



WASHINGTON REPORT

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Subject: **General Estate and Gift Tax Developments: March 2008**

1. **Tax Court Finds Significant and Legitimate Non-tax Purpose for Forming and Funding Family LLC; Assets of LLC Therefore Not Includible in Decedent's Estate**

Major References: [*Estate of Mirowski v. Commissioner, T.C. Memo 2008-74*](#)

Prior AALU Washington Reports: 00-43; 02-71; 02-78; 02-114; 03-56; 04-30; 04-42; 04-70; 04-110; 05-74; 05-77; 05-86; 07-28

2. **IRS Issues Final Regulations on Relationship Between Intermediate Sanctions and Loss of Exemption**

Major References: [*T.D. 9390, 73 F.R. 16519-16525 \(March 28, 2008\)*](#)

Prior AALU Washington Reports: 02-36; 98-83

3. **Non-Spousal IRA Beneficiary May Preserve Lifetime Distributions Notwithstanding Failure to Receive Timely Post-Death MRDs**

Major References: [*PLR 200811028*](#)

Prior AALU Washington Reports: 02-57

MDRT Information Retrieval Index Nos.: 2500.00; 7400.021; 7400.022; 7400.024

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

This Washington Report summarizes a few of the more important cases and rulings in the estate and gift tax areas which were decided or reported by the courts and the Internal Revenue Service in March of 2008, and on which we have not previously reported in Bulletins on insurance-related estate and gift tax matters.

Cases

1. *Estate of Mirowski v. Commissioner, T.C. Memo 2008-74*

The Tax Court, in Estate of Mirowski v. Commissioner, has ruled that the creation and funding of a family LLC shortly prior to the decedent's unexpected death was a bona fide sale for adequate consideration in a case where there were substantial non-tax reasons for creating and operating the LLC, and the assets transferred to the LLC were properly allocated to the decedent's capital account. Therefore, the assets of the LLC were not includible in the estate of the decedent under Sections 2036(a)(1) or (2) or Section 2038 of the Code.

Anna Mirwoski ("Decedent") was the widow of Dr. Michael Mirowski, an Israeli immigrant to the United States and resident of Maryland who developed, with a team of scientists, an automatic implantable cardioverter defibrillator (ICD) to monitor and correct abnormal heart rhythms. The ICD patents, which eventually produced revenues of millions of dollars per year, became the basis of his family's fortune.

On March 26, 1990, Dr. Mirowski died, survived by Decedent and three daughters, each of whom had medical degrees. Pursuant to Dr. Mirowski's will, the ICD patents, his interest under the ICD patents license agreement, and the remainder of his assets, except for \$600,000, passed to Decedent.

On February 27, 1992, Decedent created irrevocable trusts for each of her three daughters and their respective issue in order to provide for each daughter during the daughter's life and each daughter's children after the daughter died. Decedent named all three of her daughters as co-trustees of each of the daughters' trusts in order to encourage them to work together. On the same date, and again on June 30, 1993, Decedent funded the trusts with gifts of interests in the ICD patents license agreement. After these transfers, Decedent held a 51.09-percent interest in the royalties under that agreement, and each of those trusts held a 7.2616-percent interest in those royalties.

At least as early as late 1999 or early 2000, in large part because of her daughter Doris' chronic epilepsy, Decedent began to think about ways, in addition to her daughters' trusts, to provide for her daughters and her grandchildren on an equal basis. Therefore, in May 2000, Decedent met with representatives of U.S. Trust who introduced Decedent to the concept of a limited liability company (LLC). Thereafter, on August 31, 2000, Decedent's lawyer (with whom she consulted about the LLC) sent a letter to her (with copies to her daughters) and enclosed with that letter draft articles of organization and a draft operating agreement for an LLC to be named Mirowski Family Ventures, L.L.C. ("MFV").

Decedent waited a year, until the next - August 2001 - annual family gathering at Rehoboth Beach, Delaware, to go over the LLC plan with her family. In the meantime, Decedent, who was diabetic, underwent a surgical procedure at Johns Hopkins Hospital to treat a foot ulcer. Between March and August 2001, Decedent received treatment for her foot ulcer, but consistently declined to undergo amputation, which had been presented to her as an option.

In mid-August 2001, Decedent's daughters and their families took their annual vacation in Rehoboth Beach without Decedent, who, although continuing to suffer with the foot ulcer and cataracts,

was in no imminent danger of death. During this vacation, they discussed with Decedent's lawyer: (1) Decedent's plans to form MFV, (2) Decedent's plans to make respective gifts of interests in MFV to her daughters' trusts, (3) the manner in which MFV was to function, and (4) the responsibilities of her daughters with respect to MFV.

