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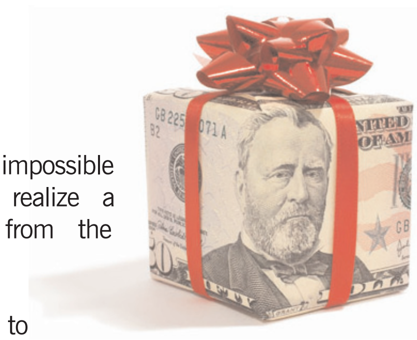
Annual Gift Tax Exclusions

The IRS is Making Things More Difficult



It is not as easy as it once was to make a tax-free gift of an interest in an LLC to family members through use of the gift tax annual exclusion. The IRS is disallowing the annual exclusion (currently $13,000 per donee) on gifts of interests in LLCs, considering them gifts of *future* interests, rather than gifts of *present* interests, which qualify for the gift tax annual exclusion.

Two recent cases, the Tax Court and the Seventh Circuit Court under *Hackl v. Com*. and a district court under *Fisher v. U.S.*, have agreed with the reasoning of the IRS.

In order to recognize it as a gift of a *present* interest, the Code requires a substantial present economic benefit by reason of:

- use,
- possession, or
- enjoyment of the property itself or income from the property.

This applies regardless of whether a gift is direct (to a person) or indirect (to a trust).

Gifts of limited partnership interests in a family limited partnership are being considered as gifts of a *future* interest that do not qualify for the annual exclusion, where the partnership agreement effectively bars transfers to third parties, and profits (distributable at the general partner's discretion) are not always distributed every year.

The IRS will disallow the annual exclusion if the donees are unable to transfer the units freely or compel distributions from the entity. Even if the LLC or family limited partnership is a legitimate operating business entity and the restrictive provisions contained in the agreement are common in closely held enterprises, the criteria for a present interest remain the same. There is no excuse for failure to meet those criteria, according to the Tax Court.

When the LLC operating agreement imposes conditions restricting the donees' rights to transfer their LLC interests (including a right of first refusal given to the LLC in the case of transfers other than to family members), the IRS and the Courts have reasoned that it makes it impossible for the donees to presently realize a substantial economic benefit from the transfer of the interests to them.

Additionally, transfers subject to the contingency of manager approval cannot support a present interest characterization. An ability on the part of the donee to withdraw his or her capital account unilaterally might weigh in favor of finding a present interest, but there is no guarantee.

Gift Tax Exclusion

Gifts of limited partnership or LLC interests may be eligible for the gift tax annual exclusion when the general partners authorize, in determining partnership distributions, to withhold only amounts that they deem appropriate for the proper operation of partnership business or its liquidation.

Regular distributions from the partnership or LLC also could help sustain the viability of the gift tax annual exclusion. Regular distributions would demonstrate that there is a present enjoyment from the entity and could argue in support of the annual exclusion.

With the IRS more closely examining transfers of interests in LLCs and family limited partnerships, particularly when those transfers are to family members, it is important to look closely at the operating agreement to determine whether or not the donees have a present economic interest in the entity that would make the transfers eligible for the annual exclusion on the gift tax return. The donor should also weigh the advantage of valuation discounts, which can be maximized with stricter controls against the possible loss of the annual exclusion. It may be that the advantages of discounting outweigh the possibility of the loss of the annual gift tax exclusion. h

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