

   > "Pursuant to section 11.1 of the partnership agreement, unless all partners consented the donees could transfer their partnership interests only to another partner or to a partner's trust. In addition, any such purchase would be subject to the option-to-purchase provisions of section 11.4 of the partnership agreement, which gives the partnership itself or any of the other partners a right to purchase the property according to a complicated valuation process but without providing any time limit for exercising the purchase option with respect to a voluntary transfer."

   Even though the donees could sell their interests to the general partner (or Father's or Mother's revocable trusts), that was not sufficient because the corporate general partners was owned by the donors and Father was the President. "If the possibility of a donor's

agreeing to buy back a gift sufficed to establish a present interest in the donee, little would remain of the present interest requirement and its statutory purpose would be subverted if not entirely defeated."

d. Borrowing Ability Too Contingent. Donors argued that the donees' interests in the partnership enhanced their "financial borrowing ability." This is "at best highly contingent and speculative and does not, we believe, constitute a source of substantial economic benefit, particularly in the light of the restrictions on alienation (including on the ability of a partner to 'encumber' a partnership interest) contained in the partnership agreement."

6. No Right to Income From Transferred Property. The Tax Court has distilled a three-part test to show that the donees had the right to immediately use, possess or enjoy the income from the transferred property: "(1) The partnership would generate income at or near the time of the gifts; (2) some portion of that income would flow steadily to the donees; and (3) the portion of income flowing to the donees can be readily ascertained." See Hackl v. Commissioner, 118 T.C. at 298 (7th Circuit opinion does not addresss that test); Calder v. Commissioner, 85 T.C. 713, 727-728 (1985).

The court agreed that the first test was satisfied — the partnership could be expected to generate income. However, it concluded that the last two tests were not met: income did not flow steadily and the portion of income flowing to the donees could be readily ascertained.

a. No Steady Flow of Income. In fact, no distributions were made in 2001.

b. Partnership Agreement Restriction That Distributions Are Secondary to Achieving Return. Profits are distributed at the discretion of the general partner (except as directed otherwise by a majority of the limited partners). Furthermore, "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments."

c. Tax Distributions Not Required. The donors allege that the partnership is expected to make distributions to cover the partners' income tax liabilities for flow-through income from the partnership, but the partnership agreement clearly says that is discretionary with the general partner.

d. No "Strict Fiduciary Duty" to Distribute Income. The court disagreed with the donors' argument that the general partner has a "strict fiduciary duty" to make income distributions and that meant the donees had a present interest. There was no citation of authority that such a strict fiduciary duty existed. Even if it did, it would not establish a present interest "where the limited partner lacks withdrawal rights." Finally, the donees were mere assignees, so there is a significant question as to whether the general partners owed them "any duty other than loyalty and due care."

Observations

1. IRS Pursuing Annual Exclusion Argument, Even Where There Are Only Limited Numbers of Donees. Hackl involved annual exclusion gifts to 41 donees; for both donor-spouses, that represent annual exclusion gifts of 41 x 2 x $10,000, or $820,000 per year. It is understandable that the IRS would challenge the annual exclusion availability in that scenario. This case, however, involves gifts to only three children, but the IRS is still pursuing the argument.

2. Substantial Discounts Allowed and Limited Tax Amount in Dispute. The IRS did not contest the valuation of the limited partner interests even though the appraisals applied "substantial

discounts." This case continues the trend of cases where substantial discounts are allowed, either by court decision or by IRS concession, for transfers of limited partnership interests.

The opinion only listed alleged tax deficiencies for 2001 and 2002 in the aggregate amount of $71,586 for both donors. It is rather surprising that both the IRS and the taxpayers chose to litigate this issue for that relatively small amount of deficiency. (The case does not address how the gift tax deficiency amounts were calculated. For example, if the issue in 2000 was the disallowance of $30,000 of annual exclusions for each donor, that would seem to result in a maximum gift tax deficiency of $30,000 x 60% [the maximum possible gift tax bracket], or $18,000 for each donor. Instead, the deficiency exceeded $20,000 for each donor [and was slightly different for each spouse].)

