Gifts of Interests in Family Limited Partnerships And Family Limited Liability Companies – Qualifying for the Annual Exclusion

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Abstract

Family limited partnerships (FLPs) and family limited liability companies (FLLCs) (hereinafter referred to as family business entities (FBEs)) provide an excellent vehicle for accomplishing goals related to asset protection planning, business and investment planning, and family gift and inheritance planning. FBEs provide an efficient means of transferring property to donees and reducing gift and estate taxes. Gifts of FBE interests are generally valued less than the value of the assets owned by the FBE due to the impact of minority and lack of marketability discounts. By gifting the interests in the FBE to donees in small increments, the annual exclusion can shield a significant portion of the gift from transfer taxes. If the assets transferred to the FLP are expected to substantially appreciate in the future, significant estate tax savings arise by excluding the appreciation from the donor's estate.

This article addresses IRS challenges related to gifts of interests in FBEs. The IRS may challenge the valuation of the FLP and FLLC interests based on the use of minority and lack of marketability discounts. The IRS may also attack the annual exclusion claimed for gifts of interests in FBEs. Recent tax cases (Hackl, Price and others) provide guidance which may help donors address IRS challenges and qualify for the annual exclusion. This article concludes with a discussion of suggestions to help shield FBE gifts from attacks by the IRS. With careful planning donors can reach tax planning goals as well as various non-tax goals related to the gifts of interest in FBEs.

Introduction

Family Limited Partnerships (FLPs) and Family Limited Liability Companies (FLLCs) (hereinafter referred to as family business entities (FBEs)) provide useful vehicles for the transfer of family assets to donees. These entities are useful in meeting transfer tax planning objectives, estate planning, and other family goals. These goals often include: (1) preserving family ownership of a business or investments, (2) centralization of management of business and investments, (3) family gift and inheritance planning, and (4) protection of assets from creditors of beneficiaries. Family business entities provide a convenient mechanism for transfer of assets to multiple donees on multiple occasions.

Due to the popularity of FBEs and perceived tax abuses resulting from transfers of assets via FBEs, the Internal Revenue Service (hereinafter referred to as the Service) has attacked the use of such entities and has employed a number of strategies to limit the usefulness of FBEs for gifting purposes. The Service may attack the use of FBEs as gifts by (1) seeking to ignore the entity and treating the transfer as a gift of the assets held by the entity, (2) challenging valuation issues related to minority discounts and discounts for lack of marketability, and (3) denying the gift tax annual exclusion. We examine the challenge to the use of the annual exclusion in this research and suggest means to avoid this challenge.

Annual Exclusion

Donors can obtain significant tax savings by making gifts of interests in FBEs that are valued less than the annual gift tax exclusion amount. Internal Revenue Code (IRC) section 2502 provides for an annual exclusion in the computation of taxable gifts. Currently the annual exclusion is $13,000 per year per donee. If gift splitting is elected $26,000 per year per donee may be excluded. By making relatively small gifts to many donees, a donor can gift substantial amounts of assets over time that will be subsequently excluded from the donor's gross estate. To qualify for the exclusion the gift must be a gift of a present interest.

To illustrate the value of the annual exclusion, consider the following set of facts. Donor owns 100 units (100%) of an LLC which contains assets worth $4,000,000. The donor would like to reduce his estate by $2,000,000 (current value of assets) and plans to make gifts of one unit per donee for each of ten donees over a five-year period. Donor retains the remaining units and controls the LLC. Donor will split gifts with his wife and claim a $26,000 annual exclusion per year with wife.

Each unit gifted is a minority interest which should be appropriately discounted. Assume that a reasonable minority interest discount is 20 percent. Further, with appropriate restrictive provisions in the LLC ownership agreement, discounts for lack of marketability may be appropriate. Assume that a reasonable discount for lack of marketability is 20 percent. Applying a 20 percent discount for a minority interest to the initial value of the LLC assets yields a net value of $3,200,000. (i.e., $4,000,000 less a 20% minority discount). This net value is further reduced by an additional 20 discount for lack of marketability which yields a discounted value of $2,560,000 (ie, $3,200,000 less a 20% lack of marketability discount). At a value of $25,600 per LLC unit (ie, $4,000,000 less $800,000 less $640,000 = $2,560,000 divided by 100 units), each gifted unit is totally shielded by the annual exclusion (assuming gift splitting). Since the per unit value is less than the annual exclusion (assuming gift splitting), no gift tax is due on the transfers.

