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The Present Interest Annual Exclusion – It's More than Just Giving Up Rights in the Gifted Property (i.e., Gifting Entity Interests May Get Crummey)

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Overview

The present interest annual exclusion is a key component of the federal gift tax.[1] The exclusion is presently $13,000 per donee per year. That means that a donor can make gifts of up to $13,000 per year per donee (in cash or an equivalent amount of property) without triggering any gift tax, and without any need to file Form 709 – the federal gift tax return.[2] Because the exclusion "renews" each year and is not limited by the number of potential donees, but only the amount of the donor's funds and interest in making gifts, the exclusion can be a key estate planning tool. Used wisely, the exclusion can facilitate the passage of significant value to others (typically family members) pre-death to aid in the succession of a family business or a reduction in the potential size of the donor's taxable estate (assuming the federal estate tax is restored in the future), or both. But, to qualify for the exclusion, the gift must be a gift of a present interest – the exclusion does not apply to future interests.

Whether gifts are present interests that qualify for the annual exclusion has been a particular issue in the context of trust gifts that benefit minors. In 1945, the U.S. Supreme Court decided two such cases. In *Fondren v. Comr.*[3] and *Comr. v. Disston*,[4] the donor created a trust that benefitted a minor. In *Fondren*, the trustee had the discretion to distribute principal and income for the minors support, maintenance and education and, in *Disston*, the trustee had to apply to the minor's benefit such income "as may be necessary for…education, comfort, and support." In both cases, the Court determined that the minor was not entitled to any amount of a "specific and identifiable income stream." So, no present interest was involved. But, what if the minor (or any other transferor, for that matter) had a right to demand the trust property via a right to withdraw the gifted property from the trust? Is that the same as outright ownership such that the gifted property would qualify the donor for an annual exclusion on a per donee basis? In 1951, the U.S. Court of Appeals for the Seventh Circuit said "yes" in a case involving an unlimited timeframe in which the withdrawal right could be exercised,[5] but in 1952 the U.S. Court of Appeals for the Second Circuit said "no" because it wasn't probable that the minor would need the funds.[6] However, in 1968, the U.S. Circuit Court of Appeals in *Crummey v. Comr.*,[7] allowed present interest annual exclusions for gifts to a trust for minors that were subject to the minor's right to demand withdrawal for a limited timeframe without any need to determine how likely it was that a particular minor beneficiary would actually need the gifted property. Since the time of the Ninth Circuit's decision, the "Crummey demand power" technique has become widely used to assure availability of annual exclusions while minimizing the donees' access to the gifted property.

Crummey-type demand powers may suddenly become more relevant in the context of gifted interests in closely-held entities. In 2003, the U.S. Court of Appeals for the Seventh Circuit, affirming the Tax Court, ruled that because there were substantial restrictions on transferred interests in a limited liability company (LLC) the donee did not have a present beneficial interest in the gifted property. Thus, the gifts of the LLC interests were taxable. Now, the Tax Court has applied the same principle to transfers of limited partnership interests, and a federal district court has again ruled similarly with respect to LLC interests. The Tax Court, however, did provide a list of the types of restrictions that made the gifts future interests. That could prove helpful for future planning in similar situations.

Hackl v. Comr.[8]

In *Hackl*, the taxpayer purchased two tree farms (consisting of about 10,000 acres) worth approximately $4.5 million. He contributed the farms along with another $8 million in cash and securities to Treeco, LLC ("Treeco"), and had an investment goal of long-term growth (the trees were largely unmerchantable timber).[9] The taxpayer and his wife initially owned all of Treeco's interests, with the taxpayer serving as Treeco's manager. Under the LLC operating agreement, the manager could serve for life (or until he resigned, was removed or became incapacitated) and could also dissolve the LLC. The operating agreement also specified that the manager controlled any financial distributions and members needed the manager's approval to withdraw from the company or sell their shares. As for cash distributions, the operating agreement specified that the taxpayer, as manager, "may direct that the Available Cash, if any, be distributed to the members pro rata in accordance with their respective percentage interests." No member could transfer their respective interest unless the taxpayer gave prior approval. If a member made an unauthorized transfer of shares, the transferee would only receive the economic rights associated with the shares – no membership or voting rights transferred. In addition, before dissolution, no member could withdraw their respective capital contribution, unless the taxpayer approved otherwise. It also took an 80 percent majority to amend Treeco's articles of organization and operating agreement and dissolve Treeco after the taxpayer ceased being the manager.

