Mirowski v. Commissioner

T.C. Memo. 2008-74; Court Rejects IRS's §§2036(a)(1), 2036(a)(2), 2038, and 2035 Arguments

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Synopsis

Decedent (Mrs. Mirowski) signed LLC documents (naming herself as the sole general manager) on August 27, 2001. On 9/01/2001, the decedent transferred 51.09% of the rights under a valuable patents license agreement (that generated revenues of millions of dollars per year) in return for 100% of the member interests of the LLC in which she was named the sole general manager. From 9/5/2001 to 9/7/2001 she transferred marketable securities worth about $62 million to the LLC. On 9/7/2001, the decedent made gifts of a 16% interest in the LLC to each of her three daughters' trusts, retaining the other 52% interest. The decedent retained $7.5 million of personal assets (including $3.3 million of cash and cash equivalents) outside the LLC. The decedent retained assets to pay her living expenses and all obligations except gift taxes on the 48% gift that she intended to make when the LLC was created, but the court concluded that she had the ability to pay the gift taxes (with her retained cash, with loan proceeds from amounts that she could borrow, and from distributions from the LLC attributable to royalties that the LLC would receive).

The decedent died unexpectedly on 9/11/2001, first experiencing a significant deterioration in her condition on 9/10. Thus, during the 16 days before the decedent died, the LLC was formed, contributions were made to it, and the decedent made gifts of 48% of the member interests.

After the decedent's death, the partnership distributed $36.4 million to her estate to cover gift and estate taxes, legal fees and other estate obligations. (Following the decedent's death, the three daughters owned the LLC in equal shares, and they opted not to make pro rata distributions to themselves.)

The IRS argued that the assets in the partnership (including the assets attributable to the 48% interest that was given to the daughters' trusts) should be included in the decedent's estate under §§2036(a)(1), 2036(a)(2), 2038, and 2035(a). The decedent retained assets for living expenses, but the IRS argued that §§2036(a)(1) and (a)(2) and 2038 applied to the contribution of assets to the LLC, and to the 48% gifts of the LLC interests, and that §2035(a) applied to all of the transfers. The court rejected all of those arguments.

As to the original transfers to fund the LLC, the court determined that the bona fide sale for full consideration applied. As to the assets attributable to the 48% gifts of LLC interests, the court emphasized that the decedent's death was unexpected and that there was no understanding that the LLC assets would be used to pay gift taxes, and the estate taxes were not discussed or anticipated because no one expected the decedent to die any time soon after the transfers. The court did not apply §2036(a)(2) or 2038 even though the decedent was the sole general manager of the LLC at her death. Section 2035 did not apply because neither 2036 nor 2038 applied, so she never relinquished rights that would have otherwise triggered inclusion under §§2036 or 2038.

Key Facts

The result of the case is very fact dependent, and the facts are summarized below in some detail.

(1) The decedent's husband died in 1990, leaving all of his estate to decedent (except $600,000 passing to a bypass trust). The estate included an approximately 73% interest in valuable patent licenses for a medical device that he had invented.

(2) In 1992, the decedent gave 21.78% of the patent license rights equally to trusts for her three daughters, retaining 51.09%.

(3) In 1999-2000, the decedent expressed the desire to provide for her three daughters and grandchildren on an equal basis, and for the daughters to have a close working relationship.

(4) In May 2000, the decedent was first introduced to the concept of an LLC, and documents were sent to her in August, 2000.

(5) In January 2001, the decedent wore a blister on her foot during a trip to France; she developed a foot ulcer as result of the blister and her diabetes.

(6) In March 2001, the decedent had a surgical procedure for the foot ulcer and had various treatments for the foot ulcer between March and August 2001. The doctors discussed various alternatives, including amputation, but the decedent was not comfortable with amputation.

(7) In March and July of 2001, the decedent purchased interests in several retirement communities (suggesting that that she did think that her death was imminent).

(8) In August 2001, there was a family meeting of the daughters where they discussed the LLC and the decedent's intent to make gifts of LLC interests.

