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Issue Contents

Bankruptcy

General

Exemptions

Residence **107**

Preferential transfers **107**

Federal Agricultural Programs

Disaster assistance payments **107**

Tuberculosis **107**

Wetlands **107**

Federal Estate and Gift Tax

Accidental death benefits **108**

Marital deduction **108**

Federal Income Taxation

Appeals **108**

Charitable deduction **108**

Corporations

Golden parachute payments **108**

Shareholder loans **108**

Court awards and settlements **108**

Disaster payments **109**

Discharge of indebtedness **109**

Education expenses **109**

Interest rate **109**

Partnerships

Administrative adjustments **109**

Pension plans **109**

Returns **109**

S corporations

Merger **109**

Sale of residence **110**

Tax on social security benefits **110**

Secured Transactions

Federal farm products rule **110**

Perfection **110**

In the News 111

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GIFTS OF FUTURE INTERESTS

— by Neil E. Harl* and Roger A. McEowen**

For many years, the problem of a gift of assets or interests in businesses being deemed to be a gift of a future interest has haunted estate planners.¹ Gifts considered to be future interests are not eligible for the federal gift tax annual exclusion² and, therefore, reduce the applicable credit amount³ (\$1,000,000 in 2002).⁴ A late March, 2002, Tax Court case has focused attention once again on the risks of gifts of business interests being held to be gifts of future interests.⁵

Facts in *Hackl v. Commissioner*

In *Hackl v. Commissioner*,⁶ a full, reviewed opinion of the Tax Court, the taxpayers gave their children and grandchildren membership units in a limited liability company formed by the taxpayers to hold and operate tree farming properties. Tracts of land which had been purchased by the taxpayer and conveyed to the LLC had little or no existing stands of timber. The timber management plan pursued by the taxpayers assured that income from the venture would commence several years in the future.

The LLC arrangement contained several provisions that led the Tax Court to hold that the transfers were gifts of future interests—(1) the LLC operating agreement prohibited the donees from selling their ownership interests without the donor's approval; (2) the LLC operating agreement gave the donor, as the LLC's manager, discretion to make or not make cash distributions to the owners;⁷ (3) the LLC operating agreement prevented the donees as LLC owners from withdrawing their capital accounts or redeeming their interests without the donor's approval; and (4) the LLC operating agreement specified that no single owner could dissolve the LLC.⁸ Under the LLC operating agreement, the members of the LLC had several rights—(1) the voting members had the right to remove the manager and elect a successor by majority vote; (2) voting members had the right to amend the operating agreement by an 80 percent vote; (3) voting and non-voting members had the right to access the books and records of the LLC; (4) voting and non-voting members had the right jointly to decide whether the LLC would be continued following dissolution; and (5) if the donor was no longer manager of the LLC, voting members could dissolve the LLC by an 80 percent vote.⁹ The Tax Court said the taxpayer had to show: (1) that the LLC would receive income; (2) that an "unascertainable portion" of the income would flow to the holders of the LLC ownership units; and (3) that a value can be

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placed on the income flowing to the holders.¹⁰

The Tax Court held that, because the gifts failed to confer a substantial present economic benefit on the donees, the gifts failed to qualify for the federal gift tax annual exclusion.¹¹ The court specifically rejected the taxpayer's argument that when a gift takes the form of an outright transfer of an equity interest in property or a business entity, no further analysis is needed or justified. Rather, the court noted that the federal gift tax regulations specify that a present interest requires an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property...."¹² The court recognized that cases involving both transfers in trust¹³ and transfers made to a business entity¹⁴ have established the proposition that where the use, possession or enjoyment is postponed to some contingent or uncertain future event, or when there is no assurance of a steady flow of funds from the trust or business entity, the gift fails to qualify for the federal gift tax annual exclusion.¹⁵ The court further noted that the taxpayer bears the burden of showing that a gift "is other than of a future interest."¹⁶

Implications of the decision

The decision in *Hackl v. Commissioner*¹⁷ clearly poses a threat to many gifts of interest in business entities whether organized as a general or limited partnership, LLC, LLP or corporation. Although an appeal of *Hackl* apparently is planned,¹⁸ business and estate planners are left with a substantial amount of uncertainty on what will assure the outcome of a present interest for gifts of entity interests. Of course, in smaller estates, where loss of the applicable credit amount¹⁹ from a gift of a future interest would not pose a serious problem for the taxpayer, the outcome in *Hackl v. Commissioner*²⁰ may not lead to an unacceptable result.

