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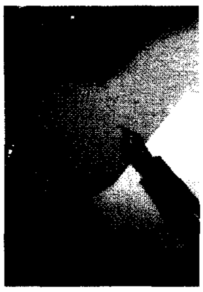
ESTATE PLANNING

# The Family Limited Partnership As An Asset Of The IRA

**THE FLEXIBILITY OF FAMILY LIMITED partnerships makes them a desirable wealth transfer planning tool for wealth transfer and asset protection purposes. The authors explore a new use for the partnership by discussing the concept of exchanging IRA assets for limited partnership interests in order to achieve valuation discounts for income tax and transfer tax purposes in addition to asset protection in states that do not provide asset protection for IRAs.**



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Almost every estate planner has heard the all-too-familiar question from their clients as they discuss the myriad of tax and non-tax benefits that they may avail themselves of by implementing a family limited partnership, "Can I put my IRA in it?" The answer to this question is usually delivered as fast as the question is posed. "No." The estate planner has learned over the years that family limited partnerships are effective estate planning vehicles for almost every asset except S corporation stock, personal residences and individual retirement accounts, IRAs. Although other estate planning vehicles such as the grantor retained annuity trust and the qualified personal residence trust can be used to transfer the S corporation stock and personal residences, respectively, there have not been any effective estate planning vehicles used for lifetime planning with IRAs. However, it might be that estate planners have been answering their clients' inquiry too quickly. Maybe there is an opportunity for the family limited partnership and the IRA to work together as an effective estate planning vehicle.

By using a family limited partnership as an IRA asset, it might be possible for clients to achieve the best of both worlds for estate and income tax planning purposes. The idea is aptly illustrated as follows; a taxpayer with an IRA forms a family limited partnership in which he (or she), his IRA and his spouse are the partners. The taxpayer and his spouse contribute nominal amounts to the partnership in order to each obtain a one percent general partnership interest while the IRA contributes all of its assets to the partnership in return for the remaining 98 percent limited partnership interest. In theory, the partnership would be an investment partnership that buys, holds and sells investment securities for profit.

Subsequently, the IRA would distribute limited partnership interests to the taxpayer (ideally not until the required beginning date) which would be subject to normal minority and lack of marketability discounts. The taxpayer would recognize as ordinary income the fair market value of the limited partnership interests distributed from the IRA, an amount substantially lower than what would be recognized as ordinary income had the underlying assets of the partnership themselves been distributed. Additionally, transfer tax savings would result from replacing marketable securities in the IRA with discounted limited partnership interests, reducing the fair market value of the taxable estate. The taxpayer might also gift these discounted limited partnership interests to his heirs after they have been distributed from the IRA.

There are numerous obstacles and controversial issues that surround the successful implementation of such a strategy. The following discussion highlights in greater detail those issues which must be addressed if the strategy is to be properly implemented.

## Non-Tax Purposes For The Strategy

For income, estate, gift and generation skipping transfer tax purposes, a partnership is defined as a syndicate, group, pool, joint venture or other unincorporated organization, through which any business, *financial operation* or venture is carried on.[1] Clearly, Congress intended that a financial operation be considered as an undertaking different and distinct from that of a business. As demonstrated throughout Subchapter K of the Internal Revenue Code and its regulations, Congress and the U.S. Treasury have adequately demonstrated their intention that the government's recognition of partnerships not be limited to only those partnerships that carry on a trade or business. IRC Sec. 721(b) and 731(c), along with Treasury Regulation Sec. 1.704-3T(e)(3) and 1.761-2(a), contain provisions that are applicable to partnerships that merely hold passive investment assets.

The Internal Revenue Service has respected the intentions of Congress with regard to partnerships in a number of published rulings. Through the publication of two Revenue Rulings on the subject, the Service held that "passive investment clubs" may be conducted in partnership form and that they will be treated as partnerships for federal tax purposes.[2]

The Service has also held recently that arrangements identical to passive investment partnerships have a business purpose. Where a family contributed marketable securities to a charitable remainder trust, the Service determined that no trust existed for federal tax purposes because the family members were associates who, "pooled their assets with an object *to carry on business* and divide the gains therefrom."[3] Consequently, not only has the Service recognized that passive investment partnerships are valid for federal tax purposes, but the Service has also ascribed a business purpose to these arrangements as well.

Through the publication of two Revenue Rulings on the subject, the Service held that "passive investment clubs" may be conducted in partnership form and that they will be treated as partnerships for federal tax purposes.

Regardless of the authority that supports the validity of passive investment partnerships for federal tax purposes, the nagging question remains, "Why would an IRA contribute its investment portfolio to a family limited partnership?" Although there are many sound answers to this question, there are two particularly persuasive reasons that merit discussion — asset protection and simplified administration of assets.