3. Planning Keys from This Case.

a. Use Rights of First Refusal, No Transfer Prohibitions. The court focused primarily on the restrictions against transferring an interest to anyone other than existing partners without written consent of all partners. Instead of including such a prohibition, provide that any transferee will be subject to a right of first refusal, with reasonable time limits on exercise. Furthermore, some planners even give donees the right to sell interests that could become "full-fledged" substitute limited partners, subject only to a right of first refusal, to build the best possible argument for the annual exclusion. (As a practical matter, the donee will probably have difficulty selling the interest in any event.) (However, the Hackl court intimated that permitting the donees to sell their interests, alone, does not assure annual exclusion treatment because the extreme lack of marketability of interests may raise questions about whether the right is by itself sufficient to produce a present interest. The Price court did not suggest any such hesitancy. In any event, that issue seems to merely go the valuation of the interest — it is marketable at a certain price, and if the interest is properly valued, the interest would be marketable at that price.)

The court rejected the ability to sell to other partners as constituting a present interest because the only possible purchasers were the donors' revocable trusts or the wholly owned corporation. Furthermore, the court said that any sale to a partner would be subject to a purchase option by other partners or the partnership to purchase the interest under a "complicated valuation process" involving three appraisers "without providing any time limit for exercising the purchase option with respect to a voluntary transfer."

b. Make Sure Donees Are Not Mere Assignees. Mere assignees have limited rights. Hackl and Price both concluded that gifts of assignee interests could not be present interest gifts because they "lack the ability 'presently to access any substantial economic or financial benefit that might be represented by the ownership units.'" Formally document that the existing partners consent to admit donees who receive limited partnership interests as substitute limited partners.

c. Do Not Explicitly Favor Reinvestments Over Distributions in the Partnership Agreement. In reasoning that there was no present enjoyment of income, the court focused on the fact that distributions of profits were discretionary with the general partner and that the partnership agreement specifically provided that "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate or return, on a long-term basis, with respect to its investments."

d. Making Distributions Every Year and "Regularizing" Distributions Helps Bolster Annual Exclusion Qualification But May Make §2036(a)(1) Inclusion More Likely. To be in the best position to argue that the right to receive income creates a present interest, make distributions from the FLP or LLC every year. The court pointed out that the partnership did not make any distributions in 2001 for some reason (did the partnership not have any profits in 2001?), thus flunking the requirement that "some portion of the income … flow steadily to the donees." Making distributions every year does not assure present interest treatment based on the right to income because another requirement is that the portion of income flowing to the donees can be readily ascertained. (The Tax Court emphasized this test in Hackl: "Furthermore, even if petitioners had shown that Treeco would generate income at or near the time of the gifts, the record fails to establish that any ascertainable portion of such income would flow out to the donees. Members would receive income from Treeco only in the event of a distribution. However, the Operating Agreement states that distributions were to be made in the manager's discretion. This makes the timing and amount of distributions a matter of pure speculation…") Indeed, making "regular" distributions in some manner would help satisfy the "readily ascertainable" requirement. In any event, the failure to make distributions every year sure made the court's argument easier, even though very large distributions had been made in other years.

Of course, all of this discussion must be considered in light of §2036. If regular distributions are made to the decedent (as well as to the donee-partners), the court may have little trouble in finding the existence of an implied agreement to make regular distributions, triggering the application of §2036(a)(1) at the individual's death.

e. Consider Mandating Distributions of "Net Cash Flow." Some attorneys favor requiring the distribution of net cash flow (defined to include the discretion to retain reserves needed to carry out the partnership's purposes), as a way of rebutting an allegation that §2036(a)(2) or §2038 would apply. That also has the advantage of bolstering an argument that the annual exclusions should be available. *However*, the IRS has argued in some cases that such a provision triggers §2036(a)(1), to create an express or implied agreement of retained enjoyment. For example, the IRS's brief in Estate of Black v. Commissioner, 133 T.C. No. 15 (2009) made that argument. Therefore, careful consideration must be given to including such a provision. The results of estate inclusion under §2036(a)(1) are much more draconian than the loss of gift tax annual exclusions.