Over the ten year period, 50 units (with assets initially valued at \$2,000,000) could be gifted at no gift tax cost. Assuming that the assets owned by the FBE increase in value, additional amounts are excluded from the donor's estate. These gifted assets will not be added to the donor's taxable estate for the purposes of computing the estate tax. Thus, transferring individually insignificant interests in the LLC to multiple donees over an extended period of time may result in significant gift and estate tax savings.

One common attack by the Service on perceived abuses related to gifts of interests in family business entities is to denial of the annual exclusion. Often the gifted interests are vulnerable to attack for failure to transfer a present interest in the gifted property. Reg. Sec. 25.2503-3(b) defines the terms present interest and future interest and provides that: "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." In contrast, the same regulation provides that: "Future interest is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time."

Prior to recent court rulings in Hackl (118 TC 279, 2002), Fisher (105 AFTR 2d 2010-1347) and Price (TC Memo 2010-2), it was assumed that a mere transfer of a vested interest (ie, a present right to property, not contingent upon the happening of future events) in a FLP or a FLLC constituted a transfer of a present interest (as defined in the Regulations) because the donee received all of the rights available to the owner of the interest and had a right to transfer the property (albeit frequently subject to substantial restrictions). Recent court cases have confirmed the Service position that mere conveyance of a vested ownership interest in a FLP or FLLC does not necessarily constitute a transfer of a present interest. If significant restrictions are placed upon the right of the donee to manage operations of the entity, receive distributions of cash or property from the entity, or sell the interest in the entity, the Service may challenge the right to claim the annual exclusion. If successful, the gift tax liability of the donor may be substantially increased. An analysis of major recent tax cases (Hackl, Fisher and Price) follows and tax planning tips are provided for donors who seek to avoid the "present interest" trap.

Recent Cases - Facts

In Hackl (118 TC 279, 2002), the taxpayers (husband and wife) transferred cut-over tree farms, cash and investments to an LLC and gifted units of the LLC to children and grandchildren. In Price (TC Memo 2010-2)) the taxpayers (husband and wife) created an LLP and transferred traded stocks in exchange for equity interests in the LLP. Over a six year period the LLP interests were gifted to the children of the donor and his wife. In Fisher (105 AFTR 2d 2010-1347) the taxpayers (husband and wife) transferred a parcel of undeveloped land to an LLC.

Over a three year period units in the LLC were gifted to the children of donor and his wife. In each of these cases the donor claimed the benefit of the annual exclusion and elected gift splitting.

The value of the gifts was substantially reduced by discounts for minority interests and lack of marketability. Gifted interests in the entities per donee per year were generally very small percentages of the total equity interests (as low as .5%). Discounted values of the interests transferred combined with gift splitting resulted in either no or little gift tax liability. In none of these court cases was the amount of the discounts at issue. Each case dealt only with qualification for the annual exclusion. Each case hinged on the following issue: Did the donor transfer a present interest in the gifted property to each donee?

Position of the Service

In each case, the Service took the position that the gifts did not result in the transfer of a present interest in the FBE. Thus, annual exclusions were denied. The Service contended that the gifts were future interests due to various restrictions including (1) limitations on the right of the donee to transfer the gifted interest and (2) limitations on rights of the donee to income from the entity. The Service asserted that the transfer provided no substantial present economic benefit to donees such that the donees had immediate use, possession, or enjoyment of either (1) the property or (2) income from the property.

