Estate of Wimmer v. Commissioner, T.C. Memo 2012-157 (June 4, 2012)

Gifts of Limited Partnership Interests Qualified as Present Interests for Purposes of Gift Tax Annual Exclusion Because Donees Received Income Distributions From Partnership

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Synopsis of Basic Facts and Court's Analysis

Three prior cases have refused to allow an annual exclusion for gifts of limited partnership interests, for various reasons based on the facts in those cases. *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003); *Price v. Commissioner*, T.C. Memo. 2010-2; *Fisher v. Commissioner*, 105 AFTR2d 2010-1347 (S.D. Ind. 2010). *Estate of Wimmer* holds that gifts of limited partnership interests *did qualify* for the gift tax annual exclusion because the donees received income distributions from the partnership.

In *Estate of Wimmer v. Commissioner,* T.C. Memo 2012-157, the court (in a decision by Judge Elizabeth Paris) held that gifts of limited partnership interests to eleven donees (six of those eleven were beneficiaries who had Crummey withdrawal powers over gifts to a grandchildren's trust) in each of five years (1996-2000, potentially representing annual exclusion gifts up to $550,000) constituted gifts of "present interests" that qualified for the gift tax annual exclusion. Therefore the gifts were not adjusted taxable gifts that had to be considered in calculating the estate tax (and therefore did not "use up" any of the decedent's unified estate and gift tax credit amount).

The partnership assets consisted of publicly traded stocks that paid dividends. The partnership received dividends quarterly. For the first three years of the partnership (1996 -1998), the partnership made distributions to the partners of enough cash so that they could pay their income taxes on the "flow-through" income from the partnership. (Apparently, this was not all of the partnership's income.) Beginning in 1999, the partnership distributed all dividends, net of partnership expenses, to the partners. Partners also had access to capital account withdrawals, and some partners actually made such withdrawals for, among other things, paying down their residential mortgages. (The opinion did not refer further to the partners' access to capital account withdrawals.)

The *Wimmer* court noted that "an outright transfer of an equity interest in a business or property, such as limited partnership interests, is not necessarily a present interest gift." The gift tax regulations describe a "present interest" as "an unrestricted right to immediate use, possession, or enjoyment of property or the income from property." Treas. Reg. §25.2503-3(b). The U.S. Supreme Court in *Fondren v. Commissioner,* 324 U.S. 18, 20-21 (1945) stated that there must be a "substantial present economic benefit" to qualify as a present interest for this purpose. In summary, *Wimmer* stated: "Therefore, to qualify as a present interest, a gift must confer on the donee a substantial present economic benefit by reason of use, possession, or enjoyment (1) of property or (2) income from the property."

The court held that the donees did not have immediate use, possession or enjoyment of the gift *property* (i.e., the gifted limited partnership interests) because of restrictions on the ability of the donees to transfer their limited partnership interests. As to this issue, the court concluded that "the donees did not have the unrestricted and noncontingent rights to immediate use, possession, or enjoyment of the limited partnership interests themselves." The partnership agreement imposed significant transfer restrictions on transfers to anyone other than existing partners or related parties (as defined in the agreement). Limited partnership interests could be transferred only with the prior written consent of the general partners and 70% in interest of the limited partners. Furthermore, a transferee would not become a substitute limited partner until the transferee had been accepted as a substitute limited partner by "unanimous written consent of the general partners and the limited partners." (Apparently, the partnership agreement did not allow transfers subject to a right of first refusal by the partnership or the remaining partners.)

As to whether the donees had the use, possession, or enjoyment of *income from the property,* the court applied a three-part test (as announced in *Calder v. Commissioner*, 85 T.C. 713, 727-28 (1985)), under which the estate had to "prove, on the basis of the surrounding circumstances, that: (1) the partnership would generate income [the opinion later referred to this as a "partnership that expected to generate income"], (2) some portion of that income would flow steadily to the donees, and (3) that portion of income could be readily ascertained."