(9) <u>Legitimate and Significant Non-Tax Purposes</u>. Based apparently on the testimony of two of the three daughters, the court found that the decedent was aware that "certain tax benefits" could result from the LLC, but they were not "the most significant factor" in the decision to form the LLC. The court found that the decedent had the following legitimate and significant purposes:

> "(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 an equal basis."

(10) A "legitimate, but <u>not</u> significant, nontax reason" was to provide additional protection from potential creditors, including particularly divorce protection for her daughters.

(11) On August 27, 2001, the decedent signed the LLC documents. The decedent was the sole general manager from the time the LLC was created until the time of her death (16 days later).

(12) On September 1, 2001, the decedent transferred the patents and her 51.09% interest in the patents license agreement to the LLC in return for 100% of the member interests. (No person other than the decedent made any transfers of property to the LLC.) (The patents license rights were valuable, producing royalties of millions of dollars per year.)

(13) On September 5-7, 2001, the decedent transferred more assets to the LLC, including about $62 million of marketable securities and cash.

(14) Even after the various transfers to the LLC, the decedent retained about $7.5 million of personal property assets, including $3.3 million of cash or cash equivalents. The court found that the decedent "retained more than enough personal assets to meet her living expenses" but did not retain enough to pay anticipated gift taxes attributable to the contemplated gifts of LLC interests.

(15) From the outset, the decedent contemplated making gifts of interests in the LLC after creating it. On September 7, 2001, the decedent gave a 16% interest to each of her three daughters' trusts. The decedent retained the remaining 52% interest in the LLC.

(16) The daughters did not know how the decedent planned to pay the substantial gift taxes (eventually determined to be over $10 million), but she had retained substantial personal assets, including over $3 million in cash and cash equivalents. In addition, the decedent "anticipated receiving as an interest holder in [the LLC] future income of millions of dollars a year attributable to royalty payments" from the license rights that were contributed to the LLC. Also, the

daughters believed that the decedent could have borrowed against her retained personal assets and her retained 52% interest in the LLC in order to pay the gift tax liability. "At no time before Ms. Mirowski's death did the members of [the LLC] have any express or unwritten agreement or understanding to distribute assets of [the LLC] in order to pay that gift tax liability." There were similarly no discussions about how estate taxes would be paid because at no time before September 10, 2001 did the doctors, the decedent or her family expect her to die.

(17) Despite the finding immediately above that the decedent "anticipated receiving as an interest holder in [the LLC] future income of millions of dollars", the court found that there was no express or unwritten agreement or understanding among members of the LLC that the decedent, at her own discretion, could have access to assets she had transferred to [the LLC], the right to income from those assets, or the right to determine who can possess or enjoy those assets.

(18) The decedent was admitted to the hospital for more treatments on her foot ulcer beginning on August 31, 2001. However, until September 10, everyone thought that the treatments would allow her to recover and return home. The decedent discussed with a daughter who lived in Philadelphia that she planned to travel to her home on September 18 for a Rosh Hashanah celebration. Another daughter left the country to attend a medical conference on September 6.

(19) The decedent's medical condition deteriorated significantly on September 10. The doctors recommended amputation to avoid further complications including possible life-threatening infections. The decedent refused, and she developed "sepsis, caused by an overwhelming infection of the blood stream". The decedent died the next day, September 11, 2001 [yes, *that* September 11].

(20) In 2002, $36.4 million was distributed from the LLC to pay transfer taxes, legal fees, and other estate obligations. (The decedent's will left her 52% interests in the LLC equally to her daughters' trusts, so they would own 100% of the LLC interests. The daughters decided not to make pro rata distributions to themselves. "In making that decision, [the daughters] had in mind that those members will own collectively 100% of [the LLC], in three equal shares, after decedent's estate is closed.")

(21) The estate filed a gift tax return reporting $9.7 million of gift tax. Eventually, the gift tax was settled, increasing the value of each 16% interest from $5.7 million to $6.8 million (see footnote 36).

