ADVANCED ESTATE PLANNING WITH IRAs

* USE OF IRAs IN FAMILY LIMITED PARTNERSHIPS

* ALTERNATIVE STRATEGIES INVOLING RESTRICTED MANAGEMENT ACCOUNTS

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Use of Individual Retirement Accounts in Family Limited Partnerships

I. Introduction

Family limited partnerships (FLPs) have become a widely used advanced estate-planning device. Practitioners consider the FLP a staple in their repertoire of tools used to reduce their client's estate tax exposure. In this regard, one common use of the FLP has been to provide a convenient mechanism for annual exclusion gifts of limited partnership interests to family members in order to reduce the value of an individual's gross estate.

Practitioners, perhaps optimistically, have set up FLPs seeking estate tax discounts. FLP's have also been successfully used in a host of lifetime situations. Thus, the FLP in the lifetime context is seen not just in conjunction with straight gifts of limited partnership (LP) interests but also with grantor retained annuity trusts, sales to grantor trusts as well as the more aggressive private annuities and self-canceling installment notes.

A salient feature of the above lifetime arrangements is the valuation of the limited partnership interests for transfer tax purposes. If the LP interests are valued at a substantial discount from their *pro rata* value, the transfer tax results can be significant. In addition to other benefits that may be obtained (asset protection planning, pooling of assets, centralized management, access to superior money managers), the difference between the *pro rata* value of the transferred LP interests and their fair market value escapes the transfer tax regime.

Planning in the context of Individual Retirement Accounts (IRAs) has tended to focus on the previously arcane rules surrounding minimum distributions, income tax issues and the use of charitable planning strategies. However, a 2000 Advisory Opinion by the Department of Labor (DOL) changed the landscape. (U.S. Department of Labor, Pension and Welfare Benefits Administration, Advisory Opinion 2000-10A. http://www.dol.gov/dol/pwba/public/programs/ori/advisory2000/2000-10a.htm)

The DOL opinion (discussed below) approved, with caveats, an IRA's investment in the family limited partnership context. The factual circumstances of that arrangement were complex and its analysis even more so because the entire discussion of this type of planning is circumscribed by the tedious "prohibited transaction rules" provided under Section 4975 of the Code. Enforcement of the prohibited transaction rules regarding IRAs was transferred from the IRS to the Department of Labor pursuant to the Presidential Reorganization Plan No. 4 of 1978. The Treasury is bound by such interpretations.

If an IRA engages in a so-called prohibited transaction, under the rules, the IRA ceases to be considered an IRA and all of the inherent income tax on the account is immediately payable (IRC 408(e)(2)). This makes a prohibited transaction the equivalent of a total distribution of the IRA.

Accordingly, a thorough understanding of the prohibited transaction rules is required to understand the DOL ruling referenced above and to make appropriate recommendations to clients as to whether or not an IRA should invest in a partnership. While the prospect of achieving aggressive discounts is a lure (and perhaps a trap for the unwary), careful practitioners will want to thoroughly familiarize themselves with the prohibited transaction rules under 4975 of the Code. These rules are discussed in detail below and included in the Appendix.

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II. DOL Advisory Opinion 2000-10A

A. The facts in the advisory opinion are as follows. An extended family created a general partnership. The pooling of assets in this partnership was necessary to retain the services of an investment advisor (unrelated) who required minimum capital accounts of at least $1,000,000. One of the family members – Adler – also wanted to invest about $500,000 of his IRA assets in the partnership. Based on the $1,000,000 capital requirement of the investment advisor, Adler would not have been able to take advantage of the investment advisor's services unless there was some pooling arrangement. Crucially, the partnership itself – without Adler's IRA – *would* have been able to utilize the services of the investment advisor. If the partnership could not have retained the advisor's services without the IRA, because Adler was a contributor to the partnership separately from his IRA, the DOL could have made an argument that Adler was benefiting himself by the transaction. This conclusion would easily follow if the IRA was *necessary* for the partnership's ability to hire the investment manager. In this case, the IRA was <u>not</u> necessary for the partnership to retain the investment manager's services. This point – that the partnership was eligible for the investment advisor's servies regardless of whether the IRA invested in the partnership – was a crucial factor in the DOL's analysis.

B. The partnership was converted from a general partnership into a limited partnership and Mr. Adler became the sole general partner. However, Mr. Adler had no management authority over the assets of the partnership. The investment advisory firm had sole control over the investments of the partnership. Mr. Adler would receive no compensation whatsoever. Additionally, it was specified that all of the limited partnership's assets would be held in liquid securities and none of the assets attributable to the investment by the IRA would be utilized to liquidate or redeem any of the other partners' interests in the partnership.

C. Adler requested an advisory opinion as to whether the proposed investment would constitute a prohibited transaction under Section 4975 of the Internal Revenue Code. The Department of Labor held that no prohibited transaction would occur. The pivotal determination by the Department of Labor was that the investment was a transaction between *the IRA* and the limited partnership, not between *Mr. Adler* and the IRA. Some commentators have suggested that the DOL elevated form over substance and that the partnership could have been viewed as an alter ego of Adler. If that were the case, they argue, the transaction should have been viewed as one between Adler and the IRA – a prohibited transaction. Nonetheless, the ruling was unequivocal on this point. In the view of the DOL, the transaction was between <u>the IRA and the FLP</u>.

D. One caveat of the ruling was that 4975(c)(1)(E) and (F) which prohibit transactions that are part of an agreement or understanding in which the fiduciary uses plan assets to primarily benefit <u>himself</u> are questions of fact which will not be ruled upon. However, it is permissible for a fiduciary to use plan assets to benefit the <u>plan</u>. But the question of whether the assets are being used to benefit the plan or to benefit the fiduciary are questions of fact on which the DOL will not rule. Given that background, after a summary of the prohibited transaction rules a possible strategy is discussed below.

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III. Prohibited Transaction

Under the Internal Revenue Code, a prohibited transaction is any direct or indirect sale or exchange of any property between a "plan" and a "disqualified person" (4975(c)(1)). An IRA is a plan (4975(e)(1)). Accordingly, the definition of a "disqualified" person is pivotal in the determination of whether or not an IRA's investment in a limited partnership will be considered a prohibited transaction. If the answer is that a particular partnership is a "disqualified person", the formation of a partnership with the IRA would thus subject the IRA owner to immediate income tax on the entire IRA.

