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FINDING A SILVER LINING IN A NEGATIVE RULING FROM IRS

Christopher P. Bray, CPA, who is with Deloitte & Touche LLP in Cleveland, writes to us as follows.

In November of last year, a fairly innocuous letter ruling was published concerning the proposed formation of a charitable remainder unitrust (CRUT). In *Ltr. Rul.* 9547004, the husband-and-wife taxpayers and their six grandchildren wanted to contribute property to a charitable remainder unitrust in return for an 11% life unitrust interest payable first to the taxpayers for their joint lives and then to the grandchildren as a class after the death of the surviving spouse. The taxpayers and their grandchildren proposed to contribute approximately $2 million in cash and appreciated securities to the trust.

The taxpayers requested rulings on several issues, the first of which was that the trust would meet the requirements of a CRUT under Section 664. The Service concluded that the trust *would not* satisfy the requirements of this section and declined to respond to the other issues.

Interestingly, the Service used the well-known six-factor test for entity classification under Reg. 301.7701-2(a) to deny the taxpayers a favorable ruling. As of late, practitioners have focused on four of the six factors (continuity of life, centralization of management, limited liability, and free transferability of interests) in trying to ensure that limited liability companies are classified as federal tax partnerships rather than corporations. The Service, however, employed the other two factors—the existence of associates and the objective to carry on business and divide the gains therefrom—in ruling that the proposed trust did not lack these characteristics and was therefore precluded from being classified as a trust for federal income tax purposes (Reg. 301.7701-2(a)(2)). Consequently, whether the trust met the requirements of Section 664 was moot.

The bad news for the taxpayers in the ruling may prove to be good news for other taxpayers. The use of family limited partnerships holding only marketable securities (FLPHOMS) for estate planning purposes has been the topic of much controversy. Although commentators have been concerned with the concept of discounting limited partnership interests in limited partnerships, this concern has waned as it is now becoming more accepted in the valuation community that the value of a limited partnership interest generally depends more on that partner's rights as a limited partner than on the activities engaged in by the partnership.

The other major concern in this area involves business purpose. Some commentators have argued that FLPHOMS have no business purpose and therefore will not be characterized as partnerships, thus preventing the use of discounting. Those opposed to this argument usually have conceded the business purpose issue but have insisted that the Code does not require partnerships to have a *business* purpose, only an *investment* purpose (Sections 731(c)(3)(C), 761(a), and 7701(a)).

Regardless of whether FLPHOMS are given validity because of investment purpose, *Ltr. Rul.* 9547004 provides that these arrangements *will have a requisite business purpose.* Although the taxpayers only contributed cash and securities, the Service held that "the grantors are associates and have pooled their assets with an object *to carry on business* and divide the gains therefrom." (Emphasis added.)

As a result, it appears that those practitioners who were concerned about a possible business-purpose attack on FLPHOMS by the Service, despite the existence of authority that only investment purpose is required, can take some solace from this ruling. It is the Service's position in *Ltr. Rul.* 9547004—not the taxpayer's—that arrangements identical to FLPHOMS have a business purpose as well as an investment purpose, and practitioners should be aware of this when planning with FLPHOMS.