Shore to Shore
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"Technically speaking"

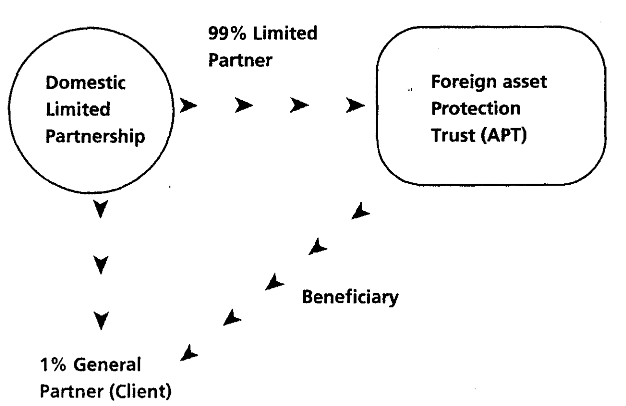
In the first of a new series of features by Offshore Institute members providing technical advice on their areas of expertise, ***Mark Merric*** examines the investment company pitfall when creating a foreign APT structure

This article analyses the tax consequences under §351(e) of the Internal Revenue Code of 1986, as amended (IRC), when a husband and wife both contribute marketable securities to a domestic limited partnership in a two-settlor foreign asset protection trust structure (defined below). While the Treasury never intended its regulations to encompass a two-settlor foreign asset protection trust structure, depending on the proportion of the assets that are marketable securities in the domestic limited partnership, the contribution of marketable securities to the domestic limited partnership may be considered a contribution to an investment company under IRC §351(e). If the contribution of marketable securities by the husband and wife is considered a contribution to an investment company, gain is recognised on the difference between the fair market value of the market securities and the adjustable basis of such marketable securities. Asset protection planners need to advise clients of this potential pitfall and the methods by which the pitfall may be avoided.

Background

While the structure of a foreign asset protection trust may vary from planner to planner, the more sophisticated foreign asset protection trusts (APT[s]) usually employ a domestic family limited partnership (FLP). Under this structure, once the APT and the FLP have been created, the client assigns the 99 per cent limited partnership interest to the APT. The client retains a one per cent general partnership interest. The client then contributes most of his or her assets to the FLP. However, certain assets, such as a personal residence or subscriber S stock which have potential tax problems if they are owned by a partnership, are contributed directly to the APT[1]. The purpose of the FLP is to provide the client with direct control over most of his or her assets. As general partner of the FLP, while the client owes a fiduciary duty to the APT as the limited partner, the client has the authority to make any operating decisions regarding the assets of the FLP without obtaining any approval from a trustee of the APT. Besides lower trustee fees, the ability of a client to directly control most of the assets of the APT is one of the key selling points of a foreign APT structure. Figure 1 depicts a sophisticated APT structure.

Figure 1



An APT structure may be created for a single person or it may be created for both a husband and wife. When the APT structure is created for both husband and wife, in order to reduce the cost of having multiple foreign trusts, many planners use one APT which by the terms of the APT is divided into husband and wife accounts.[2] This type of APT structure is referred to as a two-settlor trust. A two-settlor trust structure with the husband and wife accounts is detailed in Figure 2.

Problem

As mentioned above, in order for a husband and wife to have direct control, they will contribute properly to the FLP. Under IRC §351(e), if the partnership is classified as an investment company, gain will be recognised as the difference between the fair market value of the marketable securities and the adjustable basis of such marketable securities. For example, assume that the husband owns IBM stock worth $1,000,000 and the adjustable basis of such stock is $200,000. Also, assume that the wife owns GM stock worth $500,000 and the adjustable basis of such stock is $100,000. If the husband and wife both contribute the marketable securities to the FLP, and the FLP is classified as an investment company under IRC §351(e), gain on $1,200,000 will be recognised on the transfer.

Analysis

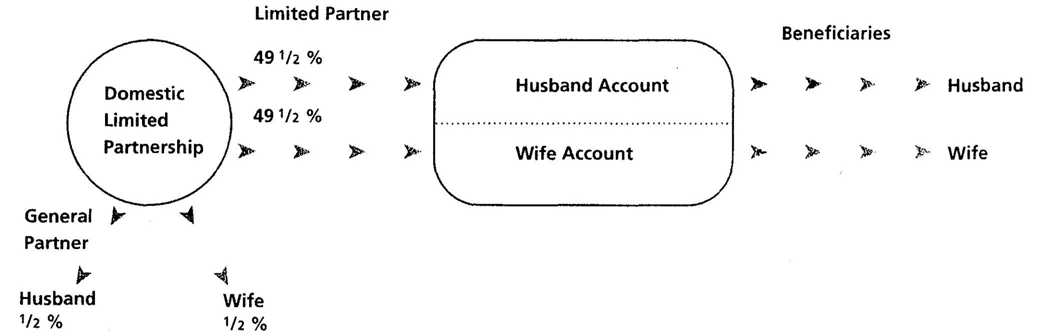
Under IRC §351(e), gain or loss is recognised if property is transferred to an investment company in exchange for stock. A transfer is deemed a transfer to an investment company if:

