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High Net Worth Family
TAX REPORT

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Taxpayers Enjoy Success in Recent Family Limited Partnership Cases

Many recent court decisions concerning family limited partnerships or limited liability companies ("LLCs") have involved "bad facts making bad law." The "bad facts" include commingling of partnership and personal assets, deathbed formations, non–pro rata distributions, and paying estate taxes out of partnership funds. The "bad law" results in inclusion of the partnership assets in the decedent's estate for estate tax purposes. In recent months, several "better" or even "good" facts cases have been decided in favor of the taxpayers. The most important of these is *Estate of Anna Mirowski, T.C. Memo 2008-74 (March 26, 2008)*.

Anna Mirowski's deceased husband was credited with developing the implantable cardioverter defibrillator ("ICD") to monitor and correct abnormal heart rhythms. When her husband died in 1990, Ms. Mirowski received the ICD patents and Dr. Mirowski's interests under the license agreements for the patents. For various reasons, after Dr. Mirowski's death, the royalties received from the ICD patents increased dramatically. Ms. Mirowski conservatively invested the proceeds at various financial institutions. By 2000, Ms. Mirowski's assets totaled millions of dollars, and she was introduced to the concept of consolidating the assets into fewer accounts and contributing those assets to an LLC for estate planning purposes. After discussing the matter with her attorney, Ms. Mirowski waited for the next annual family meeting with her three daughters in 2001 to present the matter and move forward with the plan. Although she understood that certain tax benefits could result from forming the LLC, those potential tax benefits were not the driving factor in her decision to form the LLC.

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Her primary nontax reasons were:

- joint management of the family assets by her daughters and eventually her grandchildren,
- maintenance of the bulk of the family's assets in a single pool in order to allow for investment opportunities that would otherwise not be available,
- providing for each of her daughters and eventually each of her grandchildren on an equal basis, and
- providing additional protection from potential creditors for the interests in the family's assets not provided by the existing trusts.

In August 2001, Ms. Mirowski formed the LLC and over the next few weeks funded the LLC with the ICD patents, her interests under the license agreements, and securities totaling more than $70 million. In exchange, she received a 100% membership interest in the LLC. She was the sole general manager of the LLC. Shortly after forming and funding the LLC, Ms. Mirowski made gifts of 16% membership interests to three trusts for the benefit of her three daughters.

Ms. Mirowski suffered from diabetes but was generally in good health. Around the same time as the formation and funding of the LLC and the gifts to the daughters, Ms. Mirowski's health deteriorated quickly as a result of a foot ulcer that had caused an infection of her bloodstream. In September 2001, three days after completing the gifts, Ms. Mirowski passed away. Ms. Mirowski may have anticipated receiving substantial distributions from the LLC's cash flow to pay the anticipated gift taxes resulting from the gifts (she retained $7.5 million of assets outside of the LLC, including her personal residence and $3 million in cash and cash equivalents, but the gift taxes were more than $10 million). In the year after Ms. Mirowski's death, the LLC distributed $36.4 million just to the estate (not pro rata to the other LLC members) to pay transfer taxes and estate obligations.

The IRS contended that the assets owned by the LLC were includible in Ms. Mirowski's gross estate. The IRS argued that there was no legitimate, significant nontax reason for Ms. Mirowski's forming and transferring assets to the LLC. The court disagreed, instead believing the testimony of the decedent's daughters (with apparently little documentary evidence) about the significant nontax reasons for creating the LLC. The court analyzed the IRS's contentions that the LLC lacked legitimacy because (1) Ms. Mirowski failed to retain sufficient assets outside of the LLC, (2) the LLC lacked any valid functioning business operation, (3) Ms. Mirowski delayed forming and funding the LLC, (4) Ms. Mirowski sat on both sides of the transaction, and (5) the LLC made a large non–pro rata distribution to pay the transfer taxes and estate obligations.

The court concluded that the IRS's contentions were not supported by the facts and that the transfers to the LLC were bona fide transfers for adequate and full consideration. The court noted some assets had been kept outside of the LLC (even though not enough to pay the gift and estate taxes), the activities of the LLC did not need to rise to those of a "business" under federal tax laws, there were no express or implied agreements between members to distribute LLC assets to pay Ms. Mirowski's tax liabilities, there was no commingling of personal and partnership assets, and Ms. Mirowski's death was very unexpected. In addition to the detailed analysis of the various contentions, the court gave significant consideration to the family history of financial planning involving the junior generation, having annual family meetings with professionals present, and running the LLC as a real business.

