Judicial Expansion of the Future Interest Exception to the Gift Tax Annual Exclusion—Examination of the Legislative History and Policy Basis for the Future Interest Exception

WILLIAM C. BROWN*

I. Introduction

When the Tax Court issued its opinion in *Hackl v. Commissioner*[1] in 2002, the estate planning community initially stood up and took notice. The case represented a dramatic new line of attack by the Service against one of the best tools in the estate planner's arsenal—the family limited partnership (FLP).[2] Prior to that time, the Service had principally attacked FLPs with only limited success on the grounds that they constituted transfers with retained interests includable in the donor's estate under sections 2036(a)(1), 2036(a)(2), and 2038, or as indirect gifts of the underlying assets, without valuation discounts, under substance over form grounds.[3] By and large, the estate planning community had adjusted to these potential attacks by (1) making sure personal assets were not placed in an FLP, (2) advising clients not to use FLP funds to pay personal expenses, (3) meticulously documenting the form of the formation transaction and subsequent transactions with the FLP, (4) retaining sufficient donor assets outside of the FLP to support the donor following the formation of the FLP, (5) not pursuing an FLP strategy for terminally ill donors, and (6) avoiding contemporaneous formation and gifting of FLP units. The *Hackl* case represented a new threat with which planners needed to deal effectively to assure the maximum benefits available from an FLP planning strategy.

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*William C. Brown is a member of the BrownWinick law firm in Des Moines, Iowa. Mr. Brown is a fellow of the American College of Tax Counsel, former chair of the Section on Taxation of the Iowa State Bar Association, a member of the S Corporation Committee of the Section on Taxation of the American Bar Association, and a former instructor of Federal Income Taxation at the Drake University College of Law.

[1] 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003).

[2] In this Article, references to "FLP" and "family limited partnership" include limited liability, limited liability partnerships, and similar entities, as well as limited partnerships.

[3] Of course, the Service routinely also questions the valuations of FLP interests in both gift and estate tax contexts. The enactment of the Chapter 14 valuation rules—I.R.C. §§ 2701 to 2704—also gives the Service a tool to reduce applicable valuation discounts in these valuation controversies.

After the initial reaction to *Hackl* was digested, practitioners began to examine the case more closely, and many began to marginalize the holding based on its peculiar facts, which could be easily distinguished from those in most FLP situations.[4] Most notably, *Hackl* involved a limited liability company that principally held tree-farming operations that were not expected to generate income for many years and that had been operating at a loss for several years.[5] As a consequence, the LLC acknowledged that it did not intend to make distributions to members for many years. Since most FLPs do not involve non-income-producing property, many estate planners felt that their FLPs could easily be distinguished from *Hackl* so as to enable a donor to utilize annual exclusions with respect to gifts of their interests, particularly if distributions were being made—even if those distributions were irregular. Moreover, in the immediate aftermath of *Hackl*, there were no further cases holding gifts of FLP interests to not qualify for the gift tax annual exclusion, which added to the complacency of the estate planning community in dealing with eligibility of a gift for the annual exclusion under section 2503(b). *Hackl* came to be viewed by many as an outlier case with little applicability to the standard FLP holding income-producing property.

The complacency that developed in the estate planning community concerning annual exclusion qualifications on FLP gifts was also a function of the few challenges to annual exclusion claims that arise in a typical estate planning practice. Many gifting plans are structured as only annual exclusion gifts which do not result in the necessity of filing gift tax returns unless spouses elect to split gifts, and as a result many gifting plans do not generate audits. Planners have often been lulled into a false sense of security because of the absence of gift tax audit challenges with respect to such plans.[6]

In 2010, all of this changed. First, the Tax Court issued a memorandum opinion in *Price v. Commissioner*[7] in which the court held that gifts of limited partnership interests in a limited partnership holding commercial real estate and marketable securities were gifts of future interests not qualifying for the gift tax annual exclusion. The court cited substantial similarities in the limited partnership agreement to the operating agreement in *Hackl*, including (1) a provision which restricted the transfer of units without the consent of

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[4] *See, e.g.*, Hackl v. Commissioner—*A Valuation Practitioner's Perspective*, 14 Mercer Capital's Value Added (2002), *available at* http://www.mercercapital.com/print/?id=421.

[5] *Hackl*, 118 T.C. at 286.

[6] There is a natural tendency of estate planners to worry less about gift tax annual exclusion eligibility than about the estate tax retained interest inclusion provisions because of the perceived magnitude of the risk. Of course, if a gift tax return is not filed, the Service is not barred by the statute of limitations from assessing gift taxes in those years, even upon the audit of the decedent's estate tax return many years later. When raised in the context of an estate tax audit, the audit adjustment can be very substantial if many annual exclusion gifts were made over a lengthy period of time, but the planner only becomes aware of that adjustment after the death of the donor.

[7] Price v. Commissioner, 99 T.C.M. (CCH) 1005, 2010 T.C.M. (RIA) ¶ 25,035.

all of the limited partners,[8] (2) the grant to the limited partnership and the other limited partners of an option to purchase the interests of a partner from an assignee, and (3) a provision granting the general partner discretion as to whether to distribute profits to the partners.[9] In addition, the Tax Court expressly reaffirmed its specific formulation of the income test of present interest qualification[10] which it had set forth in the *Hackl* case as a three-part test: (1) the partnership must "generate income at or near the time of the gifts," (2) some of that income must flow steadily to the donees, and (3) "the portion of income flowing to the donees can be readily ascertained."[11] This case made it clear that the Tax Court did not regard the decision in *Hackl* to be limited to FLPs holding non-income-producing property which generated losses.[12]

About two months later, in *Fisher v. United States*, an Indiana federal district court held that transfers of membership interests in an LLC principally holding beachfront real estate bordering Lake Michigan were gifts of future interests not qualifying for the gift tax annual exclusion.[13] In so holding, the court pointed to several LLC operating agreement provisions it deemed per-

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[8] Except to another general or limited partner or to a trust for the benefit of a general or limited partner.

[9] *Price*, at 1007–08, 2010 T.C.M. (RIA) ¶ 25,035 at 9–10.

[10] Section 2503(b)(1) makes the annual exclusion available to "gifts (other than future interests in property)." Reg. § 25.2503–3(b) states that "[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." Prior to the enactment of section 2503(c), the U.S. Supreme Court held that gifts to trusts for minors, which directed the trustee to accumulate net income until the minor reached a designated age, were gifts of future interests not qualifying for the annual exclusion. Fondren v. Commissioner, 324 U.S. 18 (1945); Commissioner v. Disston, 325 U.S. 442 (1945). While the results of these cases has been changed by the enactment of section 2503(c), the court in *Hackl* cited *Fondren* for the proposition that for a gift to be a present interest gift, the donee must have both vested rights in the gift and a substantial present economic benefit from the gift. Hackl v. Commissioner, 118 T.C. 279, 288 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003). The three-part formulation of the present interest test is a further elucidation of the substantial present economic benefit test identified in *Hackl*. *See infra* Part IV.

[11] *Price*, 99 T.C.M. (CCH) at 1006–07, 2010 T.C.M. (RIA) ¶ 25,035 at 13. The formulation in *Price* is also an outgrowth of the Fourth Circuit's opinion in *Maryland National Bank v. United States*, in which the court held that the gift of income interests in a trust owning a one-half interest in a real estate partnership were not gifts of present interests qualifying for the gift tax annual exclusion despite trust terms requiring annual disbursement of the entire net income of the trust. 609 F.2d 1078, 1081 (4th Cir. 1979). The court noted that because the partnership had been operating at a loss for a number of years, there was no steady stream of income. *Id.* at 1079. As a result, the court found that the absence of a steady flow of ascertainable income to the beneficiary, whether by lack of prospects for income or restrictions on the trustees' power to disburse, resulted in the right to income being illusory and that all the beneficiaries received was the future enjoyment of the trust corpus. *Id.* at 1080; *see also infra* Part V.

[12] *Price*, 99 T.C.M. (CCH) at 1006, 2010 T.C.M. (RIA) ¶25,035 at 13.

[13] Fisher v. United States, 2010-1 U.S.T.C. ¶ 60,588, at 85,013, 105 A.F.T.R.2d 1347 at 1350 (S.D. Ind. 2010).

tinent to the present interest question: (1) that the general manager would determine the timing and amount of all distributions to members, (2) that members could only transfer their share of profits and losses and the right to receive distributions, and (3) a right of first refusal to purchase the membership units on a proposed transfer and pay for the units by means of a nonnegotiable promissory note to be paid over a period not to exceed 15 years.[14] The court also quoted the *Hackl* court's statement that a present interest "connotes the right to substantial present economic benefit"[15] and found such a benefit lacking. There seems to be little question that the district court's holding was also influenced significantly by the fact that an appeal from that court would lie with the Seventh Circuit Court of Appeals, which had previously affirmed the Tax Court in *Hackl*.[16]

While the FLP in the *Fisher* case contained non-income-producing property like the LLC in *Hackl*, in contrast the FLP in *Price* held only income-producing property and hence cannot be distinguished from most FLPs on that basis.

This Article examines the history and policy reasons behind the present interest requirement[17] for qualifying for the gift tax annual exclusion. It also looks at the development of the formulation of the present interest test in *Hackl* and *Price* and the historical application of the present interest test to gifts involving public and closely held business interests. Finally, this Article considers the implications of the application of the *Hackl* and *Price* formulation of the present interest requirement to transfers of business interests, whether such an application is consistent with the policy for the present interest requirement of the gift tax annual exclusion, and whether such an approach should be applied to business interests in the absence of further legislative action.

[14] *Id.*

[15] *Id.* (quoting *Hackl*, 118 T.C. at 288).

[16] Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003).

[17] While in fact section 2503(b) only references a future interest in an exclusionary manner, the developed case law often uses the term present interest to mean an interest other than a future interest. Consistent with the case law, this Article uses the term present interest to mean an interest other than a future interest.

II. History

The current federal gift tax dates back to 1932,[18] when it was reenacted after the first federal gift tax[19] was repealed in 1926.[20] The acknowledged purpose of the gift tax is to serve as a backstop to prevent avoidance of the federal estate tax,[21] but it also serves to discourage income shifting from high bracket taxpayers to low bracket taxpayers under the progressive rate structure of the federal income tax.

The original 1924 gift tax enactment included a $500 per donee deduction in determining gifts subject to gift tax,[22] but this deduction did not exclude gifts of future interests from eligibility for the deduction. After the repeal of the gift tax in 1926, Congress, in the 1932 legislation, established the annual exclusion amount at $5,000 per donee per calendar year[23] but specifically

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[18] Revenue Act of 1932, ch. 209, 47 Stat. 169.