Generally, qualified plans are subject to the anti-alienation provisions of Title 1, Part 2 of ERISA. The assets in these plans are therefore unavailable to creditors holding claims against the plan's beneficial owner. Unlike qualified plans, IRAs do not enjoy federal protection from creditors under ERISA.[4] As a result, judgment creditors have had little trouble reaching assets of IRAs.5 By placing assets in a family limited partnership, however, an IRA may be able to obtain a heightened degree of asset protection than might otherwise be available.

Before the enactment of the Uniform Partnership Act and the Uniform Limited Partnership Act, creditors of partners could take action upon specific assets owned by the partnership, often wreaking significant havoc upon the partnership's business activity.[6] These Acts eliminated this procedure. Now creditors may only "charge" the partnership interest of the partner and not attach the underlying assets of the partnership.

The charging order acts as a lien on the partnership interest allowing a creditor to receive the partner's distributive share of distributions actually made by the partnership. Additionally, the creditor will be subject to federal income taxation on all of the partner's distributive share of taxable income, regardless of whether or not distributions are actually made.[7] In the context of a family limited partnership where the debtor's family member has control over the distribution of cash and property from the partnership, the remedy of a charging order may not be an appealing prospect.[8] Consequently, the partnership represents a formidable barrier to creditors trying to reach the partnership's underlying property.

Using a family limited partnership as an asset protection strategy may not be appropriate for IRAs in some states. Despite the lack of federal protection provided to IRAs by ERISA, some states expressly protect IRAs from the reach of creditors.[9] In states that provide only partial protection[10] or no protection for IRAs it might make sense to seek out the additional asset protection afforded by a family limited partnership.[11]

The use of a partnership can also substantially simplify the administration and management of investment assets. If there is doubt as to whether this seemingly vague goal of simplified asset management represents a legitimate reason to use a partnership, one need only consider the plight of a surviving spouse in a community property state.

Consider a married couple living in California with $3,000,000 of total investment assets in a joint revocable trust. At the death of one of the spouses, the surviving spouse may be left with four trusts to contend with; a surviving spouse trust of $1,500,000, a family trust of $600,000, a reverse QTIP trust of $400,000, and a QTIP trust of $500,000, each with a separate investment portfolio. Such an arrangement may not only be extremely unwieldy for a surviving spouse, but highly confusing as well.

Enter the limited partnership. By having each of the trusts contribute its investment portfolio to a limited partnership, the surviving spouse can deal primarily with the investment partnership as the centralized asset management entity for his or her affairs. One notable commentator has suggested that this may be one of the finest reasons to use a limited partnership.[12]

Suppose that one of the spouses of the aforementioned marriage also has an IRA of $1,000,000. This would add yet another entity and another layer of confusion for the surviving spouse to deal with. However, the IRA, like the trusts, could contribute its assets to the investment partnership to further the goal of simplification. Consequently, instead of having to deal with four trusts and an IRA, the surviving spouse would be dealing primarily with the investment partnership managing a $4,000,000 portfolio of assets.

## Prohibited Transaction Issues

Undoubtedly, this is the most serious area of concern in the implementation of this strategy. This is so for two reasons. First, the economic consequences of having the IRA engage in a prohibited transaction are devastating. Second, the strategy outwardly appears to be an act of "self dealing."

Financial devastation can result because an IRA that engages in a prohibited transaction with its owner loses its status as an IRA, resulting in the immediate income taxation of the total value of the assets held within the account.[13] Qualified plans engaging in prohibited transactions are subject to onerous excise taxes.[14] IRAs, however, are exempt from these excise taxes.[15]

Although the transaction appears to result in an act of "self dealing," it may in fact not result in a prohibited transaction. A "prohibited transaction" as defined in IRC Sec. 4975(c)(1) includes:

...any direct or indirect -

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(B) lending of money or other extension of credit between a plan and a disqualified person;

(C) furnishing of goods, services or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) act by a disqualified person who is a fiduciary whereby he deals with the assets of the plan in his own interest or for his own account; or

(F) receipt of any consideration for his own personal account by any person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

"Disqualified persons" are defined in IRC Sec. 4975(e)(2). They include the following:

(A) a fiduciary...

(B) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A)...

(C) a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of -

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate,

is owned directly or indirectly, or held by persons described in subparagraph (A)....

Likewise, ERISA Sec.n 406(a), which also governs qualified plans, specifies five categories of transactions that a fiduciary may not cause the plan to engage in, directly or indirectly, with a party in interest.[16] Like the I.R.C., these prohibited transactions include:

1. any sale, exchange or leasing of any property between a plan and a party in interest;[17]

2. the lending of money or other extension of credit between a plan and party in interest;[18]

3. the furnishing of goods, services or facilities between a plan and party in interest;[19]

4. any transfer to, or use by or for the benefit of, a party in interest, of any assets of a plan;[20] or

5. causing a plan to acquire and to retain employer securities or employer real property in violation of ERISA Sec. 407(a).[21]