Upon Treeco's creation, the taxpayer and his wife began transferring voting and nonvoting shares of Treeco to their eight children, the spouses of their children and a trust established for their 25 minor grandchildren. Eventually, a majority of Treeco's voting shares were held by the children and their spouses. The taxpayer and his wife elected split-gift treatment,[10] and reported the transfers as present interest gifts covered by the annual exclusion ($10,000 per donee per year at the time).[11] However, the IRS disallowed all of the annual exclusions, taking the position that the transfers involved gifts of future interests. The taxpayer claimed that the gifts were present interests because all legal rights in the gifted property were given up (in other words, the donees received a complete set of legal rights in the gifted property), but IRS viewed the gifted interests as still being subject to substantial restrictions that did not provide the donees with a substantial present economic benefit. As a result, the IRS position was that the gifts were future interests ineligible for the exclusion.

The Tax Court agreed with the IRS that the transfers were gifts of future interests that were not eligible for annual exclusions. The Tax Court opined that the proper standard for determining present interest gift qualification was established in *Fondren*[12] where the key question was whether the transferee received an immediate "substantial present economic benefit" from the gift. To answer that question, Treeco's operating agreement became the focus of attention. On that point, the Tax Court noted that Treeco's operating agreement required the donees to get the taxpayer's permission before transferring their interests and gave the taxpayer the retained power to either make or not make cash distributions to the donees. In addition, the donees couldn't withdraw their capital accounts or redeem their interests without the taxpayer's approval, and none of them, acting alone, could dissolve Treeco.[13] Based on those restrictions, the Tax Court determined that the donees did not realize any present economic benefit from the gifted interests.[14] Thus, the gifts, while outright, were not gifts of present interests.[15] On appeal, the U.S. Court of Appeals for the Seventh Circuit agreed.[16]

***Price v. Comr*.**[17]

The taxpayer started a company in the mid-1970s, eventually building it to a point where it had 90 employees. The taxpayer's children were not interested in working in the business and when a group of the company's long-term employees made an offer to acquire the business, the taxpayer made plans to sell the business. Those plans included creating a limited partnership in which another corporation that the taxpayer controlled was the 1 percent general partner, and the taxpayer's revocable trust as well as his wife's revocable trust each held a 49.5 percent limited partnership interest. The partnership's assets consisted of the stock of the taxpayer's corporation and three tracts of commercial real estate that were under long-term leases to the taxpayer's company and another company. Eventually, the partnership sold the stock in the taxpayer's company and invested the proceeds in marketable securities. Over approximately a five-year period, the taxpayer and his wife gifted partnership interests to their children such that, at the end of the gift transactions, the children cumulatively owned 99 percent of the partnership interests. Over much of that same timeframe, the partnership made cash distributions to the children. The taxpayer treated the gifts as annual exclusion gifts, but the IRS, as they did in *Hackl*, took the position that the gifts were not present interests. Thus, the focus became the language of the partnership agreement.

The partnership agreement (which was governed by Nebraska law) barred any partner from withdrawing capital contributions, and restricted transfer and assignment of partnership interests. The partnership agreement also provided that if either a voluntary or involuntary assignment of a partnership interest occurred, the remaining partners had the option to buy the partnership interest from the assignee at fair market value. As for dissolution, the partnership agreement specified that the partnership would terminate after 25 years, but could be dissolved sooner upon written consent or vote of holders of at least two-thirds of the partners. Partnership profits were shared by the partners in accordance with partnership interests, but profits were distributed to partners at the general partner's discretion.

While the Tax Court noted that the Code does not define "future interest," the court noted that a Treasury Regulation takes the position that when a trustee has the discretion to withhold payments of income to addition to trust corpus, the beneficiary's right to receive the income payments is not a present interest.[18] The court also applied the reasoning of *Hackl*, and refused to reconsider its rationale utilized in that case. The court noted that, under the partnership agreement, there were numerous economic restrictions on the gifted limited partnership interests. The court noted that the donees had no unilateral right to withdraw their capital accounts, and could not sell, assign, or transfer their partnership interests to third parties or encumber or dispose of the interests without the written consent of all of the partners. In addition, the court noted that the donees merely received an assignee interest (rather than a full limited partnership interest), and that the partnership's income did not flow steadily to the partners (in some years, no distributions were made). Likewise, partnership profits were distributable only at the general partner's discretion as was any distribution of profits to assist partners in paying their taxes. As such, the case was factually identical to *Hackl* and the donees lacked the ability "presently to access any substantial economic or financial benefit that might be represented by the ownership units."