IV. The Strategy in a Nutshell

A. An IRA owner (the participant) creates a limited partnership using both IRA and non-IRA assets with another individual or entity. Each partner receives a *pro rata* share of the partnership interests in exchange for his or her contribution to the partnership. The IRA assets, the IRA owner's other assets and the owner's family (defined below) assets represent less than 50% of the assets in the partnership. The IRA owner is not the general partner and receives no compensation (other than *pro rata* distributions going to all of the partners). Crucially, a factual issue must be discussed and addressed at the outset. The partnership must not receive a benefit (e.g. access to a money manager who has set a minimum account value) that hinges on the IRA's participation. Thus, if the partnership is accessing a money manager with a $10,000,000 minimum, the partnership must have $10,000,000 without considering the IRA funds. In short, whatever benefits will be received on the basis of the partnership formation, must have been available to the partnership if the IRA had not participated. After formation, the IRA assets now consist of LP interests, as the former assets of the IRA have been invested in the new partnership.

B. Distributions from the IRA to the owner, for example, of required minimum distributions, consist exclusively of LP interests. For income tax purposes, the LP interests are valued at their fair market value - presumably far less than their *pro rata* value. At the death of the IRA owner, the IRA's LP interests in the FLP are valued much less than their *pro rata* value. Treas. Reg. §20.2031-1(b) and §25.2512-1. Revenue Ruling 59-60, 1959-1 C.B. 237. See also, <u>Moore v. Commissioner</u>, 62 T.C.M. 1128 (1991); <u>Kerr v. Commissioner</u>, 113 T.C. 449 (1999) and <u>Strangi v. Commissioner</u>, 115 T.C. 35 (2000). In short, the same benefits available with traditional FLPs can, if the partnership is not a "disqualified person," be obtained for FLPs consisting, in part, of IRA assets.

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V. Comparison of an IRA and an IRA that has invested in an FLP

A. Assumptions:

IRA Value	$ 2,000,000
Growth Rate	8%
Assumed Discount Applicable to an LP Interest	40%
Assumed Age of IRA Owner	77

B. IRA with no Planning

Year	Beginning Value	Growth of IRA	Minimum Distributions	Tax on Minimum Distributions at 40%	End of Year Value	Estate Tax on IRA at 50% if owner passes away
2005	2,000,000	160,000	99,502	39,801	2,060,498	1,030,249
2006	2,060,498	164,840	107,318	42,927	2,118,020	1,059,010
2007	2,118,020	169,442	115,110	46,044	2,172,352	1,086,176
2008	2,172,352	173,788	123,429	49,372	2,222,711	1,111,355

Total Income Tax and Estate Tax at end of 4 Years if owner passes away at end of period 1,289,499

C. IRA Invested in an FLP

Year A	Beginning Value B	Growth C	Minimum Distributions D	FMV of Minimum Distribution E	Tax on Minimum Distributions at 40% F	End of Year Pro Rata Value G	FMV of End of Year Value H	Estate Tax on IRA at 50% if owner passes away I
2005	2,000,000	160,000	99,502	59,701	23,881	2,060,498	1,236,299	618,149
2006	2,060,498	164,840	107,318	64,391	25,756	2,118,020	1,270,812	635,406
2007	2,118,020	169,442	115,110	69,066	27,626	2,172,352	1,303,411	651,705
2008	2,172,352	173,788	123,429	74,057	29,623	2,222,711	1,333,626	666,813

Total Income Taxes and Estate Tax at end of 4 Years if owner passes away at end of period 773,699

D. Total Taxes Saved by Strategy: $ 515,800

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E. As can be seen from the chart, the discount associated with limited partnership interests results in the argued for income and estate tax savings. The savings will be proportional to the discount on the FLP interests and the size of the IRA. One cautionary note is necessary regarding an issue that has not been addressed by the DOL to date. Is the investment in the FLP a prudent investment considering the underlying assumption to the strategy? The estate planning objective of obtaining a fair market value of the IRA's interest that is less than the *pro rata* value may be inconsistent with the fiduciary duty to prudently invest the plan assets. In other words, the immediate reduction in value of the IRA investment (based on the discount associated with an LP interest) may be viewed as imprudent. See ERISA section 404(a)(1)(B).

VI. Definition Under the Internal Revenue Code of Who is a Disqualified Person.

A sale or exchange between a "plan" and a "disqualified person" results in the disqualification of the plan, and the entire inherent income tax on the plan becomes due. If a **partnership** is disqualified, an IRA's purchase of interests in the partnership would be a prohibited transaction. The determination of who is a disqualified person requires a rigorous and tortuous path through the Code, but one that is necessary.

A. IRC 4975(e)

1. (2) **Disqualified Persons**

A. A fiduciary; . . .

F. A member of the family (as defined in paragraph (6)) [See paragraph 3 below] of any individual described in subparagraph (A) [Fiduciaries], . . .

G. A corporation, partnership, or trust or estate of which (or in which) 50 percent or more of [the voting power, capital interest or beneficial interest] is owned directly or indirectly or held by persons described subparagraph (A) [Fiduciaries] . . .

2. (5) **Partnerships; trusts**.

For purposes of paragraph (G) . . . the ownership of profits or beneficial interests shall be determined in accordance with the rules for constructive ownership of stock provided in 267(c) (other than paragraph (3) thereof, except that section 267(c)(4) shall be treated as providing that the members of the family of an individual are the members with the meaning of paragraph (6).

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3. (6) **Member of the family**

For purposes of paragraph (2)(F), the family of any individual shall include his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant.

B. IRC 267(c)

(c) **Constructive ownership of stock**.

For purposes of determining, in applying subsection (b), the ownership of stock – . . .

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family; . . .

(4) [The family of any individual shall include his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant . . .]

C. Prohibited Transaction 4975(c)(1)

(1) General Rule. For purposes of this section, the term "prohibited transaction" means any direct or indirect –

(A) sale or exchange . . . of any property 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 income or assets of a plan in his own interest or for his own account;

(F) receipt of any consideration for his own personal account by any disqualified 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.

