1-28-2013

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Recommended Citation
Wimmer Wins FLP Annual Exclusions, 138 Tax Notes 489 (January 28, 2013)

# Wimmer Wins FLP Annual Exclusions

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In *Wimmer*, the Tax Court held that the income stream from a taxpayer's gifts of family limited partnership interests was eligible for the annual exclusion. By comparing the income interest in the partnership's dividend-paying marketable securities to the income interest in a trust, the court made Wimmer a winner. But does the opinion logically lead to that conclusion?



In *Wimmer*,[1] the Tax Court held that a taxpayer's gifts of family limited partnership interests were not eligible for the annual exclusion, but it did allow annual exclusions for the income streams from those gifts. The court analogized the income flow from the FLP's dividend-paying marketable securities to what it considered a similar trust arrangement and allowed the donor five years of annual exclusions — thus allowing Wimmer to take all.

In 1996 and 1997, the decedent, George H. Wimmer, and his wife combined their trusts and formed an FLP under California law, with the partnership agreement executed June 27, 1996. The agreement restricted transferability by requiring prior consent of the general partners and 70 percent of the limited partners, and by imposing additional requirements for a transferee to become a substitute limited partner.[2] However, gifts or bequests to related parties[3] were exempt from those requirements. In November 1997 the FLP was reorganized under Georgia law. The provisions remained intact except for the substitution of Georgia's statutes for California's. In the years 1996 to 2000, the taxpayer made gifts of FLP stock to related parties who were then listed as limited partners. The parties stipulated the taxable value of the gifts after applying annual exclusions.

The FLP agreement stated that the entity's purpose was to invest its assets — which were envisioned to include "stock, bonds, notes, securities, and other personal property and real estate,"[4] but in fact consisted solely of marketable dividend-paying securities[5] — in order to "increase family wealth, control the division of family assets, restrict nonfamily rights to acquire such family assets and, by using the annual gift tax exclusion, transfer property to younger generations without fractionalizing family assets."[6] According to the agreement, profits were to be distributed proportionally and in cash from partnership income. From 1996 to 1998, the FLP distributed cash for payment of federal income tax. In 1999 and 2000, the FLP distributed all dividends less partnership expenses when the dividends were received. Also, the limited partners withdrew from their capital accounts, for example, to pay their personal mortgage loans.[7]

The court reviewed the statute, regulations, and some case law[8] dealing with the annual exclusion

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[1]*Wimmer v. Commissioner*, T.C. Memo. 2012-157, *Doc 2012-12044*, *2012 TNT 108-8*.

[2]*Id.* at 2-3. Those requirements for the transferee are that he "(1) accepts and assumes all terms and provisions of the partnership agreement; (2) provides, in the case of an assignee who is a trustee, a complete copy of the applicable trust instrument authorizing the trustee to act as partner in a partnership; (3) executes such other documents as the general partners may reasonably require; and (4) is accepted as a substitute limited partner by unanimous written consent of the general partners and the limited partners." *Id.* at 3.

[3]Related parties include "descendants and ancestors, or an estate or trust the sole beneficiaries of which are one or more descendants or ancestors of a Partner, a [qualified terminable interest property] trust under Code section 2056(b)(7) or similar irrevocable trust for a Partner's spouse, provided that the remainder beneficiaries of the trust consist exclusively of the Partner's descendants or ancestors." *Id.* at 4.

[4]*Id.* at 5.

[5]*Id.* at 6. The FLP held only that type of asset throughout the tax years at issue. *Id.*

[6]*Id.* at 5.

[7]*Id.* at 6-7.

[8]Section 2503(b); Reg. section 25.2503-3(a) and (b); and *Fronden v. Commissioner*, 324 U.S. 18 (1945); *Hackl v. Commissioner*, 118 T.C. 279 (2002), *Doc 2002-7590*, *2002 TNT 60-9*, *aff'd*, 335 F.3d 664 (7th Cir. 2003), *Doc 2003-16504*, *2003 TNT 135-8*;

(Footnote continued on next page.)

and stated that to qualify for that benefit, the donee must receive "a substantial present economic benefit by reason of use, possession, or enjoyment (1) of property or (2) of income from the property."[9] Because the transfer was a gift of a limited partnership interest, the court compared that interest to a traditional interest in trust.[10] Since the FLP agreement restricted the donees' transfer rights, "the donees did not receive unrestricted and noncontingent rights to immediate use, possession, or enjoyment of the limited partnership interests"[11]; therefore, the donor's transfer of the FLP interests did not qualify for the annual exclusion.