- the transfer results in a direct or indirect diversification of the transferors' interests (Diversification Requirement);
- the transferee is a corporation where more than 80 per cent of its assets are held for investment and are readily marketable securities (Marketable Securities Requirement).[3]

Even though IRC §351(e) refers only to a corporation, a partnership will also be classified as an investment company when there is a transfer of marketable securities to such partnership and the transfer meets the Diversification Requirement and the Marketable Securities Requirement.[4]

When two or more persons transfer non-identical marketable securities to a partnership, generally the Diversification ▶

Figure 2



Requirement is met.[5] If the husband transfers IBM stock and the wife transfers GM stock in exchange for their partnership interests, both the husband and wife now indirectly own undivided interests in both the IBM and GM stock. Since the husband and wife now have indirect ownership in each stock, the Diversification Requirement of Treas. Reg. §1.351-1(c)(5) has been met.

In addition to the Diversification Requirement being met, the Marketable Securities Requirement must also be met before the partnership will be considered an investment company. The Marketable Securities Requirement only looks at the percentage of the total assets of the FLP that are composed of marketable securities after the contribution. In order for the Marketable Securities Requirement to be met, 80 per cent of the assets of the FLP must consist of marketable securities. Therefore, if the husband contributes $1,000,000 worth of IBM stock and the wife contributes $500,00 worth of GM stock and a rental property worth $300,000, marketable securities represent 83 per cent of the FLP and the Marketable Securities Requirement is met.

As noted above, if both the Diversification Requirement and the Marketable Securities Requirements are met, the husband and wife will recognise $1.2m of gain attributable to the formation of the APT structure. This is obviously an unanticipated result of being considered an investment company under §351(e).

Proposed solutions

There are four possible solutions to the investment company dilemma in a two settlor APT structure:

- interspousal gifts;
- diversified portfolios;
- Contributing non-marketable security assets to the FLP;
- creating two separate FLPs.

The first two solutions avoid the FLP being classified as an investment company by failing the Diversification Requirement. The third solution avoids the FLP being classified as an investment company by failing the Marketable Securities Requirement. The fourth solution involves creating two separate FLPs to completely avoid the investment company issue.

Prior to the recently enacted Treas. Reg. §1.351-1(c)(6), in order for a husband and wife to avoid the Diversification Requirement, the husband and wife would each need to own and contribute the same marketable securities to the FLP. For example, if the husband owned only IBM stock and the wife owned only GM stock, they did not have identical assets and a contribution of the IBM and GM stock to the FLP would result in the recognition of gain under IRC §351(e). Therefore, in order to avoid meeting the Diversification Requirement, the husband and wife would both need to own IBM and GM stock prior to the contribution.

Under PLR 9012024, the husband gifted identical marketable securities to the wife. After the gift to the wife, identical portfolios were gifted to the FLP. Since the husband and wife both contributed identical portfolios to the FLP, the Diversification Requirement was not met, and therefore, the FLP was not considered an investment company under IRC §351(e).

While an interspousal gift prior to contributing the property to a FLP is a method to escape being classified as an investment company under IRC §351(e), should the couple ever divorce, many states consider a gift between spouses as non-marital property. In the divorce context, if the gift is considered non-marital property, the gifting spouse would not be entitled to any portion of such property upon the dissolution of the marriage.[6]

Under the newly enacted Treas. Reg. §1.351-1(c)(6), in addition to the husband and wife avoiding the Diversification Requirement by contributing the same marketable securities, the Diversification Requirement may be avoided by each spouse contributing a diversified portfolio to the FLP. Under IRC §368(a)(2)(F)(ii), a portfolio is diversified if:

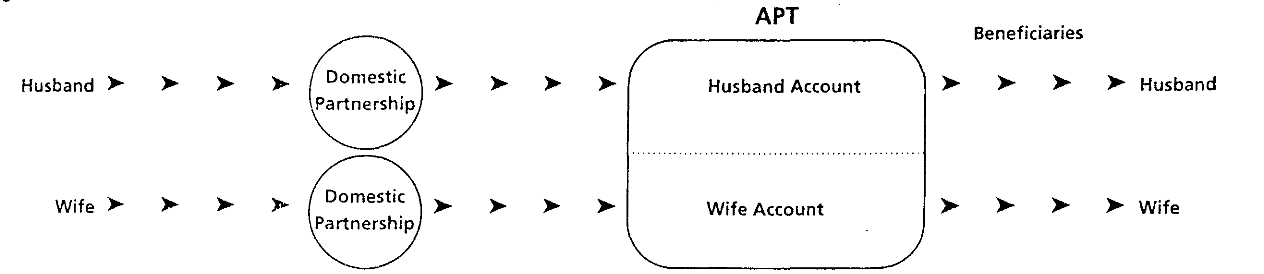
- not more than 25 per cent of the value of the portfolio is invested in the stock and securities of any one issuer;
- not more than 50 per cent of the value of the portfolio is invested in the stock of five or fewer issuers.