Although IRAs are generally excluded from the provisions of ERISA, the Department of Labor (DOL) has been authorized and specifically delegated the authority to issue individual exemptions from the prohibited transaction rules under Presidential Reorganization Plan No. 4 of 1978.[22] The Secretary of Treasury, however, has exclusive jurisdiction with respect to the enforcement of IRA prohibited transactions.[23]

In analyzing whether or not a prohibited transaction has occurred within the context of the proposed strategy, it is clear that the owner of the IRA is a disqualified person with respect to the IRA as a result of his or her role as fiduciary of the IRA.[24] Consequently, the owner's spouse, ancestors, lineal descendants and spouses of lineal descendants will be disqualified persons with respect to the IRA.[25] Since these persons will be partners with the owner's IRA in a family limited partnership, it needs to be determined whether or not a contribution of assets by these persons and the IRA to the partnership in its formation will result, directly or indirectly, in one of the five transactions IRC Sec. 4975(c)(1) defined as prohibited transactions.

Of the five possible prohibited transactions, it appears the initial formation of the partnership has the greatest likelihood of being characterized as a prohibited sale or exchange of property between the IRA and disqualified persons[26] or a prohibited use by or for the benefit of disqualified persons of the assets of the IRA.[27] If the danger of either of these two transactions occurring as a result of the partnership's formation can be overcome, then the formation should not result in a prohibited transaction.

The formation of a corporation or partnership is typically characterized as a transfer of assets by a shareholder or partner in exchange for shares of stock or partnership interests.[28] Arguably, the contribution of assets to the partnership by an IRA in exchange for partnership interests falls within the purview of IRC Sec. 4975(c)(1)(A) "sale or exchange...between a plan and a disqualified person." If the formation of the IRA results in an "exchange" as contemplated by IRC Sec. 4975(c)(1)(A), then whether or not the formation results in a prohibited transaction will hinge on the identity of the partnership as a disqualified person.

As mentioned earlier, a disqualified person includes a partnership of which 50 percent or more of the capital interest or profits interest of such partnership is owned directly, or indirectly, by a fiduciary.[29] In an arrangement where an IRA and its owner form a partnership, that partnership will be a disqualified person with respect to the IRA, regardless of the ownership interest percentage of the owner. This result occurs because the partnership will be 100 percent owned by the owner; directly, through his or her direct ownership of the partnership, and indirectly, through the IRA. Since the owner is also the fiduciary of the IRA, the partnership will be a disqualified person with respect to the IRA. Consequently, the contribution by an IRA of its assets to a partnership in which the owner is the other partner appears to result in a prohibited transaction. Appearances, however, may be deceiving.

In *Swanson v. Commissioner*[30] a taxpayer's IRA became the sole shareholder of a newly formed domestic international sales corporation (DISC) that exported goods for the taxpayer's wholly owned operating corporation. The IRS attacked that transaction as one prohibited under IRC Sec. 4975(c)(1)(A) and sought to collect tax on the recognition of the IRA's assets as taxable income due to the loss of the IRA's tax exempt status as a result of engaging in the prohibited transaction. The taxpayer disagreed and the matter ended up before Tax Court. Upon the filing of a motion for partial summary judgment by the taxpayer asking the court to rule that no prohibited transactions had occurred with respect to the taxpayer's IRA, the Service conceded their position by filing a notice of no objection. The taxpayer then sought an award for attorney's fees from the court based on the premise that the Service's position was not substantially justified.

The Tax Court agreed with the taxpayer that the Service's position lacked a foundation in fact or law. In deciding that the Service's position was not substantially justified, the court reasoned:

> We find that it was unreasonable for respondent to maintain that a prohibited transaction occurred when DISC stock was acquired by (taxpayer's IRA). The stock acquired in that transaction was newly issued — prior to that point in time, DISC had no shares or shareholders. A corporation without shares or shareholders does not fit within the definition of a disqualified person under 4975(e)(2)(G). It was only after DISC issued its stock to (taxpayer's IRA) that petitioner held a beneficial interest in DISC stock, thereby causing DISC to become a disqualified person under Sec. 4975(e)(2)(G). Accordingly, the issuance of stock to (taxpayer's IRA) did not, within the plain meaning of Sec. 4975(c)(1)(A), qualify as a "sale or exchange. or leasing, of any property between a plan and a disqualified person." Therefore, respondent's litigation position with respect to this issue was unreasonable as a matter of both law and fact.[31]

Based on the reasoning in *Swanson*, a contribution of assets by an IRA to a partnership in its formation with the IRA's owner should not result in a prohibited transaction. Assuming, arguendo, that the contribution to the partnership represents an "exchange" contemplated by IRC Sec. 4975(c)(1)(A), a partnership without partnership interests or partners does not fit within the definition of a disqualified person under 4975(e)(2)(G), just as a corporation without shares or shareholders didn't fit within the definition of a disqualified person in *Swanson*. Only after the formation of the partnership will the partnership become a disqualified person with respect to the owner's IRA.