[19] Revenue Act of 1924, ch. 234, §§ 319–324, 43 Stat. 253, 311. It appears that the brief presence of the gift tax from 1924 until its repeal in 1926 suggests that the enactment of the gift tax was quite controversial at the time. In fact, the Senate Finance Committee report on the bill recommended omission of the gift tax contained in the House bill "since the tax would be a further levy upon capital, would be entirely ineffective, and would be impossible of effective administration." S. Rep. No. 68-398, at 7 (1924). Notwithstanding this critical language, the gift tax was enacted in 1924, only to be repealed in 1926.

[20] Revenue Act of 1926, ch. 27, § 1200, 44 Stat. 9, 125. The 1926 Act also retroactively reduced the gift tax rates substantially, including a reduction in the top marginal rate from 40% to 25%. Clayton F. Moore, Comm. on Ways and Means, 69th Cong., Comparison of the Revenue Acts of 1924 and 1926 134–35 (Comm. Print 1926).

[21] The current estate tax was enacted in 1916. Revenue Act of 1916, Pub. L. No. 271, 39 Stat. 756. The estate tax had been imposed several times previously in times of war or threats of war in order to raise revenue for the government but had typically been repealed after the diminishing of the threat. The estate tax was first imposed for the period from 1797 to 1802, by the Act of July 6, 1797, ch. 11, 1 Stat. 527, then was repealed by the Act of Apr. 6, 1802, ch. 19, § 1, 2 Stat. 148, 148. It was then reinstated from 1862 to 1872 by the Act of July 1, 1862, ch. 119, § 110, 12 Stat. 432, 483, modified by the Act of June 30, 1864, ch. 172, § 1, 13 Stat. 218, 218, and by the Act of June 30, 1864, ch. 173, § 126, 13 Stat. 223, 285–91, repealed in part by the Act of July 14, 1870, § 1, 16 Stat. 256, 256, repealed in full by the Act of June 6, 1872, ch. 315, § 36, 17 Stat. 230, 256, reinstated from 1898 to 1902 by the Act of June 13, 1898, ch. 448, § 29, 30 Stat. 448, 464–65, then repealed by the Act of Apr. 12, 1902, ch. 500, 32 Stat. 96. Despite the previous enactment of an estate tax several times, a gift tax was not included in any of these prior enactments. The estate tax imposed in 1916 was enacted for a similar purpose, but unlike prior enactments was not repealed after the end of the war.

[22] Sections 321(a)(3) and 321(b)(2) of the Revenue Act of 1924, ch. 234, 43 Stat. 253, allowed a deduction in computing the gifts subject to tax of "gifts the aggregate amount of which to any one person does not exceed $500." While the deduction does not specifically indicate it was an annual amount, it is apparent that an annual deduction was intended since the gift tax was imposed on gifts made during the calendar year. Thus, it appears that this original deduction was similar in structure to the annual exclusion adopted as part of the 1932 gift tax—that is, a per donee per year amount.

[23] Revenue Act of 1932, ch. 209, 47 Stat. 169 (1932). The 1932 Act made it clear that the exclusion was calculated on a per donee per calendar year basis. Section 504(b) of the Act provided "[i]n the case of gifts (other than future interests in property) made to any person by the donor during the calendar year, the first $5,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year."

excepted gifts of future interests from eligibility for the annual exclusion. The amount of this limit has bounced around over the years, but the current iteration of the exclusion amount dates back to 1981,[24] when the annual exclusion was raised from $3,000 to $10,000 and the indexation for inflation of this amount in $1,000 increments in 1997.[25] As a result of this indexing for inflation, the annual exclusion amount currently stands at $13,000 per donee per year. Since the 1932 gift tax law was enacted, the annual exclusion has always included the limitation that it does not apply to gifts of future interests, and the basic formulation of the annual exclusion has remained identical to that contained in the 1932 Act, except for the variations in the amount of the annual exclusion.[26]

In 1938, Congress denied the use of the gift tax annual exclusion to all gifts to trusts[27] because of lower court holdings that gifts in trust were deemed to be present interest gifts to the trustee,[28] which allowed donors to avoid the gift tax entirely by creating multiple trusts with multiple annual exclusions for the same beneficiary. The U.S. Supreme Court did not have occasion to deal with the gift tax annual exclusion until 1941, when several cases involving donative transfers to trusts were considered. In *Helvering v. Hutchings*, the U.S. Supreme Court held that it was the trust beneficiary, rather than the trustee, who was the donee to whom the annual exclusion applied in the case of a transfer to a trust.[29] As a result of this decision, Congress thereafter reinstated

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[24] Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 441(a), 95 Stat. 172, 319. In the 1981 Act, section 2503(e) was also added to exempt from the gift tax transfers for certain educational expenses and medical expenses directly to the educational organization or the medical care provider.

[25] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 501(c)(1)–(3), 111 Stat. 788, 846. Since the indexation was in increments of $1,000, it was not until 2002 that the annual exclusion amount increased from $10,000 to $11,000. The amount increased again in 2006 to $12,000 and in 2010 to its current level of $13,000.

[26] *See* I.R.C. § 2503(b)(1).

[27] Revenue Act of 1938, Pub. L. No. 75-554, §505(b), 52 Stat. 447, 565. This was done simply by adding a further exception for gifts in trust in addition to the exception for future interests in property to the parenthetical exception provision of the statute. The Senate Report to the bill noted:

> [T]he committee is also proposing an amendment by which the exclusion would not apply to gifts in trust. The Board of Tax Appeals and several of the Federal courts have held, with respect to gifts in trust, that the trust entities were the donees and on that account the gifts were of present and not of future interests. The statute, as thus construed, affords a ready means of tax avoidance, since a donor may create any number of trusts in the same year in favor of the same beneficiary with a $5,000 exclusion applying to each trust, whereas the gifts, if made otherwise than in trust, would in no case be subject to more than a single exclusion of $5,000.

S. Rep. No. 75-1567, at 41 (1938).

[28] *See* Commissioner v. Krebs, 90 F.2d 880, 881 (3rd Cir. 1937); Commissioner v. Wells, 88 F.2d 339, 341 (7th Cir. 1937); Noyes v. Hassett, 20 F. Supp. 31, 33 (D. Mass. 1937).

[29] Helvering v. Hutchings, 312 U.S. 393, 397 (1941).

the annual exclusion with respect to gifts to trusts.[30] In two companion cases to *Helvering v. Hutchings*, the U.S. Supreme Court also considered two other cases involving whether the particular transfers of beneficial interests in trusts were future interests and hence ineligible for the gift tax annual exclusion.[31]

III. Policy of Gift Tax Annual Exclusion

The legislative history to the 1932 Act clearly indicates that the principal policy behind the gift tax annual exclusion is administrative in nature—to avoid the necessity of tracking small gifts which do not materially avoid the federal transfer tax system.[32] Without the annual exclusion, taxpayers would be required to track and maintain records of all *de minimis* donative transfers, such as buying lunch for a friend, modest birthday or holiday gifts, and even the loaning of your lawn mower to your neighbor. Imposing the gift tax on such transfers would inspire taxpayer revolt and would impede the substantial voluntary compliance upon which all U.S. tax systems are based. Taxpayer protests over such a system might also doom the perpetuation of any federal gift tax system.

A gift qualifying for the annual exclusion of a value less than the annual exclusion amount also is not a "taxable gift," and hence no gift tax return filing is required if all of a taxpayer's gifts during the year qualify for the annual exclusion and are within the value limit.[33] This provision also serves the policy objective of simplifying administration and compliance.

Unfortunately, the legislative history regarding the adoption of the gift tax annual exclusion is more opaque about the policy behind the exclusion of future interest gifts from eligibility for the gift tax annual exclusion. The definition of future interest in the Committee Reports for the 1932 Act simply references the term to refer to "any interest or estate, whether vested or con-

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[30] Revenue Act of 1942, Pub. L. No. 77-753, § 454, 56 Stat. 798, 953. The Senate added this provision by amendment, noting:

> [Y]our committee adopts these amendments and adds an additional amendment to section 1000(b)(3), as added by the House bill, so as to allow the exclusion in the case of gifts in trust made in 1943 and thereafter. Since the Supreme Court decided, in *Helvering v. Hutchings* (312 U.S. 365 (1941)), that the beneficiaries of the trust rather than the trustee or the trust are the donees of a gift in trust, it is no longer necessary to discriminate against gifts in trust by disallowing the exclusion in such cases (except in the case of gifts of future interests in property) to prevent gift tax avoidance through the device of multiple trusts for the same beneficiary.

S. Rep. No. 77-1631, at 243 (1942).

[31] United States v. Pelzer, 312 U.S. 399, 403 (1941); Ryerson v. United States, 312 U.S. 405, 408 (1941); *see also* discussion *infra* Part IV.

[32] The legislative history to the provision states "[s]uch exemption, on the one hand, is to obviate the necessity of keeping an account of and reporting numerous small gifts, and, on the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts." S. Rep. No. 72-665, at 41 (1932); H.R. Rep. No. 72-708, at 29 (1932).

[33] I.R.C. § 6019(1).

tingent, limited to commence in possession or enjoyment at a future date."[34] This reference is substantially similar to the *Black's Law Dictionary* definition of a future interest.[35] The regulations on the annual exclusion have always done little more than parrot the above-referenced language in the legislative history to the 1932 gift tax enactment[36] and hence give little further guidance on the legislative intent or policy behind the exclusion.

The legislative history to the 1932 Act does, however, include the following statement regarding the future interest exception to the gift tax annual exclusion: "The exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of gifts of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts."[37]

This legislative history thus evidences two separate concerns that justify the future interest exclusion: (1) ascertaining the identity and number of donees and (2) determining the value of the gifts to such donees. This language from the legislative history to the 1932 Act was also specifically cited by the U.S. Supreme Court in one of the first cases considering the application of the future interest exception to the annual exclusion, *United States v. Pelzer.*[38]

The gift tax is imposed upon the transfer of property, and when an outright or fee interest in property is transferred, it is only necessary to value the actual property transferred to determine the total gift received by the donee.[39] However, since the annual exclusion is based upon what a particular donee receives rather than the aggregate value transferred by the donor and reduction for the annual exclusion determines the amount of the taxable gift, with a split interest gift, it becomes necessary in applying the annual exclusion to identify each of the donees and to value the various interests received by the donees if any of those interests may qualify for the annual exclusion. These difficulties were clearly the principal focus in excluding future interest gifts from the benefit of the annual exclusion.