These requirements were satisfied. (1) The partnership assets consisted of publicly traded stocks that paid dividends quarterly. (2) The general partners owed fiduciary duties to the limited partners under the agreement and state law. One of the donee-partners was a trust for grandchildren that owned only the limited partnership interests and no other assets with which it could pay income taxes on the partnership's flow-through income. The court reasoned that "the necessity of partnership distributions in these circumstances comes within the purview of the fiduciary duties imposed on the general partners. Therefore, the general partners were obligated to distribute a portion of partnership income each year to the trustee." Because the agreement required that distributions of net cash flow be made to all partners proportionately, distributions would be made to all partners of at least a portion of the partnership income. Therefore, "on the date of each gift some portion of partnership income was expected to flow steadily to the limited partners," and the partnership in fact made distributions pro rata from the dividends paid each year at issue. (3) The income could be readily ascertained because "the limited partners could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership in the partnership."

The gifts of the limited partnership interests qualified for the gift tax annual exclusion (even though the donees did not receive *all* of the partnership income in some years).

Planning Observations

1. *Case Allows Annual Exclusion, Following Three Cases That Did Not*. The IRS often argues that gifts of limited partnership interests do not qualify for the gift tax annual exclusion, following the government's success in the *Hackl*, *Price,* and *Fisher* cases. (The *Hackl, Price*, and *Fisher* cases, as well as other relevant background cases and rulings, are discussed in detail in the following section of this summary.) This Tax Court Memorandum case reverses that trend of cases, and allows the annual exclusion.

2. *Annual Exclusion Allowed Based on Expectations of Income Distributions*. In the context of gifts of FLP or LLC interests, the *Hackl, Price, Fisher,* and *Wimmer* cases suggest that the present interest determination can be based either on (1) the immediate right to sell the interest without substantial restrictions, or (2) having an immediate expectation of income distributions. *Wimmer* relies on the second approach.

   Relying on a reasonable expectation of receiving income distributions may not be appropriate in all circumstances.

   - The partnership may not own income producing assets (which was the case in *Hackl*, where the LLC owned freshly planted timberland).
   - Even if the asset produces some income, if there are large fluctuations in the income that is produced, the third test (i.e., the portion of income that is distributed is ascertainable) may be hard to meet. *Wimmer* analyzed this requirement in terms of the regularity of dividends produced by the stock held by the partnership, as opposed to the regularity of distributions from the partnership.
   - *Requiring* distributions of income may raise potential §2036(a)(1) arguments by the IRS if the donor retains any of the FLP or LLC interests.

- As illustrated in *Price,* if distributions are not made in *all* years, reliance on the "income for property" leg may be unsuccessful. (In *Price,* substantial distributions were made, but there were no distributions in 2 of the 6 years considered by the court.)

3. *What If All Income is Not Distributed*? The *Calder* test requires that "(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." *Calder v. Commissioner*, 85 T.C. 713, 727-728 (1985).

   What if a portion *but not all* of the income "flows steadily" to the donees? Is the annual exclusion allowed in full or for only some proportionate value of the gift property? The cases do not discuss the impact of the annual exclusion if the partnership distributes only a portion of the income. Interestingly, in *Wimmer*, only a portion of the partnership income was distributed to the partners in the first three years of the five years when gifts were made, and all of the income was distributed only in the last two years. However, the court allowed a full annual exclusion.

4. *IRS Policy of Denying Annual Exclusion If Discounts Applied in Valuing Gift.* IRS agents have told some planners in gift tax audits that the IRS policy is to disallow any annual exclusion for gifts of FLP or LLC interests if a discount is taken in valuing the gifted interest. However, the legal tests for the annual exclusion and whether an interest should be valued with a discount as compared to pro rata asset value have nothing to do with each other. If the IRS policy is actually to deny the annual exclusion in gift tax audits automatically if discounts are taken, that policy is outrageous. If taxpayers took positions that were as unsupportable, the IRS would undoubtedly apply penalties. (For example, assume taxpayers were to take that same position, and argue that because a discount was not taken on the value of the gift of an interest in an FLP, it should necessarily qualify for the annual exclusion. If the gift were of an interest in a partnership with no income producing assets and that prohibited any transfers for a number of years, the IRS would be outraged if the taxpayer claimed that the gift qualified for the annual exclusion.)