(22) The estate filed an estate tax return reporting estate taxes of $14.1 million. The IRS proposed to increase the gross estate from $27.8 million to $71.1 million and increase the estate tax by $14.2 million.

(23) After the decedent's death, the three daughters carried out the decedent's intentions for them to actively work together in managing the LLC assets, making joint investment decisions, and managing the patents licenses and related litigation. The LLC has invested in certain investments that would not have been available on an individual basis to the daughters or their trusts if the decedent had transferred her assets to them separately rather than transferring the assets to the LLC for investment as a single pool.

Holding

Sections 2036(a)(1), 2036(a)(2), and 2038 do not apply to the contribution of assets to the LLC or to the LLC assets attributable to the 48% member interests that were given to the daughters' trusts. Section 2035 does not apply, in light of the fact that the decedent did not relinquish any rights or powers that would otherwise have triggered inclusion under §§2036 or 2038.

Analysis

(1) Burden of Proof. Neither party addressed §7491(a), and the court concluded that the resolution of the issues does not depend on who has the burden of proof.

(2) Application of §2036 and §2038 to Contributions From Decedent to LLC.

a. Bona Fide Sale For Full Consideration Exception.

1. Legitimate and Significant Nontax Reasons. While the decedent was aware of potential tax advantages, they were not the "most significant factor" in the decision to create the LLC. The court cited the "legitimate and significant nontax reason" test from Bongard, and found that the decedent had three legitimate and significant nontax reasons.

- Joint management. The decedent wanted her daughters and eventually her grandchildren to jointly manage the family assets, based on her family background of working together in a family business.
- Single pool of assets. The decedent wanted to maintain her assets in a single pool for her daughters to allow for investment opportunities that would otherwise be unavailable. Indeed, certain investment opportunities at Goldman Sachs would not have been available if the assets had been separated among the daughters and their trusts.
- Equal provisions. The LLC assisted with the decedent's goal of providing equally for her daughters, and eventually her grandchildren.

[Observe that these are pretty common goals. These same reasons potentially could apply in many family situations.]

Creditor planning. Creditor planning was an additional "legitimate but not significant" nontax reason, particularly providing possible divorce protection for the daughters.

2. Credibility of Witnesses. Apparently, the nontax reasons were established by the testimony of two of the daughters. No documentary evidence of these reasons were mentioned in the opinion. The IRS argued that their testimony should be disregarded, because of their personal interest. However, the court found the witnesses to be credible, based on their "candor, sincerity, and demeanor" as well as the "reasonableness" of their testimonies. The court found them to be "completely candid, sincere, and credible".

3. IRS Counter Arguments As to Bona Fide Test. The IRS restated some of the standard reasons that have been cited in prior cases.

- Failure to retain assets for anticipated financial obligations. The court found that the only anticipated significant financial obligation when the decedent formed and funded the LLC was a substantial gift tax that would be attributable to the contemplated gifts of member interests. However, there was no express or unwritten agreement or understanding to distribute LLC assets to pay the gift tax liability. The decedent could have (i) used a portion of her remaining $7.5 million of personal assets that she retained, including cash and cash equivalents of over $3.3 million, (ii) used a portion of the distributions "that she expected to receive as a 52% interest holder in [the LLC] of the millions of dollars of royalty payments… that she expected {the LLC] to receive", and (iii) borrowed against her personal assets that she retained and her 52% interest in the LLC.

As to estate tax payments, the court observed that at no time before September 10, 2001 did the decedent, her daughters, or her physicians expect her to die. Consequently, "at no time did Ms. Mirowski and her daughters discuss or anticipate the estate tax and similar transfer taxes and the other estate obligations that would arise only as a result of Ms. Mirowski's death".