After the family annual meeting, Decedent's lawyer finalized the documents required for Decedent to form MFV. The Court noted that:

“Although Decedent understood that certain tax benefits could result from forming MFV, those potential tax benefits were not the most significant factor in her decision to form MFV. “To the contrary, Decedent had the following legitimate and significant nontax purposes for forming, and transferring the bulk of her assets to, MFV: (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 Decedent 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.”

The Court continued:

“In addition to the above-described legitimate and significant nontax purposes, another legitimate, but not significant, nontax reason Decedent formed, and transferred the bulk of her assets to, MFV was that she wanted to provide additional protection from potential creditors for the interests in the family's assets that she intended to provide to her daughters and eventually her grandchildren. Although Decedent was aware that her daughters' trusts included provisions providing spendthrift protection from creditors, she desired the additional creditor protection provided by an LLC, in particular the protection that an LLC would provide in the event of any negative developments in the respective marriages of her daughters.”

On August 27, 2001, Decedent executed MFV's articles of organization and operating agreement (the principal provisions of which are included in an Appendix to the opinion. On August 30, 2001, the department of assessments and taxation of the State of Maryland accepted MFV's articles of organization for filing. On August 31, 2001, Decedent was admitted to Johns Hopkins Hospital for further treatment of her foot ulcer.

On September 1, 2001, Decedent made a “bona fide, arm's-length transfer” to MFV of certain property, including the ICD patents and Decedent's 51.09-percent interest under the ICD patents license agreement, and received in exchange for that property a 100-percent interest in MFV. After Decedent's September 1, 2001 transfer, Decedent was the only member of MFV, and no person other than Decedent made any transfers of property to MFV. On September 5, 6, & 7 2001, Decedent made other bona fide, arm's-length transfers to MFV of certain property consisting of securities and cash with an aggregate value in excess of \$61 million that she held in an investment account. After these transfers, Decedent continued to hold a 100-percent interest in MFV.

On September 7, 2001, Decedent made a gift of a 16 percent interest in MFV to each of her daughters' trusts, retaining a 52 percent interest in MFV. Decedent retained substantial (over \$7.5 million) personal assets that she did not transfer to MFV, including over \$3 million in cash and cash equivalents. Decedent also anticipated receiving as an interest holder in MFV future income of millions of dollars a year

attributable to royalty payments under the ICD patents license agreement. Decedent was the initial general manager of MFV. All of Decedent's powers as MFV's initial general manager were subject to the provisions of MFV's operating agreement and the requirements of applicable law, including the applicable (Maryland) law, which imposed on her a fiduciary duty to the other members of MFV. The Court found that there was no implied understanding that Decedent

“ . . . could have access to any of the assets that she transferred to MFV for her own possession or enjoyment, the right to income from those assets, or the right to determine who could possess or enjoy those assets. Nor was there any express or unwritten agreement or understanding among the members of MFV that Decedent (1) would retain during her life the economic use and benefits of the assets that she transferred to MFV and (2) would provide for her daughters and her grandchildren only upon her death.”

Decedent died unexpectedly from sepsis related to her foot ulcer on September 11, 2001 after refusing further medical treatment. Approximately two weeks elapsed from the date that MFV was created and the date of Decedent's death.

During 2002, MFV, which had made no distributions during 2001, made distributions totaling \$36,415,810 to decedent's estate in order for decedent's estate to pay Federal and State transfer taxes (including gift taxes related to the 2001 gifts), legal fees, and other obligations of Decedent's estate.

The government, on audit of Decedent's estate, determined to include the respective date-of-death fair market values of all of the assets that Decedent transferred to MFV in her gross estate under section 2036(a) of the Internal Revenue Code. Sections 2036(a)(1) and (2) include in the gross estate of a decedent assets that the decedent has transferred during life, other than as a bona fide sale for adequate consideration, with respect to which the decedent retained, either alone or in conjunction with any person, the income therefrom or the right to designate the persons who shall possess or enjoy the transferred property.

To escape the application of Sections 2036(a)(1) and (2), a decedent's estate must prove the existence of a legitimate and significant nontax reason (an “actual motivation, not a theoretical justification”) for creating the family limited partnership (or LLC), and that the transferors received partnership (or LLC) interests proportionate to the value of the property transferred. See the cases discussed in our Bulletins Nos. 00-43, 02-71, 02-78, 02-114, 03-56, 04-30, 04-42, 04-70, 04-110, 05-74, 05-77, 05-86 and 07-28.

