Avoiding the Investment Company Trap When Forming FLPs and LLCs

Although the formation of a partnership is generally tax-free, the investment company exception to this rule may cause gain to be recognized. This article analyzes the rules and suggests curative steps to avoid potentially costly taxes.

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Although family limited partnerships (FLPs) and limited liability companies (LLCs) (sometimes referred to collectively in this article as "FLPs") are a commonly used estate planning technique, clients, promoters, and even some practitioners may be unaware of the investment company rule, which may inadvertently cause taxation on the formation of an FLP.

Background

The investment company exception to the tax-free organization of an FLP or an LLC taxed as a partnership—especially after the additional restrictions of TRA '97—presents a significant trap for the unwary. Several tiers of requirements must be met before this tax cost will be triggered. First, the entity must be classified as an investment company by virtue of the fact that more than 80% of its assets constitute listed property, which generally means marketable securities.

Once the entity is classified as an investment company, taxation will occur only if the assets transferred to the entity are not diversified portfolios. If the assets transferred are not diversified, the transaction—in order to be taxable—must result in diversification which is not insignificant.

If these hurdles are met, several options exist to address this tax problem in the event it is inadvertently triggered. The entity can elect out of partnership tax status, can structure a partnership or operating agreement to negate the diversification that has occurred, or can rescind the transaction. A significant obstacle to these alternatives is that they are time-sensitive. If none of these choices is available, it may be possible—as a last resort—to argue for discounts from the value of the partnership interest in order to reduce the gain.

The investment company rule

A contribution of property to a partnership in exchange for a partnership interest is a realization event for tax purposes.[1] Therefore, absent an express Code provision permitting nonrecognition, gain must be recognized by the contributing partner to the extent that the fair market value (FMV) of the partnership interest received in the exchange exceeds the adjusted basis of the property contributed.

Nonrecognition treatment, however, generally applies to such transactions,[2] if specified exceptions to the nonrecognition rules are not applicable.[3] If nonrecognition treatment applies, the partner's basis in the contributed property will equal his basis in the partnership interest received.[4]

An exception to nonrecognition is that gain will be recognized if a partner contributes appreciated property to a partnership that is classified as an investment company and if "diversification" occurs.[5] Once an entity is classified as an investment company, the gain on all appreciated securities

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is taxed.[6] Thus, gain is recognized to the extent that the FMV of the partnership interest received in the exchange exceeds the basis of the assets transferred. Although it may be little consolation, the transferor's basis in his partnership interest will be increased by the gain recognized.[7]

Step 1: Is the FLP classified as an investment company?

The 80% test. The first step in the analysis is to determine whether the FLP can be classified as an investment company. The corporate rules of Reg. 1.351-1(c)(1) are used to determine whether a partnership is an investment company.[8] A transfer of property is considered a transfer to an investment company if: (1) the transfer results, directly or indirectly, in diversification of the transferors' interests; and (2) the transferee is (a) a regulated investment company (RIC), (b) a real estate investment trust (REIT), or (c) a corporation more than 80% of the value of whose assets are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs.

Listed assets. An entity is characterized as an investment company if, among other conditions, more than 80% of the value of its assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are "readily marketable." Stocks and securities will be considered readily marketable if (and only if) they are part of a class of stock or securities which is traded on a securities exchange or traded or quoted regularly in the over-the-counter market. Stocks and securities will be considered to be held for investment unless they are (1) held primarily for sale to customers in the ordinary course of business, or (2) used in the trade or business of banking, insurance, brokerage, or a similar trade or business.[9]

What items are considered securities? In TRA '97, Congress sought to restrict the use of swap funds structured to allow the tax-free exchange of stock and securities for an interest in a fund holding similar interests.[10] Congress attempted to achieve this goal by expanding the types of assets included in the investment company calculation. As amended by TRA '97, an FLP will be classified as an investment company if more than 80% of the assets of the partnership consist of the following assets ("listed assets"):

1. Money, including foreign currency, unless intended to be used as part of a plan to purchase nonmarketable assets.
2. Stocks and other equity interests in a corporation.
3. Evidences of indebtedness.
4. Options.
5. Forward or futures contracts.
6. Notional principal contracts and derivatives.
7. Interests in precious metals unless the metal is used in an active trade or business after contribution.
8. Interests in a RIC, a REIT, common trust funds, and publicly-traded partnerships.[11]
9. Other interests in noncorporate entities that are convertible or exchangeable for any of the listed assets.
10. Other assets added to the list by Regulation.
11. An interest in an entity substantially all the assets of which are listed assets. If 90% or more of the entity's assets are listed assets, the "substantially all" test will be deemed met.[12]
12. An interest in an entity to the extent of the value of the interest that is attributable to listed assets. Until Regulations addressing this are published, the Regulations previously issued under similar provisions of Section 731(c)(2) will apply. This would imply that if 20% to 90% of the entity's assets were listed assets, a pro rata portion of an interest in the entity would be a listed asset.[13]