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VII. Application of these Definitions

Row Number	Person/ Entity	Disqualified?	Notes
1	IRA owner	Yes	Fiduciary. See 4975(e)(2)(A). (But what if the IRA owner irrevocably transferred her interest to a non-self directed IRA and retained no investment or direction powers?)
2	IRA	Probably Yes	A trust is disqualified if 50% or more of the beneficial interest is owned by a disqualified person. See 4975(e)(2)(G). Because the IRA (trust) is owned by a disqualified person (the fiduciary owner), the IRA would seem to always be a disqualified person.
3	Family Partnership owned by a fiduciary as to the IRA	Yes	A partnership, more than 50% of which is owned by a fiduciary is a disqualified person. See 4975(e)(2)(G).
4	Family Partnership controlled by IRA owner, owner's spouse, ancestor, lineal descendants, or any spouse of a lineal descendant	Yes	A partnership, more than 50% of which is controlled by certain members of the family of a fiduciary, will be considered owned by the fiduciary. See 4975(e)(6) and 4975(e)(5) which requires, under 4975(e)(2)(G), the constructive ownership tests of 267(c) to apply except that 267(c)(4) shall be treated as providing that members of the family are to be construed within the meaning of 4975(e)(6).
5	Family Partnership controlled by IRA owner's sibling	No	See notes above on 4975(e)(6) and 4975(e)(5) applying 4975(e)(6) to 267(c)(4).
6	Family Partnership less than 50% of which is controlled by IRA owner	No	See notes in Row 4 above.

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VIII. Consequences of Engaging in a Prohibited Transaction

An IRA that is involved in a prohibited transaction ceases to be an IRA and the income taxes on the IRA immediately become due as if the account had been distributed in its entirety on the first day of such tax year. IRC 408(e)(2).

IX. Unrelated Business Income

Income from any trade or business carried on by a qualified plan or by a partnership of which it is a member may be unrelated business income. The IRS may tax an otherwise tax-exempt entity that conducts business unrelated to its original purpose. The rules cover income-producing "businesses" in tax-exempt entities, including trusts (i.e. IRA trusts under section 408(e)(1) that are considered businesses). Investments can lose their tax-exempt status and be taxed as business entities even though they operate in a tax-exempt environment. The question of whether an investment in an FLP would be considered taxable is beyond the scope of this material but practitioners should be aware of this possibility.

X. Self-Dealing

Applying the rules above to our hypothetical (Paragraph IV) on page 4, if the partnership is structured as described (e.g., <50% owned by the fiduciary and "family"), the partnership should <u>not</u> be a disqualified person. One factual issue concerns 4975(c)(1)(E) and (F): these Code sections prohibit an act by a fiduciary whereby the fiduciary deals with the income or assets of a plan in the fiduciary's individual own interest. The rules also prohibit a fiduciary from receiving consideration in connection with a transaction involving the plan. These issues are questions of fact and practitioners must be careful to avoid factual situations – both at the outset of the partnership formation and down the road – where the DOL could argue that the fiduciary was benefiting the fiduciary/individual rather than the plan.

For example, the retention by a fiduciary of his son to provide administrative services to the IRA for a fee is likely a factual situation where a fiduciary had dealt with the plan in his own interest. Although the son's provision of services to the plan would be a prohibited transaction in and of itself, it may be exempt from excise tax if it meets the conditions of IRC 4975(d)(2). However, the fiduciary's action in causing the plan to pay a fee to his/her son is a separate prohibited transaction under IRC 4975(c)(1)(E) which would not be exempt under IRC 4975(d)(2).

Benefits for the plan are fine; however, benefits to the fiduciary are forbidden. For example, as in the earlier example an IRA may invest in a partnership in order to obtain the services of an investment advisor that would not be available to the IRA on its own because of the minimum account size required by the investment advisor. As long as the services of the advisor are available to the partnership without the IRA, then the investment by the IRA in the partnership appear to be a benefit to the IRA plan and not a benefit to the fiduciary. On the other hand, if the services of the investment advisor would not have been available to the partnership without the investment of the IRA in the partnership, the DOL would have an easier argument that the transaction was benefiting the fiduciary rather than the plan.

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XI. Nutshell Review

A. On page 3 a possible estate planning strategy was discussed. The goal is to ensure that in forming a limited partnership the planner does not run afoul of any of the prohibited transaction rules. Accordingly, upon formation, each partner should receive a *pro rata* share of the partnership interests in exchange for their contribution. This allocation addresses the factual argument discussed above and may prevent the DOL from alleging a prohibited transaction. In other words, by conferring *pro rata* shares at the outset, the DOL may not argue that the IRA owner received a gift at the time of the formation of the partnership.

B. Also, practitioners want to ensure that a combination of the IRA's interest, any individual interests of the IRA owner and the IRA owner's family represent less than 50% of the partnership. This addresses the 4975(e)(5) concern whereby a partnership is a disqualified person if 50% or more is owned by a fiduciary or member of the fiduciary's "family". Thus, if less than 50% is owned by a fiduciary (after considering the attribution rules including those under 267(c)), the partnership should not be considered a disqualified person. The IRA owner should not be a general partner or receive any compensation in order to address 4975(c)(1)(E) and (F) – i.e. the factual issues discussed above. If the IRA owner did receive compensation, the DOL might be able to sustain the view that the transaction allowed the fiduciary to deal with the plan assets for his own account – a prohibited transaction under 4975.

C. Finally, the benefits to be achieved by the partnership should not be contingent on the IRA's participation. If that were the case, the DOL could argue under 4975(c)(1)(e) that the IRA owner was using the plan for his own benefit. Thus, it is imperative that no benefit to the partnership, *e.g.,* access to a particular money manager, be contingent on participation by the IRA.

