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Gifts of Family LLC Units in a Post-Hackl Era: Present Interests or Future Interests?

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COMMENTS

GIFTS OF FAMILY LLC UNITS IN A POST-*HACKL* ERA: PRESENT INTERESTS OR FUTURE INTERESTS?

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INTRODUCTION

A.J. and Christine Hackl had eight children, twenty-five minor grandchildren, and a significant accumulation of wealth, which they desired to give to younger members of the family.[1] In order to increase their long-term growth investments[2] and transfer a portion of their property to their descendants, the Hackls invested in multiple tree farms.[3] In order to ease this transfer, the Hackls used an organization commonly referred to as a family limited liability company ("family LLC")[4] to own and operate the tree farms.[5]

The operating agreement for the Hackls' family LLC was notably restrictive and provided that: 1) the family LLC was to be managed exclusively by a manager, initially A.J., who would "serve

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* The author would like to thank Professor William Wright for his guidance.

1. Hackl v. Comm'r, 118 T.C. 279, 280 (2002), *appeal docketed*, Nos. 02-3093, 02-3094 (7th Cir. 2002).

2. *Id.* at 281.

3. *Id.*

4. Family LLCs have grown in popularity in recent years as a way to avoid estate taxes. *See* Thomas E. Dew, *Sharing the Family's Wealth: A Family LLC Is Still an Attractive Way to Make Annual Exclusion Gifts*, 81 MICH. B.J. 50 (2002). The basic strategy is as follows: First, one or more elder family members transfer assets to an LLC in exchange for ownership interests in the entity. *Id.* Then, the elder family members gift the ownership units to their descendants. *Id.* The value of these gifts is often significantly discounted. *Id.* The gifts, at least prior to this decision, have been considered present interest gifts and qualified for the annual exclusion. *Id.; see also infra* note 12.

5. *Hackl*, 118 T.C. at 281–82.

for life, or until resignation, removal, or incapacity;"[6] 2) cash distributions could only be made with the approval of the manager;[7] 3) no member could withdraw his capital contribution without approval of the manager;[8] 4) manager consent was necessary for a member to withdraw from the family LLC;[9] and 5) without written consent from the manager,[10] no member could "transfer, assign, convey, sell, encumber or in any way alienate all or any part of the Member's Interest."[11]

The Hackls gifted units of the family LLC to their eight children and twenty-five grandchildren.[12] In 1996, they gave 500 voting and 750 non-voting units to their children and 31,250 non-voting units to a trust that was established for the benefit of their grandchildren.[13] The Hackls filed gift tax returns, which reported

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6. *Id.* at 282.

7. *Id.*

8. *Id.*

9. *Id.*

10. Such consent was in the manager's sole, unfettered discretion. *See id.* at 282–83.

11. *Id.* at 283. If consent was attained from the manager, the transferee was to be admitted as a substitute member. *Id.* However, if the manager withheld consent for any reason, a transfer would give the transferee nothing more than a right to receive distributions. *Id.*

12. *Id.* at 284. One reason for the recent popularity in family LLCs and family limited partnerships is the allowance of significant valuation discounts when ownership interests are transferred. *See* Charles A. Rosebrock, *Adventures in Valuation: Recent Developments*, A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 103, 105 (2001). Minority interest discounts and lack of marketability discounts are two common valuation discounts. *See* Okerlund v. United States, 53 Fed. Cl. 341, 345 (2002); *see also* Estate of Branson v. Comm'r, 1999 Tax Ct. Memo LEXIS 267, at *29 (1999). Specifically, "[a] minority interest discount reflects the minority shareholder's inability to compel either the payment of dividends or liquidation .... A lack of marketability discount reflects the fact that there is no ready market for shares in a closely held corporation." *Id.* With such valuation discounts, the total value of the individual shares is less than the value of the assets owned by the family LLC. *See* Rosebrock, *supra* 12, at 108–09. For this reason, the IRS has frequently argued that the discounts should not be applied. *See* Russell Standaland, Note, *Valuation Discounts After* Estate of Nowell v. Commissioner*: A Clear Formula for Reducing Estate Taxes*, 30 GOLDEN GATE U. L. REV. 679, 690 (2000); s*ee also* Rosebrock, *supra* note 12, at 105.

