THE PARTNER'S PERSPECTIVE by *Charles R. Levun, Esq.*

Charles R. Levun, JD, CPA, is a Partner in the Chicago-area law firm of Levun, Goodman & Cohen, Adjunct Professor of Law at the IIT Chicago-Kent Graduate Tax Program, Consultant to the **CCH** INCORPORATED's PARTNERSHIP TAX PLANNING and PRACTICE GUIDE *and Editor-in-Chief of the* JOURNAL OF PASSTHROUGH ENTITIES.

IRS Suffers FLP Defeat in Mirowski

Over the years, a lot of ink has been devoted in the Partner's Perspective to the benefits of FLP planning—how to couple accomplishing a family's objectives with achieving gift and estate tax discounts. Much commentary has focused on how to do them right and how to do them wrong, and the tax community has seen the evolution of FLPs from the structuring stage to the audit stage to the litigation stage. The Partner's Perspective has been monitoring the litigation stage since just before the turn of the century in the taxpayer's victory in *Kerr* (¶9632), through the taxpayers' losses in *Strangi* (¶9674) and *Thompson* (¶9688) and the taxpayers' rallies in *Stone* (¶9679) and *Kimball* (¶9685), and ending with the taxpayer's split decision in *Bongard* (¶9696) in 2005.

Since then, the Partner's Perspective has been silent insofar as FLP "discount" litigation is concerned. The reason—the IRS has been extremely selective in the cases that is has brought, focusing on extremely bad factual situations where the FLP had been established for a taxpayer who was mentally infirm and/or where substantially all the taxpayer's assets had been transferred to the FLP, such as in *Korby v. Commissioner*, TC Memo 2005-102 (2005); *Estate of Austin Korby v. Commissioner*, TC Memo 2005-103 (2005); *Estate of Ida Abraham v. Commissioner*, 2005-1 USTC ¶60502 (1st Cir. 2005); *Rosen v. Commissioner*, TC Memo 2006-115 (2006); *Erickson v. Commissioner*, TC Memo 2007-107 (2007); *Gore v. Commissioner*, TC Memo 2007-169 (2007); and *Rector v. Commissioner*, TC Memo 2007-367 (2007). None of these cases reached surprising results given their factual profiles, and none of them shed much light on FLP standards that needed to be followed for valuation discounts to be sustained.

The IRS's succession of FLP victories recently ended in *Mirowski v. Commissioner*, TC Memo 2008-74 (March 26, 2008). Not only is the taxpayer victory good news for tax professionals, some of whom may have begun to question whether meaningful transfer tax valuation discounts were still available for FLPs, but the case also provides some guidance on open issues that have been of concern to tax professionals. This month's Partner's Perspective will discuss the *Mirowski* decision and what it adds to the FLP planning landscape.

The General FLP Standards and Some Open Issues

The IRS's attack on FLP discounting has now become fairly predictable—the IRS tries to bring the assets of an FLP back into a decedent's estate under Code Sec. 2036, which provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (*except in case*

> *of a bona fide sale for an adequate and full consideration in money or money's worth*), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right either alone or in conjunction with any person to designate the persons who shall possess or enjoy the property or the income therefrom. [Emphasis added.]

While the rhetoric of the cases can sometimes differ, the differences are not material. The well-established battleground is whether the exception to the application of Code Sec. 2036 italicized above, i.e., the "bona fide sale" exception, has been met. This exception involves a two-part test: (1) was there adequate consideration for the transfer and (2) was the transfer of assets to the partnership a bona fide sale. As to whether there has been adequate consideration, the Fifth Circuit in *Kimbell* expressed the test well:

> The proper focus therefore on whether a transfer to a partnership is for adequate and full consideration is: (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership, (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners, and (3) whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

Based on the above *Kimbell* criteria, the adequate consideration portion of the bona fide sale exception can be satisfied in most circumstances. Note, however, that in the recently decided *Bigelow* case (503 F.3d 955), the Ninth Circuit expressed a broader standard for the adequate consideration test, requiring the taxpayer to show a "genuine pooling of assets" and a "potential for intangibles stemming from pooling for joint enterprise." The Ninth Circuit further stated that "the validity of the full and adequate consideration prong cannot be gauged independently of the non-tax-related business purposes involved in making the bona fide transfer inquiry." Consequently, the real battleground is whether the transfer was bona fide. In this regard, there must be a significant non-tax reason for the formation of the partnership. In many cases brought by the IRS, the IRS has prevailed on this point, especially in situations dealing with death-bed formation transactions, or transactions done by power of attorney where there is no change in the manner in which the transferor's assets are managed.