XII. Conclusion

The potential for IRAs to invest in limited partnerships is a new (and exciting) technique that should be considered by advanced estate planners who are familiar with the prohibited transaction rules. The potential savings to be achieved mirror those savings available for limited partnership transactions outside the IRA context. While there is uncertainty – and only select clients may want to assume the inherent risks – the importance of taking aggressive measures should militate in favor of looking at IRAs in this context. Particularly now, while the estate tax may be phased out, it is crucial that IRA assets be included in planning for clients who want to achieve aggressive transfer tax savings.

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XIII. Restricted Management Accounts

A "Restricted Management Account" ("RMA") is an account established with an investment manager under an agreement containing certain restrictions designed to enable the manager to improve the account's overall investment performance. These restrictions, with certain exceptions discussed below, prevent distributions from the account and also lock in an investment manager.

A. Description of the Restricted Management Account

1. **Creation and Terms**. To create an IRA RMA, an investor designates or establishes an individual retirement account and enters into a management agreement with an investment manager.

2. **Investment Manager**. Securities Exchange Commission (SEC) rules preclude registered investment advisors from entering into an RMA agreement. The SEC has taken the position that a registered investment advisor (RIA) may not restrict an investor's ability to withdraw his funds from the investment advisor. While this rule was certainly adopted in a different context, its applicability and effects are clear. Importantly however, non-registered investment advisors, such as many banks and trust companies, could enter into such arrangements because they are not subject to this SEC position.

The terms of the investment management agreement would include the following:

3. **Term Agreement**. During the specified term of the agreement (*e.g.*, 5 years), the investment manager has the exclusive right to manage, invest and reinvest the cash and securities in the account and the investor may not withdraw assets from the account (except for minimum required distributions).

   a) The reason for the fixed term of at least several years is to permit the investment manager to manage the account for greater long-term performance, rather than being forced to achieve short-term results in an effort to retain the investor as a client. By investing for the long term, the overall performance of the account may be increased. As an example, the "herd" mentality, elevated valuations (P/E ratios) and high trading volume of the late 1990s may have been symptomatic of investors' very short-term investment focus.

   b) At any time during the term of the agreement, the agreement could be extended by the parties for one or more additional years.

   c) Absent the consent of both parties (*i.e.*, the investor and the investment manager), the investor cannot change investment

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managers and the investment manager is obligated to manage the IRA assets until the RMA term ends. Distributions from the account – with the exception of minimum required distributions – are also restricted.

4. **Restrictions on Transfers**. Ownership of the RMA or any portion of it may not be transferred until the owner's death because it is an IRA account. A minimum required distribution may be distributed from the IRA and these proceeds are not subject to the RMA's restrictions.

a) The purpose of the prohibition on non-MRD distributions from the IRA is based on the original agreement and purpose of the RMA. The RMA is set up for long term growth, with a long term investment horizon for the manager. Thus, the only expected (and permitted withdrawls that do not require consent) are the required minimum distributions. The exception for minimum required distributions to the IRA owner is required under the Code.

b) Any MRDs may be transferable in whole or in part following a taxable distribution from the IRA to the IRA owner. If the investor does wish to transfer a MRD, the account could be divided, at the investor's direction, and the resulting account then would not be subject to the RMA unless a new agreement was entered into with the investment manager.

5. **Income Distributions**. The agreement would direct that all the accounting (book) income earned by the account would be be reinvested as a part of the IRA account.

6. **Benefits of Restricted Management Account**. The tax and non-tax benefits provided by the RMA include the following:

a) **Greater Investment Performance**. As discussed, the fixed term of the RMA permits the investment manager to manage the account assets for greater long-term investment performance. This is the primary non-tax benefit.

b) **Reduced Investment Management Fees**. The investor may be able to negotiate a lower investment management fee in exchange for the advisor having a guaranteed fee over the fixed term of the agreement.

c) **Valuation Discounts.** As a consequence of the various restrictions inherent in the RMA, minimum distributions during life, and the account value at death, should be entitled to valuation discounts for gift and estate

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tax valuation purposes based on lack of marketability and lack of control.[1] The transfer tax saving resulting from the discounted valuation may benefit the investor's heirs. Required taxable minimum distributions during life may be minimized because of the discounted account value as determined by a professional appraiser.

7. **Cost Effective Creation and Administration**. The RMA may be more straightforward to create and less expensive to administer than other estate planning techniques used to obtain valuation discounts, such as family limited partnerships. One of the primary expenses will be the annual valuation that is required.

8. **Income Tax Reporting**. As with any IRA, the investor need not report any income, gains or losses of the RMA on his personal income tax return. Only taxable distributions are reported.

9. **Flexibility in Making Gifts**. The investor does not need to make an educated guess about which securities are the most likely to appreciate significantly in deciding which securities to gift following a taxable distribution. Instead, the investor may direct that his RMA distribution be made in kind with a fractional interest in every security from the original account. The investor then may gift such a portfolio – and if the manager agrees, subject to the RMA terms - to a family member.

B. Example of Use of Restricted Management Account in the IRA Context

Mr. Smith owns $5 million of marketable securities in an IRA that is currently managed by a large bank. To achieve greater long-term investment performance, Mr. Smith establishes an RMA at the bank. Under the RMA agreement, the bank is obligated to manage the securities in the IRA/RMA for a period of five years. At the end of the five year term, the account will terminate and the IRA will be free of the RMA restrictions. All income and capital gains will be reinvested in the IRA/RMA by the bank. During the five year period, Mr. Smith may make minimum required distributions. Three options are possible. First, distributions could be made from other IRA accounts held by Mr. Smith. Second, distributions could be made in cash from the IRA/RMA. Third, the required distributions could be made "in kind."

Two years later, when the IRA is worth, say, $6 million, Mr. Smith makes a required minimum distribution from the IRA. He also wants to gift his distribution to a trust for the benefit of his children. Under the minimum distribution rules, assume the required distribution is one tenth of the account value. If a 33% discount was applicable to the IRA/RMA, then the value of the IRA/RMA would have a reported value of $4 million, rather than $6 million. Mr. Smith directs the bank to distribute a $400,000 payment (rather than $600,000 that would have

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[1] The appraisal of an RMA first would require the valuation of the underlying investment assets, and then the application of lack of marketability and minority discounts to reflect the lack of access to and control over such property.