The court then addressed whether the donees received a present interest in their right to receive FLP income. Citing *Calder*,[12] the court said the test required proof that "(1) the partnership would generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of income could be readily ascertained."[13] The court held that in each year of FLP interest gifts, the partnership expected to produce income. Moreover, because of the general partners' fiduciary duties, "some portion of partnership income was expected to flow steadily to the limited partners."[14]

The grandchildren's trust contained only the FLP interest, which under the trust documents could not be liquidated or exchanged for cash. The FLP's only asset was dividend-paying stock. The court noted that the FLP's only business was investing marketable securities, which the court equated with dividend-paying stock:

> This investment, when combined with partnership purposes to increase partners' net worth and transfer wealth using the annual gift tax exclusion, suggests that the partnership was created with the intent to make periodic distributions to the limited partners. Indeed, the limited partners not only received annual distributions but also had access to capital account withdrawals to pay down residential mortgages, among other reasons. Intent notwithstanding, the expectation that some portion of partnership income would flow steadily to the limited partners is supported by the general partners' fiduciary duties owed to the trustee of the Grandchildren Trust.[15]

Further, the court stated that FLP distributions of income were necessary each year in order for the grandchildren's trust, which had no other income source, to pay its income tax liabilities. For those reasons, the court concluded that "the general partners were obligated to distribute a portion of partnership income each year to the trustee."[16] Thus, the court held that the taxpayer proved that some amount of income "was expected to flow steadily to the limited partners." The court contrasted *Wimmer* to *Hackl* and *Price* in that in *Wimmer*, as general partner of the FLP, the donor was required to make — and did make — distributions of income in each year at issue.

The court held that the gift of income flowing to the donees was easily ascertainable. The stock was publicly traded and produced a dividend; thus, the donees "could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership in the partnership."[17]

### *Calder*

In *Calder*, the artist's widow transferred his artwork to four trusts, one for each of her two children and one trust each for two sets of grandchildren. The court held that her transfers to the four trusts with a total of six beneficiaries were six separate gifts, were entitled to blockage discounts for each gift separately valued using actual sales prices for each gift, and were not eligible for any annual exclusions.[18]

The terms of the two children's trusts were the same: Each required that all net income be paid "periodically" to the beneficiary during her life. The grandchildren's trusts provided for like net income payments in equal shares to them or to their issue. All the trusts provided that the trustees in "their absolute and uncontrolled discretion" could make payments of principal as they deemed advisable for the welfare of the beneficiaries without any accountability for those decisions throughout the term of the trust.[19] Under those same conditions, the trustees could hold (without being limited to trust or chancery investments provided by law), sell, convey, or exchange both income-producing and non-income-producing property.[20] Finally, the

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*Price v. Commissioner*, T.C. Memo. 2010-2, *Doc 2010-111*, *2010 TNT 2-9*. *aff'd*, 335 F.3d 664 (7th Cir. 2003), *Doc 2003-16504*, *2003 TNT 135-8*.

[9]T.C. Memo. 2012-157 at 9, citing *Hackl*, 118 T.C. at 293.

[10]T.C. Memo. 2012-157 at 9, citing *Hackl*, 118 T.C. at 292.

[11]T.C. Memo. 2012-157 at 10.

[12]*Calder v. Commissioner*, 85 T.C. 713, 727-728 (1985).

[13]T.C. Memo. 2012-157 at 10.

[14]*Id.* at 11.

[15]*Id.* at 12-13, n.9.

[16]*Id.* at 13.

[17]*Id.* at 14.

[18]85 T.C. at 713.

[19]*Id.* at 715-716.

[20]*Id.* at 716.

trust agreement stated that it was irrevocable and that the grantor could not revoke, change, or annul any of its provisions, and that it was governed by the laws of New York state.[21]

The court addressed the annual exclusions by explaining that the statute requires that gifts must be present interests — that is, other than gifts of future interests in property.[22] The regulations define a present interest in property as "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain)."[23] Citing *Fronden*, the *Calder* court said the donee must have "the right to substantial present economic benefit." By contrast, the court explained that when there were limitations on the payment of trust income, as in *Disston*,[24] or when there was no evidence in the trust or "surrounding circumstances that a steady flow of some ascertainable portion of income to the (beneficiary) would be required," the gift would be determined to be a gift of future interest. Thus, the *Calder* court stated *Disston*'s three requirements to qualify for the annual exclusion as: "(1) that the trust will receive income, (2) that some portion of that income will flow steadily to the beneficiary, and (3) that the portion of income flowing out to the beneficiary can be ascertained."[25]

The donor argued that the trustees had discretionary power to convert those assets to income-producing ones and that under state law governing the trusts, the trustees had a fiduciary duty to sell those assets and acquire income-producing property.[26] However, according to the court, the donor had not satisfied even the first element of that test. When the property was transferred to the trust, the trust property consisted only of the deceased artist's work, and there was no evidence that the trust would produce distributable income for the beneficiaries. Rather, the record lacked proof that the beneficiaries would receive any income.[27]

Moreover, even if a present interest were created, it could not be valued, because it was "impossible to predict with certainty whether and to what extent the trustees would sell the gouaches and invest in income-producing property."[28] Finally, there was no evidence of any sales and subsequent purchase of income-producing property.[29]

[21] *Id.* at 717.
[22] *Id.* at 727.
[23] Reg. section 25.2503-3(b).
[24] *Commissioner v. Disston*, 325 U.S. 442 (1945).
[25] 85 T.C. at 727-728.
[26] *Id.* at 729.
[27] *Id.* at 728.
[28] *Id.*
[29] *Id.* at 730.