Donee identification and interest valuation are particular problems with trusts for a number of reasons: (1) the frequent use of trusts to divide current benefits of the trust estate from future benefit of the trust estate, either through life estates or terms of years followed by remainders or reversions, (2) the frequent use of trusts to benefit multiple beneficiaries, and (3) the wide variety of distribution standards which donors use in their trusts. Unless the remainder beneficiary is the same person as the current income beneficiary, uncertainty can arise as to how many annual exclusions are available,

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[34] S. Rep. No. 72-665, at 29 (1932); H.R. Rep. No. 72-708, at 41 (1932).

[35] *Black's Law Dictionary* defines a "future interest" as "[i]nterests in land or other things in which the privilege of possession or of enjoyment is future and not present." Black's Law Dictionary 885 (9th ed. 2009).

[36] *See* Reg. § 25.2503-3(a).

[37] S. Rep. No. 72-665, at 41 (1932).

[38] 312 U.S. 399, 403 (1941).

[39] *See* Reg. § 25.2503-3(b).

particularly if the trustee has discretionary distribution authority. Moreover, unless the value of the income interest is ascertainable, in many cases it cannot be determined what portion of the annual exclusion is utilized with the gift of the interest.

For instance, a trust that directs the trustee to accumulate income until the occurrence of an event in the future, including the mere lapse of time, does not constitute a present interest qualifying for the annual exclusion.[40] Likewise, if distribution of income is in the discretion of the trustee, the interest of the income beneficiary will not be regarded as a present interest since the amount of income the beneficiary will receive is not ascertainable.[41] Trustee discretion to sprinkle income amongst multiple beneficiaries also prevents a finding of a present interest gift of the income interest in the trust since it is uncertain whether any of the beneficiaries will receive any distribution of income.[42]

Despite the "apprehended difficulty" noted in the legislative history to the 1932 Act and in *Pelzer*, many future interest gifts present no particular problem in identifying the donee or the value of the donee's rights.[43] For instance, in the case of a transfer to a trust with all income required to be distributed to *A* for life with a remainder to *B* where no discretionary distribution rights exist, clearly *A* and only *A* has an income interest and *B* and only *B* has a remainder interest, both of which are easily valued under the Service valuation tables.[44] In addition, no problems in donee identification or valuation are present with a trust with multiple income beneficiaries if each beneficiary is to receive a fractional share of the trust income. Likewise, a standard legal life estate with a remainder or a reversion presents neither identification nor valuation problems.

So, if donee identification and valuation are not always an issue with split interest gifts, why are only present interests subject to the gift tax annual exclusion? It could, of course, be simply that identification and valuation

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[40] *See* Skouras v. Commissioner, 188 F.2d 831, 831–32 (2d Cir. 1951); Hessenbruch v. Commissioner, 178 F.2d 785, 786–87 (3d Cir. 1950); Hopkins v. Magruder, 122 F.2d 693, 697 (4th Cir. 1941); Blasdel v. Commissioner, 58 T.C. 1014, 1019 (1972).

[41] Hamilton v. United States, 553 F.2d 1216, 1218 (9th Cir. 1977); Welch v. Paine, 130 F.2d 990, 991 (1st Cir. 1942).

[42] Although the issue has never been definitively decided, it is possible that an income distribution provision which requires distributions of income to a beneficiary under an ascertainable standard might be regarded as a present interest gift of the income interest to the extent that the amount of future income distributions to the beneficiary can be ascertained with reasonable certainty. This possibility was suggested by the court's analysis in *Fondren v. Commissioner*, 324 U.S. 18, 19 (1945), and *Commissioner v. Disston*, 325 U.S. 442, 449 (1945), discussed below. *See infra* note 74 and accompanying text.

[43] United States v. Pelzer, 312 U.S. 399, 403 (1941); H.R. Rep. No. 72-708, at 41 (1932) ("the denial of the exemption in the case of gifts of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts").

[44] *See* Reg. §1.7520-1(c)(2)(i); Internal Revenue Serv., Pub. No. 1457, Actuarial Valuations Version 3A (2009).

problems come up often enough with split interest gifts that Congress simply decided to draw a somewhat arbitrary line by permitting annual exclusions on present interest gifts but not on gifts of future interests.

However, one commentator has suggested the following explanation:

> Minor, routine gifts tend to be gifts of present interests. One seldom makes a gift of a future interest without the advice and intervention of an attorney or other professional. If a gift is in the form of a future interest, it is likely to have been made as much from tax-reduction motives as from a simple desire to make the kind of gift that Congress sought to exempt through section 2503(b). Accordingly, Congress chose, rather than requiring an investigation into the motives prompting each gift of a future interest, to disqualify such gifts altogether for the annual exclusion.[45]

Essentially, this commentator believes that Congress intended to not allow donors to utilize the annual exclusion on the type of gifts which are designed to reduce the donor's estate tax liability. This explanation, however, seems inadequate because the $5,000 annual exclusion enacted as part of the 1932 Act was a very significant exclusion amount relative to the size of the specific exemption amount of $50,000 in the gift tax[46] and hence would be expected to generate gifts designed to reduce future estate tax liability. Moreover, this explanation is also based on the prevailing view that the sole purpose of Congress in enacting the gift tax was to discourage gifts designed to circumvent the estate tax. A recent commentator has, however, pointed out that the historical background of the 1932 gift tax is far more complicated than this simplistic viewpoint, and in fact, the enactment of the gift tax was actually designed to raise revenue by encouraging donors to make taxable gifts.[47]

The specific language of section 2503(b)(1) makes it clear that the future interest exclusion from eligibility for the annual exclusion is specifically directed at split interests gifts and gifts in trust because the term "future interest" in legal parlance is generally applicable only to such interests. At the time of the enactment of the gift tax, the FLP was unheard of, and the concern of Congress about avoidance of the estate tax through lifetime gifts was focused on the predominant estate planning technique at the time—gifts through the

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[45] Jeffrey G. Sherman, *'Tis a Gift to be Simple: The Need for a New Definition of 'Future Interest' for Gift Tax Purposes*, 55 U. Cin. L. Rev. 585, 590 (1987).

[46] Revenue Act of 1932, ch. 209, 47 Stat. 169. As noted, the original annual exclusion amount was ten percent of the lifetime exemption amount. With a current five million dollar exemption equivalent amount, a comparable annual exclusion today would be $500,000. Moreover, if the $5,000 annual exclusion in effect for 1932 were adjusted for inflation using the CPI-U, the current amount of the exclusion would be approximately $77,000.

[47] Jeffrey A. Cooper, *Ghosts of 1932: The Lost History of Estate and Gift Taxation*, 9 Fla. Tax Rev. 875, 913 (2010). Since an individual must die to generate estate tax for the government, the estate tax did not quickly generate revenue. Needing revenue at a time during which government revenues had plummeted during the depression, Congress chose to incentivize lifetime gifts by enacting a gift tax which had rates substantially lower than the estate tax, hoping that taxpayers would choose to pay gift tax now at a lower rate rather than estate tax later at a higher rate.

use of trusts or split interest gifts.[48]

A better explanation for the inapplicability of the annual exclusion to future interest gifts lies in the essential nature of future interests. Gifts of remainder interests represent transfers similar to a bequest to the extent that the donor or a close relative holds the income interest for a period tied to the life of the donor.[49] The estate tax contains numerous provisions which pull back into a donor's gross estate property transferred where the donor has retained certain rights with respect to the transferred property for a period linked to the donor's life.[50] The rationale for these provisions is the view that the transfer is effectively a transfer similar to a bequest, and hence, the transferred property is treated as if it were bequeathed at death. Even if the delay in enjoyment of the interest is not tied to the donor's life, future interest gifts represent a type of delayed bequest to the extent that intervening interests continue beyond the lifetime of the donor. Moreover, a well-advised donor can structure a deferred gift in such a manner to be similar to a bequest but not be pulled back into the donor's gross estate under the retained interest provisions of the estate tax.[51] As a result, it makes sense to not give favorable gift tax treatment to such transfers.

The enactment of the gift tax annual exclusion must also be considered in the context of developments that occurred contemporaneously. The estate tax originally included a provision which included in a decedent's gross estate property transferred "in contemplation of or intended to take possession or enjoyment only at or after death."[52] The enactment of the federal gift tax occurred at the same time that Congress was reacting to the Supreme Court's

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[48] *See* H.R. Rep. No. 72-708, at 8 (1932).

[49] Under current law, a transfer with an income interest retained by the donor for his life will, of course, be pulled back into the donor's estate under section 2036(a)(1) and a transfer with an income interest left to another which is tied to the life of the donor will be pulled back into the donor's estate under section 2037 if the donor retains a reversionary interest with a value immediately prior to the donor's death of greater than five percent of the value of the transferred property.

[50] I.R.C. §§ 2035, 2036(a)(1), 2036(a)(2), 2037. A similar rationale exists for sections 2038, 2039, and 2040 which, although not requiring the retention of an interest by the decedent, are testamentary-type transfers which pass property to another upon the death of the donor.

[51] For instance, if a donor with a 20-year life expectancy transferred property to a trust that provides for income to the donor's sibling for 20 years with a remainder to the donor's child, the trust property would not be included in the donor's estate under any of the retained interest provisions since the donor would not have retained an interest in the trust. It also would not be included under section 2037 since the child receives the property at the end of the term rather than as a result of surviving the donor and would also not be included under section 2039 since not paid by virtue of surviving the decedent under a contract or agreement.

[52] Revenue Act of 1916, Pub. L. No. 64-271, § 202(b), 39 Stat. 756, 778. This provision included in the gross estate interests "which the decedent has at any time made a transfer, or with respect to which he has created a trust, in contemplation of or intended to take possession or enjoyment at or after death." Under this provision property transferred within two years of death was rebuttably presumed to have been made in contemplation of death.

decision in *May v. Heiner*[53] in which the U.S. Supreme Court held that the contemplation of death provision in the estate tax did not apply to a transfer to trust with a retained life estate because the life estate was extinguished by virtue of the transferor's death and hence no transfer of an interest in property from the transferor occurred on the transferor's death. After passing a Congressional Joint Resolution on March 3, 1931,[54] that interpreted the contemplation of death provision contrary to the Supreme Court's decision in *May*, Congress adopted in the Revenue Act of 1932 the language in what has since become section 2036(a).[55] Thus, this context clearly shows that Congress was focused on not providing advantageous treatment for split interest gifts of remainder interests in property.

