

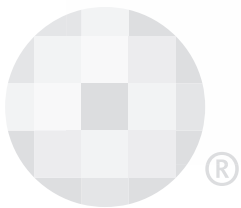
Advanced Planning Strategies

By Stan Miller and D. Scott Schrader

Most Recent Tax Court Cases Provide Roadmap for Designing FLP/FLLC Plans That Work

Only a few years ago, practitioners were uncertain as to what legitimate client objectives could be accomplished with the traditional limited partnership and LLC vehicles. In an attempt to suppress the perceived abuses of these entities, the Tax Court issued opinions that called into question the most fundamental of traditional practices causing many practitioners to seriously question the viability of these entities as legitimate planning tools.¹ Practitioners who continued to use these entities developed exotic drafting solutions in an attempt to circumvent the most extreme positions of the Tax Court in the event those positions were eventually upheld on appeal. Fortunately, the appellate courts took a more practical approach, and our worst fears subsided and have continued to subside as more cases have worked their way through the appellate process. Two recent opinions² delivered by the Tax Court continue to expand on that trend. These cases, particularly *Mirowski*, will be helpful to practitioners in devising a roadmap for the creation of family limited partnerships and family limited liability companies. These cases provide solid evidence that many of the cautions suggested by commentators in recent years are unnecessary overreactions to perceived Tax Court hostility. In this article, we will make some observations derived from these and other more recent cases which practitioners may find helpful as they work with their clients to accomplish legitimate planning objectives.

The narrative is important. If we could draw only one conclusion from the recent cases in which the taxpayers were successful, it would be that the most important element in planning is not how the documents are drafted (although that is important also), but rather how the narrative of the planning is devel-



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oped. Since the IRS began having success with the Code Sec. 2036 (a)(1) and 2036 (a)(2) arguments, we observe that the taxpayer successes come in those fact patterns in which the court was convinced that the taxpayer had objectives other than tax savings as a motive in creating the partnership.³ We agree with our colleague John Porter,⁴ who has previously written for this publication, who commented that practitioners should begin preparing for the trial before the client arrives for their first appointment. The *Mirowski* case is the clearest example of this idea. In *Mirowski*, the court devoted 20 pages to a discussion of the fact pattern that included an extensive narrative on the taxpayer's personal history and attitudes toward family, business and investing, ultimately relating that to the taxpayer's objectives in forming the family investment LLC.⁵ What we learn here is that if the story is authentic and compelling, estate planning objectives constitute a legitimate and significant nontax business purpose.

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The senior generation can be the general partner. One of the cautions expressed by some commentators over the years is the suggestion that the senior generation that provides the majority of the capital to the partnership should not serve as the general partner of the partnership (or manager of the FLLC). While that approach probably does reduce the likelihood that an IRS examiner will take the position that the senior generation has retained a 2036 power over the assets of the partnership, it also makes it far more likely that the client will simply not go forward with the planning. Most of us who practice in the real world know that normal, healthy people do not give up control of their assets until they are well into mental or physical decline, and sometimes not even then. In both *Mirowski* and *Holman*, the senior generation that provided the capital for the entity also served as the general partner or manager. In both cases, they had a fiduciary duty to the limited partners or members of the entity. The *Mirowski* court carefully reviewed the powers of the manager (Ms. Mirowski) and concluded that she did not retain the authority to decide the timing and amounts of distributions from the LLC.⁶ That finding was based on the specific design of the *Mirowski* LLC, so we cannot conclude as a general proposition that the general partner of a partnership

or manager of an LLC would not retain a 2036 power. But the design of the *Mirowski* LLC was not unusual, so it is possible to create a mainstream entity for a client and achieve this result. The *Mirowski* LLC contained a provision that mandated a distribution of "distributable cash flow."⁷ This provision is significant. If the general partner or manager does not have the power to make the decision to distribute or to withhold cash flow—if the mandatory distribution is expressly required by the partnership agreement or operating agreement—then the distribution of the entity's cash flow to partners is robotic rather than discretionary. Thus, the general partner or manager cannot affect the

beneficial ownership of other members by exercising discretion to distribute or withhold distribution. In *Mirowski*, other distributions were to be determined by members holding a majority of the LLC interests.⁸ The court found no Code Sec. 2036 problem with Ms. Mirowski, who held a majority of the LLC interests, having the power to exercise the right to vote on those additional distributions.