f. Should "Tax Distributions" Be Required? The court noted that the partnership agreement gave the general partners discretion as to whether to make "tax distributions" so the partners could pay their income taxes on flow-through income from the partnership in response to the taxpayers' argument that the donee-partners expected to receive such distributions. Including a requirement to make "tax distributions" would provide a further argument for present interest status. However, be aware that the IRS has argued that the presence of mandatory tax distribution provisions triggers §2036(a)(1). In Estate of Black v. Commissioner, 133 T.C. No. 15 (2009), the IRS's brief argued: "Thus although there was no guarantee that Sam Black would receive the full amount of the dividends earned on the Erie stock he contributed, he nevertheless retained an express right to receive at least a significant portion of those dividends through the mandatory cash distribution provision contained in the partnership agreement." (That was not addressed in the reported case because the court in Black determined that the bona fide sale exception to §2036 applied.) Again, because the results of §2036(a)(1) inclusion can result in huge additional estate

taxes, give careful consideration as to whether to include a mandatory tax distribution provision even if it could help as to the annual exclusion issue.

g. Fiduciary Duty. Be sure to provide that the general partner owes fiduciary duties to the partners. This can assist in rebutting an argument for estate inclusion under §§2036(a)(2) and 2038 and may help to bolster the availability of the annual exclusion, as discussed immediately below.

4. Fiduciary Standard Regarding Distributions. The court in Price rejected that there was a "strict fiduciary duty" to make income distributions, or that such a duty (even if it existed) would establish a present interest. However, some older IRS private rulings (predating both Hackl and Price) concluded that gifts of limited partnership interests may qualify as present interests if the general partner's discretion over distributions is subject to a fiduciary standard and if the donees have the right at any time to sell or assign the interests, subject to a right of first refusal. See Tech. Adv. Memo. 9131006 & Ltr. Rul. 9415007. Those rulings emphasized that the general partner has a fiduciary duty to limited partners and distinguished a general partner's powers from a trustee's discretionary power to distribute or withhold trust income or principal and also emphasized that the donees had the right at any time to sell or assign their interests, subject to a right of first refusal.

5. Substantial Actual Distributions Did Not Establish Immediate Right to Income. In one respect, this case is particularly hard-nosed in refusing to recognize a present interest right to income even though a majority of partners could demand distributions of profits and even though very substantial distributions were *actually made* from this partnership.

First, under the partnership agreement, a majority of partners could demand distributions of profits. The three children collectively constituted a majority of the partners and could have demanded distributions of profits under the agreement. However, the court apparently dismissed this as an issue because none of the donee-children individually held a majority interest and could demand a distribution. (In 2002, any two of the three children would have held a majority interest.) Prior cases certainly establish that if a donee can access immediate enjoyment only through the joint action of others, the present interest requirement is not satisfied. See Ryerson v. United States, 312 U.S. 405 (1941); Skouras v. Commissioner, 14 T.C. 523, 524-525 (1950), affd, 188 F.2d 831 (2d Cir. 1951) (gifts of undivided interests in life insurance policy to multiple donees did not qualify for annual exclusion).

Second, very large distributions were actually made from this partnership, and even in that situation the court agreed with the IRS that there was no immediate enjoyment of income from the donated asset under the three-part test announced in Hackl (because income did not "flow steadily" and the income flow could not be readily ascertained).

