<u>The Darwinian Approach to Partnership Sustainability: *Mirowski*</u>

The partnership cases over the last 5 years (since what has become known as *Strangi II*, T.C. Memo.2003-145) have provided the tax planner with a reasonable roadmap as to how to structure sustainable partnerships for estate tax planning purposes. The cases established that the Tax Court is more than willing to apply a broad reading and liberal application of Code section 2036, meaning that it will apply 2036 to partnership cases to ignore the partnership for purposes of valuing partnership assets. The net result is that no discount would be allowed in these instances.

In order to be conservative and to avoid this liberal application, in a recent column we summarized the steps necessary to have a sustainable partnership as follows:

1. There must be demonstrated “substantial business and other non-tax reasons." Without this, any partnership stands a difficult time being taken seriously, that is, being respected for tax purposes.

2. There must be actual consideration received in terms of the partnership interests: equity interests, cash flow and tax implications should be proportional to the level of contribution.

3. Outside of the partnership, partners should retain other assets for his or her support. [Reason: to avoid the argument that there is an implied retention sufficient to invoke section 2036 (a)(1)];

4. There must be actual transfers: the assets have to be re-titled in the partnership name; the i’s must be dotted and t’s crossed. [Reason: create credibility that the establishment of the partnership was really intended for economic purposes; ignoring formalities creates the impression that the partners do not really intend to operate as a partnership. Further, ignoring partnership formalities makes it easier to argue Code section 2036 (a) (2) should apply.]

5. The partnership must be maintained as a separate entity; there can be no commingling.

6. Investments within the partnership should maintain some integrity: who is monitoring them, are they being re-invested, actively managed, consistent with some end game on the investment world? [Reason: need to establish an economic justification for the partnership; contributing assets to a partnership with no activities within the partnership changing sort of indicates that there is no reason for the partnership even though this would not be true in all circumstances (e.g., divesting control in order to prevent third parties from exercising undue influence); still, changing the investments within the partnership after contribution provides a good indicia that the partnership was established for a real business reason]

7. The requisite returns should be filed.

8. The partnership should actually be managed pursuant to the purposes set forth for its establishment. [Reason: consistency demonstrates the economic substance of the partnership.]

Prior to this recent Tax Court case, *Mirowski v. Comm'r*, T.C. Memo. 2008-74, the question was whether the above steps would be sufficient, or whether the planners could expect an even broader reading by the court of section 2036 (a) (2). In what can be described as a taxpayer victory, the Tax Court in *Mirowski* established by its holding the following principle: if the taxpayer can legitimately establish that the partnership was set up for reasons in addition to tax planning, the Court will work hard to avoid a liberal application of section 2036 to the partnership. The smell test, or better yet, the stink test, continues to be alive and well to the partnership area in estate planning.

Specifically, if the partnership is a sham, set up for only tax reduction purposes, the practitioner should expect the Service and Tax Court to aggressively apply Code section 2036 to ignore the partnership for planning purposes.

If, on the other hand, the partnership was set up for a valid economic purpose, e.g., consolidating a family's assets, the Tax Court will take a more restricted view on whether section 2036 applies.

Mirowski certainly cannot be viewed as a "good facts" case, other than evidence that it was set up for (barely sustainable) reasons in addition to tax planning. The decedent transferred marketable securities of $62,000,000 into the partnership. The decedent retained (only) $3.3 million of cash and cash equivalents outside of the partnership. The decedent retained control as general partner in the partnership. The decedent died within a month of establishing the partnership and funding it. In this short window between partnership establishment and death, the decedent transferred about 48 % of the partnership (with a gift tax liability of about $11, 750, 623 and insufficient liquidity outside of the partnership in which to pay that liability).

Based on prior cases, specifically *Bongard*, 124 T.C. 95 (2005), *Erickson [insert cite]*, and *Strangi II*, these would be bad facts and the decedent would have expected the Tax Court to include the assets in the decedent's estate without discounts, especially true because of the lack of assets retained to pay gift and estate taxes (2036 (a)(1) inclusion), control as a general partner (2036 (a)(2) inclusion), and death within 1 month of establishment (showing that it was a sham and not available for the bona fide full and adequate consideration exception to section 2036 application).

However, two of the three daughters, partners in the partnership, testified as to the investment and family control purposes to the partnership, and evidence supported that the decedent did not die of an illness expected at the time of the partnership inception. Despite the lack of a contemporaneous writing substantiating these reasons, the court found the daughters "testimonies to be reasonable….[and] relied on those testimonies in making our findings of fact, including our findings that Ms. Mirowski had the following legitimate and significant nontax reasons for forming, and transferring certain assets" to the partnership:

> "(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."

Because of *Mirowski*, the following two concerns at the margin of section 2036 should be interpreted in the taxpayer's favor provided the partnership is set up with a degree of economic substance and purpose independent of mere tax savings:

1. Did the decedent retain sufficient assets to maintain the decedent's lifestyle without relying on distributions from the partnership, necessary to avoid section 2036 (a) (1)? Even though assets outside of the partnership retained by the decedent may be insufficient to pay gift or estate taxes, the *Mirowski* court did not conclude that this invoked 2036 (a)(1). The court took every step to conclude that the decedent could reasonably expect cash flow from the retained assets sufficient to cover these liabilities even when it was certain that the decedent would not.

2. Retention of control of the partnership by the decedent does not necessarily invoke section 2036 (a) (2). Contrary to Judge Mary Ann Cohen’s scary extension and application of section 2036 (a) (2) in *Strangi II*, *infra*, any time the decedent is acting as a general partner in the partnership, the *Mirowski* court was not willing to accept that conclusion. The *Mirowski* court held, correctly, that a general partner's adherence to fiduciary obligations takes control as general partner out of section 2036 (a) (2). This is true even with regard to a certain amount of discretion in the general partner as to the distribution of cash flow.

The *Mirowski* case does not mean that practitioners can be cavalier about partnership planning. It does mean that families should set up partnerships to achieve non tax goals, should work hard on establishing viable and correct reasons in this regard, should manage the partnership consistent with those reasons, both pre mortem and post mortem, and should have evidence, written (if possible) and oral that substantiate these reasons. Further, letters in the file that are inconsistent with those reasons, or that demonstrate that the partnership was set up merely to achieve tax purposes, will go counter to the substance that the *Mirowski* court relied on to sustain the partnership.

With *Mirowski*, the planner now has available the tools to sustain partnership discount planning in the vast majority of cases outside of the deathbed arena. Importantly, the decedent has to want the partnership. A practitioners recognize on numerous occasions, the potential for saving estate taxes is not a sufficient reason for many clients to enter into partnerships; these same clients will often say "no" to partnership planning for a variety of reasons, including short term expense, confusion, sharing control, reducing flexibility, and lack of desirability of having a business arrangement with family members. Therefore, "yes" partnership planning could work; but "no," it will not be used by clients in all cases in which it could be so effectively used.