Upon a partnership's becoming a disqualified person with respect to an IRA after the formation of the partnership with the IRA's owner, it appears as though another possible prohibited transaction occurs. It appears that the partnership, as a disqualified person, has a requisite "use" of the assets of the plan resulting in a prohibited transaction pursuant to IRC Sec. 4975(c)(1)(D). However, this might not be so.

In *Etter v. J. Pease Construction Company*[32] an employee brought suit under ERISA for a plan trustees' alleged violation of fiduciary obligations. Specifically, the employee charged that an investment by the plan in a real estate venture with two of the plan's trustees was a prohibited transaction. The plan invested almost the entirety of its assets as a 37 percent partner in the venture with the plan trustees who invested funds entitling them to the remaining 63 percent of the deal. The employee sought a determination that the arrangement resulted in a prohibited transaction under ERISA Sec. 406(a)(1)(D) (which is the ERISA counterpart to IRC Sec. 4975(c)(1)(D)) claiming that the plan trustees, as disqualified persons (or parties in interest under ERISA), used the assets of the plan. The court affirmed a district court's determination that the arrangement did not result in a prohibited transaction under ERISA Sec. 406(a)(1)(D).

Similarly, a partnership's ongoing management of assets contributed to it by an IRA and its owner as partners should not result in a prohibited transaction per se under IRC Sec. 4975(c)(1)(D).

The DOL seems to be in tune with the judicial branch's interpretation of the prohibited transaction provisions. The DOL has permitted a self-directed IRA participant to cause the trustee of the IRA to purchase stock of a company in which he served as both an officer and a shareholder without running afoul of the prohibited transaction provisions.[33]

In a related context, the Service ruled favorably where 12 charitable remainder trusts proposed to invest their assets in one or more investment partnerships to be managed by beneficiaries or grantors of the trusts.[34] IRC Sec. 4941 operates with regard to split interest trusts much like IRC Sec. 4975 operates with regard to qualified plans and IRAs. Like IRC Sec. 4975, which imposes excise taxes for prohibited transactions between a plan and a disqualified person, IRC Sec. 4941 imposes excise taxes for acts of "self-dealing" between certain split interest trusts and a disqualified person.[35]

The term "self-dealing" is defined in IRC Sec. 4941(d) almost identically to the term "prohibited transaction" defined in IRC Sec. 4975(c). Similarly, a disqualified person for purposes of acts of self-dealing is defined in IRC Sec. 4946(a) in much the same manner as a disqualified person is defined in IRC Sec. 4975(e)(2) for purposes of a prohibited transaction. A "foundation manager," which includes an officer, director or trustee of the trust, is a disqualified person for purposes of the self-dealing rules.[36] Both provisions include as a disqualified person a partnership owned by other disqualified persons.

Through the ruling requests, the trustees explained that the primary purpose for the investment of trust assets within investment partnerships was to facilitate a common investment or common investment program with some or all of the trusts.[37] The trustees also maintained that a number of investment opportunities were not available to the trusts unless the investment was made through the vehicle of an investment partnership.

Much like the prohibited transaction concern of having an IRA invest its assets in an FLP, the trustees were concerned that investment by the trusts into the proposed investment partnerships might constitute an act of self-dealing. The Service ruled, however, that the transaction would not result in either a direct or indirect act of self-dealing. In addition, the Service ruled that neither pro rata distributions by the proposed partnerships to its partners, nor pro rata capital contributions to the proposed partnership by its partners would result in acts of self-dealing.

A final area of concern for an IRA that enters into partnership with its owner by contributing its assets to a limited partnership may present itself when the IRA makes distributions of it assets, in the form of limited partnership interests, to the IRA owner. However, there is nothing in the current tax law which would prohibit an IRA from making distributions in-kind. Additionally, IRC Sec. 4975(d)(9) specifically states that "receipt by a disqualified person of any benefit to which he may be entitled as a participant or beneficiary in the plan" is exempted from being a prohibited transaction.

## Valuation Discounts

When an IRA owns limited partnership interests in a privately held limited partnership rather than a portfolio of publicly traded stocks and bonds, the same discounts for lack of marketability and lack of control that have traditionally been applied to such interests in the estate and gift tax arena should be available here as well.[38] Fundamentally, the fair market value of property is determined in the same manner for income tax purposes as it is for estate and gift tax purposes. Fair market value under both Subtitle A of the IRC, governing income taxes, and Subtitle B of the IRC, governing transfer taxes, is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[39]

The fair market value of property is determined in fundamentally the same way for income tax purposes as it is for estate and gift tax purposes with one exception, Chapter 14. Presumably, Chapter 14 is applicable in making final determinations of the fair market value of property for estate, gift, and generation skipping transfer tax purposes only, not for income tax purposes. Accordingly, IRC Sec. 2701 through 2704 are meaningless with reference to the determination of the fair market value of limited partnership interests in the context of their income tax consequences with respect to IRA ownership and distribution.