- Lack valid functioning business operation. The court concluded that the LLC has at all times been a valid functioning "investment operation and has been managing the business matters related to the …patents." Moreover, the court rejected the suggestion that the activities of the LLC "had to rise to the level of a 'business' under the Federal income tax laws in order for the exception under section 2036(a) …to apply."
- Delay in forming and funding the LLC until shortly before death. The court responded by noting that the decedent was not expected to die before her health quickly and unexpectedly deteriorated on September 10.
- "Sat on both sides." The IRS repeated the statement, that has been included in various cases (but has never appeared to be a determinative factor, but just one of many listed by a court in what the court perceives as an abusive situation), that the decedent "sat on both sides" of the transaction (apparently meaning that there was no negotiation). The court responded that would eliminate single member LLCs from the statutory exception. Furthermore, the court noted that only the decedent contributed assets to the LLC, apparently intimating that it is totally expected that only the sole contributing member of the entity would make decisions about its terms.
- Post-death distributions. The IRS argued that the post-death distribution of $36.4 million keeps the transfer to the LLC from meeting the bona fide sale exception. The court responded that her death was not expected, so the decedent and the daughters never discussed or anticipated providing for the estate taxes and estate obligations. Perhaps more important, the court seems to suggest that failing to keep enough assets to pay estate taxes does not necessarily negate the applicability of the exception:

> "Moreover, we reject the suggestion … that respondent's contention … is determinative in the instant case of whether Ms. Mirowski's transfers to [the LLC] were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a)."

4. Full Consideration Requirement. The court finds that the Bongard standard is satisfied: (i) The decedent received interests proportionate to her transfers (i.e. 100% in this case); (ii) her capital account was credited with her transfers; and (iii) on liquidation or dissolution she had the right to receive property in accordance with her capital account.

5. <u>IRS Counter to Full Consideration Requirement</u>. The IRS's countering argument is a twist on its "gift on creation" and its "integrated transaction" theories. The IRS argued that because the decedent always intended to make gifts of 48% of the LLC interests, she did not receive full consideration for her transfers to the LLC. The IRS does not use the phrase "integrated transaction," but that is the effect. The court disagreed, treating (i) the transfers to the LLC in return for 100% of the member interests, and (ii) the subsequent gifts of member interests as separate transactions. The full consideration requirement is satisfied as to the contribution to the LLC if proportionate interests are received in the first step.

b. <u>Section 2036(a)(1) and (a)(2) and §2038 Retained Interests and Powers</u>. The court said that it did not have to address whether there were retained interests under §§2036(a)(1) or (a)(2) or 2038 as to the transfers to the LLC because the bona fide sale exception applied. (The §§2036 and 2038 issues are discussed more fully below as to the transfer of the 48% member interests, because the bona fide sale exception does not apply to those transfers.)

(3) <u>Application of §§2036 and 2038 to Transfer of 48% Interests by Gifts</u>. The court separately analyzed the application of §§2036 and 2038 to the subsequent gifts of LLC interests. (All too often, courts have addressed whether to include all FLP or LLC assets in the estate under §2036, even as to assets attributable to gifts of FLP or LLC interests, without addressing how the string statutes would apply to the gifts. Even if §§2036, 2038, or 2035 apply, one possible approach would be to bring back just the transferred interest into the estate — i.e. the discounted LLC interest in this situation. The court does not address that approach. However, its rebuttal to the IRS's lack of full consideration argument clearly recognized the initial gift and subsequent gift as separate transactions.)

a. <u>Bona Fide Sale Exception Not Applicable</u>. The court easily concludes that the bona fide sale for full consideration exception does not apply, because these transfers are gifts, and obviously were not made for full consideration.

b. <u>Section 2036(a)(1), Express Agreement</u>. The IRS apparently argued that the decedent had the right under the operating agreement to cause the distribution to herself of all income and assets of the LLC, even including income and assets attributable to the 48% interests that were given to the trusts. The IRS says there is an express agreement that the decedent would continue to retain the possession or the enjoyment of or the right to income attributable to the 48% member interests that were given to the daughters' trusts because the decedent was the general manager, and the general manager had sole authority to manage the LLC affairs, including the authority to determine the timing and amounts of distributions. The LLC operating agreement says that except as otherwise provided, "the timing and the amount of all distributions shall be determined by the Members holding a majority of the Percentages then outstanding".