13. *Hackl*, 118 T.C. at 284.

the transferred units as "split gifts."[14] In these returns, they claimed the annual exclusions available in section 2503(b).[15] In April, 2000, the IRS claimed both that the annual exclusion did not apply to the gifts made in 1996 and that A.J. and Christine had tax deficiencies in their federal gift taxes of $ 309,950 and $ 309,866, respectively.[16]

Upon receiving the IRS's notice of deficiency, the Hackls filed for a redetermination of the matter from the U.S. Tax Court.[17] The sole issue before the Tax Court was whether the gifts of the family LLC units were gifts of a present interest, which would allow the benefit of the annual exclusion, or gifts of a future interest, leaving the Hackls with a tax deficiency.[18] The Tax Court held that the operating agreement "foreclosed the ability of the donees presently to access any substantial economic or financial benefit" derived from owning the units of the family LLC.[19] Further, the Tax Court expressed that there was no present interest gift of income resulting from ownership of the units because 1) the property held by the family LLC was held for long-term growth, thus there was no plan for the investment to produce short-term income, and 2) the manager had unfettered discretion to give distributions if there was any income.[20]

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14. A split gift is a present interest gift made from the assets of one spouse, yet the IRS considers it to have been made one-half by each spouse. *See* 26 C.F.R. § 25.2513-1(c) (2002). A split gift "effectively enables a husband and wife to give each object of their bounty $20,000 per year without liability for gift tax [and] further enhances the[ir] ability to transfer significant amounts of money and property free of gift tax consequences." Dickman v. Comm'r, 465 U.S. 330, 341–42 (1984). The annual exclusion was previously $10,000 per year, but it has been indexed so that it is $11,000 in 2003. *See* Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

15. *Hackl*, 118 T.C. at 285.

16. *Id.* at 279.

17. *Id.*

18. *Id.*

19. *Id.* at 296.

20. *Id.* at 298.

I. RELATED LAW

A tax is imposed on gifts of property.[21] The scope of this tax is quite broad—it applies "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."[22]

A taxable gift is the total amount of the gift less any applicable deductions.[23] However, an annual exclusion is allowed for the first $10,000[24] of present interest gifts per donee.[25] Thus, taxable gifts, as defined in 26 U.S.C. section 2503(a), do not include the first $10,000 of gifts given to each donee each year unless the gifts are not present interests.[26] A present interest is "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property."[27]

Many cases have applied the definition of a present interest.[28] The standard applied to determine whether a gift is a present or future interest is summarized in *Fondren v. Commissioner*.[29] Vested rights alone do not create a present interest; instead, it is necessary that the donee receive a "substantial present economic

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21. 26 U.S.C. § 2501(a)(1) (2000).

22. *Id.* § 2511(a).

23. *Id.* § 2503(a).

24. The annual exclusion was $10,000 when the Hackls made their gifts in 1996. *See* 26 U.S.C. § 2503(b)(2). However, the exclusion has been indexed so that it is $11,000 in 2003. *See supra* note 14.

25. 26 U.S.C. § 2503(b)(1).

26. *Id.*

27. 26 C.F.R. § 25.2503-3(b) (2002).

28. *See, e.g.*, United States v. Pelzer, 312 U.S. 399, 404 (1941) (finding that gifts to several beneficiaries of a trust were future interests, rather than present interests); Ryerson v. United States, 312 U.S. 405, 409 (1941) (concluding that gifts to several beneficiaries of a trust were future interests because the gifts were contingent upon certain survivorship criteria); Fondren v. Comm'r, 324 U.S. 18, 24–25 (1945) (finding that gifts were "future interests in property" where the enjoyment of property was contingent upon the occurrence of future events); Comm'r v. Disston, 325 U.S. 442, 449 (1945) (finding that a gift was a future interest where there was no requirement of "a steady flow of some ascertainable portion of income" from a trust to the beneficiary).

29. *Fondren*, 324 U.S. at 20.

benefit" from the gift.[30] In other words, it is necessary to determine at what point enjoyment of the property begins. If enjoyment begins immediately, the gift is classified as a present interest.[31] The burden is on the taxpayer to prove that the gift is a present interest in order to take advantage of the annual exclusion.[32]

The standard announced in *Fondren* might best be explained by using two cases to distinguish present interest gifts from future interest gifts. In *Wooley v. United States*, a partnership was created where each partner had the right to demand repayment of capital contributions.[33] One partner, the decedent, made gifts to the other partners' capital accounts.[34] The district court decided that these were present interest gifts because the donees "had the immediate and unrestricted right to possess and enjoy the decedent's gifts to their partnership capital accounts."[35]