Because of the similarity of donative transfers of future interests to bequests by the donor, it is likely that the true reason for the exclusion of future interest gifts from the annual exclusion benefit was because such transfers represented testamentary transfers similar to bequests which Congress appropriately regarded as not properly exempted from either the gift or estate tax. Since in many cases the value of the gifted property would not be pulled back into the estate because of the limited reach of the retained interest provisions of the estate tax, Congress could understandably conclude that at least the value of such bequest-type gifts should not be excluded from the gift tax base.

The intended scope of the future interest exception to the gift tax annual exclusion becomes apparent when the initial Treasury regulations under the 1932 gift tax are examined. The pertinent provision of these regulations dealing with future interests in property gives the following example of the manner of ascertaining the amount of gifts subject to gift tax based upon the $5,000 annual exclusion under the Act:

> A resident donor gives $10,000 in cash to each of his two sons and conveys, without a valuable consideration, property of the value of $100,000 to a trustee who is to pay the income to the donor's wife during her lifetime and at her death deliver the property to his two daughters. There should be subtracted $5,000 from each of the $10,000 gifts to the sons, and $5,000 from the value of the life estate given to the wife, *assuming that the value of her estate equals or exceeds that amount*. The interests of the daughters in

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[53] 281 U.S. 238 (1930).

[54] H.R.J. Res. 529, 71st Cong. (1931).

[55] Revenue Act of 1932, Pub. L. No. 72-154, §803(a), 47 Stat. 169, 279. The House Report to the bill stated:

> The purpose of this amendment . . . is to clarify in certain respects the amendments made to that section by the joint resolution of March 3, 1931, which were adopted to render taxable a transfer under which the decedent reserved the income for life. The joint resolution was designed to avoid the effect of decisions of the Supreme Court holding such a transfer not taxable if irrevocable and not made in contemplation of death.

H.R. Rep. No. 72-708, at 46 (1932).

> the trust property being future interests, no such subtraction is to be made therefrom.[56]

The illustration clearly indicates a focus on split interest gifts only. This portion of the regulations references another provision for the valuation of future interests which deals exclusively with the valuation of annuities, life, remainder, and reversionary interests.[57] It values annuities payable annually at the end of each year by reference to Table A and Table B in that regulation, which consist of single life and term certain tables calculating the present worth of both present and future interests payable annually based upon a four percent discount rate and provides mechanisms for adjusting such valuation if the payments are semiannual, quarterly, or monthly.

A portion of this provision also contains the following statement:

> If a gift consists of the donor's right to receive the entire income of certain property during the life of Z, or for a term of years, and the annual rate of income for a period equal to or exceeding the life expectancy of Z, or for such term of years, is fixed or definitely determinable at the time of the gift, then the value of the gift should be computed as explained above in the case of an annuity. Where the rate of annual income is not determinable, or where the donor is entitled merely to the use of nonincome-producing property, a hypothetical annuity at the rate of 4 per cent of the value of the property should be made the basis of the calculation.[58]

These regulations, having been adopted close in time to the original enactment of the 1932 gift tax, reveal that the government's sole concern with the future interest exclusion related to the valuation of split interest gifts and these regulations provided a framework for valuing such interests. They do not, however, suggest that the concern extended beyond split interest gifts or that the Service envisioned the future interest exception to the annual exclusion to extend beyond the future interest component of a split interest gift. In fact, the reference in the regulation to use of the applicable tables to value the use of non-income-producing property indicates that the absence of an ascertainable amount of income would be no impediment to valuing a split interest gift of an income interest.[59]

Unlike gifts in trust or split interest gifts, ascertaining the donee of a business interest is usually not a significant problem because ownership of businesses is typically not bifurcated between those with immediate enjoyment and those with deferred enjoyment. Moreover, while the valuation of closely held business interests is often difficult, it does not involve the same valuation

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[56] Reg. 79, Art. 11 (1933). Note that at the time this regulation was issued, no marital deduction was allowable either under the gift tax or the estate tax.

[57] Reg. 79, Art. 19 (1933).

[58] Reg. 79, Art. 19, ¶ 7 (1933).

[59] Later regulations omit the reference to income interests in non-income-producing property, thus opening the door for the cases discussed below. Clearly, *Hackl*, *Price*, and *Fisher* are inconsistent with this regulation.

considerations present with split interests because it is not dependent upon valuation tables with fixed and specified present value discount rates.

IV. Case Law Development of Present Interest Requirement

The only U.S. Supreme Court cases addressing the present interest–future interest issue under the gift tax annual exclusion were rendered in the 1940s, and all of these cases involved transfers to trusts.

The U.S. Supreme Court first addressed the question of what transfers were gifts other than future interests in a trio of companion cases decided in 1941, *Helvering v. Hutchings*,[60] *United States v. Pelzer*,[61] and *Ryerson v. United States*.[62] While the *Hutchings* case did not specifically address what constituted a future interest ineligible for the gift tax annual exclusion,[63] both *Pelzer* and *Ryerson* did. In *Pelzer*, the trust which received the gifts provided that the beneficiaries were not entitled to receive any benefits from the trust until the later of the beneficiary attaining age 21 or the accumulation of ten years of trust income.[64] The court rejected the claim that the annual exclusion applied to the additions to these trusts, noting that the beneficiaries had no right to the present enjoyment of the corpus or income and would only receive a portion of the trust if they survived ten years and reached the age of 21.[65] The court also rejected the taxpayer's argument that the term future interest in the annual exclusion statute is limited by state law but held that it was instead to

[60] 312 U.S. 393 (1941).
[61] 312 U.S. 399 (1941).
[62] 312 U.S. 405 (1941).
[63] *See supra* text accompanying note 29.
[64] 312 U.S. at 400.
[65] This case was decided before the enactment of section 2503(c), which now permits certain trusts which accumulate income for minors to qualify for the gift tax annual exclusion. *Pelzer*, 312 U.S. at 403.

be interpreted in light of the purpose of the gift tax statute.[66]

In *Ryerson*, gifts were made to two separate trusts and annual exclusions were claimed with respect to the trustees of one of the trusts, who had the right to terminate the trusts and receive the trust assets upon their joint agreement, and to the beneficiaries of the other trust, who would receive the proceeds of insurance on the donor's life upon survivorship of certain individuals.[67] The court held that the interests gifted in the first trust were future interests because immediate use and enjoyment were contingent on events which had not yet occurred—an agreement amongst the trustees to terminate the trust—and that the interests gifted to the second trust were future interests because all beneficiaries who might be entitled to use and enjoyment of the trust were ascertainable only upon the happening of one or more uncertain future events.[68]

Another pair of annual exclusion cases reached the U.S. Supreme Court in 1945. In *Fondren v. Commissioner*,[69] the grantor gifted to trusts in which the trustee was instructed to accumulate income until the beneficiaries reached age 25, although the terms of the trust directed the trustee to use the income to provide for the support, maintenance, and education of beneficiaries if necessary. The court held that the trust interests were future interests since the rights of the beneficiaries to income were not absolute and immediate because the need for distributions for support had not yet arisen[70] and that as

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[66] The court stated:

> [T]he revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its application dependent on state law. Burnet v. Harmel, 287 U.S. 103, 110, 53 S.Ct. 74, 77, 77 L.Ed. 199; Morgan v. Commissioner, 309 U.S. 78, 81, 60 S.Ct. 424, 426, 84 L.Ed. 585. We find no such implication in the exclusion of gifts of "future interests" from the benefits given by § 504(b). In the absence of any statutory definition of the phrase we look to the purpose of the statute to ascertain what is intended. It plainly is not concerned with the varying local definitions of property interests or with the local refinements of conveyancing, and there is no reason for supposing that the extent of the granted tax exemption was intended to be given a corresponding variation. Its purpose was rather the protection of the revenue and the appropriate administration of the tax immunity provided by the statute. It is this purpose which marks the boundaries of the statutory command.

Id. at 402–03. While it is well settled that state law determines the nature of property interests and federal law determines the federal transfer tax treatment of transfers of such interests, this statement seems to go a bit further by suggesting that a property interest that is not a future interest for state law may nevertheless be considered a future interest under the gift tax statute. This suggestion opens the door to the decisions in *Hackl*, *Price*, and *Fisher*, but is inconsistent with the legislative history to the future interest exception to the annual exclusion.

[67] *Ryerson*, 312 U.S. at 406–07.

[68] *Id.* at 408–09.

[69] 324 U.S. 18 (1945).

[70] *See supra* note 42.

a result use and enjoyment of the trust assets was conditioned during minority and until the beneficiaries reached a certain age.[71]

The U.S. Supreme Court again addressed a trust for minors in *Commissioner v. Disston*.[72] In this case the trustees were directed to accumulate net income until the minor beneficiary reached age 21 but also were directed to apply income from the trust as was necessary for the education, comfort, and support of the minor.[73] The court noted that there was no requirement to pay the income nor was there any means of ascertaining the amount of the income to be paid to the beneficiary and that as a result the interest was a future interest and the annual exclusion was not available.[74] Congress, apparently thinking that deferring income distributions to minors was not such a bad idea, responded by enacting section 2503(c),[75] which grants annual exclusions to additions to trusts for minors under certain conditions even though accumulation of trust income may be permitted until the beneficiary reaches age 21. Nevertheless, the principles in these cases are the foundational building blocks upon which all later case law has been based regarding the present interest requirement of the gift tax annual exclusion.

The formulation of the test for determining a present interest gift by the Tax Court in *Hackl* originated with the statement by the U.S. Supreme Court in *Fondren v. Commissioner* that the concept of a present interest "connote(s) the right to substantial present economic benefit."[76] The Tax Court acknowledged that such a benefit could arise either because of the use, possession, or enjoyment of the property itself or of the income from the property.

The Tax Court then examined the terms of the organizational documents of the FLP to determine whether there was the requisite substantial present economic benefit from the use, possession, or enjoyment of the property itself and determined that several operating agreement provisions precluded such a finding. In particular, the court identified the following: (1) that no member had the right to withdraw his capital account or demand a return of his capital contribution, (2) that each member waived any right to partition of

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[71] 324 U.S. at 24.

[72] 325 U.S. 442 (1945).

[73] *Id.* at 443–44.

[74] The court stated:

> In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required, there is no basis for a conclusion that there is a gift of anything other than for the future.

Id. at 449. Note that the 1932 gift tax regulations, discussed above, would not have required any ascertainable portion of income to be payable to the income beneficiary in order for a gift of the income interest to qualify for the gift tax annual exclusion and would have valued an income interest in non-income-producing property according to the valuation tables contained in the regulations.

[75] Section 2503(c) was originally enacted as part of the Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3.