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been required if no RMA was in place). This leaves $5.6 million in the IRA/RMA. Mr. Smith then reports the distribution and makes a taxable transfer of the $400,000 account to the trust for the benefit of his children outside of the IRA context. The trust could enter into an agreement with the bank to subject that account to the RMA if the bank consents.

For simplicity, assume that Mr. Smith pays the tax on the IRA distribution from other assets.

During the next three years, the IRA/RMA enjoys investment success, achieving an annualized rate of return of 12%. The RMA agreement terminates at the end of the fifth year, at which time the trust for his children holds securities worth about $560,000, and Mr. Smith holds nearly $8 million in his IRA/RMA. (Further required distributions are ignored for simplicity of the illustration.)

Pleased with the returns on his RMA, Mr. Smith renews his RMA for another five years, and extends the term at the end of each year for one additional year, thus always maintaining an unexpired term of four to five years. Mr. Smith dies 10 years after the original RMA was established, at which time the securities in his RMA have a value of nearly $14 million (assuming a 12% annualized rate of return, and for simplicity, no further distributions). Because the securities are still subject to the RMA agreement that will not terminate for four to five more years, a 33% valuation discount is claimed based on a professional appraisal. Thus, for estate tax purposes, the RMA is valued at just over 9.2 million. Assuming the RMA does not pass to a surviving spouse or charity, the nearly $4 million valuation discount saves nearly $2 million of estate tax.

C. Risks of the IRA/RMA

An IRA/RMA is an aggressive planning technique that is not sanctioned by Congress or the Treasury. Furthermore, no court has had the opportunity to opine on this strategy. Accordingly, there is uncertainty as to how the strategy will be treated if challenged. The RMA concept is built upon a straightforward tool – restrictions on transfereability imply a discounted value – but which is under attack by the Service. Fundamentally, the Service is challenging valuation discounts that they claim are predicated on strategies put in place solely to reduce transfer taxes. Further, efforts to discount an IRA for estate tax purposes have so far met with failure. See, for example, Carlin v. Division of Taxation, 19 NJ Tax 545, Dkt. No. 001852-2000, 7-9-2001, which denied an appeal by a taxpayer on an assessment of New Jersey inheritance taxes on an IRA he inherited from his sister. The taxpayer claimed that he was entitled to reduce the value of the IRA by the Federal and New Jersey income taxes payable in connection with its distribution.

Chapter 14 of the Code and specifically Section 2703 could be applied by the Service in the case of an IRA/RMA. The IRS could argue that the IRA/RMA itself is a “device” to transfer property for inadequate consideration and Code §2703 applies. Thus, the IRS would argue Code §2703 allows the IRS to value the underlying securities in the RMA and disregard the RMA restrictions.

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Code Section 2703 as applied to FLPs may provide some comfort on this point because of the Service's lack of success. The IRS's arguments that Code §2703 should be invoked to disregard discounts on FLP interests held by an individual at death have been rejected by the Tax Court. See Church v. United States, 2000-1 U.S.T.C. (CCH) ¶60369 (W.D.Tex. 2000) aff'd, 268 F.3d 1063 (5th Cir. 2001); Estate of Strangi v. Commissioner, 115 TC No 35 (2000) affirmed in part, reversed in part 293 F.3d 279 (5th Circuit 2002) rehearing and rehearing en banc denied 2002 WL 31017825 (5th Cir. 2002) and on remand to T.C. Memo 2003-145, 2003 WL 21166046 (May 20, 2003). Although the IRS has lost on the 2703 argument at the Tax Court level, they are likely to continue to invoke Code §2703 arguments. See for example Field Service Advisory 200049003 (Sept. 1, 2000); Field Service Advisory 200143004 (July 5, 2001).

In certain contexts, the IRS continues to argue that the language of Code §2703 applies to estate planning structures and the applicability of discounts. Thus, they would focus on Code §2703(a)(2). "[T]he value of any property shall be determined without regard to . . . (2) any restriction on the right to sell or use such property." Code §2703(a). Additionally, Code §2703(b) provides that Code §2703(a) shall *not* apply to any right or restriction that is *not* a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

The Senate report on Code §2703 indicates that the "mere showing that the agreement is a bona fide business arrangement would not give the agreement estate tax effect if other facts indicate the agreement is a device to transfer property to members of the decedent's family for less than full and adequate consideration." Explanatory Material Concerning Committee on Finance 1990 Reconciliation Submission Pursuant to House Concurrent Resolution 310, 101st Cong., 2d Sess., 136 Cong.Rec. p. 15632, 15683.

However, the RMA should be able to pass muster under Section 2703 because it ***is*** a bona fide business arrangement. Because the purpose is to maximize long term investment returns, the restrictions on transfer are a necessary part of the arrangement. Further, because the RMA restrictions reduce the value of the IRA to the IRA holder and, ultimately, to a beneficiary receiving such assets, it should not be considered a "device." Clearly, the RMA is not being set up solely, or perhaps even primarily, to reduce transfer taxes. For these reasons, the Code §2703 arguments may be more difficult for the IRS to sustain with respect to an RMA then, for example, a partnership that is not adequately documented and administered.

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Appendix

A. Code Section 4975

B. Code Section 267

C. DOL Advisory Opinion 2000-10A

Appendix A – Code Section 4975

Sec. 4975 Tax on prohibited transactions

§ 4975. Tax on prohibited transactions

(a) Initial taxes on disqualified person.--There is hereby imposed a tax on each prohibited transaction. The rate of tax shall be equal to 15 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such).

(b) Additional taxes on disqualified person.--In any case in which an initial tax is imposed by subsection (a) on a prohibited transaction and the transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 100 percent of the amount involved. The tax imposed by this subsection shall be paid by any disqualified person who participated in the prohibited transaction (other than a fiduciary acting only as such).

(c) Prohibited transaction.--

(1) General rule.--For purposes of this section, the term "prohibited transaction" means 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 income or assets of a plan in his own interest or for his own account; or

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(F) receipt of any consideration for his own personal account by any disqualified 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.