The court responds that the general manager has a fiduciary duty under state law. Also, other provisions of the operating agreement require pro rata allocations of profit and loss and pro rata distribution of capital proceeds from capital transactions. Furthermore, the authority to determine the timing and amounts of all distributions was a power given to the majority members, not the general partner.

Even as to the decedent's authority as the majority holder of the member interests, the section referring to determining the timing and amounts of distributions is subject to other provisions of the operating agreement, including pro rata distribution of "cash flow", pro rata allocation of profit and loss and pro rata distribution of capital proceeds from capital transactions.

c. Section 2036(a)(1), Implied Agreement. The IRS argues there was an implied agreement of retained possession or enjoyment or income attributable to the 48% interests that were given to the daughters' trusts because of the post mortem distribution of $36 million to the estate in order to pay transfer taxes, legal fees and estate obligations. The court responded that the decedent's death was not anticipated at the time of the transfers, and there was no understanding to make LLC distributions to pay the gifts taxes or other amounts due after her death.

The court did not specifically address what suggested an implied agreement that the decedent somehow kept the right to receive assets attributable to the daughters' interests, when her own 52% interest was sufficient to fund the $36 million of distributions.

The $36 million was paid as a "distribution" from the LLC, and was not accomplished by purchasing assets from the decedent's estate or redeeming some of the estate interests (as was done in the Erickson case.) Even so, the court disagreed that the post-mortem $36 million distribution evidenced an implied agreement of retained enjoyment of assets attributable to the 48% interest that had been given to the daughters' trusts. The court acknowledged that there were not pro rata distributions to the other members, but noted that was a decision by the daughters in light of the fact that their trusts would equally own 100% of the member interests in the LLC after the decedent's estate was settled.

d. Section 2036(a)(2). The IRS argued that the decedent kept the right to designate who could possess or enjoy the transferred property or the income therefrom as to the 48% interests that were given to the daughters' trusts. The IRS points to the decedent's right to dispose of assets in the ordinary course of business (with the approval of the daughters), and the decedent's power as majority member owner to determine the timing of the distribution of capital transaction proceeds. *[Observe: The IRS does not argue that merely being the sole general manager of an LLC results in keeping proscribed powers under §2036(a)(2).]* The court said that it rejects that argument for the same reasons it gave for the similar argument as to the express retention of a §2036(a)(1) right under the same general reasoning.

e. Section 2038. The issue is whether the enjoyment of the transferred property (i.e., the gifts of the 48% interests) was subject to a power exercisable by the decedent alone or in conjunction with another person to alter, amend, revoke, or terminate within the meaning of §2038(a)(1). The IRS gave the same reasons as under its §2036(a)(2) argument, and the court summarily rejects the arguments for the same reasons as under the §2036(a)(2) analysis.

(4) Section 2035. Because §§2036 and 2038 do not apply as to any of the transfers, §2035(a) cannot apply, because it only applies to the relinquishment of powers that would otherwise cause inclusion under those sections (or §§2037 or 2042, neither of which are applicable).

Observations

(1) Smell Test. The only way to rationalize the various FLP/LLC §2036 cases is to recognize that the courts apply a "smell test" to avoid allowing a valuation discount in what the court perceives as abusive case involving paper shuffling (often immediately before death) just to generate a valuation discount. The estate in Mirowski passed the smell test — Judge Chiechi perceived that

the family did not create the LLC just to get a valuation discount, but she believed the testimony of the daughters that there were significant non-tax reasons for creating the LLC, even though those reasons related primarily to how the assets would be managed after they were transferred to trusts for her daughters.

(2) Transfer Shortly Before Death. Most of the FLP and LLC §2036 cases have involved the creation of FLPs/LLCs shortly before the decedent's death. This case continues that pattern, with the entire formation, funding, and gifting occurring within only 16 days of the decedent's death. That appears to be a common theme of situations that the IRS chooses to take to court. However, in this case the court found strong evidence that the decedent's death was not anticipated when the LLC was formed and funded or when the gifts were made.