[76] 324 U.S. 18, 20–21 (1945).

the property held by the company, (3) a prohibition on a sale of a member's membership interest except with the prior written consent of the manager, and (4) a right of first refusal by the manager in the event a member wished to sell his membership interest.[77]

The court then distilled case law into a three-part test for determining whether rights to income satisfy the present interest requirement: "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."[78]

In so doing, the court relied principally on its own decision in *Calder v. Commissioner*[79] and the Fourth Circuit's decision in *Maryland National Bank v. United States*,[80] both of which involved transfers to trusts and a determination as to whether the income interest therein qualified for the gift tax annual exclusion. Because the company in *Hackl* was operating at a loss and was not expected to generate net income in the near future, the court also held that the donee did not have the necessary substantial present economic benefit in the income to meet the present interest requirement.[81]

In *Price*, the Tax Court made a similar analysis of the limited partnership agreement provisions, which were similar to those in *Hackl*, to determine that there was no substantial present economic interest in the transferred property itself to justify an annual exclusion.[82] The court then analyzed the historical income of the partnership and its distributions to partners and held that no ascertainable portion of the income of the partnership would flow steadily to the donees because no income had been distributed to the partners in two of the six years examined by the court.[83] Of course, unlike *Hackl*, the partnership in *Price* had a history of regular earnings because of the nature of its holdings, so the court instead looked at the partnership distribution history to support its holding.

A few months after *Price*, the U.S. District Court for the Southern District of Indiana decided *Fisher v. United States*.[84] Since an appeal from that court's decision would lie with the Seventh Circuit Court of Appeals which had affirmed the Tax Court in *Hackl*, the court applied the substantial present economic benefit standard referenced in the Seventh Circuit's decision in *Hackl*. In holding that the donees did not have a substantial present economic

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[77] Hackl v. Commissioner, 118 T.C. 279, 296–98, (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003).

[78] *Id.* at 298.

[79] 85 T.C. 713 (1985).

[80] 609 F.2d 1078 (4th Cir. 1979).

[81] *Hackl*, 118 T.C. at 299.

[82] Price v. Commissioner, 99 T.C.M. (CCH) 1005, 1008–10, 2010 T.C.M. (RIA) ¶ 25,035, at 12–13.

[83] *Id.* at 1010.

[84] Fisher v. United States, 2010-1 U.S.T.C. ¶ 60,588, 105 A.F.T.R.2d 1347 (S.D. Ind. 2010).

benefit in the transferred property, the court looked both at the transferrees' inability to cause income to be distributed to them and the transfer restrictions and associated right of first refusal granted to the LLC.[85] Unlike the Tax Court in both *Hackl* and *Price*, the court did not separately analyze the right to the present use, possession, and enjoyment of the property itself as contrasted to the right to the present use, possession, and enjoyment of the income from the property.

V. Development of the Tax Court's Criteria

As noted above, the Tax Court's standards for judging whether a gifted interest is a present interest came principally from its decision in *Calder* and the Fourth Circuit's decision in *Maryland National Bank*.

In *Calder v. Commissioner*,[86] the taxpayer, the widow of well-known artist Alexander Calder, transferred paintings she had inherited from her husband as a result of his death approximately a month earlier to four separate trusts. Two of the trusts were for the benefit of each of the donor's daughters and required distribution of all of the net income to the donor's daughters, and two of the trusts were for the benefit of the donor's grandchildren and required distribution of all of the net income in equal shares to the grandchildren. Each trust also granted the trustees the discretion to distribute corpus to the beneficiaries as they deemed advisable for the welfare of the beneficiaries. After citing the statement in *Disston* that "a steady flow of some ascertainable portion of income"[87] to the beneficiary was required for an income interest to be a present interest, the court then summarized the requirements as follows: "*Disston* thus requires the taxpayer to prove three things: 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."[88]

The court held that the trust failed the first prong of the test because of the nature of the assets held by the trust, and hence, the income interests did not qualify for the annual exclusion—stating that there was no showing that the trusts will generate income for distribution to the beneficiaries.[89] In so holding, the court rejected the taxpayer's argument that a trust indenture provision authorizing the trustees to sell the paintings and reinvest the proceeds in income-producing property and state law fiduciary duties imposed on the trustees to convert the paintings to income-producing property dictated a contrary finding since there was no evidence that the trustees intended to so convert the trust estate.[90]

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[85] *Fisher*, 2010-1 U.S.T.C. ¶ 60,588 at 85,013, 105 A.F.T.R.2d at 1349.
[86] 85 T.C. 713 (1985).
[87] *Id.* at 727 (citing Commissioner v. Disston, 325 U.S. 442, 449 (1945)).
[88] *Id.* at 727–28.
[89] *Id.* at 727.
[90] *Id.* at 730.

The court also distinguished *Rosen v. Commissioner*,[91] in which the Fourth Circuit had found a present interest in a trust income interest where the trust owned non-income-producing property but the trustees were specifically granted the power to sell non-income-producing assets and reinvest them in income-producing property in the trust instrument.[92] It also reaffirmed its prior refusal to follow *Rosen* in *Berzon v. Commissioner*,[93] stating that the possibility that the trustees may sell the gifted property and reinvest in income-producing property was so uncertain as to render the gifted property incapable of valuation, thus resulting in failure to meet the third prong of the test it had set forth.[94]

In *Maryland National Bank*, the Fourth Circuit disallowed annual exclusions on transfers of one-half interests in an unprofitable real estate partnership[95] to a trust for the benefit of 17 members of the donor's family which required distribution of all net income annually. Unlike in *Calder*, the trustees were given broad powers to invest in or retain nonproductive assets and were under no duty to make the trust property generate income. In citing the Supreme Court's requirement of "a steady flow of some ascertainable portion of income," the court noted that "[t]he absence of a steady flow of ascertainable income to the beneficiary can result just as surely from a lack of any prospect of income as it can from restrictions on the trustees' power to disburse income."[96] The court then indicated that the taxpayer must show "that the trust will receive income, and second, that some ascertainable portion of the income will flow steadily to the beneficiary"[97] and held that the taxpayer had failed to sustain this burden in light of the character of the trust assets and the specific authorization for the trustees to hold unproductive property.

The court also rejected valuation of the income interests under the Service's valuation tables, stating that use of such tables is appropriate "only when

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[91] 397 F.2d 245 (4th Cir. 1968).

[92] In contrast, in *Calder* the trustees were expressly given the authority to continue to hold the property transferred to the trust—whether or not income-producing—but could also choose to sell such property and reinvest in income-producing property. 85 T.C. at 729.

[93] 63 T.C. 601 (1975)

[94] *Calder*, 85 T.C. at 729–30.

[95] Md. Nat'l Bank v. United States, 609 F.2d 1078, 1081 (1979). The real estate involved included a farm and waterfront property with recreational facilities, both of which contained rental housing. *Id.* at 1082. The court does not make clear whether the partnership was unprofitable only from a tax perspective or also from a cash flow perspective. The presence of substantial depreciation deductions may have rendered it unprofitable from a tax perspective even though it may have generated positive cash flow.

[96] *Id.* at 1080.

[97] *Id.*

there is proof that some income will be received by the trust beneficiaries."[98] Finally, the court distinguished its prior decision in *Rosen v. Commissioner* in which publicly traded corporate stock was held to confer a present interest even though the stock had never paid dividends on the basis that the income component of the gift in *Rosen* was reflected in the stock's growth and that, as a result, use of the tables would not result in an unrealistic and unreasonable valuation of the present income interest.[99]

Several things stand out from these cases as applied by the court in *Hackl*. First, none of these cases involved transfer restrictions which the court held to prevent a finding of present use, enjoyment, or possession of the property gifted in *Hackl*. Instead, they dealt only with present use, enjoyment, or possession of the income from the trust estate gifted. As such, *Hackl* clearly represents an extension of prior precedent. Second, the court's formulation of the test of whether the donee had the present use, enjoyment, or possession of the income from the gifted property came from two cases involving a determination of whether a trust income interest qualified for the annual exclusion and not from a transfer of property outside of the trust context. As will be noted later in this Article, this distinction matters because trust income interests are valued according to valuation tables assuming a designated present value discount rate, while property transferred outright is not valued under such tables. Third, it is apparent from the court's discussion of the Service's valuation tables in *Maryland National Bank* that the principal reason for the tests for determining whether there was a present interest with respect to a trust income interest was the question of whether actuarial tables valuing income interests could be appropriately utilized. While this is a legitimate consideration in the application of valuation tables using assumed present value discount rates, because such valuation tables are not utilized in outright gifts of property those considerations are not present with gifts of business interests.

VI. Use, Enjoyment, and Possession of the Property Transferred

As noted above, the analysis and application of the present interest test as applied to the property transferred rather than to income from the property

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[98] *Id.* at 1081. Note that the original regulations under the 1932 gift tax would not have reached this conclusion. As noted above, paragraph 7 of Article 19 of those regulations specifically applied the valuation tables in the regulations to income interests in trusts where the trust owned non-income-producing property. Moreover, the U.S. Supreme Court cases referenced above did not consider the nature of the property owned by the trust in determining whether the trust income interests qualified for the gift tax annual exclusion.

[99] *Md. Nat'l Bank*, 609 F.2d at 1081. Based upon this distinction, the Tax Court in *Calder* could have found a present interest gift since the artwork placed in the trust had significant future appreciation potential just as the corporate stock did in *Rosen*. The court's distinguishing of *Rosen* is quite weak, since non-income-producing property often has appreciation potential just as corporate stock does. The Fourth Circuit also attempted to distinguish *Rosen* on the basis that the corporation in *Rosen* was a profitable enterprise, even though no distributions of dividends to shareholders had ever been made, while the partnerships involved in *Maryland National Bank* were consistently operated at a loss.

by the Tax Court in *Hackl* was quite novel—particularly in light of the prior precedent on outright gifts of property. Moreover, the court did not cite any authority for this approach.

Regulation section 25.2503-3 specifically states that a gift of a bond or a note qualifies as a present interest gift even if it is in the nature of a zero coupon instrument that does not pay until maturity.[100] An outright gift of a policy of life insurance is also not regarded as a future interest under the same regulation,[101] and the payment of premiums on life insurance owned by another person is likewise regarded as a present interest gift.[102] The regulation does, however, indicate that a future interest may exist in such contractual obligations "by the limitations contained in a trust or other instrument of transfer effecting a gift."[103] For instance, certainly a transfer of property which by its terms is to only take effect at a designated future time would not be regarded as a present interest gift. This language does not appear by its terms, however, to apply to business entity organizational documents since those are not instruments of transfer *effecting* a gift—even though their provisions may indeed *affect* enjoyment of the gifted property. Rather, organizational documents which define the parameters of the property ownership interest are fundamentally similar to bond or insurance policy contractual provisions since they define the rights of the owner of the interest in the same manner as do contractual provisions of a bond or insurance policy.