(2) Special exemption.--The Secretary shall establish an exemption procedure for purposes of this subsection. Pursuant to such procedure, he may grant a conditional or unconditional exemption of any disqualified person or transaction, orders of disqualified persons or transactions, from all or part of the restrictions imposed by paragraph (1) of this subsection. Action under this subparagraph may be taken only after consultation and coordination with the Secretary of Labor. The Secretary may not grant an exemption under this paragraph unless he finds that such exemption is--

(A) administratively feasible,

(B) in the interests of the plan and of its participants and beneficiaries, and

(C) protective of the rights of participants and beneficiaries of the plan.

Before granting an exemption under this paragraph, the Secretary shall require adequate notice to be given to interested persons and shall publish notice in the Federal Register of the pendency of such exemption and shall afford interested persons an opportunity to present views. No exemption may be granted under this paragraph with respect to a transaction described in subparagraph (E) or (F) of paragraph (1) unless the Secretary affords an opportunity for a hearing and makes a determination on the record with respect to the findings required under subparagraphs (A), (B), and (C) of this paragraph, except that in lieu of such hearing the Secretary may accept any record made by the Secretary of Labor with respect to an application for exemption under section 408(a) of title I of the Employee Retirement Income Security Act of 1974.

(3) Special rule for individual retirement accounts.--An individual for whose benefit an individual retirement account is established and his beneficiaries shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if, with respect to such transaction, the account ceases to be an individual retirement account by reason of the application of section 408(e)(2)(A) or if section 408(e)(4) applies to such account.

(4) Special rule for Archer MSAs.--An individual for whose benefit an Archer MSA (within the meaning of section 220(d)) is established shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if section 220(e)(2) applies to such transaction.

(5) Special rule for Coverdell education savings accounts.--An individual for whose benefit a Coverdell education savings account is established and any contributor to such account shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if section 530(d) applies with respect to such transaction.

(d) Exemptions.--Except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to--

(1) any loan made by the plan to a disqualified person who is a participant or beneficiary of the plan if such loan--

(A) is available to all such participants or beneficiaries on a reasonably equivalent basis,

(B) is not made available to highly compensated employees (within the meaning of section 414(q)) in an amount greater than the amount made available to other employees,

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(C) is made in accordance with specific provisions regarding such loans set forth in the plan,
(D) bears a reasonable rate of interest, and
(E) is adequately secured;
(2) any contract, or reasonable arrangement, made with a disqualified person for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor;
(3) any loan to an [FN1] leveraged employee stock ownership plan (as defined in subsection (e)(7)), if--
(A) such loan is primarily for the benefit of participants and beneficiaries of the plan, and
(B) such loan is at a reasonable rate of interest, and any collateral which is given to a disqualified person by the plan consists only of qualifying employer securities (as defined in subsection (e)(8));
(4) the investment of all or part of a plan's assets in deposits which bear a reasonable interest rate in a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan and if--
(A) the plan covers only employees of such bank or other institution and employees of affiliates of such bank or other institution, or
(B) such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or institution or affiliates thereof) who is expressly empowered by the plan to so instruct the trustee with respect to such investment;
(5) any contract for life insurance, health insurance, or annuities with one or more insurers which are qualified to do business in a State if the plan pays no more than adequate consideration, and if each such insurer or insurers is--
(A) the employer maintaining the plan, or
(B) a disqualified person which is wholly owned (directly or indirectly) by the employer establishing the plan, or by any person which is a disqualified person with respect to the plan, but only if the total premiums and annuity considerations written by such insurers for life insurance, health insurance, or annuities for all plans (and their employers) with respect to which such insurers are disqualified persons (not including premiums or annuity considerations written by the employer maintaining the plan) do not exceed 5 percent of the total premiums and annuity considerations written for all lines of insurance in that year by such insurers (not including premiums or annuity considerations written by the employer maintaining the plan);
(6) the provision of any ancillary service by a bank or similar financial institution supervised by the United States or a State, if such service is provided at not more than reasonable compensation, if such bank or other institution is a fiduciary of such plan, and if--
(A) such bank or similar financial institution has adopted adequate internal safeguards which assure that the provision of such ancillary service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority, and
(B) the extent to which such ancillary service is provided is subject to specific guidelines issued by such bank or similar financial institution (as determined by the Secretary after consultation with Federal and State supervisory authority), and under such guidelines the bank or similar financial institution does not provide such ancillary service--
(i) in an excessive or unreasonable manner, and
(ii) in a manner that would be inconsistent with the best interests of participants and beneficiaries of employee benefit plans;

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(7) the exercise of a privilege to convert securities, to the extent provided in regulations of the Secretary, but only if the plan receives no less than adequate consideration pursuant to such conversion;

(8) any transaction between a plan and a common or collective trust fund or pooled investment fund maintained by a disqualified person which is a bank or trust company supervised by a State or Federal agency or between a plan and a pooled investment fund of an insurance company qualified to do business in a State if--

(A) the transaction is a sale or purchase of an interest in the fund,

(B) the bank, trust company, or insurance company receives not more than reasonable compensation, and

(C) such transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank, trust company, or insurance company, or an affiliate thereof) who has authority to manage and control the assets of the plan;

(9) receipt by a disqualified person of any benefit to which he may be entitled as a participant or beneficiary in the plan, so long as the benefit is computed and paid on a basis which is consistent with the terms of the plan as applied to all other participants and beneficiaries;

(10) receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan, but no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred;

(11) service by a disqualified person as a fiduciary in addition to being an officer, employee, agent, or other representative of a disqualified person;

(12) the making by a fiduciary of a distribution of the assets of the trust in accordance with the terms of the plan if such assets are distributed in the same manner as provided under section 4044 of title IV of the Employee Retirement Income Security Act of 1974 (relating to allocation of assets);

(13) any transaction which is exempt from section 406 of such Act by reason of section 408(e) of such Act (or which would be so exempt if such section 406 applied to such transaction) or which is exempt from section 406 of such Act by reason of section 408(b)(12) of such Act;

(14) any transaction required or permitted under part 1 of subtitle E of title IV or section 4223 of the Employee Retirement Income Security Act of 1974, but this paragraph shall not apply with respect to the application of subsection (c)(1)(E) or (F); or

(15) a merger of multiemployer plans, or the transfer of assets or liabilities between multiemployer plans, determined by the Pension Benefit Guaranty Corporation to meet the requirements of section 4231 of such Act, but this paragraph shall not apply with respect to the application of subsection (c)(1)(E) or (F).

