Supporting gift and valuation discounts

Future interests and applicable restrictions

By Thomas E. Rutledge and R. David Lester

Valuations of non-controlling interests in various business enterprises are often requested and delivered in the context of gifts of interests. Problems may arise, however, if assets characterized as "future interests" or assets with "applicable restrictions" are present, but not addressed before preparing a valuation report.

Future interests

As of 2011, the definition of taxable gifts excludes the first $13,000 (on an annual basis) of gifts made to any person "other than gifts of future interests in property." [IRC §2503(b).] Gifts of future interests are subject to gift tax unless sheltered by the donor's lifetime annual gift tax exemption. [IRC §2505.] The Internal Revenue Code (Code) does not define the term "future interest." Thus it is necessary to look to the IRS Regulations and case law to define the term.

IRS Regulations provide that a "future interest in property" includes not only reservations and remainders, but also "other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at a future date or time." Conversely, "[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) is a present interest in property." The courts have said that the sole statutory distinction between present and future interests "lies in the question of whether there is a postponement of enjoyment of specific rights, powers or privileges which would be forthwith existent if the interest were present." [Stinson Estate v. Commissioner, 214 F.3d 846, 848-49 (7th Cir. 2000).]

Applicable restrictions

Certain restrictions on liquidation typically found in an entity's organizational documents are disregarded for valuation purposes. These "applicable restrictions" are defined in IRC §2704(b) and the related IRS Regulations as any restriction on the ability to liquidate an entity that is more restrictive than the limitations that would generally apply under the relevant state law in the absence of the restriction. [IRS Reg. §25.2704-2(b).] However, a restriction is an applicable one only to the extent that the restriction will lapse by its terms, or that the transferor and any members of the transferor's family can remove the restriction immediately after the transfer. Moreover, "[a] restriction imposed or required to be imposed by federal or state law is not an applicable restriction." [Reg. § 25.2503(b).]

The valuation problems

LLCs and limited partnerships are often utilized as vehicles through which gifts are made to family members. For example, the family patriarchs organize a limited partnership and contribute $1 million of marketable securities. Ownership in the venture is divided into 100,000 units each having a pro-rata value of $10. However, on an individual basis the units are illiquid and do not give control of the venture. Assuming all else to be equal, each parent may convey 1,300 units, having a pro-rata value of $13,000 to each child. Assuming that the valuation yields a 40 percent discount on the units to account for illiquidity (lack of marketability) and lack of control of the venture (the patriarch generation are the general partners of the limited partnership or, in the alternative, the managers of the LLC), then each parent could, absent other gifts for the year, use the annual exclusion to convey 1,354 ($13,000 ÷ $9.60) units to each child. However, it may not be as simple as that.

Assume if you will that we are dealing with a limited partnership and that the limited partnership agreement provides that all distributions will be made at the discretion of the general partners. There is nothing out of the ordinary with respect to such a

provision; it is simply repeating what would otherwise be the applicable rule of law. *See KRS § 362.2-406(1).* With the marketable securities owned by the limited partnership generating dividends, all of the partners run the risk of phantom income unless and until the partnership makes distributions to satisfy those obligations. In this situation, it could be argued that these LP units constitute "future interests" and, irrespective of whether valued with or without marketability/lack of control discounts, they may not be eligible for the parents' annual exclusion amount. Thus, gift tax returns would need to be filed and subject to availability of each parent's lifetime exclusion, gift taxes may be imposed.

With respect to future interests analysis, attention needs to be paid not only to the documents at issue but also to the nature of the underlying assets. In the (in)famous Hackl decision, 118 T.C. 279 (2002), affd. 335 F.3d 664 (7th Cir. 2003), gifts of interests in a limited liability company that owned a couple of tree farms that would not for many years generate income were held to be gifts of future interests. The appellate court in Hackl determined that the key determination in whether a gift constitutes a present interest is whether the donee has the right to a "substantial present economic benefit." Whether a future interest is present should be determined before a costly valuation is undertaken if the purpose of the valuation is to qualify the gift for the annual exclusion amount. The presence of a future interest may call the necessity for a valuation into question.

Applicable restrictions can affect the reliability of the valuation. Assume, for example, that a particular operating agreement provides that a limited liability company may not be dissolved without the unanimous consent of all the members. In reliance upon this characteristic, the valuation for lack of marketability may be larger than it would have been if the company could be dissolved upon the approval of only a majority-in-interest of the owners. In this instance, however, the controlling limited liability company law provides (the various states have different rules on this and similar points) that, absent an agreement to the contrary, only a majority-in-interest is required to dissolve the company. Thus, the requirement of unanimity is more limiting than would be the case if otherwise applicable state law had governed. As such, the requirement is an "applicable restriction" and, in the course of the valuation, should be ignored except to the degree provided by the state default rule. Again, the reliability of the valuation report may be brought into question if it gave a greater discount because of this provision.

Applicable restrictions and the risk of characterization of a gift as a future interest implicate a number of points, possibly including the reliability or necessity of the valuation report and the risk of accuracy related penalties. A legal opinion that the interests in a particular venture constitute present, as contrasted with future interests, as well opining as to the degree to which the limitations in the organic documents do or do not constitute applicable restrictions, might address any concerns regarding the necessity for the valuation, might enhance the reliability of the valuation and might help provide protection from accuracy related penalties.

About the authors: Both authors are members at Stoll Keenon Ogden PLLC. Thomas Rutledge focuses his practice on business organization law and disputes between business owners. R. David Lester focuses his practice on business transactions and healthcare law matters. *www.skofirm.com.*

Partner program

World Trade Day Sept. 26

Robert Powell, senior economist, Economist Intelligence Unit, will address the luncheon at World Trade Day on Sept. 26. at the Louisville Marriott Downtown in Louisville. Powell's speech on the global economic outlook aligns with this year's theme, Market Intelligence - Moving at the Speed of Trade. Organized by the World Trade Center of Kentucky, World Trade Day is the largest gathering of international trade and business professionals in the state. For more information and registration, please contact the World Trade Center of Kentucky at 502.574.2400 or go to www.kwtc.org.