Special rules affecting application of 80% test. In applying these rules, only assets held for investment are considered in the determination of investment company status. Stock and securities in subsidiary corporations are disregarded, and the parent corporation is deemed to own its ratable share of its subsidiaries' assets. A corporation is a subsidiary if the parent owns 50% or more of (1) the combined voting power of all classes of stock entitled to vote, or (2) the total value of the shares of all classes of stock outstanding.[14] The purpose of this rule is to pre-

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[1] See Section 1001 and Reg. 1.1001-1(a).
[2] Section 721(a).
[3] Sections 721(b) and 7701(a)(45).
[4] Section 722.
[5] Section 721(b) and Reg. 1.351-1(c)(1)(i).
[6] Section 721(b).
[7] Sections 722 and 723.
[8] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 657 (1976); S. Rep't No. 938, 94th Cong., 2d Sess. 43 (1976).
[9] Reg. 1.351-1(c)(3).
[10] Section 1002(a) of TRA '97, amending Code Section 351(e)(1).
[11] As defined in Section 7704(b).
[12] Senate Committee Report to TRA '97 section 1002, fn. 69, referring to Reg. 1.731-2(c)(3)(i).
[13] Senate Committee Report to TRA '97 section 1002, fn. 69, referring to Reg. 1.731-2(c)(3)(ii)
[14] Reg. 1.351-1(c)(4).

vent the use of tiered entities to circumvent the investment company rules.

The determination of investment company status must consider any plan with regard to an entity's assets in existence at the time of the transfer.[15] The Senate Committee Report notes that money is counted toward the 80% test, but if money is contributed pursuant to a plan to purchase nonlisted assets (i.e., nonmarketable assets), the test will be applied after the transaction.[16]

Time of analysis. The determination of investment company status is ordinarily made by reference to the circumstances existing immediately after the transfer. Nevertheless, if circumstances change thereafter pursuant to a plan in existence at the time of the transfer, this determination is made by reference to the later circumstances.[17]

In Rev. Rul. 88-32,[18] after the initial transfer of marketable stock to a newly formed corporation, that corporation sold the transferred stock in taxable transactions in order to achieve greater diversity. The IRS concluded that the transfer and sale of stock did not retroactively taint the tax-free status of the formation of the corporation. Similarly, in Ltr. Rul. 9013016, timber and timber rights (which on a percentage basis were sufficient to prevent a partnership from being classified as an investment company) were to be sold in the ordinary course of business after formation of the partnership. The sales could reduce the percentages so that the investment company exception could apply. The IRS found that the sales would not taint the contributions to the partnership as being contributions to an investment company.

Step 2: Does the transfer result in diversification?

The legislative intent behind the enactment of the investment company rule was to thwart attempts at diversifying marketable securities through the guise of a tax-free formation of a partnership. If the marketable securities which each transferor, in the aggregate, transfers to the partnership are already diversified, the abuse that concerned Congress cannot be present.

The general diversification rules. Even if an FLP is classified as an investment company, Reg. 1.351-1(c)(1)(i) provides that gain is not triggered unless the transfer results in the "diversification of the transferors' interests." The legislative history discusses this prerequisite of direct or indirect diversification of the transferors' interests to the recognition of gain.[19]

The Regulations illustrate diversification with the following example.[20] A, together with 50 other transferors, organizes a corporation with 100 shares of stock. A transfers $10,000 worth of stock in corporation X, listed on the New York Stock Exchange, in exchange for 50 shares of stock in the new corporation. Each of the other 50 transferors transfers $200 worth of readily marketable securities in corporations other than X in exchange for one share of stock in the new corporation. In determining whether diversification has occurred, all transfers are taken into account. Hence, diversification is present, and gain or loss is recognized.

If there are two or more transferors of identical assets to a newly organized FLP, the transfer will generally not result in diversification. A transfer will ordinarily result in diversification if two or more persons transfer nonidentical assets to an FLP.

The 25%/50% tests to determine if the transferred portfolio is diversified. The Regulations provide a mechanical test to determine whether diversification has occurred.[21] But problems can arise because FLPs often are funded without advance consideration of this test.

A transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities. A portfolio of stocks and securities is diversified if it satisfies the 25% and 50% tests of Section 368(a)(2)(F)(ii). In calculating these percentages, government securities are included in total assets for purposes of the denominator of the 25% and 50% tests, but are not treated as securities of an issuer for purposes of the numerator of the 25% and 50% tests. If, however, the government securities were acquired to meet the 25% and 50% tests, they cannot be so included.

To avoid diversification, not more than 25% of the value of the FLP's *total assets* may be invested in the stock and securities of any one issuer, and not more than

[15] Senate Committee Report to TRA '97 section 1002, citing Reg. 1.351-1(c)(2).

[16] Senate Committee Report to TRA '97 section 1002, fn. 70.

[17] Reg. 1.351-1(c)(2).

[18] 1988-1 CB 113.

[19] S. Rep't No. 938, 94th Cong., 2d Sess. pt. 2, at 43-4 (1976).

[20] Reg. 1.351-1(c)(7), Example (2).

[21] Reg. 1.351-1(c)(6)(i). See also Ltr. Rul. 199917049.

[22] Section 368(a)(2)(F)(ii). The test under this provision was noted in several private letter rulings without further description of the terms used in the statute; see Ltr. Ruls. 9024006, 9121012, 9207019, and 9220019.

[23] Section 368(a)(2)(F)(iii).

50% of the value of its total assets may be invested in the stock and securities of five or fewer issuers. All members of a controlled group of corporations (within the meaning of Section 1563(a)) are treated as one issuer.

A person holding stock in a RIC, a REIT, or an *investment company* that meets the requirements of Section 368(a)(2)(F)(ii) is treated as holding its proportionate share of the assets held by such company or trust.[22] An investment company is defined as including a RIC, a REIT, or a corporation that meets two tests: (1) 50% or more of the value of its total assets are stock and securities; and (2) 80% or more of the value of its total assets are assets held for investment.

In making the 50% and 80% calculations, stock and securities in any subsidiary are disregarded, and the parent entity is deemed to own its ratable share of the subsidiary's assets. An entity is a subsidiary if the parent entity owns 50% or more of the combined voting power of all classes of stock entitled to vote, or 50% or more of the total value of shares of all classes of stock outstanding.[23]

For purposes of Section 368(a)(2)(F), the term "total assets" excludes cash and cash items (including receivables), government securities, and—under Regulations—assets acquired (through incurring indebtedness or otherwise) for purposes of ceasing to be an investment company.[24]

Exceptions to the diversification rule. A number of exceptions to the diversification rule exist which provide opportunities to avoid taxation on a transfer to an investment company.

Single-member LLC. If there is only one transferor to a newly organized LLC, the transfer will generally not result in diversification.[25] If, however, a transfer is part of a plan to achieve diversification without recognition of gain, the transfer will be treated as resulting in diversification.[26]

Gifts following formation. The fact that a transferor intends from the outset to make gifts of partnership interests to the other transferors following the initial formation of the partnership should not affect the tax status of the transaction, so long as it does not constitute a plan to diversify.[27]

24 Section 368(a)(2)(F)(iv).
25 Reg. 1.351-1(c)(1)(i).
26 Ltr. Rul. 9544012.
27 See Ltr. Rul. 9606007.

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De minimis diversification. If any transaction involves one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, such transfers are disregarded in determining whether diversification has occurred.[28] While such an exception could be useful and fair, the Regulations include an example which is so limited as to make this exception useless.[29]

Assume that individuals A, B, and C organize an FLP with 101 units. A and B each transfer to it $10,000 worth of the only class of stock of corporation X, listed on the New York Stock Exchange, in exchange for 50 units. C transfers $200 worth of readily marketable securities in corporation Y for one unit. In determining whether diversification has occurred, C's participation in the transaction is disregarded. Therefore, according to the example in the Regulations, there is no diversification, and gain or loss is not recognized.[30]

This de minimis concept was illustrated in Rev. Rul. 87-9.[31] That Ruling states that a transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets to the corporation in the exchange, unless the portion of the assets that are nonidentical to the other assets transferred constitutes an insignificant portion of the total value of the assets transferred. In Ltr. Rul. 9544012, the Service concluded that the transfer of cash constituting 1/2% of a partnership interest by several family members was insignificant and did not result in diversification.[32]

Transfer of identical assets. If two or more transferors transfer identical assets to a partnership, no diversification results.[33] Similarly, in Ltr. Rul. 9451004, the initial transfer of identical securities by various parties did not trigger gain since no diversification will occur.