(e) Definitions.--

(1) Plan.--For purposes of this section, the term "plan" means--

(A) a trust described in section 401(a) which forms a part of a plan, or a plan described in section 403(a), which trust or plan is exempt from tax under section 501(a),

(B) an individual retirement account described in section 408(a),

(C) an individual retirement annuity described in section 408(b),

(D) an Archer MSA described in section 220(d),

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(E) a Coverdell education savings account described in section 530, or
(F) a trust, plan, account, or annuity which, at any time, has been determined by the Secretary to be described in any preceding subparagraph of this paragraph.
(2) Disqualified person.--For purposes of this section, the term "disqualified person" means a person who is--
(A) a fiduciary;
(B) a person providing services to the plan;
(C) an employer any of whose employees are covered by the plan;
(D) an employee organization any of whose members are covered by the plan;
(E) an owner, direct or indirect, of 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 a corporation,
(ii) the capital interest or the profits interest of a partnership, or
(iii) the beneficial interest of a trust or unincorporated enterprise,

which is an employer or an employee organization described in subparagraph (C) or (D);
(F) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);
(G) 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), (B), (C), (D), or (E);
(H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or
(I) a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G).

The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than 50 percent for subparagraphs (E) and (G) and lower than 10 percent for subparagraphs (H) and (I).
(3) Fiduciary.--For purposes of this section, the term "fiduciary" means any person who--
(A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,
(B) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or
(C) has any discretionary authority or discretionary responsibility in the administration of such plan.

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Such term includes any person designated under section 405(c)(1)(B) of the Employee Retirement Income Security Act of 1974.

(4) Stockholdings.--For purposes of paragraphs (2)(E)(i) and (G)(i) there shall be taken into account indirect stockholdings which would be taken into account under section 267(c), except that, for purposes of this paragraph, section 267(c)(4) shall be treated as providing that the members of the family of an individual are the members within the meaning of paragraph (6).

(5) Partnerships; trusts.--For purposes of paragraphs (2)(E)(ii) and (iii), (G)(ii) and (iii), and (I) the ownership of profits or beneficial interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) (other than paragraph (3) thereof), except that section 267(c)(4) shall be treated as providing that the members of the family of an individual are the members within the meaning of paragraph (6).

(6) Member of family.--For purposes of paragraph (2)(F), the family of any individual shall include his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant.

(7) Employee stock ownership plan.--The term "employee stock ownership plan" means a defined contribution plan--

(A) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and

(B) which is otherwise defined in regulations prescribed by the Secretary.

A plan shall not be treated as an employee stock ownership plan unless it meets the requirements of section 409(h), section 409(o), and, as applicable, section 409(n), section 409(p) [FN2], and section 664(g) and, if the employer has a registration-type class of securities (as defined in section 409(e)(4)), it meets the requirements of section 409(e).

(8) Qualifying employer security.--The term "qualifying employer security" means any employer security within the meaning of section 409(l). If any moneys or other property of a plan are invested in shares of an investment company registered under the Investment Company Act of 1940, the investment shall not cause that investment company or that investment company's investment adviser or principal underwriter to be treated as a fiduciary or a disqualified person for purposes of this section, except when an investment company or its investment adviser or principal underwriter acts in connection with a plan covering employees of the investment company, its investment adviser, or its principal underwriter.

(9) Section made applicable to withdrawal liability payment funds.--For purposes of this section--

(A) In general.--The term "plan" includes a trust described in section 501(c)(22).

(B) Disqualified person.--In the case of any trust to which this section applies by reason of subparagraph (A), the term "disqualified person" includes any person who is a disqualified person with respect to any plan to which such trust is permitted to make payments under section 4223 of the Employee Retirement Income Security Act of 1974.

(f) Other definitions and special rules.--For purposes of this section--

(1) Joint and several liability.--If more than one person is liable under subsection (a) or (b) with respect to any one prohibited transaction, all such persons shall be jointly and severally liable under such subsection with respect to such transaction.

(2) Taxable period.--The term "taxable period" means, with respect to any prohibited transaction, the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of--

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(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a) under section 6212,

(B) the date on which the tax imposed by subsection (a) is assessed, or

(C) the date on which correction of the prohibited transaction is completed.

(3) Sale or exchange; encumbered property.--A transfer of real or personal property by a disqualified person to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer.

(4) Amount involved.--The term "amount involved" means, with respect to a prohibited transaction, the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received; except that, in the case of services described in paragraphs (2) and (10) of subsection (d) the amount involved shall be only the excess compensation. For purposes of the preceding sentence, the fair market value--

(A) in the case of the tax imposed by subsection (a), shall be determined as of the date on which the prohibited transaction occurs; and

(B) in the case of the tax imposed by subsection (b), shall be the highest fair market value during the taxable period.

(5) Correction.--The terms "correction" and "correct" mean, with respect to a prohibited transaction, undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would be if the disqualified person were acting under the highest fiduciary standards.

(6) Exemptions not to apply to certain transactions.--

(A) In general.--In the case of a trust described in section 401(a) which is part of a plan providing contributions or benefits for employees some or all of whom are owner-employees (as defined in section 401(c)(3)), the exemptions provided by subsection (d) (other than paragraphs (9) and (12)) shall not apply to a transaction in which the plan directly or indirectly--

(i) lends any part of the corpus or income of the plan to,

(ii) pays any compensation for personal services rendered to the plan to, or

(iii) acquires for the plan any property from, or sells any property to,

any such owner-employee, a member of the family (as defined in section 267(c)(4)) of any such owner-employee, or any corporation in which any such owner-employee owns, directly or indirectly, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

(B) Special rules for shareholder-employees, etc.--

(i) In general.--For purposes of subparagraph (A), the following shall be treated as owner-employees:

(I) A shareholder-employee.

(II) A participant or beneficiary of an individual retirement plan (as defined in section 7701(a)(37)).

(III) An employer or association of employees which establishes such an individual retirement plan under section 408(c).

