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More Guidance for Gifts Under the Federal Gift Tax Annual Exclusion

-by Neil E. Harl

The 2002 Tax Court case, Hackl v. Commissioner, surprised some and the affirmance by the Seventh Circuit Court of Appeals in 2003 shocked even more although Hackl did not depart markedly from prior authority. Two more recent cases, Price v. Commissioner and Wimmer v. Commissioner have provided more detailed guidance on the bounds of what is a “present interest” in the context of transfers to family members involving an entity.

Hackl v. Commissioner

In Hackl v. Commissioner, the taxpayers gave their children membership units in a limited liability company formed by the taxpayers to hold and operate tree farming properties. The timber management plan under which the LLC was operating assured that income from the venture would commence some time in the future.

Several features of the entity and the way transfers were handled led the Tax Court (and the Seventh Circuit Court of Appeals) to hold that the transfers were gifts of future interests, not eligible for the federal gift tax annual exclusion — (1) the donees were prohibited from selling their ownership interests without the donor’s approval; (2) the LLC operating agreement gave the donor (who was also the LLC’s manager) discretion to make or not to make cash distributions to the members; (3) the donees were prevented from withdrawing their capital accounts or redeeming their interests without the donor’s approval; and (4) the operating agreement of the LLC specified that no single owner could cause dissolution of the LLC. The Tax Court and the Court of Appeals concluded that the gifts of LLC interests failed to confer a substantial present economic benefit on the donees and, therefore, failed to qualify for the federal gift tax annual exclusion. The courts rejected the argument that when a gift takes the form of an outright transfer of an equity interest in property or a business entity, no further inquiry need be made and no further analysis was needed.

Price v. Commissioner

In the 2010 case of Price v. Commissioner, transfer of limited partnership interests failed to qualify as present interests and thus were ineligible for the federal gift tax annual exclusion because no substantial present economic benefit was received by the donees. The Tax Court followed Hackl in requiring that, to qualify as a present interest, the gift

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must confer a substantial present economic benefit by reason of the use, possession or enjoyment of the property or income from the property. However, the limited partnership agreement—(1) prevented the partners from selling, assigning or transferring their partnership interests without the consent of all of the partners; (2) did not allow the partners to withdraw their capital accounts; and (3) gave the donees only the right to share in income. That was insufficient for the gifts to be gifts of present interests.

**Wimmer v. Commissioner**

In the latest case, *Wimmer v. Commissioner,* gifts were made of limited partnership interests to the decedent’s sons, children of the decedent’s sister-in-law and a trust benefitting the decedent’s grandchildren and his sister-in-law’s grandchildren. The partnership was funded primarily by stock which had a history of paying dividends. The partnership received dividends on the stock and made distributions to the limited partners.

Notwithstanding the restrictions on transfer in the partnership agreement, which prevented the gifts from conferring unrestricted rights to the immediate use, possession and enjoyment of the partnership interests, the court found that, on the date of each gift, the partnership expected to generate income, under the circumstances a portion of the income was expected to flow steadily to the limited partners and the portion of income flowing to the limited partners could be readily ascertained. Those factors added up to a present interest in the income.

Moreover, the partnership agreement created an exception for transfer to related parties for one of the restrictions on transfer: the partnership agreement allowed the transfer of partnership interest by gift or as a result of a partner’s death without the prior written consent of the general partners if the transfer was to or for the benefit of an incumbent partner or a related party. Further, the partnership agreement allowed a transferee of a partnership interest to be admitted to the partnership without the prior written consent of the general partners if the transferee was an existing partner or a related party.

The court found that the gifts, to be present interests, must have conferred on the donees a substantial, present economic benefit by reason of use, possession or enjoyment (1) of property or (2) of income from the property. With the decision turning on the issue of rights to income, not property, the court noted that the estate had to prove that (1) the partnership would generate income; (2) some part of that income would flow steadily to the donees; and (3) that part of the income could be readily ascertained. The Tax Court found that those conditions were met and the gifts were eligible for the federal gift tax annual exclusion.

**ENDNOTE**

1 118 T.C. 279 (2002).
2 See Heringer v. Comm’r, 235 F.2d 149 (9th Cir. 1956) (transfer of stock to family corporation; gifts were future interests although court did not face the issue of whether gift was to corporation or to shareholders); Chavin v. United States, 393 F.2d 972 (Ct. Cl. 1968); George Ketteman Trust v. Comm’r, 86 T.C. 91 (1986) (gift of future interest; argument rejected that donees comprised entire membership of board of directors and could have declared corporate dividends); Ltr. Rul. 9751003, Aug. 28, 1997 (transfers of limited partnership interests to children were not gifts of present interests where partnership agreement (1) prevented partners from selling, assigning or transferring their partnership interests without consent of all partners, (2) prevented partners from withdrawing capital accounts and (3) gave donees only a right to share in income). See generally 6 Harl, Agricultural Law Digest § 46.04[1][a] (2012).
3 T.C. Memo. 2010-2.
5 118 T.C. 279 (2002), aff’d, 335 F.3d 664 (7th Cir. 2003).
6 I.R.C. § 2503(b).
7 Hackl v. Comm’r, 118 T.C. 279 (2002), aff’d, 335 F.3d 664 (7th Cir. 2003).
8 T.C. Memo. 2010-2.
9 See note 5 supra.
12 Id.
13 Id.
14 Id.
15 Id.
16 Id.
17 Id.