   Interestingly, the IRS has not always contested the availability of the annual exclusion for gifts of FLP or LLC interests. For example, in the recent *Wandry* case approving a defined value formula transfer, the IRS apparently did not contest the availability of the annual exclusion for gifts of limited partnership interests to 9 donees by Mr. and Mrs. Wandry (representing $198,000 of value covered by the annual exclusion). T.C. Memo. 2012-88. In *Turner I*, *the IRS* argued that gifts of limited partnership interests qualified for the annual exclusion. T.C. Memo. 2011-209, *aff'd on other grounds on motion for rehearing,* 138 T.C. No. 14 (2012).

5. *Planning and Drafting Suggestions.* The following are planning and drafting suggestions in light of *Hackl, Price, Fisher,* and *Wimmer*. There are two alternate ways to cause the gift of partnership or LLC member interests to qualify for the annual exclusion as discussed in these cases: (1) the ability to transfer the interests for substantial present value, or (2) the expectation of regular distributions of the partnership income (or some portion of the income — with the uncertainty that raises as to whether the annual exclusion is allowed in full if only a portion of the income is distributed). Planners may want to try to qualify under both alternatives, although that is not required.

   An alternative to avoid the issue of whether a gift of a partnership or LLC interest qualifies for the annual exclusion is to make cash gifts to donees (perhaps grantor trusts). The donees could exercise their own discretion to purchase limited partnership or LLC interests from the donor.

   The following planning strategies are relevant primarily to the free transferability alternative.

   - *Right of First Refusal Rather Than Prohibition on Transfers.* Do not include a prohibition on transfers but provide that any transfer will be subject to a right of first refusal, with reasonable time limits. If the right of first refusal is exercised, provide that the purchase price would be paid in cash or with negotiable instruments (do not allow payment with non-negotiable notes as was done in *Fisher,* because that means the donee would have no way immediately to obtain a "substantial present economic benefit" for his or her interest).

- *Do Not Just Give Assignee Interests.* Mere assignees have limited rights. *Hackl* and *Price* both suggested 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.
- *Put Right for Limited Period.* Give donee-partners a limited period of time to sell the interest to the donor (or perhaps the partnership) for its fair market value, determined without regard to the existence of the put right; this provision could be included in a conditional assignment that is subject to the transferee being allowed to require the donor or the partnership to substitute income producing property equal in value to the value of the donated partnership interest. Typically, the put option would require that the donor purchase the interest if the put option is exercised. If the partnership has the obligation to purchase the interest if the put option is exercised, the partnership would have to be a party to the assignment agreement if the put option is placed in the assignment. (The provision could also say that the partnership would have the first option to purchase the partnership interest but if it did not exercise the option, the donor would have to buy the interest.)

  A put option, which would *require* the donor to repurchase the interest if the donee wished to exercise the put option, is distinguished from a mere possibility that a donor may buy back a gift, which the Tax Court in *Price* said would not be sufficient:

  > "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."

- *Withdrawal Power From Partnership.* Alternatively, give donees a Crummey withdrawal power with respect to gifts of limited partnership interests that would enable the donees to withdraw the fair market value of their limited partnership interests for a limited period of time after each gift (this is obviously an unusual provision to be in a partnership agreement).

The following planning strategies are relevant primarily to the income alternative.