In *Estate of Mirowski*, the Court concluded that Decedent had legitimate and substantial nontax purposes (set forth above) for forming, and transferring assets to, MFV, and that she received an interest in MFV proportionate to the value of the assets that she transferred to it. Decedent's capital account was properly credited with those assets, and in the event of a liquidation and dissolution of MFV, Decedent had the right to a distribution of property from MFV in accordance with her capital account.

The Court was not troubled by the fact that MFV made a substantial post-death distribution to Decedent's estate to pay her gift taxes from the 2001 transfers because it found that Decedent could have funded this obligation, had she lived, from other sources with relative ease. In addition, the daughters made a post-death business decision to keep their shares of the LLC in the operating entity.

Because the court found that Decedent's transfers to MFV were bona fide sales for adequate and full consideration in money or money's worth, it did not find it necessary to address, with respect to the creation of MFV, “the factual issue presented under section 2036(a)(1) as to whether Decedent retained for life the possession or the enjoyment of, or the right to the income from, the property transferred or the

factual issue presented under section 2036(a)(2) as to whether Decedent retained for life the right, either alone or in conjunction with any person, to designate who shall possess or enjoy the property transferred or the income therefrom.”

Unlike Decedent’s transfers in connection with the creation of MFV, Decedent’s gifts - *per se* - were not bona fide sales for adequate and full consideration in money or money’s worth under section 2036(a). The government contended that Decedent retained the right to designate the persons who would enjoy the transferred property because MFV’s operating agreement gave Decedent the authority, as MFV’s general manager, to decide the timing and amounts of distributions from MFV. The court found, however, that both the operating agreement and state law constrained the exercise of Decedent’s authority. Therefore, Section 2036(a) should not apply to these transfers.

For similar reasons, the Court found that Section 2038(a)(1) (pertaining in large part to revocable transfers) should not apply to Decedent’s transfers.

Estate of Mirowski, despite the compressed timeline, is a “good facts” case. All of the “i’s” were dotted and “t’s” crossed. The witnesses were credible and a foundation of business purpose - with respect to prior family history - was laid. There is no discussion of discounts, but presumably these were not excessive if they in fact existed. Mrs. Mirowski’s death was unexpected (even though she was not in perfect health) and she retained sufficient assets to cover her living expenses outside of the LLC. These are all good points to keep in mind when undertaking this type of planning.

Final Regulations

2. T.D. 9390, 73 F.R. 16519-16525 (March 28, 2008)

In final regulations, the Treasury explains the circumstances in which an exempt organization that engages in “excess benefit transactions” under the intermediate sanctions rules may also be subject to loss of exemption.

Section 4958 of the Internal Revenue Code, referred to as the “intermediate sanctions” rules (*see* our Bulletins Nos. 02-36 and 98-83), imposes excise taxes on each “excess benefit transaction” between an “applicable tax-exempt organization” and a “disqualified person.” A disqualified person is generally any individual who is in a position to exercise substantial authority over an organization’s affairs, regardless of the individual’s official title. The excise taxes are imposed against the disqualified persons and the organization managers who engage in the excess benefit transaction. A disqualified person who benefits from an excess benefit transaction is subject to a first-tier penalty equal to 25% of the excess benefit. A second-tier tax, equal to 200% of the amount of the excess benefit, can be imposed if the prohibited transactions continue uncorrected. Organization managers who knowingly participate in an excess benefit transaction are subject to an excise tax equal to 10% of the amount of the excess benefit, up to a maximum penalty of \$10,000.

An excess benefit is the amount by which the value of the economic benefit provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person exceeds the value of the consideration received for providing such benefit. For example, excess compensation may be considered an excess benefit.

In September 2005, the Treasury published proposed regulations clarifying, among other things, the relationship between the substantive requirements for tax exemption under Section 501(c)(3) and the imposition of the Section 4958 excise taxes, with particular emphasis on the conditions pursuant to which a

tax-exempt organization that engages in excess benefit transactions may, in addition to being subject to excise taxes, lose its exemption. These regulations were finalized on March 28, 2008, in T.D. 9390.

Under the final regulations, in determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization described in Section 501(c)(3) that engages in one or more excess benefit transactions that violate the prohibition on inurement under section 501(c)(3), the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following --

- The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;
- The size and scope of the excess benefit transaction or transaction(s) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;
- Whether the organization has been involved in multiple excess benefit transactions with one or more persons;
- Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and
- Whether the excess benefit transaction has been corrected, or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction.

The regulations state that the foregoing factors will weigh more heavily in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner discovers the excess benefit transaction or transactions. Correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, will never be a sufficient basis for continuing to recognize exemption.

