Use of the Annual Exclusion for Transfers of Interests in Family Entities

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THE USE OF BUSINESS ENTITIES—LIMITED PARTNERSHIPS, CLOSELY held corporations and limited liability companies—offers clients ease of management, protection from creditors and, of course, benefits in the intrafamilial transfer of assets. However, as utilization of the $11,000 annual gift tax exclusion is often an important component of intergenerational transfer plans, the decision of the 7th Circuit Court of Appeals in **Hackl v. Commissioner** obliges practitioners to review the alienation restrictions inserted in governance agreements of entities used for intrafamilial transfers to ensure that the transferred interests are, in fact, present interests under recent judicial guidance.

The use of the annual gift tax exclusion is, subject to certain exceptions, limited to gifts of a present interest. The IRS defines a present interest as "an unrestricted right to the immediate use, possession, or enjoyment of the property or the income from the property" and thus excludes other interests or estates that "are limited to commence in use, possession, or enjoyment at some future date or time."

The IRS approaches intergeneration transfers of limited partnership units, closely held corporation stock and limited liability company units with skepticism. The fulfillment of state law formalities and the consequent legal recognition of an entity is not, of course, sufficient to cause the IRS to acknowledge its existence for tax purposes. The IRS thus scrutinizes the validity of the entity from a tax perspective and, especially in cases in which a pass-through entity is used and valuation discounts are claimed, assesses, inter alia, the applicability of (1) the economic substance doctrine (the IRS examines, in its principal line of attack on family entities and transfers of interests therein, the practical economic consequences of the transaction—other than the reduction of transfer taxes—and challenges the taxpayer to identify valid business purposes or profit motives for the transaction), (2) the gift on formation doctrine (the proposition, albeit rejected in numerous Tax Court cases, that the difference between the value of the assets contributed to an entity and the value of the interest in an entity received therefore constitutes a gift), (3) the indirect gift doctrine (the theory that the transfer of assets to a business entity for less than adequate and full consideration constitutes an indirect gift to the other owners of the entity) and (4) the retained control doctrine (the contention, often raised in cases in which the entity owners failed to respect formalities related to the entity, that the control retained by the transferor over the assets or income of the entity was so thorough that its value is included in his estate for estate tax purposes). The IRS, despite some important judicial setbacks, insists that family entity cases are fact-specific and continues to mount challenges, based on these and other theories, to the use of family entities for tax-favorable intergenerational transfers.

The **Hackl** case, which resulted in the affirmation by the 7th Circuit Court of Appeals of a Tax Court decision in favor of the IRS, involved the 1995 purchase of two tree farms by A.J. and Christine Hackl and the subsequent contribution of the tree farms and a significant amount of cash and securities to Treeco, LLC, an Indiana limited liability company, in exchange for all of the voting and nonvoting units of membership interest. There was little merchantable timber on the two farms, but long-term growth was anticipated, and the Treeco business plan thus called for long-term appreciation rather than short-term income. Indeed, as of 2003, although its foresters predicted strong future income, Treeco had neither generated any net profits nor made any distributions to its members.

The Hackls commenced the transfer of voting and nonvoting Treeco units in 1995, pursuant to the annual gift tax exclusion, to their eight children and their respective spouses as well as to a trust established for their grandchildren. Their ambitious transfer program, in fact, resulted in the transfer of 51 percent of the Treeco voting units to their children and their respective spouses within three years. The IRS disallowed the qualification of the gifts under the annual exclusion, however, and asserted that, due to significant restrictions included in the Treeco operating agreement, the transferred units constituted future interests rather than present interests.

The **Hackl** decision revolved around the Treeco operating agreement and its provisions that (1) appointed A.J. Hackl as manager for life and empowered him to designate his successor, (2) vested exclusive management rights in the manager, (3) vested approval rights for all distributions and withdrawals in the manager, (4) prohibited the sale, transfer or encumbrance of units without the approval of the manager in his sole discretion (the operating agreement provided, however, that an unauthorized transfer was not invalid but, rather, permitted the transferee to share in distributions and denied the transferee all other rights of membership) and (5) permitted the members to remove the manager with a majority vote and to amend the operating agreement with a super-majority vote.