This is significant in two respects. First, if the Service is ultimately successful in its assertion that IRC Sec. 2703 operates to disregard the entity of a partnership and looks solely to the partnership's underlying assets for purposes of valuing partnership interests,[40] such assertion will be applicable to valuing an IRA owning limited partnership interests only for estate and gift tax purposes. Sec. 2703 would have no impact on the determination of the fair market value of limited partnership interests for purposes of measuring income tax liability resulting from the distribution of those interests by the IRA in-kind to the IRA's owner.

Second, partnership restrictions more restrictive than those imposed by default state law cannot be ignored as applicable restrictions under IRC Sec. 2704(b) for income tax purposes. Therefore, Sec. 2704 would have no impact on the determination of the fair market value of limited partnership interests for purposes of measuring income tax liability resulting from the distribution of those interests by the IRA in kind to the IRA's owner.

On February 2, President Clinton submitted to Congress a $1.73 trillion budget that included a provision intended to prevent the application of valuation discounts to partnerships owning marketable securities.[41] Recall that Sec. 2704 was intended to accomplish a similar although more limited result. It is likely that if this new provision becomes law it will be housed, like Chapter 14, within the transfer tax provisions of Subtitle B, in which case the valuation of limited partnership interests for income tax purposes would remain unaffected.

## Subchapter K Anti-Abuse Regulations

The last stop in reviewing the gauntlet of tax law that could adversely impact the ownership of family limited partnership interests by an IRA is the Subchapter K anti-abuse regulations.[42] Although the primary purposes for causing an IRA to invest in a family limited partnership are to obtain asset protection and simplified administration of assets, a tax benefit clearly arises since the IRA owner will be subject to reduced income tax liability as discounted limited partnership interests are distributed in-kind and taxed to the owner pursuant to IRC Sec. 408(d)(1). This income tax benefit from the use of the partnership raises the issue of whether the anti-abuse regulations apply.

All partnerships must comply with the anti-abuse provisions of Regulation Sec. 1.701-2. This section of the Treasury Regulations contains two rules, a general anti-abuse rule and an abuse of entity treatment rule. Under the general anti-abuse rule, Regulation Sec. 1.701-2(b) contains language which explains that:

> **"if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with Subchapter K..."**

The anti-abuse rule applies if two conditions are present: 1) a principal purpose of a partnership transaction is to reduce substantially the present value of the partner's aggregate federal tax liability; and 2) such tax reduction is inconsistent with the intent of Subchapter K.

A clear distinction must be drawn between the premise that a transaction has tax reduction motives as "a" principal purpose or "the" principal purpose. The language clearly says that tax reduction need only be "a" principal purpose. In contemplation of the strategy that is the subject of this analysis, tax reduction is indeed a benefit that would hardly be absent in the minds of anyone who would attempt it. So one could safely assume tax reduction to be "a" principal purpose of the transaction. However, just as important as the tax reduction prong of the test is the question of whether the tax reduction is in a manner inconsistent with the intent of Subchapter K.

Regulation Sec. 1.701-2(a) comments on the intent of Subchapter K as follows:

> "...Implicit in the intent of Subchapter K are the following requirements -
>
> (1) The partnership must be bona fide and each partnership transaction or series of related transactions...must be entered into for a substantial business purpose.
>
> (2) The form of each partnership transaction must be respected under substance over form principles.
>
> (3) ...the tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income..."

Clearly stated in the regulation is that Subchapter K is intended to permit the conduct of joint business activities through a flexible economic agreement, without incurring an entity-level tax.[43] Therefore, a conclusion that may be drawn from Subchapter K is that it has as a principal purpose, the avoidance of tax. Realistically, however, the transaction must adequately comply with each of the above three tests if it is to hold up under scrutiny.

> (1) The partnership must be bona fide and each partnership transaction or series of related transactions...must be entered into for a substantial business purpose.

Although a transaction that has no business purpose other than tax reduction may be disregarded for tax purposes, a transaction that does have a substantial business purpose will be respected regardless of whether the taxpayer also had as a principal purpose the reduction of taxes.[44]

Asset protection from third party creditors is a stated business purpose for entering into the transaction that cannot be underestimated. In states where IRAs are vulnerable to the claims of creditors, many IRA owners may be inclined to enter into such a transaction irrespective of any ancillary tax benefits which may accrue to it. The greater the value of the assets within the IRA, the more compelling the argument is that the IRA owner entered into the transaction with a primary business purpose of asset protection.

(2) The form of each partnership transaction must be respected under substance over form principles.

