Take Care When Making Tax-Free Gifts of Business Interests

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Business owners often will gift interests in the family business to their children, grandchildren, and perhaps spouses of children. Many family businesses also have "buy-sell" or other restrictive agreements that set forth rules as to who can be an owner of the business, and specify the situations that trigger options or obligations to purchase the interests.

A recent tax court case held that partnership interests given under those circumstances did not qualify as "present" interests, and thus the gifts did not qualify for the donor's $13,000 annual gift tax free amount. (*Walter M. Price v. Commissioner*, TCM 2010-2, Jan. 4, 2010).

This case highlights the importance of carefully drafting gift documents and reviewing any agreements restricting ownership rights. In *Price*, the Tax Court stated that to qualify as present interest gifts, the gifts must include the right to *the immediate use, possession or enjoyment of* 1) the transferred *interests* or 2) the income from the interests.

Restrictions that precluded immediate use, possession or enjoyment included:

- If partners were prevented from withdrawing contributions.
- If partners were restricted from transferring and assigning partnership interests to third parties without the written consent of all partners.
- If an assignment gave the assignee the right to profits/losses and capital account, but not the rights of a full limited partner with a vote.
- If a partner assigned his or her interests, the partnership and remaining partners had the option to purchase the interests at fair market value.
- If there were no mandated distributions, but distributions could be made in the discretion of the general partner or, if directed, by a majority of all partners.

The court found these contingencies stood in the way of the children receiving economic value from the gifted interests. The fact that the children possessed the right to income generated by the interests was insufficient for the court to find a present interest because no income had historically been generated by the interests, nor did the partnership have a record of paying any distributions to the partners.

All hope is not lost, however. Properly drafted gift documents can create a present interest without disturbing transfer restrictions in buy-sells or operating agreements. We are well versed in this case and can assist you in qualifying intra-family gifts as annual exclusion gifts.