Based on the values reported on gift tax returns of gifts of specified percentage interests in the relevant years, the percentages of the partnership value actually distributed each year during 2000-2002 are as follows:

Year	2000	2001	2002
Value of gifts to children	44,715	62,310	355,215
Percentage of FLP transferred	3.0%	5.1%	30.9%
Value per 1% interest	14,905	12,218	11,496
Cumulative interests held by children	63%	68.1%	99%
Value of children's interests	993,105	832,046	1,130,067
Actual distributions to children	100,000	0	76,824
Percentage of total value distributed	10.7%	0%	6.8%

In addition, a very large distribution ($343,800) was made in 1999, the year preceding the first tax year mentioned in the case. While there is no reported value of the partnership in 1999, based on the value listed for 1999, this must have represented a distribution of over 25% of the FLP's value, estimated as follows:

In 2000, total value of partnership interests = $993,015/.63 = $1,576,214

Add distribution to children in 1999 + 343,800

Add distribution to other partners in 1999 (343,800 x 40/60) + 229,200

1999 total estimated value of partnership interests,

based on 2000 value $2,149,214

Distributions in 1999: 343,800 + 229,200 = 573,000

Percentage of value distributed in 1999: 573,000/2,149,214 = 26.7%

This background leads planners to wonder whether gifts of almost all closely held companies (both corporations, LLCs and partnerships) would have trouble satisfying the "right to income from the property" alternative for present interest treatment, unless the company actually makes regular cash distributions and the income flow is somehow ascertainable.

6. Annual Exclusion Arguably Should be Available for Value of Assignee Interest. The analysis in Hackl and Price indicates that generally the ability to sell donated property connotes a substantial economic interest in the property that qualifies for the annual exclusion. In Hackl, the court observed that the partners could sell their interests, but they could only sell what amounts to an assignee interest in the LLC. The Tax Court and the Seventh Circuit both observed that "the possibility that a shareholder might violate the operating agreement and sell his or her shares to a transferee who would then not have any membership or voting rights can hardly be called a substantial economic benefit."

In Price, §11.2 of the partnership agreement specifically says that an assignment to anyone, not already a partner, would only convey an assignee interest. However, the court said that did not override §11.1, which says that no partner shall sell any interest in the partnership without the written consent of all partners (even though the first five words of §11.1 are "except as hereinafter set forth"). That seems incorrect — purported transfers are not simply voided; indeed the partnership agreement provided that in the event of any voluntary or involuntary assignment

of a partnership interest, the assignment is not just voided but the remaining partners have an option to purchase the partnership interest for its fair market value.

In Price, the court reasoned that only an assignee interest was given to the children. If under state law and the partnership agreement (despite the court's interpretation of the agreement), a partner (or assignee) could sell the assignee interest, the entire donated interest in the partnership could be sold for value and should constitute a present interest.

However, observe that the Tax Court and Seventh Circuit clearly do not agree with that analysis.

7. Crummey-Like Withdrawal Power. Some planners have suggested giving the donees a Crummey withdrawal power with respect to gifts of limited partnership interests. Such a withdrawal right would enable the donees to withdraw the fair market value of their limited partnership interests for a limited period of time after each gift. If the donees can only withdraw the "fair market value" of their interests, this type of provision should not have a significant impact on the amount of discount allowed in valuing the interests. "I have been doing this for years in FLPs I created where (1) the partnership agreement prohibited limited partners from transferring their interests and (2) the partnership was unlikely to generate immediate income and (3) the gifts were intended to qualify for the present interest exclusion…The buyback price is the fair market value of the units (determined as you would want the FMV to be determined for gift tax purposes). The FLP can borrow money to carry out the buyback, or distribute assets in-kind."

   Comments of Natalie Choate in Leimberg Estate Planning Newsletter (April 4, 2002).

8. Gifts of Cash Followed By Purchase of Partnership Interests. Another approach to avoid the annual exclusion issue is to make cash gifts to donees (perhaps grantor trusts), and have the donees exercise their own discretion to purchase limited partnership interests from the donor.

9. Put Right. Some planners have suggested giving donee-partners a limited period of time to sell the interest to the partnership for its fair market value, determined without regard to the existence of the put right. Others have suggested using a conditional assignment that is subject to the assignee being allowed to require the donor to substitute income producing property equal in value of the donated partnership interest. In either of those cases, the planner must make sure that the client is comfortable with the possibility of such a demand being made on the partnership or the donor.

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