The transfer of assets to a partnership could be structured so that the entity fails to be characterized as an investment company.

Additional factors IRS considers in analyzing diversification. The Service has discussed ancillary factors that weigh in favor of finding that a transaction did not involve an investment company and hence qualified as a tax-free formation of a partnership under Section 721(a). These factors—although not enumerated in the statute or Regulations under Section 351, 721, or 368—are logical refinements of the intent of the investment company rules.

If the quality and level of risks of the assets transferred by each transferor are substantially identical to the quality and level of risks of assets that will be held by the transferee after the transfers, diversification may not be found. This is determined by considering the assets' relative values, nature, and mix. The Service has also cited as positive the fact that the transferee did not have any plan or intention to depart from the investment strategy or practice of the transferor.[34]

In Ltr. Rul. 9617017, the Service applied similar concepts and reached a similar conclusion, but used somewhat different language concerning the investments. In that ruling, two individuals and 13 trusts transferred assets to a Delaware LLC. The property transferred consisted of cash, cash equivalents, and publicly traded securities. The purpose of the transaction was to consolidate administration of the taxpayers' investments. Capital accounts were required to be maintained in accordance with Section 704 and the Regulations thereunder. Pre-contribution gains had to be allocated as required under Section 704(c). The portfolio transferred by each taxpayer was diversified as defined under Section 368(a)(2)(F). The portfolios were under common management and shared a common investment strategy, which the taxpayer intended to continue.

Possible solution 1: Structure contributions to fail the mechanical investment company tests

There are a number of different ways in which transfers to an entity can be structured to avoid the investment company rule. The transfer of assets could be structured so that the entity fails to be characterized as an investment company. For example, transfer sufficient nonmarketable assets to fail the 80% test. Transfer assets that have been calculated to meet the 25%/50% diversification tests. If each transferor transfers a diversified portfolio, no tax problem can result. Transfer assets that do not have any significant appreciation, so that any tax consequence would not be significant.

The problem with the above planning is that it must all be done in advance, and does not necessarily offer an opportunity to cure a problem after the fact. One

28 Reg. 1.351-1(c)(1)(i).

29 Reg. 1.351-1(c)(5); see also Rev. Rul. 88-32, 1988-1 CB 113.

30 Reg. 1.351-1(c)(7), Example (1).

31 1987-1 CB 133.

32 See also Ltr. Rul. 9733010 for a similar result.

33 Ltr. Rul. 9538023.

34 This language appears in a number of rulings; see Ltr. Ruls. 9451035, 9451036, and 9451039, which have identical language.

possible strategy after the initial transfer may be to transfer additional assets to the entity in order to then violate the investment company requirements. Will such a later transfer be effective?

The determination of investment company status is ordinarily made by reference to the circumstances in existence immediately after the transfer in question. However, if circumstances change thereafter pursuant to a plan in existence at the time of the transfer, this determination is made by reference to the later circumstances.[35]

If it can be demonstrated that there is a plan to avoid the investment company rule, perhaps these later transfers can be aggregated. Perhaps the inclusion of a recital clause in the partnership agreement indicating the intent to avoid the 80% test, or to meet the 25%/50% diversification test, will help corroborate the intent and the plan to conform with these requirements. Such a clause—especially if the investment company problem is caused by a mathematical error or other unintentional oversight—may provide credibility to an argument that the transfer of additional securities was part of the original plan. Aggregation may then be possible.

Possible solution 2: Election out of Subchapter K

If the investment company exception was inadvertently violated, and diversification has occurred, the partners could elect to be excluded from the partnership tax provisions of Subchapter K and thereby avoid the tax consequences of investment company classification. An organization used for investment purposes only and not for the active conduct of a business may, on the consent of all its partners, elect to be excluded from Subchapter K even though the organization is otherwise a partnership.[36]

Requirements to elect out. To elect out of partnership tax treatment, a number of requirements must be met. The partners must be able to individually calculate their income without the need to compute partnership taxable income.[37] The partners must own the partnership property as co-owners. The partners must reserve the right separately to take or dispose of their shares of any property acquired or retained. If the parties do not reserve the right separately to take their shares of the property, the election out is not valid.[38]

The partners cannot actively conduct business. The partners cannot irrevocably authorize a person acting in a representative capacity to purchase, sell, or exchange investment property. However, each partner may delegate the authority to purchase, sell, or exchange his share of any such investment property for his account, but not for longer than one year.[39]

Formalities of making election out. The election out available under Section 761 must be made not later than the time for filing the tax return for the partnership for the first taxable year the exclusion is desired.[40] This is vitally important because it provides an opportunity, after the investment company rules may have been triggered, to avoid the otherwise potentially costly tax generated on formation.