The Tax Court in *Hackl* and *Price* and the Indiana district court in *Fisher* focused specifically only on provisions contained in the organizational documents and not on the instruments of transfer in finding the absence of present enjoyment of the gifted property. In *Hackl* the offending provisions that led the court to determine that the donee did not use, enjoy, or possess the enjoyment of the transferred property—transfer restriction, right of first refusal on transfer, and grant of discretion to manager on distributions—appear to all have been contained in the LLC operating agreement.[104] The same appears to be true of the offending restrictions in *Price* and *Fisher*, which appear to have been contained in the limited partnership agreement and operating agreement, respectively.[105] As a result, it is safe to say that the Tax Court was plowing new ground well beyond the provisions in the regulations in using the organizational documents of the entities to establish the absence of present use, enjoyment, or possession of the transferred property—which is difficult to justify in light of the provisions of the regulations treating gifts of life insurance, bonds, and notes as present interest gifts.

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[100] Reg. § 25.2503-3(a).

[101] *Id.*

[102] Reg. § 25.2503-3(c), ex. (6).

[103] Reg. § 25.2503-3(a).

[104] Hackl v. Commissioner, 118 T.C. 279, 295–99 (2002).

[105] Price v. Commissioner, 99 T.C.M. (CCH) 1005, 1010, 2010 T.C.M. (RIA) ¶ 25,035, at 9–10; Fisher v. United States, 2010-1 U.S.T.C. ¶ 60,588, at 85,012, 105 A.F.T.R.2d 1347, 1349 (S.D. Ind. 2010).

The reliance of the Tax Court in *Hackl* and *Price* on transfer restrictions is also inconsistent with a prior decision of that very court which had acknowledged that spendthrift provisions in a trust did not prevent the transfer of an income interest in the trust from qualifying for the annual exclusion.[106] Other courts and the Service itself in a published revenue ruling have issued the same holding with respect to spendthrift provisions of a trust.[107] Such provisions are not fundamentally different than the stock transfer restrictions found to be fatal to present interest treatment in *Hackl*, *Price*, and *Fisher*.

The difficulty in using the organizational documents to support the absence of present use, enjoyment, or possession of the transferred property lies in the fact that most investment or business interests have limitations on their use and enjoyment due to the contractual provisions of the instrument creating the interest—including those interests referenced in the regulations. For instance, insurance policies require submission of documentation to the insurer in order to enjoy the benefits of the policy, and that process inevitably leads to delay in enjoying those benefits—yet the regulation specifically provides for present interest treatment of gifts of such policies. Many bonds and notes have contractual provisions in the bond or note itself that will defer payment upon the occurrence of specified events, but the regulation also would apparently treat gifts of those assets as present interest gifts as well. Unmatured insurance policies and zero coupon bonds are in fact the essence of future interests if that term is not defined by reference to state property law but in terms of the immediacy of the enjoyment of the economic benefits of the property as the courts did in *Hackl*, *Price*, and *Fisher*.

Moreover, circumstances surrounding the ownership of assets often lead to the practical absence of present use, enjoyment, or possession of property. For instance, minority interests in a closely held corporation convey no real present economic benefit unless dividends are paid because of the absence of a market for the purchase of such stock.[108] The same can be said for any property for which there is not an active trading market and no regular payment of income.[109] While the property can in theory be sold, in practice there are no buyers for these assets as to make the ownership of the property effectively worthless on a present basis even though there may be value to such property in the future. Because of these considerations, it is difficult to see a basis to

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[106] *See* Hutchinson v. Commissioner, 47 T.C. 680, 687–88 (1967). The Tax Court did not attempt to distinguish this decision nor did it reference or comment upon it in either *Hackl* or *Price*.

[107] *See* Gilmore v. Commissioner, 213 F.2d 520, 523 (6th Cir. 1954); Rev. Rul. 1954-344, 1954-2 C.B. 319.

[108] Not only is such stock not marketable, but it is also nearly impossible to obtain a bank loan secured by closely held corporation stock unless the corporation agrees to repurchase the stock if the bank puts the stock to the corporation after a loan default.

[109] For instance, it is difficult to envision in most situations a person purchasing a newly created patent for cash, although they are often purchased through future royalty payment arrangements.

limit the scope of the *Hackl*, *Price*, and *Fisher* approaches to FLP interests and not to apply them with equal force to any closely held business interest or any other property without an active trading market.

VII. Use, Enjoyment, and Possession of Income from the Property

The courts in *Hackl*, *Price*, and *Fisher* drew their authority for determining the absence of present use, enjoyment, and possession of income from the property transferred only from cases involving the determination of whether a gift of an income interest in a trust qualified for the annual exclusion. Both *Calder* and *Maryland National Bank* involved a transfer of property to a trust requiring distribution of all of the net income to beneficiaries in which the courts effectively determined that the trust income distribution rights were illusory because of the unproductive nature of the property transferred to the trust.[110]

There is a longstanding body of case law holding that an income interest in a trust is not a present interest if the trust directs the trustee to accumulate income,[111] or if the income beneficiary's right to income distributions is delayed[112] or depends upon the attainment of a designated age.[113] Case law also clearly holds that trustee discretion over distribution of income prevents the income interest from being a present interest.[114]

In fact, the ascertainable value requirement of the courts in *Hackl*, *Price*, and *Fisher* emanates from the two seminal U.S. Supreme Court cases from the 1940s referenced above[115]—*Commissioner v. Disston* and *Fondren v. Commissioner*—both of which involved the determination of whether an income interest in a trust qualified for the annual exclusion.

While it is true that there have been a number of cases not cited by the court in *Hackl* which denied the annual exclusion on trust income interests where the trust owned closely held business interests in which dividends were not paid,[116] before *Hackl* the annual exclusion had not been denied on the gift

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[110] *See supra* text accompanying notes 86–99.

[111] United States v. Pelzer, 312 U.S. 399, 404 (1941); Blasdel v. Commissioner, 478 F.2d 226, 227 (5th Cir. 1973); Skouras v. Commissioner, 188 F.2d 831, 831–32 (2d Cir. 1951); Hessenbruch v. Commissioner 178 F.2d 785, 786 (3d Cir. 1950); Hopkins v. Magruder, 122 F.2d 693, 697 (4th Cir. 1941); Perkins v. Commissioner, 1 T.C. 982, 985 (1943).

[112] Braddock v. United States, 73-2 U.S.T.C. ¶ 12,963, at 82,700, 33 A.F.T.R.2d 1394 (N.D. Fla. 1973).

[113] Commissioner v. Disston, 325 U.S. 442, 447 (1945); United States v. Pelzer, 312 U.S. 399, 403–04 (1941); Klein v. Commissioner, 34 T.C.M. (CCH) 682, 1975 T.C.M. (RIA) ¶ 75,145.

[114] Hamilton v. United States, 553 F.2d 1216, 1218 (9th Cir. 1977); Welch v. Paine, 130 F.2d 990, 992 (1st Cir. 1942).

[115] *See supra* text accompanying notes 69–76.

[116] *See* Stark v. United States, 345 F. Supp. 1263, 1265 (W.D. Mo. 1972); Berzon v. Commissioner, 534 F.2d 528, 531–32 (2d Cir. 1976). These cases, however, make clear that the principal concern of the court was the utilization of the Service's valuation tables on the income interests gifted.

of the stock itself on the basis of the nonpayment of dividends.

Generally, income interests in trusts are valued according to Service valuation tables under section 7520. These tables are based upon assumptions on present value discount rates and—with those income interests tied to beneficiary lives—actuarial tables. While these tables are utilized in most cases, the regulations specifically provide that the mortality component of the actuarial tables cannot be used in valuing a gift if the measuring life is terminally ill or is known to have an incurable illness or other deteriorating physical condition at the time of the gift.[117] Likewise, these same regulations provide that the standard section 7520 income factor is not to be used "unless the effect of the . . . governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment . . . that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time,"[118] or if the governing instrument permits the beneficiary's income to be withheld, diverted, or accumulated.[119] These are precisely the same type of restrictions on enjoyment found in the cases upon which the *Hackl* court relied to deny present interest treatment on the FLP gifts. However, it is abundantly clear that the purpose of these restrictions in the context of gifts in trust is simply to make sure that the conditions necessary to support the validity of using income interest valuation tables tied to assumed present value discount rates are present. Since the valuation of an FLP interest or any business interest is not in any way tied to the use of these tables, using this precedent in the case of a FLP interest or other business interest is not justified.

Courts have also consistently held that pure administrative powers in trusts do not prevent the value of an income interest to be regarded as unascertainable so as to disqualify the gift of such an interest from the annual exclusion as long as the powers may not be exercised in a manner to deprive the income beneficiary of all or a portion of trust income. For example, the power of a trustee to determine the manner and means of annual income distribution does not preclude the availability of the annual exclusion on a gift of the income interest.[120] Absent a provision to the contrary in the trust instrument,[121] the fiduciary duties of a trustee generally operate to preclude the trustee from exercising administrative powers in a manner that prefers one beneficiary over another, and hence most administrative powers will not

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[117] Reg. § 25.7520-3(b)(3).

[118] Reg. § 25.7520-3(b)(2)(ii)(A).

[119] Reg. § 25.7520-3(b)(2)(ii)(B)(1).

[120] Quatman v. Commissioner, 54 T.C. 339, 344 (1970); Munger v. United States, 154 F. Supp. 417, 421–22 (M.D. Ala. 1957).

[121] Powers to allocate receipts and expenses between income and principal—particularly when the trustee is given broad discretion in the exercise of such powers—may be regarded as equivalent to the power to withhold or accumulate income so as to prevent present interest treatment of the trust income interest. *See* Van Den Wymelenberg v. United States, 397 F.2d 443, 446 (7th Cir. 1968); Rev. Rul. 1977-358, 1977-2 C.B. 342.

impair present interest treatment of a trust income interest.[122]

The power of a board of directors, general partner, or manager to declare and pay dividends or distributions is an administrative power of the governing body granted to that governing body under state law. Under most state laws, corporate boards of directors, general partners of partnerships, and managers of limited liability concerns are subject to fiduciary duties similar to those of trustees with respect to their exercise of such powers. Hence, the administrative powers of those managers over distributions to owners should not be regarded as impairing present interest treatment of the business interest.[123] Indeed, before *Hackl* the Service had in several private letter rulings specifically referenced such fiduciary duties with respect to distributions to owners as part of the basis for determining that a gift of a business interest was of a present interest.[124] If such powers of distribution were not so regarded, no gift of a business interest could ever qualify for the gift tax annual exclusion under the present use, enjoyment, and possession of the income test in *Hackl*, *Price*, and *Fisher*.