Fisher v. United States[19]

In 2000, 2001 and 2002, the taxpayers transferred 4.762 percent membership interests in an LLC to each of their seven children (one-third total interest in the LLC). The LLC's primary asset was undeveloped land bordering Lake Michigan. The taxpayers claimed present interest annual exclusions for the gifts, but on audit, IRS disagreed on the basis that the gifts were future interests and assessed over a $650,000 gift tax deficiency. The taxpayers paid the deficiency, filed for a refund. Upon the refund being denied, the taxpayers filed suit in federal district court.

The court noted that the LLC's operating agreement specified that any potential of the LLC's capital proceeds to the taxpayers' children was subject to numerous contingencies that were completely within the LLC general manager's discretion. So, consistent with *Hackl*, the court determined that the right of the children to receive distributions of the LLC's capital proceeds did not involve a right to a "substantial present economic benefit." As for the taxpayers' argument that the children had the unrestricted right to possess, use and enjoy the LLC's primary asset, the court noted that there was nothing in the LLC's operating agreement that indicated such rights were transferred to the children when they became owners of the LLC interests. Finally, the court rejected the taxpayers' argument that the children could unilaterally transfer their LLC interests. The court noted that such transfers could only be made if certain conditions were satisfied – including the LLC's right of first refusal which was designed to keep the LLC interests within the family. Even if such a transfer stayed within the family, the LLC operating agreement still subjected the transfer to substantial restrictions.

So, the court upheld the IRS' determination that the gifts were not present interest gifts, just as similarly structured transfers in *Hackl* and *Price* didn't qualify as present interest gifts.

Estate of Turner, et al. v. Comr.[20]

Creation of the FLP. In this case, the decedent was the President of a lumber company. He had invested heavily in a bank and the stock appreciated highly in value. He created an FLP and transferred assets to the FLP. However, the court determined that the transfer did not constitute a bona fide sale, but rather was done primarily for tax reasons and that there was no legitimate non-tax reason for the transfers. While one of the purported reasons for formation of the FLP, consolidation of asset management, can be a legitimate non-tax reason, the funding primarily with bank stock (60 percent), fixed income investment accounts, cash and CDs, was a passive investment that didn't change the taxpayer's portfolio or investing strategy in any meaningful manner. Likewise, the argument that the FLP was formed to resolve discord within the transferor's family was refuted by the fact that there wasn't any family discord until the FLP was created. In addition, the decedent retained over $2 million worth of assets personally.

As a result, the transfers to the FLP were included in the decedent's gross estate under I.R.C. §2036(a). The court determined that the decedent retained possession and enjoyment of the transferred assets via an implied agreement. There was also a commingling of personal and partnership assets present.

> **Note:** The court seemed to place special emphasis on the fact that the FLP was created with boilerplate FLP language that wasn't carefully tailored to the client's set of facts.

***Crummey* gifts.** While the FLP was not structured properly to keep the FLP assets out of the decedent's gross estate, the court did hold that the decedent's payment of premiums on life insurance policies for the benefit of his children and grandchildren via *Crummey*-style trusts were gifts of present interests that were eligible for annual exclusions. That was the result, the court ruled, even though the payments were paid directly to the insurance company instead of the decedent transferring the premium payments to the trust and the trust remitting the proceeds to the insurance company with the trustee providing notice to the beneficiaries of their withdrawal rights simultaneous with the contributions of the premium amounts to the trust. To have present interest gift treatment, the court noted that the key question is whether the beneficiary had the "legal right to demand" withdrawal. Under the terms of the trust, the beneficiaries had the absolute right and power to demand withdrawals after each direct or indirect transfer to the trust. Thus, indirect funding was irrelevant to the demand right. In addition, the lack of notice did not affect the "legal right to demand" withdrawals.[21] Thus, the decedent's estate could exclude the *Crummey*-style gifts.

Marital deduction issues. On reconsideration, the estate claimed that under the decedent's will, the assets that were pulled back into the estate via I.R.C. §2036(a) passed to the surviving spouse. Because the surviving spouse had the right to a pecuniary marital bequest, the surviving spouse could receive an amount of assets equal to the amount necessary to reduce the estate tax to zero and, as a result, there was no estate tax deficiency. The court held that the marital deduction was not available for an FLP interest or FLP assets gifted during the decedent's lifetime. The court noted that Treas. Reg. §20-2056(c)-2(a) specifies that a property interest passes to surviving spouse only if it passes to the spouse as beneficial owner. However, under the facts of the case, the decedent's assets were first transferred to an FLP and then the decedent gifted the FLP interests to persons other than the surviving spouse. Consequently, property passing to a person other than the surviving spouse cannot also be considered as passing to surviving spouse for purposes of marital deduction. The end result was that the value of the transferred assets was included in the decedent's estate for tax purposes. However, they are owned by the FLP or non-spousal partners and would not be includible in the surviving spouse's estate.

