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Walter M. and Sandra K. Price v. Commissioner, T.C. Memo 2010-2, January 4, 2010.

The Facts:

Mr. Walter Price started his own company, Diesel Power Equipment Co. (DPEC), in 1976. In time the company grew to distribute and service approximately 40 different lines of equipment and had 90 employees. Mr. Price's children had no interest in pursuing careers with DPEC, and as such Mr. Price decided to sell the business to a group of long-term employees in the late 1990's as part of a financial plan that included placing DPEC stock into a limited partnership.

On September 11, 1997, Mr. and Mrs. Price formed Price Investments Limited Partnership in the state of Nebraska. At the formation of the partnership, Price Management Corp (PMC) was the partnership's 1% General Partner and the Walter M. Price Revocable Trust and the Sandra K. Price Revocable Trust were each 49.5% Limited Partners. Mr. Price was president of PMC (the General Partner) and Mr. and Mrs. Price, through revocable trusts, owned all of the shares of PMC. Upon formation, the Partnership's assets consisted of DPEC stock and three parcels of commercial real estate which were under lease to DPEC and another equipment company. On January 5, 1998, the Partnership sold the DPEC stock and invested the proceeds in marketable securities.

Between 1997 and 2002, Mr. and Mrs. Price gifted each of their three adult children partnership interests which resulted in the entire 99% limited partner equity interest being transferred to their three adult children by 2002. Mr. and Mrs. Price filed gift tax returns reporting the value of total gifts, total annual exclusions, and net reportable taxable gifts. Valuation reports were attached to the gift tax returns in support of the reported values which incorporated applicable discounts for lack of control and lack of marketability. The IRS audited the returns and disallowed the annual gift tax exclusions for each year on the grounds that the gifts were of future interests in property.

The Arguments and Findings:

The Court was asked to decide if the gifts of limited partnership interests made by Mr. and Mrs. Price to their children in 2000, 2001 and 2002 qualify for annual exclusions as present interests as provided by Section 2503(b), or if they should be considered future interests and therefore not qualify for annual exclusions as provided by Section 2503(b).

Section 2503(b) provides an inflation-adjusted annual gift tax exclusion per donee, which is applicable other than to gifts of future interests in property. The statute does not define the term future interest, but the regulation provides that "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) is a present interest in property."

The petitioners argued that their gifts were properly characterized as gifts of present interests because the donees can freely transfer the interests to one another or to the general partner and that each donee has immediate rights to partnership income and may freely assign income rights to third persons. The IRS, relying on a previous court decision (Hackl v. Commissioner), contended that the transferred partnership interests represent future interests because the partnership agreement effectively bans transfers to third parties and does not require income distributions to the limited partners. Thus, the Court was left to analyze the factors to determine if the gifts of interests in the partnership conferred upon the donees the immediate use, possession or enjoyment of either (1) the transferred property or (2) the income therefrom.

In regards to the immediate use, possession or enjoyment of the transferred property, the Court indicated that (1) the donees have no unilateral right to withdraw their capital accounts; and (2) the partnership agreement prohibited partners from selling, assigning or transferring an interest the Partnership to a third party without the written consent of all partners. The Court also indicated that the donees were incorrectly characterized as limited partners in the partnership because it was unclear as to how the petitioners effectuated the assignments of limited partnership interests and the partnership agreement provided that any assignment to anyone, not already a partner (of which the children were not partners at the inception of the partnership), was effective only in transferring assignee rights, not the rights of a partner. Thus, they did not become substituted limited partners, but instead were only assignees that lacked the ability "presently to access any substantial economic or financial benefit that might be represented by the ownership units." The Court also indicated that even if the donees had become substitute limited partners it would not affect the Court's conclusion that contingencies stand between the donees and their receipt of economic value for the transferred partnership interests so as to negate finding that the donees have the immediate use, possession or enjoyment of the transferred property. Finally, the Court also determined that a provision in the partnership that gave the partnership and each of the remaining partners an option to purchase from the transferee the transferred equity interest according to a complicated valuation process with no time limit to exercise this option failed to equate to immediate enjoyment of the property.

Mr. and Mrs. Price contended that the donees enjoyed a present interest in the transferred property because they were able to use their Schedules K-1 issued to them each year as evidence of their own personal assets, thereby enhancing their financial borrowing ability. The Court indicated that there was not sufficient evidence to support this contention. Thus, the Court determined that there was not sufficient evidence to support the gifts of interests in the partnership conferred upon the donees the immediate use, possession or enjoyment of the transferred property.

Regarding the evidence to support the argument that the gifts of interests in the partnership conferred upon the donees the immediate use, possession or enjoyment of the income from the transferred property, the Court indicated that Mr. and Mrs. Price must show that (1) the partnership 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 (as reference from Hackl v. Commissioner).

According to the Partnership's Federal income tax returns, the Partnership reported income from both rental activities and investment activities in each year from 1997 to 2002, and made cash distributions in equal amounts to each child in each year except 1997 and 2001. Because the Partnership owned real property generating rents under long-term leases, the Court believed that the Partnership could be expected to generate income at or near the time of the gifts. However, they felt that the record failed to establish that any ascertainable portion of the income would flow steadily to the donees because there were no distributions to the donees in 1997 or 2001. Furthermore, profits of the Partnership were to be distributed at the discretion of the general partner, except when otherwise directed by a majority-in-interest of all partners (both limited and general). Furthermore, the partnership agreement stated that "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments." In addition, the partnership agreement made distributions to cover the donees' income tax liabilities arising from the partnership's activities discretionary. Thus, the Court stated that "because the timing and amount of any distributions are matters or pure speculation, the donees acquired no present right to use, possess, or enjoy the income from the partnership interests."

Thus, the Court held that the petitioners had failed to show that gifts of limited partnership interests conferred on the donees an unrestricted and noncontingent right to immediate use of, possession or enjoyment of either the property itself or income from the property, and therefore were not entitled to exclusions under section 2503(b) for their partnership interests.

Parting Thoughts:

This was a very interesting case with a lot of twists that ended up with an unfavorable determination for the taxpayer. I had not seen this present interest challenge from the IRS in quite some time. This decision will probably make many attorneys review their partnership agreements and assess distribution restrictions as it may be wise to require partnerships to distribute annually an amount equal to the tax liability incurred by its partners. In addition, regarding the immediate use or enjoyment of the property, I have heard that attorneys are again exploring adding language to give donees the right to "put" the units back to the partnership for some period of time (e.g. 30 days) subsequent to receipt of the transfer. However, regarding the put price, I believe it would be important to state that the put price is equal to the fair market value of the subject interest without consideration of the put option itself. Otherwise, if you do not exclude consideration of the put option, you are effectively eliminating all valuation discounts.