Gifts of LLC Interests - IRS Wins Round One in Court Battle Regarding Gifts of LLC Interests

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Introduction

In 2002, the Tax Court ruled in favor of the Internal Revenue Service's (the "IRS") position that gifts of ownership interests in a limited liability company made by Albert J. Hackl and M. Hackl (the taxpayers) to their children and grandchildren were not present interests for gift tax purposes.[1] Because the Tax Court held that the gifts were actual transfers of future interest gifts, the taxpayers were not eligible to claim the gift tax annual exclusion under Section 2503(b).

The Tax Court's holding in Hackl has been a topic of discussion (if not controversy) in the estate tax planning community about the potential difficulty for taxpayers to qualify for the gift tax annual exclusion when gifting interests in closely held entities. Such potential difficulty in qualifying for the gift tax annual exclusion can present challenges for taxpayers who are relying on this planning vehicle to minimize the gift tax impact of transferring ownership interests in family limited partnerships to their family members. The use of family limited partnerships has been and continues to be a popular gift and estate tax planning vehicle for taxpayers to shift their appreciating or income-producing assets (e.g., real estate and marketable securities) to their family members. The use of family limited partnerships also affords the possibility of qualifying for valuation discounts for gift and estate tax purposes.

Despite this unfavorable ruling in Hackl, there may be ways that taxpayers can circumvent this issue in order to be eligible for the gift tax annual exclusion under Section 2503(b) and still qualify for valuation discounts. The purpose of this article is to not only provide a brief overview of Hackl and the Tax Court's rationale in its holding, but also to address the potential impact that it may have with respect to gift and estate tax planning opportunities in connection with setting up family limited partnerships. More importantly, the article will attempt to suggest possible alternatives to help estate tax planning professionals in advising their clients who might be interested in gifting ownership interests in closely held entities.

Case Background

On October 6, 1995, the taxpayers formed Treeco, LLC (the LLC). The LLC had been organized by the taxpayers to hold and operate tree-farming properties, as a way to provide investment diversification in the form of long-term growth and future income. The taxpayers

[1] Hackl, 118 T.C. 14 (2002).

contributed two tree farms and $7,918,956 in cash and marketable securities to the LLC on December 7 and 22, 1995, respectively. In 1995 and 1996, the taxpayers made gifts to their children and grandchildren of membership units in the LLC.

As part of the formation of the LLC, the taxpayers executed an operating agreement, which designated Mr. Hackl as the manager. The operating agreement provided the manager with the exclusive control over the management of the LLC's business as well as control over cash flow distributions, return of capital, and approval of membership interest transfers and withdrawals. At the time that the gifts were made, the taxpayers anticipated that the LLC would generate losses and make no cash distributions for a number of years, since the tree farms were still in their infancy stage.

Tax Court's Holding and Rationale

The main issue presented in this case was whether the gifts should have been characterized as gifts of present interests or future interests for purposes of applying the gift tax annual exclusion. Section 2503(b) provides that in order to qualify for the gift tax annual exclusion, the donated asset must be a gift of a "present interest." Reg. 25.2503-3(b) defines a present interest as "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property." In the instant case, the Tax Court held that such gifts of ownership interests in the LLC were gifts of future interests and were not eligible for the gift tax annual exclusion. Relying on existing case law and Section 2503(b) (and the Regulations promulgated thereunder), the Tax Court analyzed the gifts and concluded that the gifted ownership interests were not gifts of a present interest because the transaction failed both of the two "substantial present economic benefit" tests: (1) the property test, and (2) the income test.

The Property Test

With respect to the property test, the Tax Court concluded that the receipt of property itself, the LLC units, did not confer upon the donees use, possession, or enjoyment of property. The Tax Court examined the operating agreement and found, among other things, restrictions on transferability and restrictions on withdrawing capital accounts. According to the Tax Court, these restrictions could not support a present interest characterization. Moreover, the Tax Court reasoned that the possibility of transferring or selling the interest in violation of the operating agreement, to a transferee who would then have no right to become a member or to participate in the LLC business, could not be seen as a sufficient source of substantial economic benefit. Under this test, the Court concentrated not on the features of the gifted interest, but on the underlying limitations set by the operating agreement.