Partnerships or LLCs that own only marketable securities can work. It should be clear by now that the old belief that partnerships and LLCs are only appropriate estate planning tools when the clients contribute an active business or investment real estate is outdated. Several cases in the last three years⁹ prove that when properly designed and implemented, entities with only cash and marketable securities can produce desirable outcomes for clients. The *Holman* partnership produced a desirable outcome (although not as desirable as the clients had originally hoped) and it owned only Dell stock.¹⁰ The *Mirowski* court also produced a desirable outcome for the taxpayer and on this issue concluded:

We reject [the IRS's position] 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)* for a bona fide sale for an adequate and full consideration in money or money's worth to apply.¹¹

While it is clear that other facts have to be present, the mere fact that the entity holds only cash and marketable securities is not an automatic disqualifier.

Tax savings are a legitimate objective. The *Holman* court acknowledged that saving gift taxes was one of the taxpayer's motives in creating the partnership. The taxpayer's attorney discussed the potential savings from valuation discounts with the taxpayer, and the court recognized that this potential for gift tax savings played a role in the decision to form the partnership. But the court also recognized that the taxpayer had four other reasons for forming the partnership which were "very long-term growth," "asset preservation," "asset protection" and "education," all of which were more fully discussed in the opinion.¹² The court in *Mirowski* found that "[A]lthough Ms. Mirowski understood that certain tax benefits could result from forming [the LLC], those potential tax benefits were not the most significant factor in her decision to form [the LLC]."¹³ So it seems that we do not have to pretend that gift and estate tax savings are not a factor in the decision to form the entity. We do, however, have to be careful to insure that there are other significant and legitimate nontax reasons for doing so.

The mechanics of formation count. It should not be too difficult to form an entity that will pass muster with the courts, but some still manage to do it improperly.¹⁴ *Mirowski* and *Holman* reject the IRS's "integrated transfer" theory and "step transaction" assault. These cases reconfirm the importance of sequencing the formation of the entity and the contribution of the capitalizing assets before making gifts of the interests in the entity. If that sequence is correctly followed, and if the founder takes back initial ownership interests in proportion to the value of assets contributed, there should be no concern that the entity was not validly formed. Practitioners should get this right.

Waiting to make transfers of interests makes good sense. If gifts of an

interest in an LLC or LP are made contemporaneously with the entity's formation, the IRS might have some success with a "step transaction" theory. The *Holman* court rejected that argument in the context of the *Holman* facts and distinguished *Shepherd* and *Senda* on the basis that in *Holman* "... indeed, almost one week passed between petitioners' formation and

funding of the partnership and the 1999 gift."¹⁵ The court noted that the single asset of the partnership was Dell stock—which the court described as "heavily traded and volatile"—and that the petitioners took the economic risk during these six days that the value of the partnership would change as a result of a price movement in the Dell stock.¹⁶ The IRS apparently concluded that a two-month separation between funding and gifting was sufficient to give independent significance to the funding of the partnership, and the court assumed that concession was on account of the IRS's recognition of the economic risk of change in value of the partnership interests.¹⁷ The *Holman* court goes on to say that "We might view the impact of a six-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond."¹⁸ While there clearly is some economic risk in delaying a gift or sale of interest in the partnership or LLC after formation, in most cases it will be worth the trade-off in reduced tax risk.

No absolute requirement to change asset mix.

The Third Circuit in *Thompson*¹⁹ made much of the fact that a partnership established for investment purposes did not, in fact, change the investments from those held by the founder prior to formation. This fact was viewed by the court as indicative that the partnership was essentially a sham formed only to

accomplish tax objectives. But later, the Tax Court in *Schutt* found a valid nontax business purpose in the formation of the partnership precisely for the purpose of vindicating the founder's long-held desire to prevent his heirs from liquidating stock positions he had carefully nurtured over a long number of years.²⁰ In *Holman*, no mention is made of this factor as an indicator of entity legitimacy even

though the partnership's only asset was Dell stock. Whether the assets are retained or sold is part of the narrative that must be authentic and credible.

LLCs can work as the planning entity. The entity in *Mirowski* was a single member LLC, and the court expressly rejected the IRS's contention that transfers to a single-member LLC could not qualify as *bona*

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fide sales within the meaning of Code Sec. 2036(a). So there should be no meaningful difference in using a limited partnership or an LLC except in those states where they are taxed differently. However, one commentator²¹ does take issue with the court's rejection of the IRS's argument that a transfer to a single-member LLC could not be a *bona fide* sale under Code Sec. 2036(a) on the basis that the "check-the-box" regulations would permit a total disregard of the single member LLC for tax purposes. The IRS may appeal *Mirowski*, and if they do, this issue will almost certainly be raised. Until this issue is resolved at the appellate level, cautious practitioners should avoid using a disregarded entity as the foundation entity in an estate plan.