When the bona fide sale exception is not met, the next step in the battle generally has been under Code Sec. 2036(a)(1)—whether the transferor has retained the possession or enjoyment of, or the right to the income from, the property. Generally, this retention is not direct, rather it is implied by the facts and circumstances of the manner in which the FLP has been formed and/or operated. Often, this retention is found where the taxpayer has transferred substantially all his assets to the FLP and has not retained sufficient assets with which to maintain his lifestyle or where disproportionate distributions have been made by the partnership to the transferor partner.

In many cases where the IRS has been victorious, it has successfully shown that the taxpayer transferred "too many" assets to the FLP. What constitutes "too many" assets is anyone's guess, but many tax professionals believed that it was necessary to analyze the transferor's standard of living and life expectancy and project the amount of assets necessary to continue that lifestyle without resorting to any of the FLP's assets. If the FLP's assets were projected to be necessary to continue the transferor's lifestyle, then there was a risk of an implied retention of the benefit of the assets transferred to the FLP.

In addition to the uncertainty as to what constituted "too many" assets, other questions remained. For example, could the transferor assume that there would be income distributions from the FLP (as opposed to principal distributions) in assessing whether sufficient assets were available to continue his lifestyle? If it were projected that FLP distributions would be necessary to pay estate taxes on the death of the transferor, then did the transferor transfer "too many" assets? Could the ability to borrow against the transferor's interest in the FLP be a mitigating factor against an assertion that "too many" assets were transferred? *Mirowski* delved into some of these issues in a way that may put smiles on the faces of FLP planners.

The Mirowski Decision

When a decision is first issued by a court, attorneys for the IRS and the taxpayer often can determine who is victorious merely by reading the first few paragraphs of the decision, without even peeking at the end. The reason—a court often decides who it wants to win and them gloms onto the brief of the victorious party and adopts it as its own. In reading the *Mirowski* opinion, one can easily conclude that this was the case—the factual description, which is long and complicated, reads like a taxpayer's brief, and a well-written one at that.

The opinion begins by describing the childhoods of Ms. Mirowski and her husband, Dr. Mirowski. It recounts the family's move to the United States and Dr. Mirowski's development of the automatic implantable cardioverter defibrillator ("ICD") which he patented and subsequently licensed. The opinion describes family vacations, personal struggles and career mentors, but for purposes of FLP planning, certain of the important facts of the Mirowski decision are as follows:

Ms. Mirowski established Mirowski Family Ventures, L.L.C. ("MFV") on August 27, 2001, and funded the entity on September 1, 2001, September 5, 2001, September 6, 2001 and September 7, 2001 ("September Transfers") in exchange for a 100% membership interest in MFV. Amongst these September Transfers were the ICD patent and a 51% interest in the ICD licensing agreement, together with substantial liquid assets (as described below). On September 7, 2001, Ms. Mirowski gifted a 16% membership interest in MFV to each of her three daughters' trusts ("MFV Gifts"). She passed away on September 11, 2001. On September 16, 2001, the members of MFV executed a memorandum acknowledging the transfer of membership interests to the daughters' trusts.

Although on its face the case appears to be a "bad facts" transaction, the Court goes to great lengths to establish that Ms. Mirowski's death was not anticipated, and that the formation of MFV had been in the works for a considerable amount of time before she executed the documents. The Court notes that as early as May 2000, Ms. Mirowski began considering a family limited partnership, and she received the original drafts for MFV in August 2000. Additionally, the Court emphasized that this was not a death-bed transaction. According to the opinion, at no point during the organization of MFV, the September Transfers or the MFV Gifts, did Ms. Mirowski, her daughters, or her physicians believe she would die in the near future.

At the time of her death, Ms. Mirowski was in treatment for a foot ulcer, which had developed from a blister and was further exacerbated by her diabetes. None of her doctors or her children believed the condition to be life-threatening. According to the opinion, her health did not start to fail until September 10, 2001 (3 days after the final September Transfer/MFV Gift), when the foot ulcer suddenly worsened and she refused amputation. As a result of failing to amputate the foot, she developed sepsis and died the following morning.