(3) Significance of Tax Advantages Not Being "The Most Significant Factor." The court found that the tax advantages were not "the most significant factor" in the decision to form and fund the LLC. Is that vital? What if there were "legitimate and significant nontax reasons, but tax savings was the "most significant factor"? Would that mean that the exception could not apply? Thus far, no court has specifically imposed that requirement.

Perhaps this principle is being applied by the courts but in a non-explicit manner. Generally speaking, the same reasons that are recognized as "legitimate and significant nontax reasons" in this case have been rejected in other cases that the court perceived as abusive (where the court perceived that the parties were making transfers of almost all of the decedent's assets shortly before death just to get an estate tax valuation discount.) Perhaps it is the fact that the tax reason totally dominates, that the court finds that the other nontax reasons are not "legitimate and significant."

(4) Legitimate and Significant Nontax Reasons. Planners often search to find what nontax reasons will be viewed as acceptable by the courts. This is obviously a fact intensive issue, considering all of the surrounding circumstances. However, it is comforting to planners that the reasons that were accepted in this case would apply in many family situations (i.e., joint management, keeping assets in a single pool rather than dividing the assets among estate beneficiaries to facilitate investment opportunities, and to facilitate providing equally for descendants).

(5) Creditor Planning. The court continues the record of almost all courts in failing to find creditor planning as a legitimate and significant reason. Unlike some cases, the court does not question that there can be legitimate creditor planning advantages of using LLCs, but the court just finds that on the facts of this case, that was not a significant reason.

(6) Facilitating Gift Giving. This is the first case that has recognized that reasons to facilitate making gifts and distributions among descendants in an advantageous manner can be a "legitimate and significant reason" to support a finding that the bona fide sale exception applies. Bongard found that facilitating giving was not a nontax reason under the facts of that case, and some other Tax Court Memorandum cases have subsequently said that facilitating giving can never be a legitimate and significant nontax reason. However, the three nontax reasons recognized in this case all relate to being able to divide one's assets among distributees in an effective way. None of the three reasons directly aid the decedent during her lifetime. All three provide perceived advantages for her children (i.e., allowing the daughters to jointly manage the assets, allowing the daughters to have the benefit of a large single pool of assets by keeping all of the decedent's assets in a single pool, and facilitating equal division of the assets).

Footnote 45 directly addresses the "facilitating gifting" issue:

> "In Estate of Bongard, we did not conclude that an intention to facilitate lifetime giving may never be a significant nontax factor. Rather, we found on the record presented there that such an intention was not a significant nontax reason for forming the partnership involved in that case."

(7) No Business Purpose Requirement. Despite their failure to convince a majority of the Tax Court in Bongard to impose a business purpose requirement to satisfy the "bona fide sale" requirement in the §2036 exception, some judges have continued to restate the standards of the exception as requiring a business purpose. (For example, see the Rosen and Rector cases.) Judge Chiechi explicitly repudiates the necessity of requiring activities that rise to the level of a "business" to meet the §2036 exception.

(8) No Outside Contributions to Partnership. Planners often debate whether it is better to have third parties make contributions to the partnership. Doing so can benefit the decedent during his or her lifetime, and may provide another nontax reason for forming the LLC or FLP. Furthermore, the Ninth Circuit opinion in Bigelow literally required that there be a joint pooling of assets — which would require substantial contributions by others (even though that did not happen under the facts of that case and the court did not point out that fact.) Judge Laro's opinion in Rector seems to disregard the Bongard analysis of what is required to constitute full consideration, and instead looks to whether there is a change in the underlying pool of assets or prospects for profit. That would also seem to require outside contributions.

In Mirowski, there were no contributions from third parties, and the court still upheld the LLC against an attack under §2036.

(9) No Negotiations; Only One Attorney. Some courts (including the Eight Circuit in Korby) have listed various factors supporting the failure to apply the bona fide sale exception, including "standing on both sides of the transaction" and the fact that only one attorney represented all participants. The court specifically rejected the "standing on both sides of the transaction" argument in Mirowski, but it was a single member LLC. Also, no mention was made of the fact that one attorney planned the transaction, knowing the agreement was being prepared with the contemplation that the daughters' trusts would quickly receive member interests by gift.