In applying the substance over form principle, the Federal Court of Appeals for the Ninth Circuit has ruled that, for a transaction to avoid being recognized as a sham, the validity of the transaction will be governed by whether or not any recognizable economic relationship was altered.[45]

In the contemplated strategy, all of the IRA's assets are owned directly by the IRA prior to the establishment of the limited partnership. The beneficiary has control over the management and investment of the IRA assets. Similarly, after the formation of the partnership, the IRA owner will retain control over the management and investment of the IRA assets as general partner of the limited partnership. In this light, it would appear that no recognizable relationship is altered. However, should the taxpayer's spouse join the partnership as an additional general partner, one could argue that the economic relationship between the IRA assets and the IRA owner is altered by virtue of the fact that the IRA owner now must share control over the management and investment of the IRA assets with a spouse.

Additionally, the income tax reduction resulting from implementation of the strategy is *not related to a partnership transaction, but to an IRA transaction*. In other words, no abuse of the provisions of Subchapter K have occurred. The partnership should be formed and operated no different than millions of others like it. Any resulting income tax reduction is a function of Subchapter D in the measurement of fair market value of the property interest distributed in-kind by the IRA to its participant and taxed pursuant to IRC Sec. 408(d)(1).

(3) ...the tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income...

It would appear that the contemplated strategy satisfies the first part of the above phrase. That is "the partnership must accurately reflect the partners' economic agreement." The partnership will realize income from the disposition of investments that it owns and income and loss will be allocated to each partner in proportion to their capital contributions.

The second part of the phrase states that the partnership must "clearly reflect the partner's income..." Regulation Sec. 1.701-2(a)(3) states that the clear reflection of income standard is treated as satisfied to the extent the transaction satisfies the business purpose and substance over form requirements, and the application of the provision at issue and the ultimate tax results are contemplated by that provision.

Assuming that the transaction meets the business purpose and substance over form requirements, the issues in question are the ultimate tax results of the transaction. For purposes of the strategy, however, the ultimate tax results of the transaction are achieved through lack of control and marketability discounts which are attributable to valuation methodologies. Such valuation methodologies are not exclusive to partnerships at all but are just as applicable to closely-held corporations. Again, it is arguable that the tax results achieved through the proposed transactions are not a Subchapter K issue at all. If this is the case, an argument could be made that the tax results achieved through the transaction are not in any way an affront to the intent of Subchapter K. That being stated, it would appear that the proposed transaction would meet the clear reflection of income standard.

In addition to the general anti-abuse rule, the Treasury Regulations also contain an abuse of entity anti-abuse rule. Regulation Sec. 1.701-2(e) states that "the Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the IRC or the regulations promulgated thereunder."

The Regulation goes on to say that this rule does not apply to the extent that "a provision of the IRC or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision."[46]

It must be determined, then, whether the partnership in the contemplated strategy will be treated as an entity for purposes of IRC Sec. 408(d)(1) and whether or not the tax consequences of the transaction are in line with the intent of this governing provision.

It is in review of the abuse of entity provisions where one can see why the issuance of Regulation Sec. 1.701-2 was so bitterly opposed by the tax community.[47] Unfortunately, Sec. 408(d)(1), nor the regulations promulgated thereunder, do not overtly prescribe the treatment of a partnership as either an entity or as an aggregate of its partners. In fact, not many sections of the IRC could be characterized as "prescribing" treatment of a partnership one way or the other.

By implication and inference, however, it may in fact be argued that Sec. 408(d)(1), and the regulations promulgated thereunder, clearly prescribe the treatment of a partnership as an entity rather than as an aggregate of its partners. An IRA is not by its nature a transactional entity, but merely a passive investment holding account created for the benefit of its owner. It was clearly contemplated by Congress through its enactment of IRC Sec. 408 that an IRA, as a passive holding account rather than an operating entity, would have as its sole purpose the ownership of assets on a tax deferred basis for the benefit of its owner.

Qualified plans and IRAs distributing shares of stock to beneficiaries do not undertake the due diligence of valuing all of the derivative assets of the corporation as if they jointly owned corporate property in aggregate with the other shareholders, nor are they required to value the investments in that manner. Similarly, qualified plans and IRAs distributing limited partnership interests to beneficiaries do not value those interests by undertaking the due diligence of valuing all of the derivative assets of the partnership as if they jointly owned partnership property in aggregate with the other limited partners. Such an exercise would be ludicrous. Partnership interests owned by IRAs and qualified plans are valued based on prices determined in secondary markets, where available. Otherwise, by methodologies promulgated under Revenue Ruling 59-60.[48] Consequently, the ultimate tax results of entity treatment, taking into account all the relevant facts and circumstances, are clearly contemplated by Sec. 408(d)(1).

## Unrelated Business Taxable Income

Generally, an IRA is a tax exempt entity.[49] However, IRC. Sec. 408(e)(1) subjects individual retirement accounts to the tax on unrelated business taxable income imposed by IRC Sec. 511. The term "unrelated business taxable income" (UBTI) is defined in IRC Sec. 512(a)(1) as:

> **"...the gross income derived by any organization from any unrelated trade or business...regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications in subsection (b)."**

Partnership income retains the same character in the hands of the partners that it had when the partnership earned it. Therefore, if the partnership operates a trade or business, the income from the trade or business will be UBTI in the hands of the partner.[50] The Service has ruled that an IRA participating as a limited partner in a related private limited partnership would have to pay unrelated business income tax on UBTI over $1,000 related to a debt-financed income flowing through the partnership to the IRA.[51] (Interestingly, the taxpayer also requested that the Service rule that the IRA's participation as a limited partner in the related partnership not result in a prohibited transaction; the Service declined to rule on this issue.)