The partnership tax return on which the election out is made must include certain information.[41] If an organization does not properly comply with the above regulatory formalities for the election out of Subchapter K, the Service can permit the election to be effective if the organization demonstrated its intent to elect out of Subchapter K. This may provide additional flexibility to cure an unintended tax cost. An election out can be voided by any partner filing a statement with the Service that he wishes Subchapter K to apply and that he has notified the other partners of such intent.[42]

Income tax consequences of election out. If the partners elect out of partnership tax status, each partner reports his share of income and deductions with regard to his interest in the partnership on his individual tax return in accordance with his separate method of accounting.[43] If the entity had previously been taxed as a partnership, the election out could be treated as a liquidation of the former partnership. This could result in a deemed distribution of partnership assets for tax purposes,[44] which could trigger gain under the general partnership dissolution provisions.[45] The election out of Subchapter K applies only to the partnership tax provisions of Subchapter K, and does not apply to other aspects of the Code.[46]

Revocation of the election out. Once the election is made, it is irrevocable as long as the organization remains qualified for the exclusion or unless the IRS

35 Reg. 1.351-1(c)(2).
36 Section 761(a).
37 Section 761(a); Reg. 1.761-2(a)(1).
38 Hager, 76 TC 759 (1981).
39 Reg. 1.761-2(a)(2).
40 Regs. 1.761-2(b) and 1.6031-1(e).
41 Reg. 1.761-2(b)(2)(i).
42 Reg. 1.761-2(b)(3)(i).
43 Section 761(a).
44 See generally Sections 731-735.
45 Section 731(a).
46 Bryant, 46 TC 848 (1966), *aff'd* 399 F.2d 800, 22 AFTR2d 5375 (CA-5, 1968); Rev. Rul. 65-118, 1965-1 CB 30; GCM 39043 (10/5/83).

approves revocation of the election.[47] Thus, if an FLP elects out of partnership tax status, and thereafter wishes to restructure and be taxed as a partnership in order to facilitate the funding of grantor retained annuity trusts or other estate planning techniques, the Service's approval is necessary.

If the organization no longer qualifies for the election, the election ceases.[48] Query whether this can be used as an affirmative planning tool to later become subject to Subchapter K by intentionally violating the requirements of the election out.

Drafting when election out is intended. If the election out of Subchapter K is intended, a number of modifications should be made to the partnership or operating agreement to reflect this. Add clauses confirming the election out, and specify that the intent is to meet those requirements. State that the partners intend to individually invest property and funds in the organization, but retain separate and independent accounting of the income and capital appreciation therefrom so that each partner's interest in the organization will be accounted for separately. Expressly state the intent to elect out, that all partners agree, and that no partner will notify the Service that it desires partnership taxation to apply.

The partners should agree and acknowledge that the FLP organization is used solely for personal convenience and other purposes, and not for joint investment purposes or for the active conduct of a business. The participants own investment and other assets solely as co-owners and not as joint owners with an intent for joint profit.

The participants reserve the right to dispose of their actual interests in any specific property transferred to the organization by them, or acquired or retained, from that property. There is to be no sharing of profits and losses, although the partners may act in a manner to share certain expenses. Separate books and records of each partner's assets contributed to the organization, and the returns, gains, losses and reinvestment of same, will be maintained.

Possible solution 3: Draft partnership/operating agreement to resolve diversification problem

The partnership agreement could be drafted in a manner that negates the effect of diversification.[49] If special allocations of all gains and losses from each security are, pursuant to the agreement, required to be made solely to the contributing partner, the ability to realize the benefits of diversification is negated.[50]

Upon the withdrawal of any partner, that partner will be distributed, as part of the assets distributed in exchange for such partner's interest, any assets remaining from the assets originally contributed by such partner. If this is done, and the tax return prepared and filed accordingly, arguably it is not possible for any individual investor to realize the benefits of diversification.

Possible solution 4: Rescission of transaction

If a transfer is made to an FLP that inadvertently triggers gain under the investment company rules, and if the gain is identified during the same tax year, it may be possible to re-convey assets back from the entity to the transferors and thereby rescind the transaction. If this is accomplished, the gain resulting from the investment company rules should be avoided.