(10) Requirement to Distribute Cash Flow. The operating agreement requires the distribution of cash flow, which is defined as meaning cash flow after retaining reasonable reserves. Some planners question whether that increases the likelihood of an attack under §2036(a)(1). We cannot tell much about that from this case, because the court did not address §2036(a)(1) as to the contributions to the LLC in light of the fact that the §2036 exception applies. However, the existence of that requirement, rather than just giving the manager the discretion to make distributions, appears to have helped with the §2036(a)(2) and 2038 arguments. The IRS tried to force an argument that a power to determine the timing and amount of distributions somehow constituted a §2036(a)(2) or 2038 power over the transferred LLC interests. The court found that provision to be subject to other provisions of the agreement, all of which contemplated pro rata distributions under a fiduciary duty.

(11) Discretion to Determine Holdback For Reserves Before Distributing Cash Flow. Footnote 62 indicates that the IRS argued that the decedent had the power to determine how much cash flow and capital proceeds would be distributed by reason of the general manager's power to determine reasonable reserves. The court responded, first, that the discretion in determining reasonable reserves "was limited to establishing reserves for MFV's liabilities and obligations and future

expenses, debt payments, capital improvements, and replacements". Second, the decedent's authority to establish reserves "was subject to the fiduciary duties imposed on her by Maryland law". The court found nothing in the record suggesting that the decedent would have established reserves in violation of those duties. The court concluded that the decedent's power "as general manager to establish reserves as specified in MFV's operating agreement did not give Ms. Mirowski an interest or a right described in sec. 2036(a)(1) (or sec. 2036(a)(2))".

(12) Decedent as Sole General Partner. Planners generally avoid having the decedent serve as the sole general partner. However, that did not prevent a taxpayer victory in this case. In fact, the IRS did not even seem to argue that merely being the sole general manager (or the sole general partner in an FLP context) itself would be sufficient to invoke §2036(a)(2) or 2038. The court emphasized the limitations on the general manager's powers under the agreement and emphasized the fiduciary duties that applied to the general manager under state law. However, until there is more specific and general repudiation of Judge Cohen's reasoning in the Strangi Tax Court opinion, cautious planners will continue to be sensitive about having clients serve as the sole general partner of an FLP or manager of an LLC.

(13) Anticipated Distributions of LLC Income. Planners often ask if the entity should be able to distribute income receipts, similar to the way that the decedent would be able to receive dividends from stock that the decedent purchases. Some courts have pointed to the fact that some distributions were made to the decedent as reflecting an implied agreement of retained beneficial enjoyment of the FLP assets. In this case, the court specifically acknowledged that the decedent anticipated receiving distributions attributable to her share of the millions of dollars of royalty payments that would be made each year to the LLC. The court used that as supporting that the decedent had a method for paying anticipated expenses when the LLC was formed (i.e., the large gift tax liability) without having to access capital of the LLC.

However, planners cannot rely being able to expect distributions of LLC income without impacting the determination of an implied §2036(a)(1) right to beneficial enjoyment, because the court did not reach the §2036(a)(1) analysis as to the contributions to the LLC. (The court only discussed §2036(a)(1) as to the gifts of member interests, where the issue is whether there was an implied agreement to receive distributions of income or other assets attributable to the interests that had been transferred by gift.)

Nevertheless, it is an interesting situation that the court found that the decedent in this case anticipated receiving substantial distributions of income from the LLC, yet the LLC still passed muster under §2036 (albeit because of the §2036 exception).

(14) Not Retaining Enough Assets to Pay Anticipated Liability Directly From Retained Assets. A standard §2036 argument by the IRS is that the decedent did not retain sufficient assets to pay living expenses and other anticipated expenses. Here, the court said that the decedent did retain enough assets to provide for her living expenses, but did not retain enough assets to pay directly for her anticipated gift taxes. The court pointed to the facts that (i) there was no understanding that the LLC would make large distributions so that she could pay her gift taxes, and that (ii) she had other means of coming up with funds to pay the gift taxes, including anticipated large distributions from the LLC itself from royalties that would be paid to the LLC.