- *Agreement Should Not Favor Reinvestments Over Distributions.* Do not explicitly favor reinvestments over distributions in the partnership agreement (as was done in *Price*).
- *Regularize Distributions.* Make distributions every year and "regularize" distributions (although this may make an argument for §2036(a)(1) inclusion more likely if the parent retains interests in the partnership or LLC). The court in *Price* 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 *Hack*l:

  > "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…")

Making "regular" distributions in some manner would help satisfy the "readily ascertainable" requirement. In any event, the failure to make distributions every year resulted in *Price* refusing to recognize that the gift in that case qualified for the annual exclusion on the basis of the expectation of income distributions, 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 IRS may be more likely to argue the existence of an implied agreement to make regular distributions, triggering the application of §2036(a)(1) at the donor's death with respect to any partnership or LLC interests retained by the donor.

- *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. 340 (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.
- *Consider Whether to Require "Tax Distributions."* The court in *Price* 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. 340 (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 regarding the annual exclusion issue.
  In addition, a requirement to make "tax distributions" could impact the valuation of the gifted units.
- *Fiduciary Duties.* Specify that the general partner/manager owes fiduciary duties to the other partners/members. 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. 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. The court in *Wimmer* did not reason that a general partner necessarily had a fiduciary duty to make distributions, but reasoned that there was a fiduciary duty to make tax distributions to the trust-donee partner that had no other assets with which to make income tax payments (and other partners benefited from that duty because distributions had to be made proportionately).

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.

Background — Prior Rulings and Cases

1. *Supreme Court Guidance*. The Supreme Court in *Fondren v. Commissioner*, 324 U.S. 18, 20 (1945) after reviewing the statutory language , regulations and legislative history, concluded that a present interest is created for purposes of the gift tax annual exclusion only if the donor confers on the donee "the right to a substantial present economic benefit." The Supreme Court expanded on this discussion in *Commissioner v. Disston,* 325 U.S. 442, 446 (1945) by concluding that a gift to a trust constitutes a future interest if the trust had income but limitations were placed on its disbursement:

   > "In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the [beneficiary]would be required, there is no basis for a conclusion that there is a gift of anything other than for the future. The taxpayer claiming the exclusion must assume the burden of showing that the value of what he claims is other than a future interest." *Id*. at 449.

2. *Calder — Announcing Three-Part Test Regarding Income From Property.*

   The Supreme Court's formulation in *Disston* of when a present interest exists based on the right to income from property was the basis of the three-prong test announced in *Calder v. Commissioner,* 85 T.C. 713, 727-28 (1985):

   > "*Disston* thus requires the taxpayer to prove three things: (1)That the trust will receive income, (2) that some portion of that income will flow steadily to the beneficiary, and (3) that the portion of income flowing out to the beneficiary can be ascertained." *Id.*

   The Fourth Circuit had previously relied on the *Disston* analysis to conclude that "[t]he taxpayer must show that the trust will receive income, and, second, that some ascertainable portion of the income will flow steadily to the beneficiary." *Maryland National Bank v. United States,* 609 F.2d 1078 (4th Cir. 1979).

   In *Calder,* the Tax Court observed that it had been reversed in *Rosen v. Commissioner* by the Fourth Circuit, which held that the annual exclusion was allowable for a gift of stock which had no dividend history, relying partially on the fact that the trustees had the power to sell non-income-producing assets and to reinvest the proceeds in income-producing property. 397 F.2d 245 (4th Cir. 1968), *rev'g* 48 T.C. 384 (1967). However, the Tax Court refused to follow *Rosen* in *Berzon v. Commissioner,* 63 T.C. 601 (1975), *aff'd,* 534 F.2d 528 (2d Cir. 1976), in finding that an income interest in a trust holding non-dividend paying closely held stock was not susceptible of valuation.

3. *Private Rulings.* IRS private rulings regarding FLPs have 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 their interests, subject to a right of first refusal. *See* Tech. Adv. Memo. 9131006 & Pvt. Ltr. Rul. 9415007 (rulings emphasized that the general partner has a fiduciary duty to limited partners and distinguished 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).