The second transfer in question was the gift of the LLC interests to trusts for the benefit of the three daughters. The IRS argued that the gifts should be includible in Ms. Mirowski's estate because she retained the possession or enjoyment of, or the right to, income from the property transferred. Such an interest or a right is treated as having been retained if, at the time of the transfer of property, there was an express or implied agreement or understanding that the interest or right would later be available to the transferor. The IRS's primary argument hinged on the fact that Ms. Mirowski was the sole general manager of the LLC and, as such, had the right (along with other rights) to decide over the distribution policy of the LLC and thereby control the use and enjoyment of the LLC's income. Moreover, because she retained a majority membership interest, she could not be removed and replaced as general manager by the other members without her consent. The court concluded that Ms. Mirowski did not retain the possession or enjoyment of, or the right to, income from the transferred LLC interests. Although the LLC agreement gave significant powers to the general manager, Ms. Mirowski's authority to determine the timing and the amount of distributions was limited by the fiduciary duties imposed on her by state law and provisions in the LLC agreement requiring distributions of cash flow after withholding required reserves for specified reasons.

The *Mirowski* decision is noteworthy for its systematic dismissal of IRS arguments in a case that included an LLC holding primarily marketable securities, the retention of a majority managing interest by the decedent, and non–pro rata distributions to pay transfer tax and estate obligations. It emphasizes the importance of having legitimate, significant nontax reasons for forming and operating a family limited partnership or LLC and a history of family involvement in business affairs. Overall, the case presents a good road map for families in setting up these kinds of vehicles.

In *Astleford v. Commissioner, T.C. Memo 2008-128 (May 5, 2008),* the taxpayer benefited from several discounts. The taxpayer's family limited partnership owned a 50% interest in a general partnership that owned a 1,187 acre tract of land. First, the court allowed an "absorption discount" of 20% with respect to the land, because a sale of the entire tract would flood the market and depress prices. Next, the court allowed a 30% combined discount for lack of marketability and control with respect to the family limited partnership's ownership of the 50% general partnership interest. Finally, the court allowed a combined discount of about 35% with respect to the actual interests in the family limited partnership. If you do all the math, each $100 of value of the land was treated for gift tax purposes as being worth only $36.

This case certainly suggests that further benefits can be created by setting up family entities through multiple tiers of ownership. Caution and restraint must be exercised, however, to be certain that a business purpose can be established for each tier of entities.

In *Holman v. Commissioner, 130 T.C. No. 12 (May 27, 2008)*, the taxpayer transferred shares of Dell Computer Corp. to a family limited partnership and then made gifts of partnership interests to his children. The IRS raised an old argument that the gift should be treated as being of Dell shares, effectively ignoring the existence of the partnership. That would have eliminated the discounts that the taxpayers were claiming for minority interest and lack of control. In finding for the taxpayer on this issue, the court attached considerable significance to the fact that the partnership was formed and the gift of interests did not occur until one week later. It even contrasted this with another case where all these events had occurred on the same day.

The IRS did prevail on one issue. The partnership agreement imposed onerous transfer restrictions. The IRS convinced the court that these should be ignored for valuation purposes under the authority of IRC Section 2703, which generally provides that any restrictions more onerous than those imposed by state law are to be ignored in valuing interests for transfer tax purposes.

California Graduated Probate Filing Fee Held Unconstitutional

The State of California imposed a graduated probate filing fee structure based on the value of the probate estate. These fees could be quite substantial. We have filed probate petitions where the filing fees were multiple six-figure amounts. In *Estate of Pierre P. Claeyssens*, the California Court of Appeal for the Second Appellate District held that this fee structure is prohibited by Article II, Section 10(c) of the California Constitution, which provides that the legislature may not impose an estate or inheritance tax. This provision of California's Constitution came about as a result of Proposition 6 in 1982, which was adopted to abolish the California inheritance tax. The court referred to the graduated filing fee as "a tax masquerading as a filing fee." Since the case was decided, the California Superior Court for the County of Los Angeles has announced that henceforth a filing fee of only $320 will be required.

Despite the elimination of the graduated fee, there are still many reasons why high net worth families should not subject their assets to probate, at least in California. The biggest detriment presented by a probate proceeding is the need to file an inventory of the estate's assets and the attendant loss of privacy, since court probate files are publicly accessible. High net worth families, at least in California, should generally hold their primary assets in a revocable living trust. Living trusts are not as popular in New York, where the probate process is more streamlined than it is in California.

IRS Issues Ruling Favorable to "Intentionally Defective Grantor Trusts"

The so-called "Intentionally Defective Grantor Trust" ("IDGT") has become a very popular estate planning technique. An IDGT is a trust that does not contain any provision that would cause the assets of the trust to be included in the taxable estate of the person who created and funded the trust. However, the trust does contain a provision that makes it a "grantor" trust for income tax purposes. An income tax grantor trust is essentially ignored and all its income and deductions are reported on its grantor's income tax returns.

