 by Paul L.B. McKenney & Michael J. Mulcahy

Avoiding Taxing Gift and Estate Tax Traps

The family limited partnership (FLP) or limited liability company (LLC), which enables a senior generation to maintain control of a business while retaining appropriate gift and estate tax discount levels, remains for many clients an absolutely critical and most effective component of their estate plans. While the Internal Revenue Service (IRS) has lost a series of cases involving technical issues under Chapter 14, most of the IRS's focus has now generally shifted to haggling over the combined lack of marketability and lack of control discounts in a given situation.

However, one area that the IRS has had success in attacking, is a shoddily executed plan resulting in no valuation discount. This occurs when a taxpayer has executed the appropriate FLP or LLC documents, but does *not* follow the terms of the documents. The Tax Court's opinion in *Estate of Reicherdt* v *Commissioner*, 114 TC 144 (2000), is an instructive example of what *not* to do. Shortly after learning he was terminally ill, the taxpayer—an elderly but then single gentleman—established an FLP (about a year before his death) and transferred virtually all of his assets into the partnership, including his residence. He simultaneously gave each of his two children a 30 percent limited partnership interest. So far, so good. The problem was that the late Mr. Reicherdt continued to live in the FLP-owned house rent-free, collected 100 percent of the income from the investment assets (even though under the FLP he was only entitled to 40 percent), and generally used all of the FLP assets as his own personal piggy bank, thereby ignoring, in their entirety, the terms of the documents. After Mr. Reicherdt died, the IRS asserted, and the Tax Court wholeheartedly agreed, that he had *de facto* retained a life interest by continuing to use the FLP assets as his own, without paying fair rental value for the home, as well as taking 100 percent of the distributions. There was no shortage of factual ammunition for the government. Accordingly, for estate tax purposes, Mr. Reicherdt owned 100 percent of the FLP assets at his death under IRC 2036, and no discount was allowed for tax purposes. All the planning and its associated costs were wasted.

A case decided near the end of 2002 takes this issue a step further. *Estate of Thompson* v *Commissioner*, 84 TCM 375, TC Memo 2002-246. The 85-year-old widower established separate FLPs for each of his children. He transferred virtually all of his assets into the partnerships. He maintained a majority of the limited partnership interests in each FLP and gave a substantial minority interest to a child. A corporate general partner controlled by the younger generation managed the assets on paper. The children also contributed some assets, but they were a very small percentage of the entire FLP. Because he had given everything to the limited partnership and had no other assets to support himself, the IRS argued that, at his death, he had retained a 100 percent interest in each FLP. The taxpayer's position was damaged by the fact that although certain assets contributed to the FLP by his son were sold and all of the proceeds from the sale were distributed to the son, the transaction completely disregarded the terms of the FLP agreement.

> *[D]istributions must follow the respective percentage interests in the partnership or LLC.*

There are two lessons to be gleaned from *Estate of Thompson* and *Estate of Reicherdt.* First, do *not* contribute substantially all of a client's assets to the family LLC (which we prefer over FLPs). Second, distributions *must* follow the respective percentage interests in the partnership or LLC. In both *Estate of Reicherdt* and *Estate of Thompson*, the failure to do so led to the federal estate tax version of the death penalty and placed the client, and the attorney, in a very unenviable position.

With the above cautions, we believe that a properly managed family LLC remains an invaluable component of an effective and tax-sensitive estate plan for many high-net-worth individuals.

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