The Income Test

In connection with the income test, the Tax Court concluded that the gifts of the LLC units did not afford to the donees the right to use, possession, or enjoyment of income therefrom. Here, the Court used a three-part test for ascertaining whether rights to income satisfy the criteria for a present interest under Section 2503(b).

Under this three-part test, the taxpayer must prove (i) that the membership interest "will receive income," (ii) that "some portion of that income will flow steadily" to the membership interest, and (iii) that the portion of income flowing out to the membership interest "can be ascertained."[2]

The Tax Court applied the income test by examining the LLC's underlying property or assets and the ability to generate income. Because the taxpayers stipulated that the primary business purpose of the LLC was to acquire and manage timberland for long-term income and appreciation and not to produce immediate income, the Tax Court found that the underlying property was unable to produce sufficient income to be distributed to the LLC's members. Furthermore, even if sufficient income was generated by the underlying property, the Operating Agreement stated that distributions were to be made in the manager's discretion. Consequently, the Tax Court found that these factors made "the timing and amount of distributions a matter of pure speculation."[3]

Since the gifted interests failed both the property test and the income test, the Tax Court concluded that the gifted interest were not gifts of present interests, and therefore, the taxpayers were not entitled to claim the gift tax annual exclusion under Section 2503(b).

Potential Impact to the Taxpayers

This case could have a significant impact to taxpayers who have given or are planning to give ownership interests in closely held entities or family limited partnerships, when the main objective is to take advantage of the gift tax annual exclusion benefit. What is especially disconcerting about the Tax Court's ruling in Hackl is that the operating agreement contained language found in many operating agreements for closely held entities. Such language included the following:

- The manager had full management control of the LLC's business and investments;
- The manager had control over cash distributions;
- No member had the right to withdraw the member's capital contribution; and
- No member had the right to transfer or assign his/her interest without the written consent of the manager.

In addition to the risk that a taxpayer's gift tax annual exclusion claim would be invalidated by the IRS, the Hackl case could also have ramifications in the use of valuation discounts in estate tax plans in cases in which taxpayers who own a non-controlling interest in an entity attempt to gift those interests and claim valuation discounts. By limiting the control and rights of the owner of the interest in the entity (the same restrictions and limitations that the court said invalidated the present interest nature of the gifts in Hackl), the owner can generally claim valuation discounts and thereby reduce the gift tax burden. Despite the potential opportunity to claim valuation discounts, it appears that Hackl has created a dilemma for taxpayers in that the

[2] Calder, 85 T.C. at 727-728 (1985).
[3] Hackl at 33.

restrictive language of an entity's operating agreement that allows taxpayers to claim valuation discounts could also be used to disallow a claim for the gift tax annual exclusion.

As a result, taxpayers may have to decide whether to (i) make a gift the interest and claim valuation discounts based on the restrictive nature of the operating agreement or (ii) gift the interest (presumably in smaller shares) and claim the gift tax annual exclusion based on a less restrictive operating agreement. Some commentators have stated that the Hackl case forces taxpayers into this lose/lose scenario of either one or the other. Nonetheless, it is our belief that certain measures could be taken that would strengthen taxpayers' positions to claim the gift tax annual exclusion and potentially qualify for valuation discounts. Discussed below are several potential solutions.

Possible Approaches for Taxpayers

There are some possible estate tax planning strategies that can be implemented to help minimize the adverse consequences of the Hackl case and also claim valuation discounts when making gifts of fractional interests in closely held entities. The most straightforward approach would be not to give interests in closely held entities for purposes of using the gift tax annual exclusion but, alternatively, to give interests in closely held entities as part of a plan to use the lifetime exclusion – i.e., $1 million for the year 2003 (Under the EGTRA 2001, the lifetime exclusion (or unified credit exemption equivalent) was increased to $1 million in 2002 and will increase in phases to $3.5 million in 2009). By making a gift of the ownership interest under this approach, a taxpayer could avoid the gift tax issue raised in Hackl.

