Recent Decision Further Clouds the Muddy Waters of Annual Exclusion Giving

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Present law allows a donor who desires to make a gift the ability to transfer up to $13,000 per donee, per calendar year, free of the gift tax and without the requirement of filing a gift tax return. See IRC § 2503(b). In order to qualify for this annual exclusion, however, the gift must be of a "present interest" in property. Obviously an outright gift of cash would qualify for the exclusion, but many times a donor desires to transfer illiquid assets, or desires to place some restrictions on the use of the property transferred due to the age or maturity level of the donee. In these cases, the availability of the annual exclusion becomes less clear.

The initial annual exclusion battleground between taxpayers and IRS was set when taxpayers asserted that gifts in trust could qualify for the annual exclusion. Despite vigorous opposition by IRS, the courts generally approved such gifts in trust for the exclusion when donees were given an immediate (but temporary) right to withdraw in full the gift which was made in trust. See Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).

More recently, however, IRS has argued that gifts of interests in an entity, such as limited liability companies or limited partnerships, do not qualify for the annual exclusion. In *Hackl v. Comm'r*, 118 T.C. 279 (2002), the United States Tax Court agreed with IRS and held that transfers of interests in an LLC which operated a tree farm did not qualify for the annual exclusion.[1] The Tax Court found that the donee recipients of the interests did not enjoy a "substantial present economic benefit" from the interests because they had no right to withdraw their capital accounts without the approval of the manager of the LLC, and because they further had no right to sell their interests without the approval of the manager. Thus, the court concluded that the donees did not have a present interest in the property received.

It is important to note that the court's decision in *Hackl* did not completely foreclose the possibility that gifts of interests in an LLC could qualify for the annual exclusion. Rather, the court held that gifts of LLC interests would not qualify for the annual exclusion if the provisions of the operating agreement governing a member's ability to alienate or liquidate his or her interest were too restrictive.

The recent decision of the U.S. District Court for the Southern District of Indiana in *Fisher v. U.S.*, 105 AFTR 2010-1347, expands the decision of *Hackl* and creates uncertainty in the area of annual exclusion giving. The facts of *Fisher* are similar to *Hackl* in that a donor transferred real estate to an LLC and then made gifts of interests in the LLC to his children, intending that the gifts qualify for the annual exclusion. Like the court in *Hackl*, the court in *Fisher* sided with IRS in finding that the gifts were not gifts of a present interest. Several reasons were recited, all of which related to the perceived overrestrictiveness of the operating agreement of the LLC.

First, the court found that the operating agreement allowed the donees to withdraw their capital accounts only with the approval of the manager of the LLC (which approval could be withheld in the manager's sole discretion). This holding was similar to the *Hackl* court's holding.

Second, the court dismissed Fisher's arguments that the right to enjoy the real estate (it consisted of beachfront property) meant that the donees had a present interest in the transferred interests. The court found that the test for present interest was that a "substantial present economic benefit" be conferred on the donees.

Non-pecuniary benefits attendant to the ownership of an LLC interest were thus regarded as irrelevant in determining whether the exclusion under IRC § 2503 applied.

Finally, and perhaps most importantly, the court held that the donees had an insufficient ability to alienate their interests in the LLC. The operating agreement in *Fisher*, unlike in *Hackl*, provided that a member could transfer his or her interest to a third party and management approval was not required. However, the LLC would have a right of first refusal to purchase the interest for the price offered by the intended third party purchaser. The purchase price could be paid by means of a promissory note payable over a period of 15 years. Also, the right of first refusal would be waived if the interest was sold to a family member. The court found that this right of first refusal made it "impossible for the Fisher Children to presently realize a substantial economic benefit" from the gifts of LLC interests they received. The court therefore found that the gifts of LLC interests did not qualify for the annual exclusion.

The *Fisher* decision creates uncertainty in many current tax planning methods because most operating agreements for family-owned LLCs include a right of first refusal. The reason the right exists is to keep ownership of the LLC within the family to the extent possible, a goal which is beneficial to the family members of the LLC for obvious reasons. Unfortunately, the *Fisher* court did not explain in any particular detail why the right of first refusal at issue was considered excessive. Perhaps the payment terms (i.e., the 15 year deferred payment by promissory note) were considered to be too lengthy to equate with a "present interest." Or perhaps any right of first refusal at all would be considered too restrictive by the court in the context of family entities, and planners will need to incorporate a right of withdrawal similar to the right approved in the *Crummey* case into operating agreements going forward.

In any case, the decision in *Fisher* is the opinion only of a federal district court and thus is not binding in other circuits, although it may be utilized as persuasive authority in future challenges by IRS. It remains to be seen how the case law will develop in this area of tax planning.

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1. This decision was affirmed by the Seventh Circuit. *Hackl v. Comm'r*, 335 F.3d 664 (7th Cir. 2003).