Family Limited Partnerships: Holding up Under Fire? Part II

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Part I of this article appeared in the December 2010 issue.

The Annual Exclusion and Gifts of FLP Interests

Estate planners have often advised making gifts of interests in FLPs as a method of making annual exclusion gifts that benefit from valuation discounts. However, the annual gift tax exclusion is limited to present interests in property. As Ms. Davidowitz reminded us, this requirement has sometimes been a stumbling block for gifts of interests in FLPs.

For example, in *A.J. Hackl, Jr.*, 118 TC 279, Dec. 54,686 (2002), *aff'd*, CA-7, 2003-2 USTC ¶60,465, 335 F3d 664 (2003), the Tax Court held that gifts of LLC units did not qualify for the annual exclusion. In 1995 and 1996 Albert

and Christine Hackl gave their children and grandchildren membership units in Treeco, a limited liability company formed by Albert to hold and operate tree farming properties. The Hackls treated the gifts as qualifying for the Code Sec. 2503(b) annual exclusion.

The Tax Court, denying the annual exclusions, noted that the dispute turned on whether the transfers amounted to gifts of a present interest. The court found that the terms of the Treeco Operating Agreement foreclosed the ability of the donees presently to access any substantial economic or financial benefit that might be represented by the ownership units.

The court stressed that the Treeco operating agreement restricted access to company income and the transfer of the donees' membership interests. Members were prohibited from transferring their interests without the prior written consent of Albert as manager, who was authorized to give or withhold consent in his *sole* discretion. Moreover, the operating agreement did not allow a member unilaterally to force a liquidation or withdraw his or her own capital.

The court noted further that the LLC produced no income, and that any distributions of income were within the manager's discretion. The court indicated that the LLC's primary purpose was not to produce immediate income and that the Hackls did not expect the LLC to make any distributions during its initial years.

The court rejected the Hackls' argument that when a gift takes the form of an outright transfer of an equity interest in property, no further analysis is needed. Instead, the relevant question is whether the donees received rights that differed from those that would have come from a traditional trust arrangement. In examining the facts and circumstances of the Hackls' case, the court held that any economic benefit the donees could have ultimately obtained from their receipt of Treeco units was future, not present.

Because the gifts failed to confer a substantial present economic benefit, the court concluded that they failed to qualify for the Code Sec. 2503(b) exclusion. The Seventh Circuit affirmed the Tax Court under similar reasoning. More recently, in *J.W. Fisher*, DC-IN, 2010-1 USTC ¶60,588 (2010), a district court ruled that a gift of interests in an LLC from parents to their children did not satisfy the present interest aspect of Code Sec. 2503(b)(1).

In support of its decision, the court noted that distributions of income or capital were subject to the discretion of the general manager. The court was unmoved by the argument that the members enjoyed access to a vacation property owned by the LLC, since this right, even if it had been effectively granted to the members, was a nonpecuniary benefit. Finally, the court found that the ability of the donees to transfer their interests was not enough to give them an immediate economic benefit, since the LLC had a right of first refusal.

Uncertain Future for FLPs?

Ms. Davidowitz reminded attendees of the IRS's mixed success in arguing that family limited partnership interests should not be discounted (or at least not discounted as significantly as taxpayers have claimed). Moreover, as a result, legislation has periodically been proposed to resolve the issue once and for all. For example, one recently introduced bill, the Certain Estate Tax Relief Act of 2009 (H.R. 436) would deny a minority discount for an FLP interest where the transferee and members of the transferee's family have control of the entity.

This bill would also cause the value of any passive assets that are not used in the active conduct of business to be determined as if the transferor had transferred those assets directly to the transferee. Therefore, no valuation discount would be allowed with respect to those assets. Taking a different approach, the Obama administration has targeted marketability discounts in its fiscal 2009 and 2010 budgets by proposing a modification of Code Sec. 2704(b) to create a category of "disregarded restrictions."

These restrictions would be ignored when valuing an interest in a family-controlled entity that is transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest in the family-controlled entity that are more restrictive than regulations would permit. A disregarded restriction also would include a limitation on a

transferee's ability to be admitted as a full partner or holder of an equity interest in the entity.

Conclusion

As should be apparent from the foregoing discussion, the rules concerning FLPs are quite complicated and labor-intensive. In spite of the risks, however, many clients may still find it worthwhile to exert the effort to obtain significant potential estate and gift tax savings. Complete video and printed materials from the 41st Annual Estate Planning Institute are available at *www.pli.edu/product/clenow_detail.asp?id=60316.*