   Gifts of non-dividend paying stock qualify for the annual exclusion if there are no restrictions on transfers of the stock. Tech. Adv. Memo. 9346003.

   Technical Advice Memorandum 9751003 held that gifts of limited partnership interests (to 35 different donees over three years) did not constitute present interest gifts, focusing on special provisions in the partnership agreement that deviated from the general partnership law. First, the agreement gave the general partner (a corporation owned by the donor) complete discretion in deciding what funds to distribute from the partnership, including the discretion to retain funds "for any reason whatsoever." The IRS concluded that provision is extraordinary and outside the scope of a business purpose restriction, and "effectively obviates the fiduciary duty ordinarily imposed upon a general partner, and clothes the general partner with the authority to withhold income for reasons unrelated to the conduct of the partnership." Second, the IRS interpreted the agreement as prohibiting the donee limited partners from assigning their interests. Because the donee limited partners could not assign their interests (even to assignees) and could not unilaterally liquidate the partnership, the IRS concluded that the gifted limited partnership interests "lacked the tangible and immediate economic benefit required...for a present interest in property."

4. *Hackl v. Commissioner*. In *Hackl v. Commissioner*, the Tax Court ruled that gifts of LLC interests to 41 donees over a number of years did not qualify for the annual exclusion, and the Seventh Circuit Court of Appeals affirmed that decision. 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003).

   In *Hackl,* the donor-spouses formed an LLC and made annual exclusion gifts of member interests to 8 children, their 8 spouses and to 25 minor grandchildren (41 donees total). For both spouses, this represented annual exclusion gifts of $820,000 per year. Gifts made in 1996 generated a gift tax deficiency of over $600,000 because they did not qualify for the annual exclusion. (Annual exclusion gifts were also made in 1995 that were not questioned — presumably because the gift tax statute of limitations had run.)

   The LLC invested in a tree farming business for long-term growth. The assets constituted land with little or no existing merchantable timber — to provide a greater long-term return on investment. The LLC would not produce any significant cash flow for many years.

   Under the terms of the LLC Operating Agreement:

   - Mr. Hackl was named as the initial manager with a lifetime term (until his resignation, removal, or incapacity). He had the power to name a successor manager during his lifetime or by his will.
   - The manager "may direct that the Available Cash, if any, be distributed to the Members, pro rata in accordance with their respective Percentage Interests."

- No member had the right to withdraw except as approved by the Manager.
- A member desiring to withdraw could offer his units for sale to the company, and the Manager had exclusive authority to accept or reject the offer and to negotiate terms.
- The agreement waived the right to have any company property partitioned.
- Members could not sell their Interests except with the Manager's consent, which consent "may be given or withheld, conditioned or delayed as the Manager may determine in Manager's sole discretion."
- If the transfer is made in violation of the agreement, the transferee would have no opportunity to participate in the business affairs of the entity or to become a Member, but the transferee would only be entitled to receive the share of profits or distributions which otherwise would have inured to the transferor. (Observe, these are similar to the rights that an "assignee" would have in a partnership context.)
- The Members had no control over the date of dissolution.

The Tax Court held that the gifts of the member interests did not constitute present interest gifts and did not qualify for the annual exclusion.

Outright transfers of equity interests in a business or entity do not automatically qualify as a present interest. The court concluded that existing case law regarding indirect gifts (such as gifts in trust) would apply to gifts of interests in an entity. The court noted "the right to substantial present economic benefit" requirement described in *Fondren v. Commissioner*, 324 U.S. at 20-21. The court described a two-step alternative analysis — the donee must have "an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom."

The donees did not have "use, possession, or enjoyment" of the property itself within the meaning of section 2503(b).