After establishing that the formation of MFV and the subsequent MFV Gifts were not "death bed transactions," the Court analyzed the operation and funding of MFV. It appears that after funding MFV with the September Transfers (valued at approximately $62,000,000), Ms. Mirowski retained approximately $7,700,000 of assets in her own name, and she also anticipated receiving future income of millions of dollars a year from the ICD licensing agreements held in MFV (i.e., she anticipated future distributions from the LLC). Although, she retained substantial assets, the opinion recognizes that her personal assets after the September Transfers would be insufficient to pay the gift taxes from the MFV Gifts. The opinion listed a number of potential ways in which Ms. Mirowski could have paid these taxes and stated that "at no time was there any express or unwritten agreement or understanding among Ms. Mirowski and her daughters that Ms. Mirowski would distribute assets from MFV in order to pay any unexpected financial obligations of Ms. Mirowski."

The Court noted that Ms. Mirowski was the general manager of MFV, but she was subject to fiduciary duties under Maryland law and other restrictions in the MFV operating agreement. She retained a majority interest in MFV (52%), but according to the operating agreement, unanimous member approval was required for a number of LLC actions.

The Court appeared to give a lot of weight to Ms. Mirowski's extensive involvement in all her financial matters and the cohesiveness of the Mirowski family. The Court stressed that Ms. Mirowski wanted her daughters and, eventually, her grandchildren to work together, remain closely knit, and be jointly involved in managing (1) the investments derived from the royalties received from their father's invention and (2) the business matters relating to the ICD patents and ICD licensing agreements, including the litigation arising with respect to those patents. The Court also notes that Ms. Mirowski had previously created irrevocable trusts for her three daughters, and had appointed all the daughters as co-trustees over each trust, with the intention that the women would then continue to work together on the "family investments."

The Court cited the following as Ms. Mirowski's legitimate and significant business purposes for forming and transferring the bulk of her assets to MFV:

1. Joint management of the family's assets by her daughters and, eventually, her grandchildren;

2. Maintenance of the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of her daughters or to each of her daughters' trusts; and

3. Providing for each of her daughters and, eventually, each of her grandchildren on equal bases.

While the amount of the valuation discounts taken in the case was not set forth in the opinion, the implication of the facts is that a substantial valuation discount was taken on the gifts made by the decedent prior to her death. Needless to say, the IRS attempted to bring all the assets back into the decedent's estate to knock out these discounts. From the perspective of valuing Ms. Mirowski's remaining interest in the FLP held by her on death, the Court found that the bona fide sale exception had been met, and therefore the Court did not analyze whether there was a proscribed retention of rights with respect to the transferred assets. However, because the <u>gifts</u> of FLP interests would not themselves qualify for the bona fide sale exception, the Court examined whether there had been a proscribed retention of rights under Code Sec. 2036 with respect to the portion of the FLP assets represented by the gifted interests, which it found had not occurred.

From an FLP planner's perspective, there are many important aspects to the decedent's victory. First, the IRS argued that the decedent's power to decide the timing and amounts of distributions from MFV was a proscribed control under Code Sec. 2036. In response to this assertion, the Court found that Ms. Mirowski's distribution controls were subject to fiduciary obligations under Maryland law, thereby taking Code Sec. 2036 out of play. Of importance, is that the Court found that both Code Sec. 2036(a)(1) and Sec. 2036(a)(2) had been taken out of play:

> On the record before us, we find that the discretion, power, and authority that MFV's operating agreement granted to Ms. Mirowski as MFV's general manager do not require us to find that at the time of Ms. Mirowski's gifts and at the time of her death there was an express agreement that Ms. Mirowski retain an interest or a right described in section 2036(a)(1) (<u>or section 2036(a)(2)</u>) with respect to the respective 16-percent interests in MFV that she gave to her daughters' trusts. [Emphasis added.]

FLP planners generally have been able to deal with the potential application of Code Sec. 2036(a)(1) by warning taxpayers not to transfer "too many" assets to an FLP, so as to avoid a successful IRS assertion that there was an implied retention of the right to the assets of the FLP or the income therefrom (because of the need for distributions). However, one of the greater concerns has been the potential application of Code Sec. 2036(a)(2), where the decedent or family members were in control of the FLP (which often is the case). Many tax professionals believe that the concepts contained in the Supreme Court decision in *Byrum*, i.e., controls that are subject to fiduciary duty are not Code Sec. 2036(a)(2) proscribed controls, keep this latter Code section out of play. However, as discussed in the Partner's Perspective at ¶9674, the applicability of *Byrum* principles to FLPs had been called into question by some rhetoric in the *Strangi* decision, although the Code Sec. 2036(a)(2) argument was not that well-developed in that case. The *Mirowski* decision should be of some comfort to FLP planners that perhaps Code

Sec. 2036(a)(2) might be a dead letter for IRS attacks on FLPs, and that Code Sec. 2036(a)(1) is the relevant Code section that requires attention—a far easier road for sustaining FLP discounts.