Where inability to qualify for the federal gift tax annual exclusion is unacceptable, the focus turns to a limited number of ways to relax the limitations on owner rights in the entity. Those possibilities include—(1) a provision for mandatory distribution of earnings from the entity; (2) allowing unit owners to sell their interests without restriction (a right of first refusal granted to the entity may be acceptable); (3) an assured right on the part of donees to sell their ownership interest back to the entity or to have the interest redeemed for a stated period after the gift; or (4) the right to sell ownership interests for a limited time to anyone. The last two are similar to the widely-used right under the so-called "Crummey" powers²¹

It is the practice of many practitioners, for value discount purposes, to permit an assignment of an LLC (or family limited partnership) interest, but not allow the assignee to obtain full membership without the consent of the managing member (or general partner). If the court is saying that an assignee must have the right to be admitted as a member or partner for the interest to qualify as a present interest, that could pose a drafting problem.²²

In conclusion

The Tax Court decision²³ suggests strongly that planners would be well advised to review all files involving active gifting programs of ownership interests as well as to review with clients creating entities the alternatives for assuring a present-interest outcome where that is desirable.

FOOTNOTES

- 1 See generally 6 Harl, *Agricultural Law* § 46.04[1][a] (2002); Harl, *Agricultural Law Manual* § 6.01[2][b] (2002). See also Harl, "How Not to Make Gifts," 11 *Agric. L. Dig.* 145 (2000).
- 2 I.R.C. § 2503(b).
- 3 I.R.C. § 2010(c).
- 4 *Id.*
- 5 *Hackl v. Comm'r*, 118 T.C. No. 14 (2002).
- 6 118 T.C. No. 14 (2002).
- 7 See Ltr. Rul. 9751003, August 28, 1997 (gifts of limited partnership interests were gifts of future interests where general partner could retain funds for any reason).
- 8 *Hackl v. Comm'r*, 118 T.C. No. 14 (2002).
- 9 *Id.*
- 10 *Id.*
- 11 *Id.*
- 12 Treas. Reg. § 25.2503-3.
- 13 *Comm'r v. Disston*, 325 U.S. 442 (1945); *Fondren v. Comm'r*, 324 U.S. 18 (1945); *Ryerson v. United States*, 312 U.S. 405 (1941); *United States v. Pelzer*, 312 U.S. 399 (1941).
- 14 See, e.g., *Estate of Stinson v. United States*, 214 F.3d 846 (7th Cir. 2000) (see note 1 *supra*); *Chanin v. United States*, 393 F.2d 972 (Cl. Ct. 1968).
- 15 *Hackl v. Comm'r*, 118 T.C. No. 14 (2002).
- 16 *Id.*
- 17 *Id.*
- 18 *Lawyers Weekly USA*, April 15, 2002, p. 22.
- 19 I.R.C. § 2010(c).
- 20 118 T.C. No. 14 (2002).
- 21 *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968); *Cristofani v. Comm'r*, 97 T.C. 74 (1991), acq. in result only, 1992-1 C.B. 1. See Rev. Rul. 75-415, 1975-2 C.B. 374; Ltr. Rul. 200123034, March 8, 2001 (transfers to irrevocable trusts were present interests (Crummey power)).
- 22 See Iowa Code §§ 490A.902 (2001) (except as provided in the articles of organization or an operating agreement; assignment of interest does not entitle assignee to participate in management and offices of LLC).
- 23 *Hackl v. Comm'r*, 118 T.C. No. 14 (2002).

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