Wooley is distinguishable from the facts in Technical Advice Memorandum 97-51-003, where gifts from a general partner to several limited partners were classified as future interest gifts to which the annual exclusion did not apply.[36] Under the partnership agreement, income could be distributed only if the general partner, in her "complete discretion," approved.[37] Because the donees could not demand and receive "immediate use, possession or enjoyment of income, the income component was not a present interest . . . ."[38] Benefits resulting from ownership of the limited partnership interests were also restricted.[39] The donees were prohibited from transferring the interests or withdrawing until the year 2022.[40] Tech. Adv. Mem. 97-51-003 concluded that although the gifts had vested, they did not confer any immediate economic

30. *Id.*
31. *Id.*
32. *Disston*, 325 U.S. at 449.
33. Wooley v. U.S., 736 F. Supp. 1506 (S.D. Ind. 1990).
34. *Id.* at 1508.
35. *Id.* at 1509.
36. *See* Tech. Adv. Mem. 97-51-003, 1997 PRL LEXIS 1493 (Aug. 28, 1997).
37. *Id.* at *18.
38. *Id.* at *19.
39. *Id.*
40. *See id.* at *20.

benefit and, accordingly, were future interests.[41]

II. *HACKL V. COMMISSIONER*

In *Hackl v. Commissioner*, the U.S. Tax Court held that gifted units of a family LLC were gifts of future interests, not qualifying for the annual gift tax exclusion, where the operating agreement significantly limited immediate benefit from ownership of the units and the donees could not demand distributions of the family LLC's income.[42]

The taxpayers in the case argued that the gifts of the family LLC units should be characterized as present interest gifts.[43] The Hackls maintained that they transferred partial ownership of the family LLC to the transferees who then received the same rights that they themselves had prior to the transfer.[44] The units transferred had a substantial, stipulated value.[45] They concluded that the gifts were not future interests because the enjoyment rights were not postponed.[46]

The IRS countered that, while the interests did have a definite value, the value was a future interest.[47] Because of the restrictive nature of the operating agreement, the transferees lacked "the requisite immediate and unconditional rights to the use, possession, or enjoyment of the property or the income from property."[48] The IRS concluded that there were no present benefits resulting from ownership of the family LLC units because the transferees were restricted from both transferring the units and receiving income.[49]

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41. *See id.* at *21.

42. Hackl v. Comm'r, 118 T.C. 279, 296–97 (2002), *appeal docketed*, Nos. 02-3093, 02-3094 (7th Cir. 2002).

43. *Id.* at 289.

44. *Id.*

45. There was no dispute as to the value of the family LLC units. *See id.* at 286 ("[Parties] agreed that the fair market value of both voting and nonvoting units . . . was $10.43 per unit . . . .").

46. *See id.* at 289.

47. *See id.* at 290.

48. *Id.*

49. *Id.*

The U.S. Tax Court rejected the Hackls' position[50] and summarized the applicable law:

> [A] taxpayer claiming an annual exclusion to establish that the transfer in dispute[51] conferred on the donee 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[52] is derived therefrom.[53]

The court applied this immediate "substantial economic benefit" standard to both the gifted property and the income from the gifted property.[54] The Tax Court found that the restrictive operating agreement removed the possibility that the transferees received a substantial present economic benefit from the ownership of the units.[55] The owners of the units could not unilaterally withdraw their capital, sell their units, or dissolve the family LLC.[56] The mere ownership of the units did not confer present use, possession, or enjoyment of property under the applicable standard.[57]

Likewise, there was no present interest in income from the gifted property.[58] To prove that a gift of income is a present interest, the taxpayer must show there will be an ascertainable

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50. *Id.* at 293.

51. The Tax Court noted that although Indiana State property laws permit a gift in the ownership interest, Federal law determines whether that gift is a present interest or a future interest. *Id.* at 290. In addition to determining whether a gift was made of family LLC units, the nature of the gift needs to be considered. *Id.* at 293.

52. The "substantial economic benefit" concept is found in *Fondren v. Comm'r*, 324 U.S. 18, 20–21 (1945), where the Court explained that a present interest requires the right to present use, possession, or enjoyment of the property and that this requirement mandates that the donee receives a "substantial present economic benefit." *Id.*

53. Hackl v. Comm'r, 118 T.C. 279, 293 (2002).

54. *Id.*

55. *Id.* at 296.

56. *Id.* at 296–97.

57. *Id.* at 297–98.

