

FCG Valuation Case E-Flash

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Issue 12:1

CITATION:

WALTER M. PRICE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent, and SANDRA K. PRICE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent, T.C. Memo 2010-2, Docket Nos. 9611-06, 9642-06. Filed January 4, 2010.

The Tax Court ruled whether gifts of limited partnership interests were properly characterized as present interests, thus qualifying for annual gift tax exclusions (not lifetime gift tax exclusions).

COMMENTS:

In *Hackl v. Commissioner*, 118 T.C. 279, 294 (2002), the court found that transfers of LLC interests were gifts of future interest and the court ruled that the gifts did not qualify for the annual gift tax exclusion. According to Hackl, to prove gifts are present interests, it must be shown that:

- (1) The LLC would generate income at or near the time of the gifts,
- (2) Some portion of that income would flow steadily to the donees, and
- (3) The portion of income flowing to the donees can be readily ascertained.

THE FACTS:

Walter M. and Sandra K. Price gifted minority limited partnership interests in Price Investments Limited Partnership (the “Partnership”) to their children from 1997 through 2002. Gift tax deficiencies were asserted for 2001 and 2002.

Per the partnership agreement, the limited partners have no right to withdraw their capital accounts in the Partnership.

Additionally, the partnership agreement prohibits partners from selling or transferring their interests to third parties without the unanimous consent of all other partners. Without the unanimous consent of the partners, a partnership interest can only be transferred to another partner or to a partner’s trust. Furthermore, the sale or transfer to third parties are subject to the Partnership’s and its partners’ right of first refusal to purchase the offered interest, which does not specify a time limit for fulfilling the partners’ obligation once the right is exercised.

Section 11.2 of the partnership agreement provides, “Any assignment made to anyone, not already a partner, shall be effective only to give the assignee the right to receive the share of profits to which his assignor would otherwise be entitled ... and shall not give the assignee the right to become a substituted limited partner.”

The Partnership paid distributions in each year except 1997 and 2001 (interestingly, 1997 was not included in the deficiency notice, and 2002 was included even though distributions were made). The partnership agreement indicates distributions will be paid at the discretion of the general partner, and section 7.3 indicates, “Neither the Partnership nor the general partner shall have any obligation to distribute profits to enable the partners to pay taxes on the partnership’s profits.”

The IRS Positions

The annual exclusion gifts made by Walter and Sandra Price to their children were gifts of future interests because the partnership agreement imposes transfer restrictions to third parties.

The partnership agreement does not require distributions of Partnership income to its partners.

Because the conditions to shift the burden of proof to the IRS had not been met, the taxpayers bear the burden of proof.

The Taxpayer Positions

Hackl was decided incorrectly.

Even if the *Hackl* ruling was correct, it was dissimilar from the current case.

The Partnership intends to pay distributions sufficient to cover the tax liability associated with the Partnership's pass-through income. Hence, these distributions represent a present interest.

The general partner has a "strict fiduciary duty" to make distributions to the donees.

Court Analysis

The court followed the methodology in *Hackl* and concluded the taxpayer failed to prove that the gifts provide the "immediate use, possession, or enjoyment of either (1) the transferred property or (2) the income therefrom."

The court disagreed that the partnership agreement allows the donees to access substantial economic benefit from the transferred interests. Specifically, the donees do not have the right to withdraw their capital accounts in the Partnership. Additionally, the partnership agreement indicates any transfer or sale of a partners' interest to a third party requires the unanimous consent of the other partners. As stated in *Hackl*, transfers subject to the approval of the LLC's manager "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."

Furthermore, the donees were not partners when the gifts were made. Accordingly, the court ruled the donees were not substituted limited partners per section 11.2 of the partnership agreement. Instead, the donees held assignee interests and lacked the ability "presently to access any substantial economic or financial benefit that might be represented by the ownership units."

The court also pointed out that even if the donees were substituted limited partners, any transfer or sale of the donees' interest would be subject to the right of first refusal provision of the partnership agreement that does not specify a time limit. The absence of a time limit infers that the transfer does not represent a present interest.

Further, the court ruled distributions were discretionary, even those paid to cover the tax liability.

Regarding the taxpayers' position that the general partner had a fiduciary obligation to pay distributions, the court indicated even if such duty exists, it does not establish a present interest in a partnership where the limited partners lack withdrawal rights. Furthermore, the donees were assignees rather than substituted limited partners. Under Nebraska State Law, an assignee is not owed any duties other than "loyalty and due care" from the general partner.

Finally, the argument that an interest in the Partnership enhances the donee's financial borrowing ability was regarded by the court as highly speculative. The court indicated there is no evidence to support this argument, and it does not represent a substantial economic benefit.

CONCLUSION:

The court ruled that the gifts did not offer the donee an "unrestricted and noncontingent right to immediately use, possess, or enjoy either the property itself or income from the property" and therefore did not qualify for the annual gift tax exclusion.

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