As with post-mortem distributions to pay estate taxes (discussed immediately below), the case will be cited by planners as rebutting the Erickson and Rector citations by IRS agents that use of FLP assets to pay transfer taxes creates an implied §2036 retained right.

Again, keep in mind that the case does not directly hold that distributions to pay gift taxes cannot evidence an implied agreement of retained enjoyment in assets contributed to the LLC — because the court did not address whether there was a retained enjoyment under §2036 as to contributions to the LLC in light of the fact that the §2036 exception applied.

(15) Post Mortem Distributions to Pay Transfer Taxes, Legal Expenses, and Estate Obligations. There are reports that IRS agents are now scouring FLP records to determine if any FLP assets have been used post mortem to pay estate taxes, in light of the Erickson and Rector cases. Erickson involved a situation where the FLP purchased estate assets and redeemed some of the estate's FLP interests, rather than having distributions of FLP assets to the estate, and the court relied primarily on the post mortem use of FLP assets to find the existence of an implied agreement of retained enjoyment under §2036. The court reasoned that people know they will eventually die and that there will be obligations after their deaths, so planning to use FLP assets to satisfy anticipated liabilities after one's death is a §2036 retained right. While Mirowski does not hold that post mortem use of LLC asset to pay estate taxes is not a §2036 retained right (in light of the fact that the §2036 exception applies so the court did not address §2036(a)(1) as to the contributions to the LLC), it is nevertheless an indication that post-mortem use of FLP/LLC assets to pay estate taxes is not necessarily fatal under §2036.

(16) Post Mortem Continuation of LLC to Carry Out Decedent's Goals. Perhaps an important factor in the court's perception that there were non-tax reasons for the LLC is that after the decedent's death the daughters actively worked together to manage the LLC assets, to make joint investment decisions, and to manage the patents licenses including related substantial ongoing litigation.

(17) Repudiation of "Integrated Transaction" Argument. The IRS has on occasion made the argument (for example, in Senda) that funding of an FLP must be coupled with the intention to make gifts in an integrated transaction analysis to treat the transaction as an indirect gift of the assets themselves. The IRS made a variation of that argument in Mirowski by saying the intention to make gifts meant that the transfer was not for "full consideration" and did not satisfy the §2036 exception. The court specifically rejected that approach, treating the transfer to the LLC and the subsequent gifts as two separate transfers for purposes of determining if full consideration was received.

(18) Glitch In Income Tax Reporting Is Not Fatal. Footnotes 32 and 46 indicate that the income tax return for 2002 (when the LLC made a large distribution just to the decedent's estate to pay the transfer taxes and other estate expenses) erroneously reported that the distribution was charged against the respective capital accounts of the members on a pro rata basis. The court merely observed that the record did not indicate why the return contained that error, but concluded that it did not find "that error to be a material factor in our resolving the issues presented".

(19) Coloring of the Facts. As with most of the FLP cases, reading the court's summary of the finding of facts clearly telegraphs which side will win. It was readily apparent reading the court's summary of the facts in Mirowski, before getting to the substantive opinion, that the taxpayer would win the case.

(20) Section 2036 Exception Applies If It Is Discussed First In The Opinion. Some planners have noted that if the §2036 bona fide sale exception is discussed in the opinion before the retained interest issue, the court finds that the exception applies. If the court first discusses the retained interest issue, it will ultimately find that the exception does not apply (and the court finds the existence of retained §2036 rights because courts seem to apply the same general standards for determining the existence of a bona fide transfer and the existence of an implied agreement of retained

enjoyment.) That pattern continues with this case. The exception is discussed first, and the court finds that it applies.

(21) Appealable to Seventh Circuit. One of the two personal representatives resides in Indiana (appealable to the Seventh Circuit) and the other resides in the United Kingdom. Presumably, appeal will lie to the Seventh Circuit (if the IRS chooses to appeal the case).