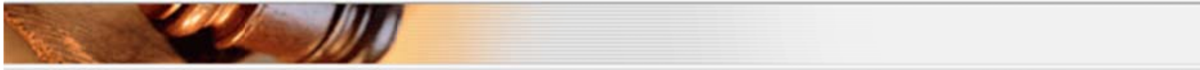
CORPORATE ASSISTANCE
Compliance Management for Business Owners



Gifting Ownership in Private Business Entities

Have you ever made a gift of a business interest in a corporation, LLC, or limited partnership to a business associate, friend, or family member?

Were you under the impression that your gift was excludable from gift taxes?

Were you acting on the belief that the result of your gift would be to decrease your income or estate tax burden?

Read the story of Albert and Christine Hackl, who had similar ideas but ran afoul of the IRS because they didn't execute their plans correctly.

The Hackls Take Up Tree Farming

Albert J. Hackl was a retiree who wanted to keep his hand in the business world. He searched for a hobby that would provide a business opportunity, diversify his investments, and provide a long-term investment for his family.

He settled on tree farming. In 1995, Albert purchased two tree farms (valued at about $4.5 million) and contributed them, as well as about $8 million in cash and securities, to Treeco, an Indiana LLC he created for the purpose.

Initially, Albert and his wife Christine owned all Treeco's membership units. Albert served as the managing member of the LLC. The Hackls had structured the operating agreement of the LLC in such a way as to give the managing member a very high degree of control over the affairs of Treeco. Namely:

- The manager served for life, or until resignation, removal, or incapacity;
- The manager had the power to appoint his/her own successor and also to dissolve the company;
- The manager controlled any financial distributions, and members needed his/her approval to withdraw from the company or sell membership units;
- If a member transferred his or her membership units without consent, the transferee would receive economic rights but no membership or voting rights.

During Albert's tenure as managing member, Treeco has operated at a loss and not made any distributions to its members. Although Treeco has yet to report a profit, Albert was named "Tree Farmer of the Year" in Putnam County, Florida, in 1999.

Gifting Ownership to the Kids

Shortly after Treeco's creation, Albert and Christine began annual transfers of Treeco voting and nonvoting units to their children, their children's spouses, and a trust set up for the grandchildren. After January 1998, 51% of the company's membership units were in the hands of the couple's children and their spouses.

The Hackls attempted to shield the Treeco transfers from taxation by treating them as excludable gifts on their gift tax returns. The IRS thought that the Hackls were wrong in doing so, contending that the transfers were

“future interests”, not “present interests”, and therefore ineligible for the gift tax exclusion. The Hackls took the dispute to the Tax Court, which sided with the IRS.

The Tax Court’s argument was that, because of the high degree of control the Treeco managing member exercised over the operations of the LLC, membership interests had no present value – the true value of the gift would not transfer so long as Albert was able to maintain such complete control over decision making and financial distributions.

The Hackls appealed the Tax Court’s decision to the Seventh Circuit Court of Appeals, who decided the case on July 11, 2003 (the wheels of justice turn slowly).

The Appeals Court Weighs In

The crux of the Hackl’s appeal was that the gift tax doesn’t apply to a transfer if the donors give up all of their legal rights. In essence, the Hackls argued that giving up all legal rights to a gift automatically makes it a “present interest”.

The applicable Treasury regulation states that a “future interest” is a legal term that applies to interests “which are limited to commence in use, possession, or enjoyment at some future date or time.” (Treas. Reg. § 25.2503-3) The regulation also provides that a present interest in property is “[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain).”

In the Hackl case, both courts agreed that Treeco’s operating agreement clearly foreclosed the donee’s ability to realize any substantial present economic benefit. Although the voting units that the Hackls gave away had the same legal rights as those they retained, Treeco’s restrictions on the transferability of the shares meant that they were essentially without immediate value to the donees.

How to Avoid the Hackl Tax Trap

The Hackl decision is troubling to some, because the decision revolved around the postponement of “use, possession, or enjoyment”. Critics ask, “what about transfers of property to a trust, where there are delays or restrictions on use, possession, or enjoyment?” These transfers could be attacked using the same logic as was used in Hackl.

Until the Hackl decision is reversed or other courts of appeals hold opposite of Hackl, LLC owners must be aware of its implications:

- Gifts must be “present benefits” - the court seemed particularly concerned with the inability of a donee to withdraw from the entity, the restrictions upon sale and the lack of regular distributions. If any of these three “defects” were not currently present, it is likely that the court would have held that the LLC units qualified as present interests.
- A right of withdrawal is needed - the entity agreement could include the right to withdraw from the entity at “fair market value” (the same definition as used in the Treasury Regulations). Fair market value could be defined to require the interest to be valued as though the “put right” (the right to sell at a given price) did not exist. The donee in that circumstance has the ability to realize immediate value through withdrawal much like a beneficiary of a trust with a withdrawal provision, and the annual exclusion should be allowed.
- Transfer restrictions cannot be absolute - a provision allowing a family member the unrestricted right of transfer of an interest in the entity to an outsider might not be palatable to most business owners. The desire to keep the assets in the family is one of the primary reasons many closely-held entities are

created. Rather than completely restricting the transfer, however, the entity or other family owners could be given a right of first refusal so that if a family member desires to transfer the interests for cash, the holder could exercise the right to purchase that interest before it is transferred to the outsider, keeping the interest in the family.

- Address the distribution problem – one of the difficulties in the Hackl case was the complete lack of distributions to members. The court's requirement that the portion of income flowing to the interest holder be "ascertainable" poses problems. Clearly, a required annual distribution of a specified amount should meet this requirement.

Conclusion

The experience of Albert and Christine Hackl highlights the need to link the creation of an entity and its ongoing management within a coherent strategy. The Hackls created an LLC that was wholly legal. That is, it was formed and established properly in accordance with Indiana law. None of its provisions were inappropriate or illegal per se. It was only when the LLC's structure was analyzed against its intended use that problems became apparent.

The case law consistently demonstrates that individuals who use business entities for family estate planning often cut corners or ignore protocols when doing so.

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