- The exception in the regulations for contractual rights in a bond, note or insurance policy is not applicable, because the regulations refer to assets "*immediately disposable by the obligee*."
- The rights granted in the Operating Agreement did not afford *substantial* economic benefits to the donees. The court was troubled by various restrictions in the Operating Agreement, including (1) the absence of the ability of the donees presently to access any substantial economic or financial benefit, (2) the restrictions on unilaterally withdrawing the capital account, (3) and member desiring to withdraw could only offer units to the Company and the Manager had the authority to accept or reject the offer, (4) no donee acting alone could effectuate a dissolution, (5) the agreement prevented a donee from selling his Interest to third parties without obtaining the consent of the Manager; the court concluded that "for all practical purposes, [the Agreement] bars alienation as a means for presently reaching economic value."

The donees did not have "use, possession, or enjoyment" of the income from the property within the meaning of section 2503(b). The three-part test described in *Calder v. Commissioner*, 85 T.C. 713, 727-728 (1985) was not satisfied because the parties anticipated that no income would be produced for about six years, and even if the partnership produced income, there was no ascertainable portion of the income that would be distributed to the donees because distributions were to be made in the manager's discretion.

The Seventh Circuit Court of Appeals affirmed, agreeing with the Tax Court's analysis that the transfer restrictions left the donees with no substantial present economic benefit:

> "In this case, Treeco's operating agreement clearly foreclosed the donees' ability to realize any substantial present economic benefit. Although the voting shares that the Hackls gave away had the same legal rights as those that they retained, Treeco's restrictions on the transferability of the shares meant that they were essentially without immediate value to the donees. Granted, Treeco's operating agreement did address the possibility that a shareholder might violate the agreement and sell his or her shares without the manager's approval. But, as the Tax Court found, 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. Thus, the Hackls' gifts — while outright — were not gifts of present interests." 335 F. 3d 664 (7th Cir. 2003).

Commentators disagreed with the *Hackl* analysis. For example, Professor Kasner concluded as follows:

> "Unfortunately, the Hackl opinion has obscured some of the issues. Is the lack of a defined income stream, taken alone, enough to deny the annual exclusion? The rulings indicate it is not unless the manager or general partner holds control over distributions in what amounts to a nonfiduciary capacity. There is certainly no requirement that the transferred property be income producing at all, *at least if the transferee has the right to transfer or assign it*. While it is clear that an absolute prohibition to an assignment of the interests in the entity will be a basis for denying the annual exclusion, is there any requirement that the assignee be admitted as a partner or member? The court contains confusing language of this issue, which is unfortunate." Kasner, Tax Analysts (April 22, 2002) (emphasis added).

Based on the Tax Court's description of the factual nature of the transfer restrictions it seems that at least the value of an assignee interest should constitute a present interest. The Tax Court acknowledged that "if the transfer was made in violation of the Agreement, the transferee would be afforded no opportunity to participate in the business affairs of the entity or to become a member; rather, he or she would only be entitled to receive the share of profits or distributions which otherwise would have inured to the transferor." Therefore, there was no restriction against selling an "assignee" interest, so the gift arguably should have been a present interest to the extent of the value of the assignee interest. The Seventh Circuit responded to this notion by merely concluding that the assignee interest, without any membership or voting rights, would not be a substantial present economic benefit. However, the Seventh Circuit did not address that the assignee interest itself may have had substantial current value. (Indeed, the IRS in various cases has argued that the value of a partnership assignee interest should not be significantly lower than the value of a full limited partner interest.)

5. *Price v. Commissioner*. Gifts of limited partnership interests by parents to their three children did not constitute present interest gifts and therefore did not qualify for the gift tax annual exclusion. T.C. Memo. 2010-2. The following is a brief synopsis of the court's analysis (discussed in more detail below). 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. Interestingly, 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.

Before selling his closely held company, Mr. Price 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. 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 Mr. and Mrs. Price's revocable trusts.

The terms of the FLP agreement include the following:

- *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.
- *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.
- *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."