An additional item of interest along the lines of control is that the Court found that the decedent did not have the authority to determine the timing and amount of distributions because FLP distributions of operating cash flow were mandated by the MFV operating agreement. Interestingly, many FLP agreements provide the manager with the discretion of distributing operating cash flow, assuming that (1) valuation discounts might be slightly higher where cash flow (i.e., typically, profits that are not re-invested) is not required to be distributed and (2) there is less of a Code Sec. 2036(a)(1) "retention" argument where distributions are not assumed. The *Mirowski* decision might suggest that mandating the distribution of profits that are not being held for reinvestment could be a better course of action, especially if the taxpayer maintained control over the LLC.

Also of substantial interest in the case is that the Court was willing to look past a $36,415,810 non pro-rata distribution from MFV to Ms. Mirowski's estate to cover federal and state estate taxes and a $11,750,623 non pro-rata distribution from MFV to pay the estimated gift tax on the MFV Gifts. As to this former distribution, a major concern of FLP planners has been whether the failure to retain sufficient assets to pay estate tax implicates a transfer of "too many" assets. Many tax professionals believe that because estate taxes are not a liability of the transferor, Code Sec. 2036(a)(1) should not be implicated. However, there was some language in a recent "bad facts" FLP case, where among the bad facts set forth in the opinion was the estate's need for distributions to pay estate taxes, although this tax issue was not well-developed in the case. *See, e.g., Erickson v. Commissioner*, TC Memo 2007-107. In footnote 49 of the *Mirowski* decision, the Court sides with the belief of these tax professionals:

> The estate tax that would arise only as a result of Ms. Mirowski's death would not have been the obligation of Ms. Mirowski. The estate tax is imposed on "the transfer of the taxable estate" of a person who dies, sec. 2001(a), and the liability for the payment of the estate tax is imposed on the executor (or other personal representative) of the estate,….

Needless to say, FLP planners prefer not to have to retain assets in the estate to pay estate tax where the decedent's preference would be to fund more assets in the FLP (because of greater discounting potential). The above statement should provide comfort to FLP planners; however, this area of the law still requires more development before FLP planners can conclude that there is not a risk of estate tax inclusion under Code Sec. 2036(a)(1) where it is anticipated that there will have to be an FLP distribution to pay estate taxes.

As to the distribution made to the decedent's estate to pay the gift tax liability attributable to the pre-death transfer, it is interesting to note that not only was this the decedent's liability, but that the amount of the liability was in excess of her retained assets. Many FLP planners would have been concerned about this aspect of the transaction; however, the Court nevertheless found that Code Sec. 2036(a)(1) was not implicated:

> As discussed above, we have found that the only anticipated significant financial obligation of Ms. Mirowski when she formed and funded MFV and when she made the respective gifts to her daughters' trusts was the substantial gift tax for which she would be liable with respect to those gifts. We have also found that at no time before Ms. Mirowski's death did the members of MFV have any express or unwritten agreement or understanding to distribute assets of MFV in order to pay that gift tax liability. In order to pay the anticipated gift tax liability with respect to her contemplated gifts of 16-percent interests in MFV to her daughters' trusts, Ms. Mirowski could have (1) used a portion of the over $7.5 million of personal assts that she retained and did not transfer to MFV, including cash and cash equivalents of over $3.3 million, (2) used a portion or all of the distributions that she expected to receive as an interest holder in MFV of the millions of dollars of royalty payments under the ICD patents license agreement that she expected MFV to receive, and (3) borrowed against (a) the personal assets that she retained and did not transfer to MFV and (b) her 52-percent interest in MFV.

It might be surprising to some tax professionals that relying on anticipated distributions of operating income of an FLP is not a proscribed Code Sec. 2036(a)(1) retention—it probably was to the IRS. And perhaps, many tax professionals will not recommend pushing the envelope as far as was done by Ms. Mirowski. However, the *Mirowski* decision is a welcome one to FLP planners, particularly with its rhetoric about the decedent's retained control as manager of the FLP and that estate tax is not a liability to be taken into account in judging the adequacy of retained assets.

F:\DOCS\CL\15001\02\Columns of 2008\4-08.doc