Estate of Wimmer v. Comr.[22]

In this case, the decedent and his wife established an FLP to invest in land and stocks. The FLP agreement stated that "partnership profits are allocated to the partners according to their proportional partnership interests. All distributions of net cash flow are also shared among the partners in proportion to their partnership interests. Distributions must be made in cash pro rata. The partnership agreement, as amended, provides that the primary source for distributions is distributable cash derived from partnership income." The decedent also established a trust for his grandchildren. The trust was a limited partner of the FLP and was set-up as a *Crummey* Trust. The trust, as a limited partner, received dividends. The decedent and his wife were limited partners and they made gifts of partial limited partner interests on an annual basis consistent with the present interest gift tax exclusion. The gifts of the limited partner interests were significantly restricted, however. For example, the transfer of limited partner interests required prior written consent of the general partners and 70 percent of the limited partners. If a transfer was approved, the transferee would not become a substitute limited partner unless the transferring limited partner gave the transferee such right and the transferee (1) accepted and assumed the terms and provisions of the partnership agreement; (2) provided (for an assignee that is trustee) a complete copy of the trust instrument authorizing trustee to act as partner in partnership; (3) executed whatever other documents the general partners might require, and (4) is accepted as a substitute limited partner by unanimous written consent of both the general partners and the limited partners. Each limited partner received net cash distributions annually that were consistent with their ownership interest.

The IRS claimed that the gifts of limited partner interests were not present interests and, as such, were not excluded from the decedent's gross estate. The court concluded that while the donees of limited partner interests did not receive an unrestricted right to the interests, they did receive the right to the income attributable to those interests. The court also noted that the estate had the burden of establishing that the FLP would generate income and that some portion of that income would flow to the donees on a consistent basis and that the portion could be ascertained. Importantly, the FLP held dividend-producing, publicly traded stock. Thus, the court determined that the income from the stock flowed steadily and was ascertainable. Accordingly, the limited partners received present interests and the gifted amounts were excluded from decedent's estate.[23]

Planning Implications

In *Hackl, Price and Fisher,* there was no question that the donees had the immediate possession of the gifted interests. Perhaps an argument could be made that the Tax Court simply ignored state property law regarding when ownership rights in entities vest. However, even if such interests have vested, the Tax Court (and the appellate court in *Hackl*) listed numerous factors that led to the conclusion that the gifted interests were not present interests – the donees did not have the current "use, possession or enjoyment" of the gifted interests within the meaning of I.R.C. §2503(b). Unfortunately, from an estate and business planning perspective, those same factors are typically drafted into operating agreements with the express purpose of generating valuation discounts for estate and gift tax purposes.

So, based on *Hackl*, *Price and Fisher*, it appears that practitioners will have to counsel clients as to the apparent trade-off between annual exclusion gifts and valuation discounts – at least if the federal estate tax is restored. But, *Wimmer* may provide a way around the corner on that problem if the FLP generates income and it can be established that at least some of that income will consistently flow to the donees in ascertainable amounts.

Beyond the approach sanctioned by *Wimmer*, there may be other ways to achieve both present interest status for gifts and valuation discounts for transfer tax purposes? Clearly, the Tax Court (and the Seventh Circuit in *Hackl* which, by the way, would be the appellate court in *Fisher*) is concerned that gifted entity interests give a donee the right to withdraw from the entity, have less restrictions on sale or transfer and that the entity make regular distributions. But, drafting an operating agreement within those guidelines could impact valuation discounts. Perhaps a way to address that problem would be to specify in the entity's operating agreement that transferred interests are subject to put rights allowing the transferee the ability to force the entity or another transferee to repurchase the transferee's interests at a particular price, after a specified date or upon the occurrence of a specified event. The operating agreement could also specify that withdrawal rights are to be at "fair market value," with fair market value defined in a manner that essentially ignores the put right. That would seemingly be within the *Crummey* construct – the donee could realize immediate value via withdrawal.[24] Similarly, another *Crummey*-like technique may involve giving transferees the temporary right to withdraw capital and/or rights of first refusal on transfers. These techniques would seem to fall short of the outright prohibitions that were problematic in *Hackl* and *Price*, and could be utilized with respect to carefully selected transferees with the understanding that the transferees would not actually exercise such rights.[25]

In any event, a combined strategy of present interest gifting of entity interests with valuation discounting requires careful drafting. Careful drafting is also critical to preserve the integrity of the FLP to keep the FLP assets out of the transferor's estates. *Turner* establishes that boiler-plate language should be avoided in the FLP context and practitioners should take the time to learn their client's facts and tailor FLP language to fit those facts.