Specifically exempted from UBTI, however, are "all dividends, interest, payments with respect to securities loans..."[52] unless they are debt financed.[53] It would therefore be advisable that the limited partnership be operated solely as a passive investment vehicle (and without debt financing) so as to avoid any UBTI and preserve the full income tax exemption on earnings attributable to an IRA partner.

## Compliance

There are a number of practical matters to consider with respect to implementation of the proposed strategy. As with the implementation of any idea, costs of implementation must be weighed against the benefits of potentially successful results. In implementing the proposed strategy the costs may be significant in terms of both time and money. Consequently, it may not be feasible to implement such a strategy unless substantial benefits will be achieved through creditor protection, simplified asset management and tax savings.

It may be necessary for the IRA owner to find a non-traditional IRA custodian or trustee to agree to serve in that capacity for the strategy. Due to the novelty of this strategy, many, if not most, traditional IRA custodians and trustees may be hesitant to serve as such when attempting to implement it.

Additionally, substantial costs in terms of both time and money may be incurred on an annual basis with respect to valuation. Custodians and trustees are required to report to the Service and IRA owner the year-end values of the assets within the IRA on an annual basis.[54] The IRA fiduciary will not be able to value the assets within the IRA by simply looking at the public market but will need to have an annual appraisal of the limited partnership interests completed. This can be quite costly.

## Example

Surviving spouse is a 70 year old Ohio resident with a $5,000,000 IRA rolled over from a decedent spouse's qualified plan. Additionally, surviving spouse is the income beneficiary of a $4,600,000 QTIP trust, a $400,000 reverse QTIP trust, and a $600,000 family trust each established by decedent spouse with surviving spouse's only child as trustee.

Since Ohio offers no creditor protection for surviving spouse's IRA, and since trustee child desires simplified administration and management of trust assets, trustee causes trust assets and surviving spouse causes IRA assets to be contributed to a family limited partnership in return for interests in the family limited partnership. A valuation determines that the fair market value of the limited partnership interests represents a 25 percent discount from net asset value. Accordingly, surviving spouse's IRA owning limited partnership interests in family limited partnership has a fair market value of $3,750,000.

The following year, when surviving spouse reaches age 70 and 1/2, she takes her required minimum distribution of $234,375, computed based on the IRA's prior year December 31 fair market value of $3,750,00 using surviving spouses non-recalculated single life expectancy, in an in-kind distribution of limited partnership interests. Surviving spouse pays income tax of $105,469 based on a combined federal and Ohio effective income tax rate of 45 percent, and consumes the after tax proceeds.

Surviving spouse then dies leaving a taxable estate of $7,265,625 (assuming no appreciation has occurred in her estate) consisting of the IRA with a fair market value of $3,515,625 (after the required minimum distribution) and the combined QTIP and reverse QTIP trusts with a fair market value of $3,750,000 ($5,000,000 less a 25 percent discount from net asset value). The combined federal and Ohio estate taxes are computed at $3,434,844.

Had the family limited partnership not been formed, surviving spouse's required minimum distribution on her IRA of $5,000,000 would have been $312,500 resulting in combined federal and Ohio income taxes of $140,625. Upon her death, surviving spouse's taxable estate would have been $9,687,500 consisting of her IRA of $4,687,500 (after the required minimum distribution) and the combined QTIP and reverse QTIP trusts with a fair market value of $5,000,000. The combined federal and Ohio estate taxes would have been computed at $4,766,875.

The strategy results in a net income and transfer tax savings to surviving spouse's family of $1,367,187.

## Conclusion

The ability to invest IRA assets in a family limited partnership may solve an untold number of estate planning problems that both clients and practitioners currently face. In certain circumstances, however, it may create just as many, if not more problems than it solves. Such a strategy should not be undertaken lightly. Practitioners and clients should understand all of the risks as well as the benefits before exploring this new frontier in estate planning. ◆