If an appreciating asset is sold to an IDGT for its current fair market value (usually for consideration including a substantial promissory note), no gift tax results. The seller also does not recognize any income tax gain from the sale or any interest income from the note payments, since the trust and hence the sale itself are disregarded for income tax purposes. If the asset appreciates before the death of the seller/grantor, that appreciation has been removed from his taxable estate at no tax cost whatsoever since the trust assets are not included in his taxable estate. The IDGT can present an attractive way for parents to transfer appreciating assets to their children.

Only a few trust provisions make a trust a grantor trust for income tax purposes yet do not require its assets to be included in the grantor's taxable estate for estate tax purposes. One such commonly used provision is the power to take assets that the grantor had contributed out of the trust and replace them with assets of equivalent value. This is commonly referred to as a "power of substitution." While this provision has been in common use, there had been a lingering concern that the IRS might take the position that a power of substitution did cause the trust assets to be includible in the grantor's estate under IRC Section 2036, which includes assets that a decedent had transferred but over which he had retained some degree of control.

In *Rev. Rul. 2008-22 (April 17, 2008)*, the IRS significantly alleviated this concern. The ruling holds that such a power of substitution will not result in Section 2036 inclusion provided: i) the trustee of the trust has a fiduciary obligation to ensure the grantor's compliance with the terms of the power by satisfying itself that the asset withdrawn and the asset transferred to replace it are in fact of equivalent value; and ii) the power of substitution cannot be exercised in a manner that can shift benefits among trust beneficiaries. This ruling should ensure the continued popularity of these trusts for wealth transfer planning; however, in the ruling, the IRS described the power in a somewhat different manner than it is described in the statute. Extreme care should be taken in drafting these provisions. It may be appropriate to include a second power that would make the trust a grantor trust without causing the trust assets to be includible in the grantor's taxable estate. We have made appropriate modifications to the forms we use for these trusts.

A Rare Taxpayer Victory in the Tax Shelter Wars

There are so few taxpayer victories in litigated tax shelter cases that when they do come along, they are worthy of reporting. In *Sala v. United States (April 22, 2008)*, the United States District Court for the District of Colorado held in favor of the taxpayer, who was suing to obtain a refund of the taxes he paid after the IRS disallowed losses he had deducted resulting from what was clearly a tax shelter transaction.

The losses resulted from trading sophisticated foreign currency options and certain anomalies of the partnership tax rules. These transactions were widely marketed by accounting and law firms and came to be called "Son of Boss" transactions ("Boss" standing for Bond and Option Sales Strategy). Anytime a transaction becomes known by an acronym, it is best avoided, as you can be sure that the IRS has become aware of it.

In order to find in favor of the taxpayer, the court had to reject the following arguments made by the government: i) the transactions were "sham transactions"; ii) the taxpayer did not enter into the transactions for the purpose of making a profit; iii) the transactions had no economic substance; iv) the loss should be disallowed under the "step transaction" doctrine; v) there was no business purpose for the transactions; and vi) a regulation the government issued in a year after these years should be applied retroactively to deny the taxpayer the loss deduction. On each of these issues, the court found in favor of the taxpayer.

The court has already rejected the government's motion for a new trial. An appeal by the government to the United States Court of Appeals is almost a certainty. In a case involving the same kind of transactions, on July 31, 2008, the United States Court of Federal Claims held in favor of the government in *Stobie Creek Investments, LLC v. United States*. The court found that there was no economic substance behind the transactions and denied the claimed tax benefits to the taxpayer. There is little question that the government will win far more of these cases than it loses.

Donor Advised Fund Allowed to Sell Stock Shortly after Donation by Taxpayer

The IRS has issued an important and taxpayer favorable ruling in the charitable giving area. In *PLR 200821024*, the taxpayer made a gift of stock to a donor advised fund. A donor advised fund is a public charity in which the gift of each donor is segregated into a separate account. The donor or his designee is permitted to serve as an advisor regarding the investment and/or distribution of the account.

The donor made a gift of shares of a closely held company of which he was a member of the board of directors. There was no binding obligation in place to sell the shares at the time of the gift. However, it was the policy of the fund to sell shares of closely held corporations, and the fund solicited names of possible buyers from its donors.

The IRS ruled that a subsequent sale of the shares by the fund would not be attributed back to the donor. This means that the donor was able to deduct the fair market value of the donated shares without having to recognize the tax gain inherent in the shares.