58. *Id.* at 298.

amount of income flowing to the beneficiary.[59] Because the parties had stipulated that the family LLC was not organized to produce immediate income, the Hackls did not meet the standard.[60] Further, even if the family LLC was earning money, distribution of income was in the manager's sole discretion and the owners of the family LLC units could not demand any portion of the income.[61] Accordingly, the Tax Court determined that both the gifts of the family LLC units and the gifts of income from the family LLC were future interest gifts to which the annual exclusion did not apply.[62]

III. DISCUSSION

A. Hackl *As Compared To Other Case Law*

To the dismay of many individuals hoping to use restrictive family LLCs, *Hackl* was properly decided and is unlikely to be reversed on appeal.[63] The proper standard was pronounced in *Fondren*—did the transferees receive an immediate "substantial present economic benefit" from the gift?[64] If so, the annual exclusion applies to reduce gift taxes that might be owed.[65] The annual exclusion is not allowed, however, where there is no present

59. *Id.* (citing Calder v. Comm'r, 85 T.C. 713, 727–28 (1985)).

60. *Id.*

61. The court distinguished cases such as *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968), where the beneficiary of a trust received an absolute right to withdraw for a given time period. The gift in *Crummey* was a present interest gift even though it was exceptionally unlikely that a withdrawal would occur. *Id.* at 87–88. This is different from the situation in *Hackl* where, although it was exceptionally unlikely that the family LLC would receive immediate income, the transferees could not demand a withdrawal even if income was available. *Hackl*, 118 T.C. at 298. There was no absolute right to income—even for a short period of time. *Id.* at 293, 298.

62. *Hackl*, 118 T.C. at 297–98.

63. The Hackls have appealed their case to the Seventh Circuit. *See Hackl*, 118 T.C. 279, *appeal docketed*, Nos. 02-3093, 02-3094 (7th Cir. 2002). The two cases have been consolidated under No. 02-3093.

64. *See* Fondren v. Comm'r, 324 U.S. 18, 20 (1945).

65. *Hackl*, 118 T.C. at 293.

enjoyment of the family LLC units or income from the units.[66]

In comparing the facts of *Hackl* to those of *Wooley*[67] and to those of Tech. Adv. Mem. 97-51-003,[68] *Hackl* is distinguishable from the former and very similar to the latter. Unlike *Wooley*, the family LLC in *Hackl* was unlikely to have any short-term income and, even if there was income, the donees had no right to demand its distribution.[69] Instead, the case is very similar to Tech. Adv. Mem. 97-51-003 where both the partnership income and capital accounts of donee partners were classified as future interests.[70] The income was considered a future interest since a distribution could only be made in the discretion of the donor.[71] Further, the partnership agreement restricted the donees from withdrawing or transferring their interests and this foreclosed the possibility that the donees had received immediate economic benefits.[72] The similarity between the facts of *Hackl* and Tech. Adv. Mem. 97-51-003 supports the accuracy of the Tax Court's decision.

B. Consequences of Hackl

Hackl is a landmark case because it is the first example that straining too hard for a large valuation discount increases the risk of losing the annual exclusion of 26 U.S.C. section 2503(b). The IRS will certainly use this case as precedent in similar cases involving family LLCs with restrictive operating agreements. Estate planners must act defensively and draft in ways that will protect their clients from IRS claims that gifts of family LLC units are future interests while maximizing their valuation discounts. The key will be to ensure that the gifts are present interests while loosening as few restrictions as possible. If all restrictions are removed, clients will no longer want to use family LLCs because they will lose control over the assets.

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66. *Id.*
67. Wooley v. United States, 736 F. Supp. 1506 (S.D. Ind. 1990).
68. Tech. Adv. Mem. 97-51-003, 1997 PRL LEXIS 1493 (Aug. 28, 1997).
69. *Hackl*, 118 T.C. at 296–97.
70. Tech. Adv. Mem. 97-51-003, 1997 PRL LEXIS 1493, at *22.
71. *Id.* at *18.
72. *Id.* at *20.

Practitioners are considering at least five ways to protect clients from having results similar to those reached in *Hackl.* Each variation has its advantages and disadvantages. The ultimate choice of which variation is appropriate will depend on the facts and circumstances of each client's situation.

One alternative is to require that income from family LLCs is distributed on a regular basis.[73] *Hackl* gave the appropriate standard—there must be ascertainable income flowing to the owner of the family LLC units.[74] The disadvantage of this approach is that it will likely result in smaller valuation discounts. Many clients are specifically looking for large valuation discounts and this approach may not be appropriate in these cases.[75]

A second approach would be to alter the operating agreement to allow for a right of first refusal.[76] This would allow the transferee to sell his family LLC units, but only after offering the family LLC the opportunity to buy the units under the same terms or at fair market value.[77] Again, care must be paid to how such a change will affect valuation discounts.