Donee Restrictions

In each case, the donor generally retained the following powers and responsibilities in the FBE: (1) served as manager, (2) controlled all financial decisions, (3) determined timing and amount of distributions, and (4) retained the right to dissolve the FBE and distribute the remaining assets. Donee restrictions common to these cases are listed below. The restrictions are categorized as follows: (1) restrictions on rights to income from the entity, (2) restrictions on the right to transfer or assign the equity interest in the entity, and (3) other restrictions.

Restrictions on rights to income:

1. Donees could not require any distributions of profits, either in cash or property.
2. Entity profits were distributed at the discretion of the managing partner (of the LLP) or member (of the LLC). Since the entity manager was the donor, distribution decisions were made solely by the donor.
3. Entity operating agreements did not require distribution of profits.

Restrictions on the right to transfer or assign the equity interest in the entity:

1. Donees could not sell, assign, or transfer the gifted property to a third party without the consent of the manager. Consent to transfers of interests was within the sole discretion of the manager.
2. Donees could not encumber an interest without consent of the manager.
3. Donees could not liquidate the family business entity.
4. Donees did not have a right of redemption.
5. Donees could only sell units to other FLP or FLLC owners.
6. Donee had either no right to withdraw capital without the consent of the manager, or significantly restricted rights to withdraw capital.

Other restrictions:

1. Assignment limitations. In Heckl, the FLP operating agreement provided that any assignment to any nonpartner transferred less than the full rights of a limited partner. An assignment might result from a court ordered assignment to a creditor. Typically, the assignee would have no rights to manage or require distributions from the LLP. Such provisions are generally designed to discourage assignments and to discourage anyone from accepting such an assignment.

2. Right of first refusal. In Fisher, the LLC had a right of first refusal at a price equal to the amount of the offer made by the prospective buyer. Upon exercise of the right of first refusal, the LLC was required to pay the selling donee by issuing a promissory note with a term not exceeding 15 years. These terms had the intended effect of (1) keeping the entity ownership within the donor's family and (2) discouraging the donee from attempting to sell the interest by providing for a long payoff term.

Court Holdings

In Hackl, the Tax Court rejected the contention that an outright transfer of an equity interest in a business, where a vested interest passes to the donee, results in the transfer of a present interest. To qualify for the annual exclusion, a present interest must be conveyed to the donee. The court held that a present interest is conveyed if the transfer gives the donee an unrestricted and noncontingent right to the immediate use, possession, or enjoyment of either the property itself or income from the property. The court concluded that the donee must derive a substantial economic benefit from these rights.

The court examined the operating agreements and the nature of the operations of the LLC to determine if the donees had acquired a substantial economic benefit from rights to the property or income from the property (units in the LLC). The court noted that the ability of a donee to unilaterally withdraw his/her capital account might weigh in favor of finding a present interest, but no such right existed. The donees lacked the right to the immediate use possession or enjoyment of the property, because they could not sell or encumber the property or demand distributions of capital.

The court presented a three-part test (based on case law involving transfers in trust) to determine whether rights to income constituted a present interest. The test requires the donor to show that (1) the LLC will receive income, and (2) some portion of that income will flow steadily to the LLC members, and (3) the portion of the income flowing to the LLC members can be ascertained. The court concluded that the donees lacked a present right to income. The donees could not compel distributions of earnings; distributions were made only at the discretion of the manager; and no distributions were ever made to donees.

In Fisher, the Tax Court held, following the reasoning in Hackl, that transfers of FLP interests to donees were gifts of future interests and that annual exclusions were not allowable. The court relied upon Reg. Sec. 25.2503-3©, Example (1), which provides that a beneficiary's right to receive the income payments from a trust is not a present interest where a trustee is authorized in his discretion to withhold payments of income and add the income to trust corpus. The annual exclusion is not allowed with respect to the transfers into a trust containing such provisions. Such restrictions on transfer precluded immediate possession or enjoyment of the property.

The court rejected the donor’s argument that the right of the donee to sell to the partnership or to other partners created a present interest. A transfer of the gifted property by a donee was subject to option to purchase provisions with no time limit for exercising the option. Thus, contingencies stood between the donee and their receipt of economic value which effectively created a mere future interest in the principal.