Mr. and Mrs. Price each made gifts of limited partnership interests 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.

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

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.

a. *No Right to Present Enjoyment of "Property."*

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 (Mr. and Mrs. Price'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."

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

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 Mr. or Mrs. Price's revocable trusts), that was not sufficient because the corporate general partners was owned by the donors and Mr. Price 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."

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."

b. *No Right to Income From Transferred Property.* The court applied the three-part *Calder* test to show that the donees had the right to immediately use, possess or enjoy the income from the transferred property. 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.

No Steady Flow of Income. In fact, no distributions were made in 1997 or 2001.

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."

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.

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."

6. *Fisher v. U.S.* Parents gave membership interests in an LLC to each of their seven children over three years (resulting in 42 annual exclusion gifts). The principal asset of the LLC was undeveloped beachfront property. The IRS contested the availability of annual exclusions, and the court rejected the donors' three arguments. 105 AFTR 2d 2010-1347 (S.D. Ind. March 11, 2010).

First, the donors argued that the children had the unrestricted right to receive distributions. The court rejected this argument because distributions "were subject to a number of contingencies, all within the exclusive discretion of the General Manager."

Second, the donors argued that the children possessed the unrestricted right to use the beachfront property. The court responded that the Operating Agreement did not convey this right to members. Somewhat confusingly, the court added that "the right to possess, use, and enjoy property, without more, is not a right to a 'substantial present economic benefit.' *Hackl*, 335 F.3d at 667. It is a right to a non-pecuniary benefit."

Third, the donors argued that the children had the unrestricted right unilaterally to transfer their interests. Under the Operating Agreement, the children could transfer their "Interests" in the LLCs if certain conditions are satisfied. One of those conditions was that the LLC would have a right of first refusal over any such transfer. If the LLC exercises the right of first refusal it will pay "with non-negotiable promissory notes that are payable over a period of time not to exceed fifteen years" providing equal annual installments of principal and interest. The right of first refusal would not exist for transfers to the donors or to their descendants (but as noted below, the court said that other restrictions would apply, without explaining what those restrictions were). The Agreement defines "Interest" as a member's share of profits and losses and the right to receive distributions. The children could only transfer "Interests" rights as opposed to the rights of "Members" admitted by the LLC, which also include the right to inspect the Company's books and records and to "participate in the management of and vote on matters coming before the Company." (The rights that could be assigned seem analogous to "assignee" rights in the context of a partnership.) The court did not comment negatively on the fact that the children could merely transfer the right to share in profits, losses and distributions rather than a full membership right. However, the court reasoned that the right of first refusal "effectively prevents the Fisher Children from transferring their interests in exchange for immediate value." Even transfers to family members are "not without restrictions." "Therefore, due to the conditions restricting the Fisher Children's right to transfer their interests in Good Harbor, it is impossible for the Fisher Children to presently realize a substantial economic benefit."

The third argument is the one that most donors will use to support the availability of the annual exclusion for gifts of interests in partnerships or LLCs. If the donees had the immediate right to sell their interests for cash or other assets they could immediately enjoy, it would seem that the gifts would constitute present interests. The court did not explain its reasons that the right of first refusal kept the children from being able to transfer their interests for "immediate value." However, the court was probably correct in reaching this result because the LLC could pay with *non-negotiable* notes. This means that if the LLC exercised its right of first refusal, the children had no ability to sell the LLC's note for cash or other "immediate value." While the court did not explain its specific reasons, limiting the right to transfer the interest for only a non-negotiable note does seem to be a substantial impediment to being able to receive "immediate value." As suggested by *Price*, partnership or LLC agreements should not prohibit transfers. *Fisher* casts some doubt on whether merely subjecting transfers to a right of first refusal precludes annual exclusion treatment, but it would seem that the practical planning pointer from *Fisher* is that the partnership or LLC should not be able to exercise the right of first refusal by giving *non-negotiable* long term promissory notes.