This issue comes up frequently in a similar context when someone is planning to sell his company but would like to transfer the shares to a charitable remainder trust prior to their sale, in order to defer his taxable gain. The dilemma is that the taxpayer does not want to transfer the shares to the trust unless he knows they are going to be sold, but if he waits until a contract or letter of intent has been signed, he risks the IRS attributing the gain back to him. This ruling confirms that the taxpayer should be in good shape if he makes the transfer before a binding obligation to sell arises.

Expatriating to Avoid Taxes Has Become Even Less Attractive

Each year, a number of Americans give up their United States citizenship and move to a country that imposes fewer taxes. It seems like an extreme measure, but some people dislike paying taxes enough to actually do it. Enough people have been doing it that the rules you have to follow have been made much more stringent over recent years. The recently enacted Heroes Earnings Assistance and Relief Tax Act of 2008 ("Heart Act") has replaced the existing 10-year expatriation tax regime and now imposes an exit tax and transfer tax on expatriating citizens or departing long-term permanent residents (i.e., a "green card" holder who has held a green card for at least eight of the prior fifteen years). Under the exit tax provisions, an expatriating citizen, or a permanent resident, will be taxed as though he had sold his assets at fair market value when he expatriates, if the resulting gain would exceed $600,000 and he meets certain fairly low thresholds of income and net worth.

Under the new transfer tax provisions, if such an expatriate later makes a gift or bequest to a U.S. citizen or permanent resident, the donee will be subject to a transfer tax determined at the highest marginal estate or gift tax rate unless the transfer is subject to estate or gift tax and is properly reported by the expatriate or his estate, or the transfer would be eligible for an estate or gift tax charitable deduction or marital deduction if the transferor were a U.S. person. This new transfer tax also applies to transfers to domestic trusts and to certain distributions to U.S. beneficiaries from foreign trusts to which the expatriate made gifts or bequests. The new expatriation tax regime is applicable to citizens and long-term residents expatriating on or after June 17, 2008.

The new law is likely to achieve a good part of its intended impact of stemming the tide of tax-motivated departures from the United States. At the same time, it will significantly complicate and limit the planning available for U.S. citizens and, particularly, long-term resident aliens with legitimate nontax reasons for changing their status. In particular, green card holders who have not yet held their green cards for eight years should review the rules of the Act and their potential impact if the eight-year threshold is exceeded.

Do Two Gifts Result if Grandparent Makes Gift to Grandchild's Section 529 Plan?

Parents often set up Section 529 plans to fund the college education of their children. Amounts in the plan accumulate free of tax and are not taxable to the child upon distribution if they are used to pay qualified college expenses. Sometimes a grandparent may want to make a gift for his grandchild to a plan already set up by the grandchild's parent. Some, but not all, Section 529 plans do permit gifts from a person other than the person who set up the account. Some people believe, and some financial institutions are telling their customers, that two gifts may result for gift tax purposes when a grandparent makes a gift to a Section 529 plan set up by his child for his grandchild. This may be attributable to the fact that under some circumstances, the child can take funds back out of the plan. This could cause the transfer by the grandparent to be treated: i) first as a gift from the grandparent to the child who set up the plan for his child; and ii) then as a gift from the child who set up the plan for the grandchild (his child).

Based on language in the Code and proposed regulations, we do not believe this interpretation is correct or what the IRS intends. However, unless the IRS clarifies this point, the safest course of action is for the grandparent to set up his own Section 529 plan for his grandchild. Remember that gifts to these plans do qualify for the annual gift tax exclusion, which is currently $12,000 per year for each donee. If a grandparent contributes more, the transfer would also be subject to the generation-skipping tax unless he has part of his lifetime exemption remaining to apply to the gift.

Gift of IRA to Charity Does Not Result in Income to Decedent's Estate

A decedent had set up a trust that provided for certain specific gifts to be made upon his death and then for the residual amount remaining to be transferred to a charity. Part of the residual assets include an individual retirement account ("IRA"). IRC Section 691 generally provides that when someone receives something that would have been taxable income had it been received by the decedent, it is also taxable income to the recipient. This is referred to as "income in respect of a decedent." It also provides that if the holder of such right transfers it, he must report taxable income equal to the fair market value of the transferred right plus the amount by which any consideration received exceeds such value. A question arose whether the trust should recognize income upon the transfer of the IRA to the charity, since the decedent would have recognized taxable income upon receiving distributions from the IRA.