### *Hackl*

A.J. Hackl and his wife formed a limited liability company (Treeco) in which they each were 50 percent owners. Hackl, as Treeco's manager, had the power to make pro rata cash distributions. Until the company's dissolution, no one could withdraw capital contributions, partition any company property, or withdraw or transfer an interest without the manager's approval, which would be granted in Hackl's sole discretion.[30]

At the end of 1995, the Hackls began making gifts of their LLC interests to their family members. Over the next few years, they continued making gifts of successor LLC interests (Hacklco and Treesource), which perpetuated the various tree farming operations of Treeco. Each of those entities had the goals of long-term income production and appreciation. At no time were there any profits or distributions to LLC members.[31]

Because they had made direct outright gifts of their LLC interests, the Hackls contended that they were entitled to annual exclusions for them. However, both the Tax Court and the Seventh Circuit rejected that argument and looked to the LLC agreement to determine whether the donees had received any immediate, substantial economic value.

The Tax Court rejected the Hackls' arguments because the donees could not dissolve the company without Hackl's approval and because there was no LLC income. The circuit court agreed, saying, "Although the voting shares that the Hackls gave away had the same legal rights as those that they retained, Treeco's restrictions on the transferability of the shares meant that they were essentially without immediate value to the donees."[32]

### *Price*

Walter M. Price created an FLP to sell his business, Diesel Power Equipment Co. (DPEC). Price Management Corp., a Nebraska company owned by Mr. and Mrs. Price's revocable trusts and of which Mr. Price was the president, became the FLP's 1 percent general partner, and the two revocable trusts each became a 49.5 percent limited partner. FLP assets consisted of DPEC stock and commercial real estate leased to DPEC and another company. Almost four months later, the FLP sold the DPEC stock and replaced it with marketable securities.

From the time of the FLP's creation and every year for the next five years, the Prices each made

[30] 118 T.C. at 282-283.
[31] *Id.* at 284-286.
[32] 335 F.3d at 667-668.

equal gifts of FLP interests to their three adult children. The primary purpose of the FLP was to derive a long-term, reasonable compounded rate of return on the FLP's investments.[33] Partners were prohibited from transferring their interests to a non-partner without the written consent of all partners, and assignment to a non-partner would give the assignee only a right to his appropriate share of FLP profits without relieving him of his liabilities under the FLP agreement.[34] The FLP and each remaining partner could purchase an assignee's interest for fair market value. Although the FLP agreement provided for the FLP's 25-year existence, two-thirds of the partners could agree to an earlier dissolution. The FLP agreement provided that either the general partner, in his discretion, or a majority of all the FLP interests would decide when FLP profits would be distributed. Under the FLP agreement, controlled by Nebraska law, there was no requirement to make distributions even for the purpose of paying taxes on FLP profits.[35]

The Prices claimed annual exclusions for their gifts of FLP interests. They contended that the partners could freely transfer FLP interests among themselves and that they had present income rights because they could assign their interest to third parties. They maintained that *Hackl* was both incorrect and distinguishable.

The court held against the taxpayers and stated that a present interest is an unrestricted and noncontingent right to the property or its income and that a fiduciary's discretion to withhold income payments negates the present interest requirement. To qualify for the annual exclusion, the donor must give the income beneficiary an immediate right to enjoy substantial economic benefits in the transferred property. Under the FLP agreement, the donors' children could not unilaterally make withdrawals from their capital accounts or sell, assign, or transfer their interests to third parties. As in *Hackl*, any transfer or encumbrance was contingent on the approval of third parties.[36]

The *Price* court held that even if the donees, whose status was unclear, became limited partners, contingencies stood between the donees and their receipt of economic value.[37]

Finally, the court rejected the taxpayers' argument that by including the transferred property in their Schedule K-1 as an asset, the donees had a present interest in the transferred assets because they thereby increased their ability to borrow. The court described that contention as unsubstantiated, contingent, and speculative, because of the FLP agreement transfer restrictions.[38] Moreover, the FLP agreement's discretionary distributions were contrary to a finding of a continual and determinable stream of income to the donees, particularly in light of the principal purpose of the FLP. Finally, the court said there was no fiduciary duty to make income distributions because under Nebraska law a fiduciary owes assignees, the most likely status of the donees in *Price*, only the duties of loyalty and due care.[39]