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[1] See I.R.C. §2503.

[2] Spouses can elect split gift treatment regardless of which spouse actually owns the gifted property. With such an election, the spouses are treated as owning the property equally, thereby allowing gifts of up to $26,000 per donee. Also, under I.R.C. §25039(e), an unlimited exclusion is allowed for direct payment of certain educational and medical expenses. In effect, such transfers are not deemed to be gifts.

[3] 324 U.S. 18 (1945).
[4] 325 U.S. 442 (1945).
[5] Kieckhefer v. Comr., 189 F.2d 118 (7th Cir. 1951)(withdrawal right was not subject to any time limit for exercising the right and was tantamount to outright ownership).
[6] Stifel v. Comr., 197 F.2d 107 (2d Cir. 1952)(minor's access to gifted property to be evaluated in accordance with how likely it was that the minor would need the funds and whether a guardian had been appointed).
[7] 397 F.2d 82 (9th Cir. 1968).
[8] 335 F.3d 664 (7th Cir. 2003), *aff'g*, 118 T.C. 279 (2002).
[9] As part of his overall estate and business plan, the taxpayer created a separate entity to conduct the actual tree farming activities.
[10] See I.R.C. §2513.
[11] In 1995, the taxpayer and his wife attempted to use16 annual exclusions for the gifted interests. In 1996, they attempted to use 41 annual exclusions.
[12] 324 U.S. 18 (1945).
[13] The Tax Court did note, however, that Treeco's voting members could amend the operating agreement by an 80 percent vote and could, along with the non-voting members, access Treeco's books and records and could jointly decide whether Treeco would be continued after a dissolution. However, pursuant to the operating agreement, if the donor was no longer Treeco's manager, voting members had the right to dissolve the entity by an 80 percent vote.
[14] More specifically, the Tax Court found that restrictive nature of Treeco's operating agreement "foreclosed the ability of the donees presently to access any substantial economic or financial benefit that might be represented by the units."
[15] The Tax Court also noted that the applicable Treasury Regulations that a gift is a present interest only if it involves an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from the property…". Treas. Reg. §25.2503-3.
[16] *Hackl v. Comr.*, 335 F.3d 664 (7th Cir. 2003).
[17] T.C. Memo. 2010-2.
[18] Treas. Reg. §25.2503-3(c), Ex. 1. The Tax Court also cited the U.S. Supreme Court's opinion in *Fondren* for the proposition that the donee having vested rights is insufficient to create a present interest. 324 U.S. 18 at 20-21 (1945).
[19] No. 1:08-cv-00908 (S.D. Ind. Mar. 11, 2010)
[20] T.C. Memo., 138 T.C. No. 14 (2012), on reconsideration from, T.C. Memo. 2011-209.
[21] The IRS has not conceded the issue, and it remains important to properly contribute premium amounts to the trust and that notice of withdrawal right be given to the beneficiaries.
[22] T.C. Memo. 2012-157
[23] An FLP that makes distributions on at least an annual basis should allow the use of present interest gifting.
[24] While making the transferred interests subject to put rights will reduce the amount of any lack of marketability discount, that amount of the discount reduction will be impacted by the entity's ability to meet its obligations with respect to the put rights, and the extent to which the rights are enforceable.
[25] Thus, the planning technique utilized in *Crummey v. Comr., 397 F.2d 82 (9th Cir. 1968)* may be useful in addressing the Tax Court's concerns expressed in *Hackl* and *Price*. In *Crummey*, the annual exclusion was determined to be available property gifted to donees in trust where the gifts were subject to withdrawal rights that could be exercised within a specified period of time. The court held that it was immaterial that beneficiaries did not actually exercise their withdrawal rights. The court stated that it was the donees' right to enjoy the gifted property that made the gifts present interests eligible for the annual exclusion, not whether the donees actually had the present enjoyment of the gifted property.