## End Notes

1. IRC Sec. 7701(a)(2). (Emphasis added.)
2. Rev. Rul. 75-523, 1975-1 C.B. 257., Rev. Rul. 75-525, 1975-1 C.B. 350.
3. Ltr. Rul. 9547004. (Emphasis added.)
4. ERISA Sec. 206(d)(1).
5. *Oliver v. Manufacturer's Hanover Trust Co.* 1 EBC 1720 (1982 N.Y. Sup. Ct., Spec. Term, Part I, New York Co.); *Bender v. The East New York Savings Bank* (1984 N.Y. Sup. Ct., Spec. Term, Part I, New York Co.); *Steves & Sons, Inc. v. House of Doors, Inc.* (Tex. Civ. App., San Antonio, No. 04-87-00542-CV, Mar. 9, 1988). Note that certain states, such as New York, now provide asset protection for IRAs.
6. J. Gordon Gose, *The Charging Order Under the UPA*, 28 Wash. L. Rev. 1 (1953).
7. See Rev. Rul. 77-137, 1977-1 C.B. 178.
8. Stefan F. Tucker and Mary Ann Mancini, *Family Limited Partnerships and Asset Protection*, 23 The Journal of Real Estate Taxation 183 (1996).
9. See, e.g., Minn. Stat. Ann. Sec.550.37, Official Code of Ga. Ann. Section 18-4-22(a), N.J. Stat. Ann. Sec. 25:2-1(b).
10. See, e.g., 42 Pa. Cons. Stat. Ann. Sec. 8124.
11. Even if the law of the IRA owner's domicile provides creditor protection, that protection may be sacrificed if the owner moves to another state. On account of that possibility, implementing the partnership before the move may make sense.
12. See Malcolm A. Moore, *Focus on Estate Planning for the Surviving Spouse: Changing from Wide Angle to Zoom Lens*, 32nd Ann. U. Miami Philip E. Heckerling Inst. On Est. Plan. (1998).
13. IRC Sec. 408(e)(2).
14. IRC Sec. 4975(a) and (b).
15. IRC Sec. 4975(c)(3).
16. Under ERISA, the term "party in interest" is used rather than "disqualified person" in setting forth the parameters of a prohibited transaction. Generally, the IRC Sec. definition of disqualified person contemplates the same persons defined as a party in interest under ERISA. ERISA Sec. 406(a)(1), 29 U.S.C. Sec. 1106(a)(1).
17. ERISA Sec. 406(a)(1)(A); 29 U.S.C. Sec.1106(a)(1)(A).
18. ERISA Sec. 406(a)(1)(B); 29 U.S.C. Sec. 1106(a)(1)(B).
19. ERISA Sec. 406(a)(1)(C); 29 U.S.C. Sec. 1106(a)(1)(C).
20. ERISA Sec. 406(a)(1)(D); 29 U.S.C. Sec. 1106(a)(1)(D).
21. ERISA Sec. 406(a)(1)(E) and (2); 29 U.S.C. Sec. 1106(a)(1)(E) and (2).
22. 3 C.F.R. 332 (1979).
23. Announcement 79-6, 1979-4 I.R.B. 43 (Jan. 22, 1979).
24. IRC Sec. 4975(e)(3).
25. IRC Sec. 4975(e)(6).
26. IRC Sec. 4975(c)(1)(A).
27. IRC Sec. 4975(c)(1)(D).
28. See IRC Sec. 351(a), which provides for the nonrecognition of gain or loss when property is transferred to a corporation in *exchange* for stock in the corporation, and IRC Sec. 721(a), which provides for the nonrecognition of gain or loss when property is transferred to a partnership in *exchange* for an interest in the partnership.
29. IRC Sec. 4975(e)(2)(G).
30. 106 T.C. 76 (1996).
31. Id. at 88.
32. 963 F.2d 1005 (7th Cir. 1992).
33. DOL Advisory Opinion 89-3A.
34. Ltr. Rul's 9626007 through 9626018.
35. IRC Sec. 4947(a)(2).
36. IRC Sec. 4946(a)(1)(B) and 4946(b).
37. Id. at note 34.
38. See generally, Michael D. Phelan, *Valuing Limited Partnerships*, Journal of Pension Benefits, Autumn 1996, at 19.
39. Reg. Sec. 1.170-1(c) and Reg. Sec. 20.2031-1(b).
40. See Christopher P. Bray, *Does Section 2703 Apply to the Valuation of Family Limited Partnerships?*, TAXES The Tax Magazine, April 1997, at 198.
41. *Treasury Releases Explanation of President's 1999 Budget Plan*, 98 TNT 22-6 (Feb. 3, 1998).
42. Reg. Sec. 1.701-2.
43. Reg. Sec. 1.701-2(a).
44. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).
45. *Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984).
46. Reg. Sec. 1.701-2(e)(i) and (ii).
47. See Michael J. Grace, *Partnership Anti-Abuse Rule Provokes Fury*, 11 Journal of Partnership Taxation 257 (1994). See also Gouwar, *The Proposed Partnership Anti-Abuse Regulation: Treasury Oversteps Its Authority*, 11 Journal of Partnership Taxation 287 (1995).
48. Id at note 40.
49. IRC Sec. 501(a).
50. Regulation Sec. 1.512(c)-1.
51. Ltr. Ruling 9703026.
52. IRC Sec. 512(b)(1).
53. IRC Sec. 514(a).
54. See Proposed Regulation Sec. 1.408-5(b).