W H E R E T H E R E' S A W I L L

Family Limited Partnerships: Hackl'd to death?

By Dan W. Holbrook

A recent Tax Court case, Hackl v. Commissioner, 118 T.C. No 14, March 27, 2002, has estate planners worrying and scurrying. My column of January 2001 explained why Family Limited Partnerships (and LLCs) have become common instruments for transmission of wealth. Mom and Dad put valuable assets into an LLC, keep effective control, give interests away during their lifetimes (usually at a discounted value), and get additional discounts in value for estate tax purposes. Hackl denied the use of the (then) $10,000 gift tax exclusion on lifetime gifts.

Under both federal and Tennessee law, the gift tax exclusion applies only to a gift of a present interest, as opposed to a future interest. Internal Revenue Code §2503(b) and Tenn. Code Ann. §67-8-104 [the Tennessee code has minor exceptions]. In Hackl, Senior Judge Arthur L. Nims III, in a regular opinion (presumably carrying more weight than a memorandum opinion), rejected the taxpayer's argument that, when a gift takes the form of an outright transfer of an equity interest in property, no further analysis is needed. Rather, said the court, the entire bundle of rights being transferred must in substance carry a substantial present economic benefit by reason of the use, possession, or enjoyment of the property or the income from the property. The presence of restrictive terms in the LLC operating agreement and the absence of any actual income by the LLC combined to preclude the existence of a present interest.

Perhaps we should have seen this coming. The IRS fired a warning shot in Private Letter Ruling (PLR) 9751003. Under the facts in that ruling, the IRS found no present interest and denied gift tax exclusions on gifts of limited partnership interests, for two reasons. First, the partnership agreement gave the general partner total discretion over distribution of income to limited partners, including the power to withhold income "for any reason whatsoever." This negated the normal fiduciary duty of the general partner to the limited partners. Second, the agreement contained transfer restrictions far more stringent than under state law. The message seemed to be that clients should neither retain so much control nor limit so much of the donees' rights, compared to the statutory provisions, that they remove the donees' present economic enjoyment. Still, there were other PLRs, like 8611004, 9131006, and 199944003, that explicitly found gifts of partnership interests to be present interests. Estate planners were comfortable with the adage that pigs get fat, but hogs get slaughtered. Does Hackl make hogs of us all?

Experts are divided on whether Hackl was correctly decided, or whether, even if the result was right, the reasoning was wrong, confusing, or overbroad. For the rest of us, the more important question is whether the facts in Hackl are sufficiently distinguishable from our own clients' generic FLPs and LLCs that conform closely to the state law default provisions. The answer is probably. Three governing principles emerge.

The first principle is not to limit the general partner's fiduciary obligation to the limited partners. The Hackl operating agreement gave the chief manager the right to make or withhold cash flow distributions in his sole and absolute discretion (aha - recrudescence of the fatal flaw of PLR 9751003).

The second principle is to produce and share income, although this alone should not be determinative. In Hackl, the family started a tree farm, which they knew would produce no income for years, and there were in fact no income distributions for the six years in question.

The third and final principle is to provide adequate alienability of interests. Unlike the applicable Indiana law, the Hackl operating agreement:

(1) gave Mr. Hackl as chief manager the unusual personal right to name a successor manager during his life or by his will; (2) prohibited any member from withdrawing capital contributions without the chief manager's approval, and even then provided that a member who wanted to withdraw could sell only to the company, for such price and terms as the chief manager decided, whereas the state statute allowed withdrawal for fair value; and (3) absolutely and unequivocally forbade members from transferring any membership interest without the written consent of the chief manager, whose consent could be withheld for any reason. Judge Nims' language is pointed:

[T]he Agreement, for all practical purposes, bars alienation as a means for presently reaching economic value. Transfers subject to the contingency of manager approval cannot support a present interest characterization, and the possibility of making sales in violation thereof, to a transferee who would then have no right to become a member or to participate in the business, can hardly be seen as a sufficient source of substantial economic benefit.

Under the federal gift tax regulations, it is the taxpayer who has the burden of showing that a gift is not a future interest. The regulations make clear that absence of income alone does not necessarily create a future interest. So Hackl should not be interpreted to require income in all cases. What is required is either a reasonably predictable flow of income or the ability to convert the property into something income-producing. Hackl had neither. Most of our FLPs and LLCs have one or the other, or both. We hope.

In the meantime, consider amending FLPs and LLCs to increase marketability:

> (1) Withdrawal Right: Donees of interests can be given a brief period, like 60 days from the date of the gift, during which they can withdraw (i.e., redeem) their interest from the FLP/LLC at fair market value (determined without regard to the existence of this right), or else during which they can take a withdrawal from the increase in their capital account.
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> (2) Right of First Refusal: Donees of interests can be given the right to remove transfer restrictions by first offering the interests to the company or to other partners. The disadvantages are that this might decrease any valuation discounts for lack of marketability, and might also permit outsiders to become partners.
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> (3) Temporary Free Transferability: Donees of interests can be given a brief period from the date of the gift during which their interests are freely transferable to anyone.

In the end, Hackl is not a death knell for FLPs and LLCs in estate planning. Those clients not making annual gifts of the interests can freely create severe restrictions in their agreements, for family planning, control and maximum valuation discounts. But where annual gifts are desired, Hackl may mean more marketability, perhaps at the cost of some valuation discount. That tradeoff is yet one more set of variables in the calculus of proper planning.

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Tennessee Bar Journal columnist Dan Holbrook is the most recent winner of the Tennessee Bar Association's Justice Joseph W. Henry Award for Outstanding Legal Writing, for his article, "Top 10 Rules for Estate Planning in Tennessee After Tax Reform," published in August 2001. Congratulations, Dan!

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