By Thomas E. Dew

Sharing the Family's Wealth

A family LLC is still an attractive way to make annual exclusion gifts

Your clients, a married couple who have accumulated significant wealth through shrewd real estate investments, wish to give their children portions of their real estate portfolio. Their financial planner told them that giving part of their real estate holdings to their children would remove from their estates future growth in the value of the gifted property and may qualify for the annual gift tax exclusion. However, the clients do not want to split the title to their properties by making the children tenants in common with them.

Many attorneys would recommend a "family limited liability company" (a "family LLC") to these clients. This recommendation usually involves the parents first creating a limited liability company, with themselves as the initial members. The family LLC would typically be funded with the clients' real estate holdings, along with sufficient liquid assets to meet the initial working capital needs of the LLC.

Usually, the LLC's operating agreement would name the parents as its managers, and as such they would control all of its business activity. The operating agreement would provide that no distributions of cash could be made to any member without approval of the managers, and no member could withdraw any portion of his or her capital account without the managers' approval. Further, members would be prohibited from selling or transferring their membership interests without the managers' approval. Finally, the operating agreement would also provide that death, voluntary resignation, or the affirmative vote of a supermajority of the total membership interests would be the only grounds for removal of the managers.

Once the family LLC has been organized and funded, the parents would proceed to make annual exclusion gifts to their children by assigning membership interests to each of them. The value of the gifted membership interests would probably be determined using fairly aggressive discounts for lack of liquidity and minority interest. If the gifts qualify for the annual gift tax exclusion (currently $11,000 per year per donee, or $22,000 per donee for gifts split with a spouse), the first $11,000 (or $22,000) of gift value each year would be gift tax-free and would not use up the donor's lifetime gift exemption.

Before March 27, 2002, estate planners could have implemented this type of gift program with confidence—the Internal Revenue Service rarely questioned whether or not gifts of minority interests in family LLCs were gifts of a present interest (qualifying for the gift tax annual exclusion) rather than gifts of future interests (which do not qualify for the annual exclusion). The March 27, 2002 date is significant, because on that date the United States Tax Court published its opinion in *Hackl v Commissioner of Internal Revenue,* 118 T.C. 14; 2002 U.S. Tax Ct. LEXIS 16.

The following is a brief summary of the facts in *Hackl:* Albert and Christine Hackl were extremely wealthy residents of Indiana. In 1995, to diversify their investments, the Hackls purchased two tree farms. They formed a limited liability company to own and operate the tree farms to insulate their other assets from liability related to the tree farming operations, create a separate business in which their family could participate, and facilitate transfer of interests in the tree farming business to their eight children and twenty-five grandchildren.

The operating agreement for the LLC provided that (1) management of the LLC was exclusively vested in a manager (who coincidentally was Albert Hackl), who would serve until resignation, removal, or incapacity, and who had the authority to designate his own successor; (2) no cash distributions could be made without the manager's approval; (3) no member could withdraw his or her capital account; (4) members could not withdraw from the LLC without the manager's approval; and (5) members could not assign, transfer, or encumber their membership interest in the LLC without the manager's approval. The operating agreement also provided that the manager could only be removed by an 80 percent vote by the voting members.

Following organization of the LLC, the taxpayers made gifts of membership interest in 1995 and 1996 to their children and to the children's spouses. The taxpayers claimed present interest gift tax exclusions for each of these gifts. In addition, in 1996, the taxpayers created a qualified Section 2503(c) irrevocable trust for their grandchildren and gifted membership interests in the LLC to the trust. Again, the taxpayers treated the gifts as qualifying for the gift tax annual exclusion for gifts of present interests. The IRS assessed gift tax liability against each taxpayer for their 1996 gifts, claiming that none of the 1996 gifts qualified for annual exclusions.

In analyzing the case, the tax court first looked to the analysis of present interests versus future interests for gift tax purposes used by the Supreme Court in *Fondren v Commissioner,* 324 U.S. 18 (1945) and *Commissioner*

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v Disston, 325 U.S. 442 (1945). In quoting from the *Fondren* decision, the court stated:

> *[T]he [United States Supreme] Court explains the meaning of **future** versus **present** interest in general terms, stating:*
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> *It is not enough to bring the exclusion into force that the donee has vested rights. In addition he must have the right presently to use, possess or enjoy the property. These terms are not words of art, like "fee" in the law of seizen***, but connote the right to substantial present economic benefit. The question is of time, not when title vests, but when enjoyment begins. Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him and that enjoyment makes the gift one of a future interest within the meaning of the regulation.* Hackl, *118 T.C. at 25, citing* Fondren, *supra at 20–21.* [Emphasis added.]

The tax court reviewed the LLC operating agreement and concluded that the agreement, by its terms, precluded the donee/member from having access to any substantial economic or financial benefit that might have been represented by the LLC interests. The gifts of the LLC interests did not therefore give the donees any present right to use, possession, or enjoyment of the interests or the income from the interests.

In holding that the gifts of LLC membership interests failed to qualify for gift tax annual exclusions, the tax court stated that, while the donees did receive possession of the LLC interests, "the simple expedient of paper title does not in and of itself create a present interest for purposes of Section 2503(b) unless all the facts and circumstances establish that such possession renders an economic benefit presently reachable by the donees." (*Hackl,* 118 T.C. at 31).

Alternative Planning Possibilities

The point to be taken from the *Hackl* decision is that a "typical" family LLC, where all control of the enterprise is vested in the older generation who gift interests to the younger generations, may no longer be a viable method of using annual exclusion gifts to reduce the taxable estates of the older generation members.

However, there are several alternative methods that might still render such a gift program viable:

- If the LLC operating agreement requires current income distributions to its members, or allows members to sell or transfer their membership interests, this would likely allow a gift of a membership interest to qualify as a present interest gift (but probably at the cost of a smaller valuation discount for minority interest or lack of liquidity in valuing the gifted interest).
- If the donee member had the right to "put" the gifted interest for redemption by the LLC, then the gift would probably qualify for the annual exclusion. Obviously, the LLC would have to be able to fund possible redemptions, in order to make the "put" not illusory. Again, the existence of a "put" would likely reduce the size of a valuation discount.
- Finally, the donor could create irrevocable trusts for the benefit of the prospective donees, with the trusts structured to be intentionally defective grantor trusts. The donor would fund the trusts with cash gifts equal to the discounted value of the interests in the LLC. So long as Crummey notices were properly given to the beneficiaries, the cash transfers to the trusts will qualify as present interest gifts. The trustee would then use the cash to purchase LLC interests from the grantor, at the discounted value. Since the trusts are designed as grantor trusts, the donors would not recognize any gain on the sale of the interests. The end result is that the interests would be removed from the donor's estate, and the donor could still exercise full control over the LLC. In addition, the interests could still be transferred at their discounted value.

While the *Hackl* decision has complicated the use of the family LLC to shift value in a tax efficient manner, a little creativity will enable the family LLC to remain a viable and attractive estate planning device for annual exclusion gifts. ✦

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