In addition to using the lifetime exclusion, there are other potential strategies that a taxpayer could carry out to escape the Hackl problem and also to claim valuation discounts for gift and estate tax purposes. Such potential strategies include (1) using right of first refusal clauses in operating agreements to meet the property test, (2) adding a fiduciary duty clause in operating agreements, and (3) fine-tuning the gift transfer of an interest in a closely held entity to qualify under the income test. These potential strategies are discussed below. Furthermore, there is a short discussion on the potential use of *Crummey* powers as an alternative strategy for purposes of qualifying for the gift tax annual exclusion.

Use of Right of First Refusal Clauses – One way to claim the gift tax annual exclusion and qualify for valuation discounts is to include a provision in the entity's operating agreement that would restrict the transferability of the ownership interest by means of a right of first refusal clause. Instead of vesting such authority in the manager which was the case in Hackl, the operating agreement could state that the transferring member is required to notify and present the third party's offer to the other members, so they would have the opportunity to purchase the interest under the same terms.

This type of language can be found in many operating agreements of closely held entities. This approach would not only allow the members to preempt the sale of the ownership interest to outside purchasers, but also the transferring member would have some level of control to leave the entity and realize the current value of his or her ownership interest (assuming a willing buyer can be found). By using this method, a taxpayer could argue that the ability to realize the current value of the interest supports the present interest characterization under the property test in Hackl so that the gift tax annual exclusion can be claimed when gifting such interests.

In addition, under this approach, the taxpayer would generally be able to qualify for valuation discounts for gift and estate tax planning purposes. A complete review and analysis of the facts and circumstances surrounding the transfer would be required to determine the appropriate valuation discounts.

Including Fiduciary Duty Clauses **–** Another potential solution to circumvent the issue presented in Hackl is to include a fiduciary duty clause. Such provision should contain language that highlights the manager's fiduciary duties, which would include managing and operating the entity in the best interests of the entity and its owners. The clause should also include language obligating the manager to act in accordance with this fiduciary duty. This standard of care or fiduciary duty for the manager would make him or her a fiduciary in a similar way that a general partner is a fiduciary in a limited partnership.

Letter rulings and technical advice memoranda issued by the IRS have suggested that including such a provision in a limited partnership agreement would allow the gift to meet the present interest test under Section 2503(b) to qualify for the gift tax annual exclusion.[4] Even if the operating agreement has other restrictive provisions that are similar to the LLC's operating agreement in Hackl (e.g., transferability restrictions and control of distributions), the rulings have suggested that the gifted interest would have met the present interest test. The IRS's rationale in these earlier rulings was that a general partner must exercise such managerial powers in a fiduciary capacity and is held to a high standard of conduct toward the limited partners. As a result, a general partner's fiduciary powers are not the equivalent of a trustee's discretionary authority to distribute or withhold trust income or property, which normally results in the characterization of a gift to such a trust as a gift of a future interest.

Although it is unlikely that using only this practical approach would have persuaded the Tax Court in Hackl to hold otherwise, the taxpayers might have been able to present a stronger and more convincing argument to qualify for the gift tax annual exclusion if they would have combined this strategy with the use of a right-of-first refusal-clause in the operating agreement.

Fine-Tuning the Gift Transfer to Qualify Under the Income Test **–** As previously mentioned under the income test, the Tax Court used a three-part test to determine whether rights to income qualified for present interest – i.e., receipt of income, steady flow to members, and ascertainable value of that income stream. One possible way that the taxpayers in Hackl could have met the first part of the test (receipt of income) was to have the LLC generate sufficient income and have a portion of that income flow to the members. When creating family limited partnerships, estate planners could recommend to their clients that they contribute income-producing assets to the entity so that the first part of the income test could be met. In Hackl, the taxpayers could have waited until the LLC was scheduled to generate income and give the interests near that time period. Although this advice may be impractical for a new tree farming business, the taxpayers could have made better use of the $7.9 million in cash and marketable securities held by the LLC. This amount of cash and investments (or arguably some portion of

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[4] PLR 9415007 and TAM 199944003.

it) could have been retained and invested on a long-term basis or at least until the LLC was projected to produce sufficient income. A significant investment in a combination of dividend-paying stocks and interest-bearing bonds could have generated sufficient income for the entity that would have been immediate, steady, and relatively determinable.