For tax purposes, the taxable year is the measuring unit, so that gains and losses are determined on an annual basis, using the facts as they exist at the end of the year in question.[51] In determining income during a particular year, the legal concept of rescission provides that if a transaction was cancelled during the same tax year in which it occurred, then no gain would exist to be taxed at the end of the annual measuring period.

The legal concept of rescission refers to the abrogation, cancelling, or voiding of a contract, which has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.[52]

In Rev. Rul. 80-58,[53] the buyer purchased property from the seller, with the right to re-convey the property within nine months if a desired zoning change could not be obtained. When the zoning change

47 Reg. 1.761-2(b)(3)(i).

48 Ltr. Rul. 8822018.

49 Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 658 (1976); S. Rep't No. 938, 94th Cong., 2d Sess. 44 (1976).

50 The language could be an expanded version of the language used in an agreement to address the Section 704(c) requirement that pre-contribution gain be allocated to the partner contributing the appreciated property in question. In this instance, a similar concept would be applied, but would encompass both pre- and post-contribution gain.

51 Security Flour Mills Co., 321 U.S. 281, 31 AFTR 1214 (S.Ct., 1944).

52 Rev. Rul. 80-58, 1980-1 CB 181. For examples of authority involving rescission, see Penn v. Robertson, 115 F.2d 167, 25 AFTR 940 (CA-4, 1940); Rev. Rul. 74-501, 1974-2 CB 98; and Ltr. Rul. 9829044.

53 1980-1 CB 181.

could not be obtained, the purchaser re-conveyed the property to the seller, and the seller refunded to the purchaser the price paid. Because the reconveyance was consummated in the same tax year as the sale, no taxable event was deemed to have occurred.

If two primary requirements are not met—namely, that the parties are returned to the same relative positions they occupied before the transaction, and that it is accomplished in the same tax year—the rescission will not be respected by the Service.[54]

In *Blanco*,[55] the court held that an attempted rescission was not effective. The taxpayer had received cash and assets in kind in a distribution in redemption of stock. Upon learning of the unfavorable tax treatment to be afforded the transaction, the corporation returned the redeemed shares and the taxpayer issued to the corporation an interest-bearing note for the cash and assets previously received.

The court held that the rescission doctrine could not be applied. It is unclear whether the court would have reached a different conclusion had the taxpayer returned the actual assets and cash received instead of a note.

In applying the rescission doctrine to situations involving an unintended triggering of the investment company tax rules, two additional factors—which are implicit in the seminal Rev. Rul. 80-58—must be considered. In the Ruling, there was a business purpose for the rescission, not merely a tax motive. Further, an independent third party was involved, and the transaction was negotiated at arm's length.

In many FLP investment company scenarios, the motive for rescission may be solely to achieve a better tax result. It is unlikely that the Service would permit a purely tax-motivated rescission. Moreover, when only related parties are involved in the transaction (as is common in most FLP transactions), the Service is likely to require some corroboration that the transaction is arm's-length in nature. Therefore, caution should be exercised in extending the application of the rescission doctrine.

Possible solution 5: Advance an argument consistent with IRS position of gift on formation

In TAM 9842003, the Service concluded that the transfer of assets by a decedent to an FLP was a taxable gift by the decedent if valuation discounts were available to the FLP. The Service held, based on the analysis in *Estate of Trenchard*,[56] that if the FLP structure justified a discount, then the decedent made a gift upon the formation of the FLP. The value of this gift would equal the difference between the value of the assets contributed by the decedent to the partnership and the discounted value of the partnership interest received in exchange.

If the Service wishes to argue that a gift occurs on formation of an FLP, the Service should be held to a similar argument that, upon the formation of an FLP subject to the investment company rules, similar concepts of discount and gift should apply in determining gain.

Practice Ideas

Strategies to counter the investment company tax trap include (1) electing out of Subchapter K partnership tax treatment, (2) structuring the partnership or operating agreement to negate the diversification of interests, or (3) rescinding the transaction.

Conclusion

The proliferation of FLPs has resulted in a host of tax problems as well as increased scrutiny by the Service. One of the many issues is the investment company exception to the tax-free formation of a partnership. As this article has shown, there are a number of curative steps that practitioners should consider applying—even after the fact—to avoid a potentially costly tax problem. ■

54 Ltr. Rul. 9408004.

55 602 F.2d 324, 44 AFTR2d 79-5448 (Ct.Cl., 1979).

56 TCM 1995-121.