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Estate Planning & Elder Law

Recent Court Rulings Give New Life to Family Limited Partnerships

Good planning and good lawyering can yield favorable results

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Recent rulings from the U.S. Tax Court provide insight to estate planners who recommend the use of family limited liability companies ("FLLCs") or family limited partnerships ("FLPs") to their clients. Over the past several years, the U.S. Tax Court and several federal Courts of Appeals have issued opinions adverse to taxpayers. Finally, two decisions arrived showing that good planning and good lawyering can yield favorable results, even with unfavorable facts. In *Mirowski v. Commissioner*, T.C. Memo 2008-74 (March 26, 2008), the U.S. Tax Court held that assets the decedent transferred to a LLC and gift of the LLC interests just days before her death were not includible in her taxable estate. In *Holman v. Commissioner*, 130 T.C. No. 12 (May 27, 2008), the U.S. Tax Court held that the transfer of assets to a FLP followed by gifts of the FLP interests was not an indirect gift of the assets or a step transaction for gift tax purposes.

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Mirowski v. Commissioner

Anna Mirowski was the widow of the inventor of the internal implantable cardioverter defibrillator (ICD) and owned a patent license agreement and medical patents that produced millions of dollars in annual income. Mirowski managed and tracked her own investments until 1998, when she began working with investment advisors. In May 2000, Mirowski was advised about FLLCs and on August 27, 2001, she formed Mirowski Family Ventures, LLC ("MFV"). Although Mirowski knew about the tax advantages of forming MFV, she had legitimate nontax reasons to form the entity, including (1) joint management of the family's assets by her daughters, (2) maintaining the family's assets in a single pool to allow for investment opportunities that would not otherwise be available if she made separate gifts to her daughters, and (3) providing for each of her daughters on an equal basis.

On September 1, 2001, Mirowski transferred her ICD patents and patent license agreement to MFV in exchange for 100 percent of the interest in MFV. She transferred additional assets totaling $62 million to MFV on September 5, 6 and 7. Her capital account was credited in accordance with the operating agreement for each asset contribution. On September 7, 2001, Mirowski transferred 16 percent of MFV to each of her three daughters' trusts. After the transfer, Mirowski had in addition to her 52 percent interest in MFV, assets valued at $7.6 million, including $3.3 million in cash and cash equivalents. She was aware of the substantial gift tax associated with the gifts.

Mirowski was undergoing treatment for a pre-existing foot ulcer since January 2001. On August 31, 2001, she was hospitalized to receive treatment for the ulcer. Mirowski, her daughters and her doctors believed that she would recover. However, her condition rapidly deteriorated on September 10, 2001, and she died on September 11, 2001. Following Mirowski's death, her daughters continued MFV and transferred approximately $36 million to Mirowski's estate to pay estate and transfer taxes, and other obligations of her estate.

The IRS assessed an estate tax deficiency of $14 million dollars against Mirowski's estate. claiming the date of death value of the assets Mirowski transferred to MFV was includible in her estate under §2036(a) and/or §2038 of the Internal Revenue Code of 1986, as amended.

The court held that neither §2036(a) nor §2038 applied to Mirowski's asset transfers to MFV because the transfers

qualified as bona fide sales. Mirowski received a proportionate interest in MFV in exchange for the assets credited to her capital account. Mirowski had "legitimate and significant nontax reasons" for forming and funding MFV. The court further held that the MFV's activities did not need to rise to the level of a "business" to fall within the bona fide sale exception. The court also found that Mirowski was not expecting to die at the time of the transfers, rejecting the IRS' argument that it was not a bona fide sale.

Sections 2036(a) and 2038 did not apply to the transfers of the member interests from Mirowski to her daughters' trusts because there was no express or implied agreement that Mirowski would retain income from or possession or enjoyment of the transferred interests within the meaning of §2036(a) (1) . Further, Mirowski did not retain any designation right within the meaning of §2036(a) (2) or power to alter, amend, revoke or terminate within the meaning of §2038. The court thoroughly analyzed the relationship between Mirowski and her daughters as well as the operating agreement and held that it did not give Mirowski the unbridled authority to make distributions of capital proceeds, to allocate profits or losses from capital transactions and that the allocation of annual distributions was unequivocal.