Third, the results of *Hackl* may be avoided by altering the operating agreement to give owners of family LLC units a temporary opportunity to sell their units to the family LLC and

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73. Andrew M. Katzenstein & David P. Schwartz, *Tax Court Limits Annual Gift Tax Exclusion for Gratuitous Transfers of LLC Interests*, 96 J. TAX'N 290, 296 (2002).

74. *Hackl*, 118 T.C. at 298.

75. *See* Dew, *supra* note 4, at 51 (noting that although requiring current income distribution may allow a gift of membership interest to qualify for a present interest gift, such qualification would probably come "at the cost of a smaller valuation discount for minority interest.").

76. For an explanation of the rights associated with the right of first refusal, see *Roy v. George W. Greene, Inc.*, 533 N.E.2d 1323, 1325 (Mass. 1989).

77. *See* Dew, *supra* note 4, at 51 (stating that if members are allowed to sell or transfer their membership interests, this would likely allow a gift of a membership interest to qualify as a present interest gift, "but probably at the cost of a smaller valuation discount for minority interest or lack of liquidity in valuing the gifted interest."); *see also* Dan W. Holbrook, *Family Limited Partnerships: Hackl'd to Death?*, 38 TENN. B.J. 18, 20 (2002) (stating that while a right of first refusal may increase marketability of family limited partnerships, it might decrease any valuation discounts given for a lack of marketability).

withdraw.[78] Of course, this is only possible if the family LLC has cash on hand to make the payments should an owner decide to exercise his right to withdraw.[79] Again, the disadvantage of this approach is that it will often decrease applicable valuation discounts.

A similar alternative plan is to give new owners a temporary right to sell their units without restriction.[80] This approach should be used with caution, however, since the donee could transfer the units to anyone and other owners are unable to control the ultimate owners of the family LLC units.[81] Also, the increase in transferability would likely reduce valuation discounts.

A final way to avoid the results in *Hackl* would be to create intentionally defective grantor trusts[82] funded with cash and then sell the family LLC units to the trusts (at the discounted price).[83] This is a two-step process. First, intentionally defective grantor *Crummey* trusts[84] would be set up for the benefit of the people that, prior to *Hackl*, would have received outright gifts of family LLC units.[85] Each trust is funded with an amount of cash equal to the discounted value of the family LLC units.[86] Second, the family LLC units are sold to the trusts at the discounted fair market value. This method is more complicated and some clients may shy away

78. This approach would be analogous to giving "Crummey" powers to beneficiaries of trusts. *See* Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968) (holding that a limited demand right "transforms" a gift in trust from a future interest to a present interest, thereby qualifying it for the annual gift tax exclusion).

79. Dew, *supra* note 4, at 51.

80. Holbrook, *supra* note 77, at 20.

81. *Id.*

82. For more information on intentionally defective grantor trusts, see Kenneth A. Weiss, Practitioner's Note, *Drafting Louisiana Income "Spray" Trusts: After the 1997 Trust Code*, 72 TUL. L. REV. 1329, 1339–40 (1998), and DONALD H. KELLEY ET AL., SALES TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS, 1 ESTATE PLAN FOR FARMERS AND RANCHERS § 10:24 (3d ed. 2002).

83. Katzenstein, *supra* note 73, at 296.

84. By using "Crummey" trusts, the cash gifts to the trusts are considered present interests and the annual exclusion is allowed under I.R.C. § 2503(b). *See* Crummey v. Comm'r, 397 F.2d 82, 83–84 (9th Cir. 1968).

85. Dew, *supra* note 4, at 51.

86. *Id.*

from it. However, the approach does seem to successfully avoid the gifts being labeled as future interests:

> The sale of interests in such entities to an intentionally defective grantor trust . . . allows the transferor to transfer interests at a discount, to continue to maintain control of the entity, to have effective control of the trusts, and to transfer appreciation in the interest to later generations without any associated gift tax . . . .[87]

CONCLUSION

The Tax Court's decision in *Hackl* caught many people off guard since the Tax Court had not yet determined how restrictive family LLC operating agreements could be without affecting the annual exclusion of IRC section 2503(b). Many clients that currently have family LLCs may need amendments to their operating agreements because of the decision. New clients may decide to use the intentionally defective grantor trust approach. With proper planning, enlightened by the recent decision, the negative effects of *Hackl* may be avoided and the family LLC will continue to be an effective estate-planning tool.

87. Katzenstein, *supra* note 73, at 296.