**Trusts and the Annual Exclusion**

Section 2503(b) is centered on the beneficiary's actual rights — that is, the rights that are clearly enforceable by the donee and that don't depend on the actions or intentions of the donor or a third party. In a trust, when an interest depends on the discretion of someone other than a beneficiary, the value of that interest is unascertainable.[40]

Likewise, in a trust, when the trustee has the power — and often the duty — to invest in both income-producing and non-income-producing assets, courts (as the Tax Court did in *Calder*) have denied the donor an annual exclusion.[41]

The time to determine eligibility for the annual exclusion is when the gift is complete. The analysis is not an ex post facto look, and it requires examining the donee's rights at the time of the transfer. Actual events may confirm the allowance or disallowance of an annual exclusion, but qualification for the annual exclusion is determined when the gift is complete. Post-gift receipt of income may merely indicate what fortuitously happened as a result of owning an asset; if the donee can't control whether an unproductive asset is sold and replaced

[33]*Price*, T.C. Memo. 2010-2 at 5, n.3.
[34]*Id.* at 5.
[35]*Id.* at 6-7.
[36]*Id.* at 11-12.
[37]*Id.* at 14.
[38]*Id.* at 16.
[39]*Id.* at 18-19.
[40]*See* reg. section 25.2503(b)-3(c), Example 1 (''Under the terms of a trust created by A the trustee is directed to pay the net income to B, so long as B shall live. The trustee is authorized in his discretion to withhold payments of income during any period he deems advisable and add such income to the trust corpus. Since B's right to receive the income payments is subject to the trustee's discretion, it is not a present interest and no exclusion is allowable with respect to the transfer in trust''); Example 3 (''Under the terms of a trust created by E the net income is to be distributed to E's three children in such shares as the trustee, in his uncontrolled discretion deems advisable. While the terms of the trust provide that all of the net income is to be distributed, the amount of income any one of the three beneficiaries will receive rests entirely within the trustee's discretion and cannot be presently ascertained. Accordingly, no exclusions are allowable with respect to the transfers to the trust'').
[41]*See, e.g., Fischer v. Commissioner*, 288 F.2d 574 (3d Cir. 1961).

by income-producing property, she does not have a present interest in the income from that property.

**Analysis and Conclusion**

Like *Hackl* and *Price*, *Wimmer* held that gifts of restricted FLP interests do not qualify for the annual exclusion. However, the court also held that because the donees had the right to income distributions when the donor made gifts of the income streams, he made present interest gifts that qualified for the annual exclusion.

Applying the three-part test of *Disston*, quoted in *Calder*, the *Wimmer* court did not convincingly explain how the donor satisfied the first and third part of that test. When the court held that the partners had a fiduciary duty to invest in dividend-producing assets and that the general partners were therefore required to distribute income to the donees, the court took several leaps in logic to arrive at its conclusion: ''This investment, when combined with partnership purposes to increase partners' net worth and transfer wealth using the annual gift tax exclusion, *suggests* that the partnership was created with the intent to make periodic distributions to the limited partners.''[42]

The FLP agreement did not require that the FLP retain income-producing investments. That one of the purposes of the FLP was to invest in marketable securities does not equate with a purpose to invest in dividend-paying marketable securities, because many marketable securities do not produce income and even those that do may stop producing income. While it is true that the FLP's sole asset was in fact dividend-paying stock, the stated purpose of the FLP was to invest in assets such as ''stock, bonds, notes, securities, and other personal property and real estate'' the FLP was not required to hold income-producing assets or to convert any non-income producing property into income-producing assets; likewise, there is no stated FLP purpose to provide income for the limited partners.

That the partners wanted to avail themselves of the annual gift tax exclusion does not mean that the taxpayer's transfers would qualify for the exclusion. The court did not discuss where in the FLP agreement or under applicable state law there was a stated purpose or requirement either that investments be income producing or that the limited partners could demand that the FLP convert non-income-producing assets into income-producing ones.

That income was paid to the donees as owners of their FLP interests is insufficient; the donee's actual right to income must have been clear from the time of the donor's gift. The court's statement that ''the expectation that some portion of partnership income would flow steadily to the limited partners is supported by the general partners' fiduciary duties owed to the trustee of the Grandchildren Trust'' is not the same as the donees having an actual right to demand that the general partners acquire only income-producing property. In *Calder*, the donor maintained that under the state law governing the trusts, the trustees had a fiduciary duty to sell those assets and acquire income-producing property; yet that argument failed to convince the court that the donees had an income right (that is, the first part of the *Disston* test).

Thus, while the Wimmers ''won'' annual exclusions for their gifts, under a trust analogy, it is not clear from the opinion that they were actually entitled to them.

[42]T.C. Memo. 2012-157 at 12-13, n.9.