The fundamental problem with applying an income test to outright transfers of property relates to the uncertain nature of the production of income. Property that produces income may stop producing income in the future, and non-income-producing property may start to produce income at some future point. Thus, denying the annual exclusion for non-income-producing property as in *Hackl* and *Fisher* elevates the current income production of the property over its potential for providing economic benefits in other ways, such as by means of capital appreciation.

It is also problematic to apply an income distribution requirement to a business interest because businesses that pay dividends or make distributions may cease doing so in the future, and those that do not pay dividends or distributions currently may do so in the future. Businesses have a myriad of reasons for deciding to defer the payment of dividends and distributions, and when they decide not to pay out their earnings, the value of the business interest naturally increases to the extent of those retained earnings.

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[122] Most cases have held administrative powers—such as the power to allocate receipts between income and corpus to not prevent present interest treatment if the intent to provide a substantial income interest is evident in the trust document. *See* Mercantile Safe Deposit & Trust Co. v. United States, 311 F. Supp. 670, 674–75 (D. Md. 1970); Martinez v. Commissioner, 67 T.C. 60, 70–71 (1976); Brown v. Commissioner, 30 T.C. 831, 837 (1958); Swetland v. Commissioner, 37 T.C.M. (CCH) 249, 251, 1978 T.C.M. (RIA) ¶ 78,047, at 255–56.

[123] Of course, in light of *Hackl*, *Price*, and *Fisher,* it is certainly advisable to draft an FLP agreement with a provision expressly subjecting the general partners to fiduciary duties in the discharge of these powers.

[124] P.L.R. 1994-15-007 (Jan. 12, 1994); P.L.R. 1991-31-006 (Apr. 30, 1991).

VIII. Historical Application of Present Interest Test to Transfers of Business Interests

Part of the estate planning community's befuddlement with the court's decision in *Hackl* related to prior court cases and a number of prior Service pronouncements that suggested that the present interest requirement was generally met with respect to the transfer of a business interest even in the absence of a steady flow of income to the donee from the interest and even with commonplace transfer restrictions—such as are frequently present in buy–sell agreements and entity organizational documents.

Before *Hackl*, the Service had generally not challenged the utilization of the gift tax annual exclusion with respect to an outright gift of a business interest to a family member. For example, the Service did not raise the present interest issue with respect to a gift of nonvoting stock which was subordinate in the payment of dividends to outstanding preferred stock in *Estate of Josephine Alexander*.[125] Similarly, the Service did not challenge the use of the annual exclusion on gifts of corporate stock when transfer of the stock was restricted to employees of the corporation and when the stock was subject to a buyback at book value on termination of employment in *McCann v. Commissioner*.[126] A buy–sell agreement preventing sale without the consent of the other shareholders and granting the corporation and other shareholders a right of first refusal with respect to any lifetime sale and requiring the corporation to repurchase the shares at death did not generate a Service challenge to use of the annual exclusion with respect to gifts of such shares in *Ward v. Commissioner*.[127]

Even at the dawn of the new millennium, the Service remained silent about raising the present interest issue on gifts of business interests. The Service did not challenge the use of the annual exclusion on a gift of closely held corporate stock in two corporations even though the corporations paid dividends at a much lower rate than similarly situated entities in *Barnes v. Commissioner*.[128] In *Gross, Jr. v. Commissioner*,[129] the Service did not challenge the annual exclusion on gifts of closely held S corporation stock subject to a restrictive agreement which limited transferability to members of the taxpayers' families and provided a purchase option to the families at book value. And in *Estate of O'Neal v. United States*,[130] a case decided after the Tax Court's decision in *Hackl*, the Service failed to raise the present interest issue with respect to gifts of closely held S corporation stock where the donees were required to enter into a restrictive agreement with respect to the transfer of their shares during life and at death which provided an option for members of the taxpayers'

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[125] B.T.A. Memo Dec. (P-H) ¶ 42,164 (1942).
[126] 2 T.C. 702 (1943).
[127] 87 T.C. 78 (1986).
[128] 74 T.C.M. (CCH) 413, 1998 T.C.M. (RIA) ¶ 98,413.
[129] 272 F.3d 333 (6th Cir. 2001).
[130] 291 F. Supp. 2d 1253 (N.D. Ala. 2003).

family to purchase such shares at a fixed price.

The decisions in *Hackl* and its progeny were also inconsistent with prior positions of the Service itself in several technical advice memoranda and private letter rulings. In Technical Advice Memorandum 1981-21-003,[131] the Service held that an outright gift of closely held corporate stock qualified for the gift tax annual exclusion despite a stockholder's agreement provision which granted the corporation and the other shareholders a right of first refusal on an attempted transfer of the stock.

In Technical Advice Memorandum 1999-44-003,[132] the Service affirmatively determined that a general partner taxpayer's gifts of limited partnership interests to his children were present interest gifts qualifying for the annual exclusion. In this memorandum, no limited partner had a right to withdraw from the partnership and no assignee had the right to become a substituted limited partner except upon the unanimous written consent of the general partners. In holding that the annual exclusion was available with respect to these gifts, the Service also noted that the management powers the general partner possessed under the limited partnership agreement were consistent with the powers granted to general partners under state law and were similar to the powers possessed by general partners in most limited partnerships. That statement is likely true with the restrictions at issue in *Hackl*, *Price*, and *Fisher* as well.

In Private Letter Ruling 1991-31-006,[133] the donor contributed unimproved land to a limited partnership. The donor then gifted limited partnership units to family members. The partnership had nominal gross income and paid management fees to the general partner–donor to zero out net income. The general partner had the right to determine the timing and method of distribution to partners, and the donees had the right to sell the partnership units at any time—subject to a right of first refusal. The Service held that the donees received the immediate use, enjoyment, and possession of the subject matter of the gifts—the limited partnership interests—and that therefore the gifts were of present interests qualifying for the annual exclusion. In so holding, the Service noted that the powers of the general partners with respect to distributions were similar to those held by corporate boards of directors with respect to declaration of payment of dividends, that the general partners were subject to a fiduciary duty to the limited partners, and that the general partners possessed no powers other than those contained in a standard limited partnership agreement. The Service noted that such management powers are not the equivalent of a trustee's discretionary authority to distribute or withhold trust income or property—powers which would generally result in characterization of a gift in trust as a future interest.

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[131] T.A.M. 1981-21-003 (Jan. 26, 1981).
[132] T.A.M. 1999-44-003 (Nov. 5, 1999).
[133] P.L.R. 1991-31-006 (Apr. 30, 1991).

Private Letter Ruling 1994-15-007[134] involved a similar limited partnership in which the donor and others contributed cash to form the limited partnership. The Service noted that the partnership agreement provided that no partner had a right to demand a distribution or return of his capital contribution, although each partner did have the right to sell his interests to third parties—subject to a right of first refusal granted to the other partners. The Service held that the gifts would be gifts of present interests that would qualify for the annual exclusion, reasoning that the management power possessed by the donor as general partner with respect to distributions is limited by his fiduciary duties and is thus not the equivalent to a trustee's discretionary authority to distribute or withhold trust income or property.

In Private Letter Ruling 1999-05-010,[135] the Service held that gifts of limited partnership interests qualified for the gift tax annual exclusion provided that the donees have rights as limited partners in the partnership that are consistent with the rights of limited partners contained in the agreement establishing the partnership—including the right to distributions of cash and property, the right to sell or assign their interests in the partnership subject to the right of first refusal, voting rights, and rights on termination of the partnership.

The Service also issued a technical advice memorandum that suggested that transfers of other business interests were present interest gifts even though the interests may pay no dividends or distributions. In Technical Advice Memorandum 1993-46-003,[136] the Service ruled that an outright gift of stock in a closely held corporation was deemed a present interest gift even though the corporation never paid a dividend.

While these technical advice memoranda and private letter rulings are not binding upon the Service, they were publicly available to the estate planning community, and most planners relied upon them as a basis of justifying claims to annual exclusions on gifts of closely held business interests.

Notwithstanding this longstanding history of Service acknowledgment that an outright gift of a business interest would qualify for the gift tax annual exclusion, there are a few decisions which suggest that the availability of the annual exclusion on gifts of business interests is not absolute. The unusual circumstances present in these decisions, however, are not typically present with most gifts of FLP interests or of corporate stock.

For example, in Revenue Ruling 1976-360,[137] the Service held that a gift of corporate stock received in a merger which was subject to a two-year resale prohibition and upon which no dividends had been paid was not a present interest gift qualifying for the annual exclusion.

In addition, there are several court cases which have denied the taxpayer

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[134] P.L.R. 1994-15-007 (Jan. 12, 1994).
[135] P.L.R. 1999-05-010 (Feb. 5, 1999).
[136] T.A.M. 1993-46-003 (Aug. 9, 1993).
[137] Rev. Rul. 1976-360, 1976-2 C.B. 298.

the use of the annual exclusion in the context of certain donative transactions involving corporate stock. In *Chanin v. United States*, the court held that gifts of corporate stock to a wholly owned subsidiary corporation which were treated as indirect gifts by the transferors to the shareholders of the recipient corporation were not present interest gifts because the donees could use or enjoy the stock only upon liquidation of the subsidiary and the declaration of a dividend.[138] In *Stinson Estate v. United States*, the forgiveness of debt incurred by a corporation on the sale of land to the corporation was held not to be a present interest gift qualifying for the annual exclusion because the only means of present enjoyment of the property was either through the liquidation of the corporation or the declaration and payment of dividends.[139] Finally, in *Hamm v. Commissioner*, the Tax Court held that no gift tax exclusion was available for transfers of common stock to a ten-year charitable trust because the interests of the charity were too contingent to be susceptible to valuation due to the uncertainty as to whether the corporation would pay dividends.[140]

IX. Implications of *Hackl*, *Price*, and *Fisher* for Gifts of Business Interests

The legislative history attending the enactment of the gift tax evidences no intent to disqualify outright gifts of property from qualification for the annual exclusion. In fact, the Treasury regulations specifically indicate that outright gifts of insurance policies qualify for the annual exclusion even though enjoyment of the insurance proceeds is delayed until the maturity of the policy.[141]

As noted previously, the exclusion of gifts of future interests from eligibility for the annual exclusion was grounded in the concern about transfers of property to trusts or split interest gifts. From the outset, it was clear that the annual exclusion was not available for gifts of remainder interests because of their innate similarity to testamentary transfers. On the other hand, it was equally clear that gifts of income interests would be eligible for the gift tax annual exclusion as long as the right to income was absolute, indefeasible, and not subject to conditions or trustee discretion since the donees then could be identified and the right to income could be appropriately valued. If these conditions were met, the valuation tables based upon assumed present value discount rates could be relied upon.