In *PLR 200826028*, the IRS ruled that the estate did not have taxable income upon the transfer. It was treated under a provision that says if you make a specific gift of your IRA account to someone at your death, they are taxed when they receive distributions, but your estate is not taxed. While the distributions are treated as gross income to the charities, since they are tax exempt organizations, they do not have to pay income taxes on that income.

This ruling should be contrasted with *ILM 200644020* (reported on in Vol. 1, No. 3, December 2006), where the IRA was transferred to a charity to satisfy a specific pecuniary amount gift to the charity. In that case, the estate was required to report income under Section 691. IRAs can be ideal assets to leave to charity since if they are left to a family member, they become subject to both estate tax and income tax, as a result of the Section 691 rules. The best practice is to make a specific gift of the IRA to your designated charity. This will clearly avoid any income tax to the estate.

Certain Internet Retailers Required to Collect New York Sales Tax

Under the recent New York budget act, a person who makes sales of tangible personal property or services ("seller") is presumed to have nexus with New York for purposes of being required to register as a vendor and being required to collect New York sales tax if: i) one or more New York residents agree to directly or indirectly refer customers to seller for consideration, and ii) such agreements generate cumulative gross receipts from sales in New York by seller of more than $10,000 during the four preceding sales tax quarters.

A seller may rebut the presumption that it is soliciting sales in New York through a resident representative, by showing that the resident did not engage in any solicitation activities that would have caused seller to have nexus with New York during the four previous quarters. For example, the presumption will be deemed rebutted if the New York resident's only activity on behalf of a seller is a link on the resident's Web site to the seller's Web site and none of the resident's solicitation activity in New York is targeted at potential New York customers for seller. The inclusion of language in the agreement prohibiting solicitation in New York by the New York resident, however, is not sufficient by itself to rebut the presumption. The seller must also establish that the New York resident has complied with the prohibition.

Under the new rules, sellers with no physical nexus to New York may be required to collect New York sales tax. Several Internet sellers have challenged the constitutionality of this recently enacted New York nexus provision. We are following these cases closely. Their decisions will have great impact on certain Internet and other remote sellers' obligations to collect New York sales tax.

Housing Assistance Tax Act of 2008

The Housing Assistance Tax Act of 2008 ("Act") was signed into law by President Bush on July 30, 2008. While it makes many changes to the Internal Revenue Code, only a couple are of interest to high net worth taxpayers. For properties placed in service after December 31, 2007, the low-income-housing tax credit will now be available to offset the alternative minimum tax as well as the regular income tax. Similarly, for expenses incurred after December 31, 2007, the credit for qualified rehabilitation expenses will also be available to offset the alternative minimum tax.

The Act also contains a tax credit for first-time home buyers that may benefit some of your children. To qualify, the purchaser must be a first-time home owner who purchased his home between April 8, 2008, and July 1, 2009. The credit is 10% of the cost of the home, up to a maximum credit of $7,500. The credit is phased out between adjusted gross income levels of $150,000 and $170,000. A recent college graduate without too much investment income might qualify.

Reporting Offshore Accounts

There has been much in the news recently about offshore accounts. A Senate subcommittee has been investigating the role of foreign banks in facilitating tax evasion by U.S. taxpayers. In July, a federal judge agreed to allow the IRS to serve legal papers on Swiss banking giant UBS AG in an expanding investigation into U.S. taxpayers who may have undeclared foreign accounts. The IRS is seeking information on U.S. taxpayers who maintain undeclared accounts at foreign financial institutions, because the IRS believes that some of these U.S. taxpayers may be underreporting income, evading income taxes, or otherwise violating the internal revenue laws of the United States.

The use of foreign bank and financial accounts by U.S. taxpayers is not illegal in and of itself. However, U.S. taxpayers must report their foreign accounts to the U.S. government. Any U.S. citizen or resident, partnership, corporation, estate, or trust having a financial interest in or signature authority or other authority over financial accounts in a foreign country with aggregate balances over $10,000 at any time during a calendar year must report those accounts to the Treasury Department by filing a Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR") by June 30 of the succeeding year. No extension is available for filing an FBAR. An individual U.S. taxpayer must also disclose such interest on Schedule B of Form 1040 U.S. Individual Income Tax Return. Penalties may apply if the FBAR is not timely filed or the information supplied is inaccurate or incomplete. A taxpayer who willfully fails to file an FBAR may be subject to civil penalties equal to the greater of $100,000 or 50% of the amount in the account at the time of the violation. An individual who fails to file but is not willful may be subject to civil penalties equal to $10,000 for each negligent violation. Criminal violations are subject to both monetary penalties and imprisonment. Taxpayers who have not filed the required FBARs or properly disclosed their interests on Form 1040 for any prior year should contact us to address the issue.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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