Maintaining sufficient assets outside the entity. The IRS has been fairly successful in convincing courts that when the senior generation founder transfers all of his or her investible assets into the partnership or LLC the founder would retain the right to access those assets to live on during the balance of the his or her life. The argument is that no one would intentionally make themselves destitute, so there must be an expectation that the assets of the entity can be accessed to maintain the founder's lifestyle. Such an implied right would constitute a Code Sec. 2036 retention. This issue was discussed at some length in the *Mirowski* opinion. Ms. Mirowski did keep over \$7M dollars out of the LLC, clearly enough to allow her to maintain her lifestyle without resorting to the LLC's assets—but not enough to pay the significant gift tax she knew would be payable as a result of the gifts of LLC interests to her daughters. The court found that Ms. Mirowski was reasonably entitled to count on the cash flow anticipated to come from the partnership and also could borrow the funds to pay the gift tax.²² So this factor is one that courts will consider and practitioners should make certain that the client is not dependent on the assets or the income of the entity to maintain client's lifestyle.

The mandatory distribution of cash flow solves some problems (and creates others). Above, we discussed the value of mandating the distribution of

the entity's cash flow rather than leaving that decision to the general partner or manager. This issue was discussed extensively in *Mirowski* and may have been pivotal in allowing the court to reach the conclusion that there was no Code Sec. 2036(a)(2) retention of a right. If the senior generation is going to be the general partner or manager, practitioners would be well advised to sculpt the distribution of income requirements to align with those in *Mirowski*. However, asset protection lawyers will not like these mandatory distributions. Asset protection lawyers like the notion that a creditor of an LLC member cannot step into the shoes of the member under a charging order and start collecting the debtor member's distributions. They have a valid point here. It seems that if this is a concern, the practitioner should implement additional planning so that the LLC interests are owned by asset protection trusts rather than by the member individually. This does, of course, make the planning more complex and presumably more expensive to establish and to maintain, but this arrangement will provide greater asset protection to the equity stakeholders.

Conclusion: Expect a Resurgence of Interest in FLP/LLC Planning

With an election coming in just a few months, it seems to us that Americans are beginning to conclude that the estate tax will not be repealed. Neither major party candidate is currently advocating repeal, so we are expecting our wealthier clients to begin to refocus on planning for an estate tax they had hoped would just go away. Also, we have observed in our own practice that asset protection is an increasing motivator for client planning. The more recent cases, and especially the *Mirowski* case discussed in this article, provide us with a roadmap for how to implement these plans with the confidence that our client's objectives will be accomplished and will sustain an IRS challenge.

ENDNOTES

¹ See, e.g., *A. Strangi Est.*, 85 TCM 1331, Dec. 55,341(M), TC Memo. 2003-309.

² See, e.g., *A. Mirowski, Est.*, 95 TCM 1277, Dec. 57,379(M), TC Memo. 2008-74; T.H. Holman, 130 TC No. 12, Dec. 57,455 (2008).

³ See, e.g., *C.P. Schutt Est.*, 89 TCM 1353,

Dec. 56,042(M), TC Memo. 2005-126.

⁴ John Porter served as lead counsel for the taxpayer in *Holman*, discussed here.

⁵ See *Mirowski*, *supra* note 2, at 99.

⁶ *Id.*, at 86.

⁷ *Id.*, at 87.

⁸ *Id.*, at 115.

⁹ *C.P. Schutt Est.*, *supra* note 3; W.E. Kelley, *Est.*, 90 TCM 369, Dec. 56,163(M), TC Memo. 2005-235; *D.A. Kimbell Est.* CA-5, 2004-1 USTC ¶60,486, 371 F3d 257.

¹⁰ See *Holman*, *supra* note 2, at 82-86.

¹¹ See *Mirowski*, *supra* note 2, at 68.

¹² *Id.*, at 5.

¹³ See *Mirowski*, *supra* note 2, at 20.

¹⁴ *J.C. Shepherd*, CA-11, 2002-1 *ustc* ¶60,431, 283 F3d 1258; *M.W. Senda*, 88 TCM 8, Dec. 55,685(M), TC Memo. 2004-160.

¹⁵ 130 TC, at 35.

¹⁶ *Id.*, at 38.

¹⁷ *Id.*, at 37.

¹⁸ *Id.*, at 38.

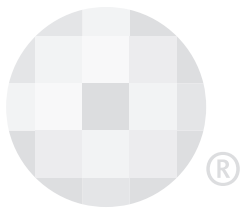
¹⁹ *T.R. Thompson*, 84 TCM 374, Dec. 54,890(M), TC Memo. 2002-246.

²⁰ See *Schutt*, *supra* note 3, at 84.

²¹ Paul Hood, commenting in LISI Estate Planning Newsletter #1272 (Apr. 9, 2008) at www.leimbergservices.com, Copyright 2008 Leimberg Information Services, Inc. (LISI).

²² See *Mirowski*, *supra* note 2, at 91.

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