FAMILY LIMITED PARTNERSHIP UPDATE

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Section 2503 – Taxable Gifts

A. **No annual exclusions for gifts of FLP interests.** So held in *Price v. Commissioner*, T.C. Memo. 2012-2, in which the court ruled that gifts of LP interests to three children over a three-year period did not constitute present interest gifts. Aside from the annual exclusion issue, the government did not contest the gift tax valuation of the LP interests even though "substantial discounts" were involved.

1. Wait a minute! Two donors, three donees, three years and $10,000 annual exclusions – this means that only $90,000 of taxable gifts by each donor were in issue. One senses that the Service was not just telling the Price family but also other donors of LP interest: Don't just assume that you're entitled to an annual exclusion; the donee must be given a present interest.

2. The interests were not present interests because the donees had no ability to withdraw their capital amounts, and partners could not sell their investments without the consent of all other partners. Moreover, the donees had no present right to income because distributions of profits were in the general partner's discretion and the partnership agreement stated that distributions were secondary to the purpose of generating a long-term rate of return.

B. **Same result in another recent case – no annual exclusion for gifts of LLC interests.** Commentators have suggested that a present interest is created (an annual exclusions are secured) if the donee is given the right to sell his interest subject to a right of first refusal by other partners – or, in the case of a limited liability company, by the LLC or it's members. *Fisher v. United States*, 105 AFTR 2nd 2010-1347 (S.D. Ind. 2010), held otherwise – but the terms of the right of first refusal were unusually restrictive. The principal asset of the Fisher LLC was undeveloped beach property. The donors had given membership interests in the LLC to their seven children over three years, for a total of 42 annual exclusions – or so they thought.

1. **No unrestricted right to receive distribution.** The donors argued that the donees had the unrestricted right to receive distributions. Not true, said the court, because distributions were subject to a number of contingencies, all of which were in the discretion of the general manager.

2. **No unrestricted right to receive property.** The donors argued, next, that the children possessed the unrestricted right to use the beachfront

property. The court responded by pointing out that the Operating Agreement did not convey such a right to the members.

3. **The right of first refusal wasn't worth very much.** While the children could sell their interests under certain conditions, the LLC had a right of first refusal over such a transfer. The kicker was that if the LLC exercised this right, it would pay with *non-negotiable* notes payable over a period not to exceed 15 years. As a result, said the court, any such transfer would not give the donees an interest of "immediate value."

C. How, then, to secure annual exclusions for gifts of FLP or LLC interests? Wile a more carefully crafted right of first refusal is one good approach, giving the beneficiary a Crummey withdrawal right also works well.

1. The Crummey withdrawal right should be drafted along the following lines:

   If at any time any additional contribution is made to the trust by the Grantor or any other person, each such designated beneficiary of the addition to the trust shall have the absolute right, at all times during the 30-day period commencing at the time of such additions, to withdraw from such addition….2148278508

XIII. Section 2512 – Valuation Gifts

"Defined value" clause upheld in gifts of LLC interests. In *Petter v. Commissioner,* T.C. Memo. 2009-280 (2010) (appealable to the Ninth Circuit), the Tax Court rejected the Service's public policy arguments against the use of defined value clauses in making gifts of hard-to-value interests. In cases involving hard-to-value assets, practitioners should give serious consideration to recommending the form of defined value clauses that this decision has approved.

The gift to each children's trust was "the number of units….that equals one-half of the maximum dollar amount that can pass free or federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c)." The gift to Seattle Foundation was the difference between (1) the total 940 units transferred and (ii) the units transferred to that child's trust under the formula gift.

1. The assignment document allocated the units by formula, with each trust receiving units worth $4,085,190 "as finally determined for federal gift tax purposes," and with any excess units passing to Foundations.

2. The formulas used to effect these transfers were not "void as contrary to public policy…and indeed no overarching public policy against these types of arrangements in the first place."

"I, Donor, a limited partner of XYZ, give to donee that percentage of my partnership interest in XYZ which is equal in value to the unused portion of my federal gift tax applicable exclusion amount."