Once the dividend or interest income was received by the LLC, it could have distributed the cash to the members in a timely manner. This would have also helped to legitimize the business purpose of the entity as well as establish a history of making cash distributions.

Finally, in addition to showing that the owners of the interest would have received income from the LLC, the taxpayers in Hackl were required to establish that some portion of that income will flow steadily to the members and the portion of the income flowing out to the members can be ascertained. Based on the Tax Court's rationale, one possible way that the taxpayers could have qualified under the second and third requirement of the income test was to draft a provision in the operating agreement that would have required the manager to distribute some ascertainable income or cash flow to the owners of the interest. One provision commonly found in operating agreements is the requirement that the manager distribute cash flow to each member equal to the income tax liability attributable to the member's ownership interest. Even a stipulated percentage based on the effective state and federal tax rates of the members (perhaps a combined percentage of approximately 30% to 40%) could have been added to the operating agreement.

For valuation purposes, an operating agreement could still contain language that provides the manager with control of the entity's cash flow distributions, but by having this additional provision that requires the manager to distribute an ascertainable amount of cash flow, it might be possible for the taxpayer to argue that the second and third requirement under the income test is met. Including such language in the operating agreement may allow taxpayers to take a position that the income test is met because "the timing and amount of distributions is not a matter of speculation."

Alternative Strategy (Use of Crummey Powers) – An alternative strategy that taxpayers could use to avoid the Hackl dilemma would be to attach *Crummey* powers with the gift of an interest in a closely held entity.[5] In general, such power would allow donees to make withdrawals or demand distribution of a particular amount within a certain time period (e.g., 30 days) after the gift is made. This ability to receive distribution normally allows the gifted interest to be categorized as a present interest gift for purposes of qualifying for the gift tax annual exclusion.

Depending upon how the distribution is structured, however, such powers attached to the gifted interest may lower or negate the valuation discount, because the donee would have the ability to realize the current value of the interest within a certain time frame. Such ability to realize the current value of the interest may enhance the marketability (or lack thereof) of the ownership interest. If a taxpayer decides to attach *Crummey* powers to the gift, it would be

[5] This *Crummey* power is based on the court case, Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), in which the Court of Appeals for the 9th Circuit held that the gift tax annual exclusion was applicable for gifts made to a trust when the beneficiaries had the right to demand immediate distribution of particular amounts.

advisable to first discuss this technique with a gift and estate tax attorney and a valuation specialist to determine the appropriate approach in order to be eligible for both the gift tax annual exclusion and valuation discounts.

Conclusion

In general, the use of family limited partnerships has been and continues to be a popular gift and estate tax planning tool for taxpayers to transfer their assets to their family members. Because many taxpayers set up these entities with operating agreements that contain language similar to the language at issue in the operating agreement used in the Hackl case, it is important to be mindful of this case and, in particular, inform clients of the potential risk that the IRS may disallow the gift tax annual exclusion benefit when clients make gifts of ownership interests in entities governed by such language. Although it is not entirely certain whether the Tax Court in Hackl would have ruled differently if the taxpayers had approached their gift and estate tax planning based on the suggestions above, such combined approaches could have, nonetheless, improved their chances of qualifying for the gift tax annual exclusion. Despite these suggestions, it will be interesting to see whether the Tax Court's holding and analysis in Hackl withstands the appellate court's scrutiny. Until then, it appears that the rationale in Hackl will provide considerable challenges for taxpayers who are interested in making gifts of ownership interests in family limited partnerships. Such difficulties may create various traps for the unwary in the gift and estate tax planning area.

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