The principal issue in the **Hackl** litigation was the qualification of the gifts of Treeco units for the annual gift tax exclusion and turned on the classification of the gifts as present interests or as future interests. The Tax Court applied its trust-based tripartite test for qualification of a present interest, pursuant to which the taxpayer is obligated to prove "[t]hat the trust will receive income . . . , that some portion of the income will flow steadily to the beneficiary, and . . . that the portion of the income flowing out to the beneficiary can be ascertained," to the stipulated facts of **Hackl** and concluded that the gifts of Treeco units were not present interests and thus failed to qualify for the annual gift tax exclusion.

The Hackls did not subject the transferred Treeco units to restrictions in addition to those set forth in the Treeco operating agreement, and, yet, the court held that, although the Hackls surrendered all of their rights in the transferred units, "some contingency stood between any individual member and his or her receipt from the company of economic value for units held" due to the restrictions in the operating agreement. The court concluded that the restrictive terms of the operating agreement, coupled with the failure of Treeco to distribute income, precluded "the ability of the donees presently to access any substantial economic or financial benefit that might be represented by the ownership units."

The Hackls offered three undistinguished arguments at the 7th Circuit of Appeals. The Court of Appeals noted that the right to substantial present economic benefit is implicit in a present interest. The Court of Appeals, like the Tax Court, focused on the restrictions included in the Treeco operating agreement and concluded that the restrictions on transfer stripped the units of "immediate value." The Hackls argued that restrictions upon the transfer of equitable interests are common for closely held entities, and, yet, the Court of Appeals stated that, "[w]hile that may be true . . . , that . . . does not mean that shares in such companies should automatically be considered present interests for purposes of the gift tax exclusion" and, in an inauspicious note, added that "Internal Revenue Code provisions dealing with exclusions are matters of legislative grace that must be narrowly construed."

The **Hackl** cases illustrate the inherent tension between the restrictions that are critical to the generation of significant valuation discounts and the importance of the clear and present economic benefit that is requisite for qualification as a present interest. **Hackl,** to the extent that its scope is limited to the elimination of the annual gift tax exclusion for interests in family entities that are subject to transfer prohibitions in their instruments of governance—restrictions that, in effect, supplement the limitations imposed under applicable state law—and are unable to produce income, reflects precedent and presents surmountable challenges to practitioners. However, to the extent that **Hackl** signifies that restrictions enshrined in state law—rather than limitations added to instruments of governance—can jeopardize characterization as a present interest, **Hackl** is inconsistent with precedent and rather portentous.

The prudent practitioner is nonetheless obligated to anticipate challenges from the IRS based upon its success in **Hackl.** Of course, if control of the family entity is critical, it appears that the use of the lifetime gift tax exclusion—rather than the use of the annual exclusion—is advisable. However, if the utilization of the annual exclusion is an integral component of the transfer plan, transferees will need to receive a clear—and immediate—economic interest. The Court of Appeals in **Hackl** focused its discomfort with the Treeco operating agreement on, in the aggregate, the absence of provisions for regular distributions, its preclusion of withdrawal rights and its limitations upon transfer of the units of membership interest.

The **Hackl** standard is likely to be satisfied by the creation of a put right of limited duration, similar to a **Crummey** option, pursuant to which the transferees can compel the family entity to purchase their respective interests therein at fair market value as defined in the Treasury Regulations. Of course, the put option is likely to minimize the discount available for lack of marketability, and, lest the IRS characterize the put right as illusory, the family entity will need sufficient cash reserves to fund potential redemptions.

It is possible that the provision of broad transfer rights subject to a right of first refusal for the benefit of the company and the other owners, too, satisfies the criteria set forth in **Hackl,** and although it will minimize the discount available for lack of marketability, it offers reasonable protection against the emergence of unrelated third parties as unwelcome participants in the family entity.

The creation of irrevocable trusts for the benefit of the prospective transferees that are funded by cash gifts, subject to compliance with applicable fiduciary standards, used to purchase interests in the family entity at discounted values offers yet another option. The proper use of **Crummey** notices will ensure the characterization of the gifts as present interests, and if the transferor utilizes intentionally defective grantor trusts, he will not be forced to recognize gain upon the future sale of the interests in the family entity.

It is not uncommon for family entities to be funded with unimproved real estate positioned for appreciation rather than generation of rental income, and, to confer a present economic benefit, it appears that substantive transfer rights are critical to passage of post-**Hackl** scrutiny. It appears likely that the contribution of significant cash reserves to family entities otherwise heavily invested in non-income-producing investments and its annual distribution in specified amounts—to ensure that the distribution of income meets the requirement that income rights be ascertainable—is advisable. ■

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