Holman v. Commissioner

In *Holman v. Commissioner*, the taxpayers, who were husband and wife, transferred a significant amount of Dell stock to a FLP, followed by gifts of the FLP interest to trusts and a custodial account for the benefit of their children. The taxpayers filed gift tax returns claiming valuation discounts totaling 49 percent. The IRS proposed to allow no valuation discounts for the gifts. The IRS argued that the transfer of assets to the FLP was an indirect gift to the other partners or was a step transaction because only five days separated the formation and funding of the FLP and the gifts to the trusts and custodial account.

The court held that because the taxpayers properly formed the FLP and received the FLP interest proportionate to the assets they transferred to it, there was no indirect gift. The court distinguished *Shepherd v. Commissioner*, 115 T.C.376 (2000), where the court concluded an indirect gift was made to the taxpayer's sons, who each held 25 percent interest in a FLP, and the taxpayer transferred property to the FLP in which he held 50 percent interest but upon contribution of the property, his capital account was credited for only 50 percent of the property he contributed. The court also distinguished *Senda v. Commissioner*, T.C. Memo 2004-160, aff'd 433 F.3d 1044 (8th Cir. 2006), where the Tax Court held that indirect gifts occurred where the taxpayers transferred stock to FLPs and then transferred the FLP interests to their children on the same day. The *Holman* court found the five-day separation between the creation and funding of the FLP and gift transfer of the FLP interest to the children's' trusts and account to be sufficient to avoid the consequences of an indirect gift. Likewise, because the taxpayers bore a real economic risk during the five days between the creation of the FLP and the initial gift, the court also held that there was no step transaction.

Holman was not a total victory for the taxpayers. The Tax Court held that the FLP's transfer restrictions were designed to discourage the dissipation of family wealth. The court substantially reduced the valuation discounts in large part because the transfer restrictions in the partnership agreement did not meet the requirements under §2703(b) because they were not a bona fide business arrangement and were a "device" to transfer assets from the taxpayers to their children.

Implication for Planning

So what do we learn from *Mirowski* and *Holman*? First, identify the right client for this technique. A client that is only interested in the tax discounts is not the best candidate for a FLLC or FLP. Although the asset transfer in *Holman* was respected, because the FLP was properly formed and the gifts were later made, the court looked through the taxpayers' tax reduction motivation and limited the valuation discount. The formation of the entity should be for legitimate and significant nontax reasons, which should be documented in the operating or partnership agreement.

Second, good planning is important. The client must balance the amount of assets transferred to the entity and the amount of assets retained apart from the entity. In *Mirowski*, the decedent retained significant assets outside of the entity. Even so, she did not have enough assets to pay the $11 million gift tax liability that resulted from the gift transfers. The Tax Court held that Mirowski's transfer of property to MFV fell within the bona fide sale exception to §2036(a) because to pay the tax liability, she could have (1) used a portion of her remaining assets, (2) used a portion or all of the distributions she expected from her remaining 52 percent interest in MFV, or (3) borrowed against her personal assets and MFV interest that she retained.

Third, good lawyering is a necessity. The operating agreement must be carefully prepared and followed. In *Mirowski*, the IRS attacked several provisions of the operating agreement. The opinion and the attached excerpts of the operating agreement are a roadmap for estate planners to follow. The operating agreement should properly specify how the capital accounts are maintained, who has authority to make distributions, when distributions are made, and under what circumstances.

Fourth, the client needs to properly maintain and document the operation of the entity after formation. Once assets are transferred to the entity, the capital accounts should be properly credited. When an entity interest is transferred, the capital accounts should reflect the transfers. A bank account should be maintained and books and records of the entity should be kept. The accounts of the entity should be kept separate from the accounts of the taxpayer.

With careful planning and drafting, FLLCs and FLPs remain an attractive option for transfers of family wealth. ■