The regulation is accompanied by several examples illustrating the application of the listed factors. While we cannot set forth all of these examples here, Example 6 is of interest because it involves an organization which appears to have done almost everything right in setting the executive compensation of its officers. The board of the organization appointed a compensation committee (composed of disinterested persons) to gather data on compensation levels paid by similarly situated organizations for functionally comparable positions. Based on its research, the compensation committee recommended a range of reasonable compensation for several of the organization's existing top executives. On the basis of the committee's recommendations, disinterested members of the board approved new compensation packages for the top executives and timely documented the basis for its decision in board minutes. The example states that the total compensation paid to the organization's top executives represented only an insubstantial portion of its total payroll expenses. In these circumstances, the organization normally would have been entitled to rely on a "rebuttable presumption" of reasonableness with respect to the compensation paid to these executives.

However, the example continues, the organizations used by the compensation committee to establish "comparability" were not similarly situated because they served substantially larger geographic regions with more diverse populations and were larger than the organization in terms of annual revenues, total operating budget, number of employees, and number of beneficiaries served. Accordingly, the IRS concluded that the compensation committee did not rely on "appropriate data as to comparability" and,

thus, failed to establish the rebuttable presumption of reasonableness. The IRS further concluded that the executives' compensation packages were excessive.

The organization's board took corrective action, including adding new expertise to the compensation committee and renegotiating the top executive's contracts on a going forward basis. Therefore, although the organization was subject to excise taxes on the excessive compensation paid in Year 1, it did not lose its exemption.

The final regulations will apply with respect to excess benefit transactions occurring after March 28, 2008.

Private Letter Rulings

3. *PLR 200811028*

In PLR 200811028, the IRS ruled that a non-spousal beneficiary's failure to receive timely minimum required distributions (MRDs) from an IRA did not require that distributions from the IRA be made in accordance with the 5-year rule instead of over the beneficiary's lifetime. The ruling, which relates to facts occurring after adoption of the final MRD regulations in 2002 (see our Bulletin No. 02-57), highlights the potential to preserve the "stretch-out" option of lifetime distributions in this circumstance.

Under the facts of the ruling, the taxpayer ("Beneficiary") was the sole surviving child of the decedent ("Decedent"). At the time of Decedent's death in 2002, the Decedent maintained two individual retirement accounts (collectively "IRA"). Beneficiary was designated as the sole beneficiary of the IRA. After Decedent's death, the IRA was re-titled to reflect the fact that the IRA was an inherited IRA.

The Decedent died prior to reaching his "required beginning date," and Beneficiary failed to take minimum required distributions in 2003 or 2004. In 2005, Beneficiary took the required minimum distributions for 2003, 2004, and 2005 in an aggregate distribution based on Beneficiary's applicable life expectancy. Subsequently, in 2007, Beneficiary paid the additional 50% excise tax prescribed under Section 4974(a) of the Revenue Code for failing to receive timely minimum required distributions for 2003 and 2004.

Under the terms of the IRA, minimum required distributions were required to be distributed to Beneficiary over Beneficiary's remaining life expectancy starting on or before December 31st of the calendar year following the calendar year of the Decedent's death. Beneficiary, however, was permitted under the terms of the IRA to elect to receive distributions in accordance with the 5-year rule provide under Section 401(a)(9)(B)(ii) of the Internal Revenue Code. It was represented by Beneficiary, and Beneficiary submitted evidence to support the representation, that Beneficiary had not elected the 5-year distribution option under the IRA.

Based on these facts and representations, the key issue addressed by the IRS was whether the failure to timely take post-death minimum required distributions required that distributions from the IRA be made in accordance with the 5-year rule. To this end, the IRS observed that the "Explanation of Provisions" of the final regulations issued under Sections 401(a)(9) and 408(a)(6) (published on April 17, 2002) provide, in relevant part, in the section titled "Default Rule for Post-Death Distributions" that

“. . . if an employee dies before the employee's required beginning date and the employee has a designated beneficiary, then the life expectancy rule in section 401(a)(9)(B)(iii) is the

default distribution rule. Thus, absent a plan provision or election of the 5-year rule, the life expectancy rule applies in all cases in which the employee has a designated beneficiary, and the 5-year rule applies if the employee does not have a designated beneficiary . . . “.

Based on this “default” rule, the IRS concluded that, in the case where an IRA owner dies prior to attaining his or her required beginning date and after designating a beneficiary, the life-expectancy rule, and not the 5-year rule, applies. Accordingly, since Beneficiary was able to provide evidence that Beneficiary had not elected the 5-year rule with respect to the IRA, Beneficiary could continue to receive minimum required distributions from the IRA under the life-expectancy rule for 2003, 2004, 2005 and all future years. The IRS, however, did not waive the 50% excise tax for 2003 and 2004.

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