In Price, the donee did have options for selling the gifted FLP interest but the court did not consider these to be viable options. Even though distributions had been made to donees in three of five years, the court determined that the three tests for a present income interest had not been met. The court found that income did not flow steadily to donees due to failure to make distributions in two of five years. The court concluded that no present economic benefit in either the principal or the income from the principal was received by the donees.

In Price, the court used the three part test of a present income interest used in Hackl. The court noted that profits were to be distributed at the discretion of the GP and concluded that the third part of the test had not been met. Thus, the donor failed to show that a present interest in income from the gift was transferred.

Planning Suggestions

In light of the objections of the Service and the courts to the various restrictions and limitations on the rights of the donees, the following suggestions are presented. The donor must transfer to the donee a present interest in either the equity of the FBE or income from the interest in the FBE.

To create a present right to the equity interest in the FBE the following suggestions may be helpful.

1. Provide a right of redemption of the equity interest for a limited period of time similar to a crummy power provided in insurance trusts. The redemption value should be limited to the gift tax value. The right of redemption should only apply to the gifted property.
2. Provide the donee with the right require the donor to buy back the gift at an amount equal to the gift tax value for a limited period of time.
3. Allow sales to third parties subject to a first right of refusal. Provide a reasonable formula for the sales price (limited to the gift tax value) rather than an obligation to match the offer of a third party.
4. Allow donee to encumber the property. However, with such a provision, the donor loses the ability to protect a donee from creditors. See further discussion regarding creditor protection, below.
5. Allow the donee to borrow from the entity, limited to the gift tax value of interest.

A combination of the above rights (not necessarily all or even most) should be sufficient to support a present interest in the equity interest of the FBE. While any one of the above-listed rights may be sufficient to create a present interest in the property, a combination of these rights may bolster the argument that a present interest has been transferred to the donee.

To create a present right to income from the FBE the following suggestions may be helpful.

1. Transfer assets to the entity which will generate an immediate stream of income. An operating business could generate an income flow; cash and security investments could generate interest and dividend income. Assets which will not generate income in the short-term (such as the clear-cut tree farm in Hackl) may also be gifted along with income-generating assets.
2. Provide for mandatory distributions to the donees. Distributions should be, at a minimum, enough to pay the tax liability of donees resulting from income reported on Schedule K-1.
3. Provide a written standard for determining the amount of distributions (to show a readily ascertainable standard for income distributions).
4. Provide for distributions from net cash flow if net income is negative.
5. Provide for and make periodic distributions (at least yearly).
6. Create a written business plan including budgeted revenues and expenses for entity. Plan business activities and investments which will generate income within a reasonably short period after the date of the gift.

Some combination of these rights may be needed to provide evidence of a right to income that the Service will not successfully challenge.

Impact on Valuation Discounts

Properly crafted provisions included in family business operating agreements and other agreements which provide for the rights and restrictions related to the ownership units will help ensure that the conveyed interests qualify for the annual exclusion. The value of the annual exclusion to the donor usually mandates that agreements be structured such that the donee acquires a present interest in the property or in the income from the property. However, provision of rights described above may have the unintended effect of reducing the lack of marketability discount. Planners must consider the trade-off between the additional rights given to ensure qualification for the annual exclusion and the discount for lack of marketability. Ideally planners would want to limit the donee's rights and, at the same time, provide enough rights to qualify for the annual exclusion. Unfortunately, the recent tax court opinions do not provide enough guidance to determine the minimum rights required. Planners may decide to err on the side of providing more rights than necessary so as to qualify for the annual exclusion.

Conclusion

Recent interpretations of present interest requirements in Heckl and Price provide guidance that should be carefully considered when gifting interest in FBEs. Tax advisors can provide value to clients by carefully planning the structure of equity instruments and operating agreements for FLPs and FLLC. Properly planned instruments allow donors to retain control over the operations of the FBE, transfer minority interests to donees as part of a gifting strategy, qualify for annual exclusions, and meet estate planning objectives. Early involvement of the tax planner can help ensure the accomplishment of these objectives.