For example, if the husband's portfolio consisted of eleven marketable securities of approximately equal value and the wife's portfolio consisted of eleven marketable securities of approximately equal value, contribution of the two portfolios to the FLP would not result in meeting the Diversification Requirement.

The prior two methods avoided investment company classification be failing the Diversification Requirement. The third method avoids investment company classification by failing the Marketable Securities Requirement. As mentioned above, after the contribution to the FLP, marketable securities must represent over 80 per cent of the total assets of the FLP. Marketable securities do not include stock in a closely held C corporation, nor do marketable securities include business interests in partnership or limited liability companies. Therefore, many clients will avoid investment company status by contributing real estate, closely held C corporation stock, and business interests in partnerships or limited liability companies.[7]

As a fourth solution, the APT structure may involve two separate FLP's: one for the husband's assets and a second one for the wife's assets. Figure 3 is a diagram of this structure. While the two FLPs combined with the APT result in one more ▶

Figure 3



entity the client must work with, such a structure does solve the investment company problems of IRC §351(e) when the other three proposed solutions will not work for the client.[8]

Conclusion

IRC§351(e) creates a unique problem for the unwary asset protection planner. While the code section was never intended to apply to a two-settlor APT, if both the Diversification and Marketable Security Requirements are met, the FLP will be classified as an investment company and gain will be recognised on the transfer. Classification as an investment company may be defeated by failing either the Diversification Requirement, the Marketable Securities Requirement, or completely avoiding investment company status.

In order to fail the Diversification Requirement, the husband and wife may either contribute the same marketable securities to the FLP, or they each may contribute a diversified portfolio as generally defined under IRC §368(a)(2)(F)(ii). When a husband and wife contribute the same marketable securities to the FLP, both the husband and wife must have an ownership interest in each type of security. For example, if IBM and GM stock are contributed, both the husband and wife must each contribute stock in both companies. Generally, for a couple to have an ownership in each security, interspousal gifts must be made so that both spouses own stock in each company. An interspousal gift may have serious long-term ramifications in the event the couple ever divorces. In many states a gift is not considered marital property in the event of the dissolution of the marriage. On the other hand, contribution of a diversified portfolio by each spouse is a second method to defeat the Diversification Requirement. Each spouse has a diversified portfolio if each spouse owns at least eleven different marketable securities and the fair market value of any five of these securities does not exceed 50 per cent of the total fair market value of the spouses portfolio.

As an alternative to failing the Diversification Requirement, the asset protection planner may structure the contribution to the FLP to fail the Marketable Security Requirement. In order to avoid the Marketable Security Requirement, the husband and wife may contribute non-marketable security assets to the FLP in an amount so that the non-marketable securities comprise over 20 per cent of the fair market value of the FLP.

If due to the nature of the assets and the parties involved, the assets protection planner is unable to fail either the Diversification Requirement or the Marketable Security Requirement, the asset protection planner may avoid investment company classification by creating two separate FLPs. Under this scenario, the husband would be the sole general partner of one FLP and contribute his marketable securities to this FLP. The wife would be the sole general partner of the second FLP and contribute her marketable securities to this FLP. Even though the husband and wife would have one more entity to work with, the pitfall of IRC§351(e) would be avoided. The creation of two separate FLPs is a solution to the investment company problem when the other three proposed solutions solutions do not work. ■

Footnotes

[1] Currently, there is not any authority on whether certain tax treatment allowed to individuals is also allowed to a family limited partnership. For example, it is uncertain whether family limited partnership may deduct qualified resident interest under IRC§163(h). It is also uncertain whether a family limited partnership may rollover the gain from the sale of personal residence under IRC§1034. Also, if a client transfers subchapter S stock to a family limited partnership, it will terminate the subchapter S election.

[2] Assuming the foreign trustee is only performing the compliance work for the APT and is not managing any investments, typical annual fees for a foreign trustee range from $3,000 to $5,000 per trust. If both a husband and wife create separate APTs, their foreign trustee fees would be from $6,000 to $10,000 per year. On the other hand, with a two-settlor trust for both husband and wife, the annual foreign trustee fees are only one-half the cost.

[3] Treas. Reg. §1.351-(c)(1).

[4] IRC §721(b).

[5] Treas. Reg. §1.351-(c)(5).

[6] Any time spouses are considering gifts between themselves for either estate planning or asset protection planning purposes, asset protection planners need to advise their clients of the problems of divorce and the benefits of an ante-nuptial agreement.

[7] As noted before, if subchapter S stock is contributed to the FLP, it will terminate the subchapter S election.

[8] In fact, an APT combined with two or more FLPs may be the preferable structure. If the husband and wife contemplate gifting limited partnership interests to their children, two or more FLPs allow the husband and wife to gift different interests to different children. Also, multiple FLPs allow the husband and wife to segregate risks between entities depending on the type of assets contributed.