The concern expressed in *Fondren* that the amount of income be ascertainable was founded on the fact that with gifts of income interests, the valuation of the income interest was based upon present value calculations with specified discount rates which could not be appropriately relied upon if there

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[138] Chanin v. United States, 393 F.2d 972, 975–78 (Ct. Cl. 1968).

[139] Stinson Estate v. United States, 214 F.3d 846, 848 (7th Cir. 2000).

[140] Hamm v. Commissioner, 20 T.C.M. (CCH) 1814, 1833–34, 1839–40, 1961 T.C.M. (P-H) ¶ 61,347 (1961).

[141] Reg. § 25.2503-3(a); *see also supra* text accompanying notes 100–03.

was no steady stream of income to the income beneficiary. Moreover, if the remainderman differed from the income beneficiary, the accumulation of income through the exercise of trustee discretion or the terms of the trust actually benefitted the remainderman rather than the income beneficiary, and hence, it was inappropriate to enable the gift to the income beneficiary to qualify for the annual exclusion based on valuation tables with assumed present value discount rates while the gift of the remainder interest remained disqualified.

Outright transfers of property, whether they are transfers of business interests or of non-income-producing property, do not present these valuation concerns. The donee is clearly identifiable and the valuation of the gifted interest is not dependent upon inflexible valuation tables with assumed present value discount rates. Valuation of the interest may well be based upon a present value analysis of future cash flows, but the applicable present value discount rate is not fixed by a regulatory table but instead by a judgment of the expected rate of return of a hypothetical investor based upon the nature of the interest and the risks of the investment.

The courts in *Hackl*, *Price*, and *Fisher* have clearly applied the present interest requirement in section 2503(b) in a manner that fails to take into account the original legislative intent for this limitation. These courts applied the present interest test based on case law involving gifts of trust income interests and without regard to consideration of the legislative justification for the present interest requirement. This independent interpretation of the present interest requirement apart from state law concepts of present and future interests is no doubt based in large measure on the statement of the U.S. Supreme Court in *Pelzer v. United States* cited previously in this Article.[142] While it is quite true that state law only determines the nature of a property interest and it is federal law that is to determine the federal tax treatment with respect to that interest, application of federal law should always be based on the statutory justification and policy reasons for the provision at issue. The courts' decisions in these cases ignore this justification.

The decisions in *Hackl*, *Price*, and *Fisher* also give rise to concerns that their reasoning may be extended in the future beyond the confines of an entity such as an FLP formed with the specific objective of making gifts to family members. The analysis of these cases could quite easily be extended to transfers of closely held corporate stock. It is impossible to find a principled basis to differentiate between a gift of such stock and a gift of an FLP interest based on the reasoning of these cases. Closely held corporate stock interests are frequently subject to buy–sell restrictions which impair the ability of the holder to transfer the stock, and regular distributions on such stock are often absent or at least uncertain. It is difficult to see why the rationale of these cases could not be applied with equal justification to gifts of such corporate stock. On the other hand, it would be nearly impossible to apply these authorities

[142] *See supra* note 66 and accompanying text.

to a gift of publicly held corporate stock since such stock typically is not subject to restrictive transfer agreements[143] and the ready market for such stock makes it relatively easy for a holder to convert his investment to cash. Moreover, because of demands of the public securities markets the likelihood of the declaration and payment of regular dividends is much greater with a publicly held stock than with a closely held stock. It is difficult to come up with an appropriate public policy that would deny annual exclusions on gifts of closely held corporate stock but allow such exclusions on gifts of publicly held stock. In addition, it is likely that it would not be politically palatable to give a benefit such as the annual exclusion to gifts of publicly held stock while denying it to closely held stock.

One certainly might reasonably argue that family partnerships in many ways operate in a similar fashion to trusts and serve many of the same estate planning objectives as transfers to trusts and that, as a result, the principles applied by the courts in determining the applicability of the gift tax annual exclusion on gifts of income interests in trusts should be likewise applied to transfers of family partnership interests. Like trusts, FLPs are useful to limit liability of the owners of the property within the entity and outside of the entity. Like trusts, FLPs also provide a mechanism for common management of family assets for the benefit of multiple family members. However, unlike trusts, FLPs do not act as testamentary substitutes,[144] which is the basis for excluding future interest gifts from the gift tax annual exclusion. While extending the analytical principles in applying the annual exclusion with trust income interests to gifts of other types of property might be appropriate public policy, the argument fundamentally ignores the history of the development of the present interest requirement for the annual exclusion and the reasons for its existence. It was clearly enacted simply to avoid the identification and valuation problems inherent in gifts of split interests—problems that simply are not present with outright gifts.

It is also understandable that the Service seeks to discourage the use of FLPs through attacks on the utilization of the annual exclusion on gifts of these interests—particularly given the very limited success of the Service in other types of challenges to such gifts. Such techniques not only provide a mechanism to make gifts to family members without losing control over the underlying property subject to the gift, but significant valuation discounts are also often present to magically reduce the value of the donor's estate subject to tax. However, the Service has been presented with similar challenges in the past and has not been able to circumvent the legislative process through the courts to rectify what the Service regarded as inadequate public policy. For instance,

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[143] Of course, some publicly held corporate stock may nevertheless be subject to resale restrictions if held by an affiliate or if acquired in a transaction not involving a public offering by virtue of the provisions of the federal securities laws, such as Rule 144. *See* 17 C.F.R. § 230.144 (2012).

[144] While FLPs often result in retention of control by the donor, gifts of these interests do result in the immediate irrevocable transfer of all ownership rights in the gifted property.

the Service attempted for years to claim that a transfer of stock with the retention of voting rights by the donor should have been treated as a transfer with a retained life estate resulting in inclusion of the transferred property in the decedent's gross estate under section 2036. When the Service ultimately failed in these efforts in *Byrum*, it was only through legislative action that the Service was able to achieve its desired objective.[145] Similarly, the longstanding battles that the Service had about corporate estate freezes were only resolved through legislative action when Congress enacted the Chapter 14 valuation rules.[146]

While trusts often have multiple beneficiaries and changes of beneficial interest over time, ownership of business interests is far different. Unless a trust or split interest arrangement is appended to ownership of a business interest, the owner of a business interest owns a fee interest in the entity. While the rights of that owner are subject to the rights of others with respect to the business entity—such as creditors, holders of superior classes of stock, and those with contracts with the business entity—such restrictions are no different than those present with the investments in business entities held by a trust. While there is authority that nonproductive property owned by a trust may preclude the availability of the annual exclusion on gifts of income interests in such a trust,[147] that authority makes sense only in the limited context of determining whether a trust income interest is in fact reasonably certain to produce income so as to justify the use of valuation tables using specified present value discount rates.

X. Conclusion

The decisions in *Hackl*, *Price*, and *Fisher* with respect to whether the gift of FLP interests conveyed the present use, enjoyment, or possession of the particular property gifted are unsupported by prior authority and are dramatic extensions of the law concerning outright gifts of property. These decisions are also inconsistent with prior authority relating to spendthrift clauses in

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[145] The Service attempted to include in the taxable estate corporate stock transferred with retained voting rights. This effort ultimately failed when the U.S. Supreme Court held that such stock was not includable in the transferor's gross estate under section 2036(a)(2) in *Byrum v. United States*, 408 U.S. 125 (1972). The Service went to Congress, which reversed the result in *Byrum* with the enactment of section 2036(c)—now redesignated as section 2036(b) after the repeal of former section 2036(b). Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(a), 90 Stat. 1520, 1893.

[146] After repeated Service failures to challenge preferred stock estate freezes successfully, in 1987 Congress enacted section 2036(c) in the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402(a), 101 Stat. 1330, 1330–431, which was later modified in the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342. These provisions proved unworkable and were replaced by the Chapter 14 Special Valuation Rules—sections 2701 to 2704—in the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388.

[147] *See* Md. Nat'l Bank v. United States, 609 F.2d 1078 (4th Cir. 1979); Calder v. Commissioner, 85 T.C. 713 (1985); *supra* text accompanying note 110.

trust instruments and the treatment under the regulations of outright gifts of life insurance, bonds, and notes.

Hackl, *Price*, and *Fisher* also inappropriately apply authority with respect to the determination of whether trust income interests are present interests to outright gifts of property because the rationale for such authority with gifts of trust income interests—the appropriateness of use of valuation tables with specified present value discount rates—is not present with outright gifts of property. Applying this authority in this manner is also inconsistent with the legislative intent for excluding future interests from gift tax annual exclusion eligibility of excepting from the benefit of the annual exclusion only testamentary type transfers.

There appears to be no principled basis to prevent the extension of these authorities to any gift of a closely held business interest or of non-income-producing property without an active trading market. While these authorities may not be appropriately extended to gifts of publicly held corporate stock or non-income-producing property with an active trading market, it is difficult to justify different treatment of publicly held stock from closely held stock or of actively traded property from property without an active market for resale based on the policies underlying the federal wealth transfer taxes. The only conceivable policy basis to support the treatment of FLPs in these cases is the view that Congress in enacting the gift tax annual exclusion did not intend to permit donors to reduce their transfer tax exposure by gifts of closely held business interests or non-income-producing property without an active trading market. An examination of the legislative history of the enactment of the gift tax and the adoption of the gift tax annual exclusion, however, does not support such a view. In fact, the adoption of the gift tax, while serving as a backstop to the estate tax, was actually designed to encourage gifting so as to produce current—rather than deferred—revenue for the government, and the exclusion of future interests from the gift tax annual exclusion was made for practical donee identification and valuation reasons associated with gifts of split interests and because of the similarity of gifts of future interests to testamentary transfers.

The Service has been confronted before with estate planning techniques which assist taxpayers in minimizing their federal wealth transfer tax liability in a manner that the Service does not deem appropriate. However, as in past situations involving transfers with retained voting rights and corporate preferred stock estate freezes, the appropriate remedy for the Service is a legislative change rather than an improper extension of precedent by the courts which is inconsistent with the statute's legislative history and which can too easily be extended further to virtually any outright gift of property.