(ii) Exception for certain transactions involving shareholder-employees.-- Subparagraph (A)(iii) shall not apply to a transaction which consists of a sale of employer securities to an

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employee stock ownership plan (as defined in subsection (e)(7)) by a shareholder-employee, a member of the family (as defined in section 267(c)(4)) of such shareholder-employee, or a corporation in which such a shareholder-employee owns stock representing a 50 percent or greater interest described in subparagraph (A).

(iii) Loan exception.--For purposes of subparagraph (A)(i), the term "owner- employee" shall only include a person described in subclause (II) or (III) of clause (i).

(C) Shareholder-employee.--For purposes of subparagraph (B), the term "shareholder-employee" means an employee or officer of an S corporation who owns (or is considered as owning within the meaning of section 318(a)(1)) more than 5 percent of the outstanding stock of the corporation on any day during the taxable year of such corporation.

(g) Application of section.--This section shall not apply--

(1) in the case of a plan to which a guaranteed benefit policy (as defined in section 401(b)(2)(B) of the Employee Retirement Income Security Act of 1974) is issued, to any assets of the insurance company, insurance service, or insurance organization merely because of its issuance of such policy;

(2) to a governmental plan (within the meaning of section 414(d)); or

(3) to a church plan (within the meaning of section 414(e)) with respect to which the election provided by section 410(d) has not been made.

In the case of a plan which invests in any security issued by an investment company registered under the Investment Company Act of 1940, the assets of such plan shall be deemed to include such security but shall not, by reason of such investment, be deemed to include any assets of such company.

(h) Notification of Secretary of Labor.--Before sending a notice of deficiency with respect to the tax imposed by subsection (a) or (b), the Secretary shall notify the Secretary of Labor and provide him a reasonable opportunity to obtain a correction of the prohibited transaction or to comment on the imposition of such tax.

(i) Cross reference.--

For provisions concerning coordination procedures between Secretary of Labor and Secretary of the Treasury with respect to application of tax imposed by this section and for authority to waive imposition of the tax imposed by subsection (b), see section 3003 of the Employee Retirement Income Security Act of 1974.

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Sec. 267 Losses, expenses, and interest with respect to transactions between related taxpayers

§ 267. Losses, expenses, and interest with respect to transactions between related taxpayers

(a) In general.--
(1) Deduction for losses disallowed.--No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.
(2) Matching of deduction and payee income item in the case of expenses and interest.--If--
(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and
(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)), such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).
(3) Payments to foreign persons.--The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.
(b) Relationships.--The persons referred to in subsection (a) are:
(1) Members of a family, as defined in subsection (c)(4);
(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
(3) Two corporations which are members of the same controlled group (as defined in subsection (f));
(4) A grantor and a fiduciary of any trust;
(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
(6) A fiduciary of a trust and a beneficiary of such trust;
(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

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(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(10) A corporation and a partnership if the same persons own--

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

(c) Constructive ownership of stock.--For purposes of determining, in applying subsection (b), the ownership of stock--

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

(d) Amount of gain where loss previously disallowed.--If--

(1) in the case of a sale or exchange of property to the taxpayer a loss sustained by the transferor is not allowable to the transferor as a deduction by reason of subsection (a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939); and

(2) after December 31, 1953, the taxpayer sells or otherwise disposes of such property (or of other property the basis of which in his hands is determined directly or indirectly by reference to such property) at a gain,

then such gain shall be recognized only to the extent that it exceeds so much of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer. This subsection applies with respect to taxable years ending after December 31, 1953. This subsection shall not apply if the loss sustained by the transferor is not allowable to the transferor as a deduction by

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reason of section 1091 (relating to wash sales) or by reason of section 118 of the Internal Revenue Code of 1939.

(e) Special rules for pass-thru entities.--

(1) In general.--In the case of any amount paid or incurred by, to, or on behalf of, a pass-thru entity, for purposes of applying subsection (a)(2)--

(A) such entity,

(B) in the case of--

(i) a partnership, any person who owns (directly or indirectly) any capital interest or profits interest of such partnership, or

(ii) an S corporation, any person who owns (directly or indirectly) any of the stock of such corporation,

(C) any person who owns (directly or indirectly) any capital interest or profits interest of a partnership in which such entity owns (directly or indirectly) any capital interest or profits interest, and

(D) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to a person described in subparagraph (B) or (C),

shall be treated as persons specified in a paragraph of subsection (b). Subparagraph (C) shall apply to a transaction only if such transaction is related either to the operations of the partnership described in such subparagraph or to an interest in such partnership.

(2) Pass-thru entity.--For purposes of this section, the term "pass-thru entity" means--

(A) a partnership, and

(B) an S corporation.

(3) Constructive ownership in the case of partnerships.--For purposes of determining ownership of a capital interest or profits interest of a partnership, the principles of subsection (c) shall apply, except that--

(A) paragraph (3) of subsection (c) shall not apply, and

(B) interests owned (directly or indirectly) by or for a C corporation shall be considered as owned by or for any shareholder only if such shareholder owns (directly or indirectly) 5 percent or more in value of the stock of such corporation.

(4) Subsection (a)(2) not to apply to certain guaranteed payments of partnerships.--In the case of any amount paid or incurred by a partnership, subsection (a)(2) shall not apply to the extent that section 707(c) applies to such amount.

(5) Exception for certain expenses and interest of partnerships owning low- income housing.--

(A) In general.--This subsection shall not apply with respect to qualified expenses and interest paid or incurred by a partnership owning low-income housing to--

(i) any qualified 5-percent or less partner of such partnership, or

(ii) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to any qualified 5-percent or less partner of such partnership.

(B) Qualified 5-percent or less partner.--For purposes of this paragraph, the term "qualified 5-percent or less partner" means any partner who has (directly or indirectly) an interest of 5 percent or less in the aggregate capital and profits interests of the partnership but only if--

(i) such partner owned the low-income housing at all times during the 2-year period ending on the date such housing was transferred to the partnership, or

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(ii) such partnership acquired the low-income housing pursuant to a purchase, assignment, or other transfer from the Department of Housing and Urban Development or any State or local housing authority.

For purposes of the preceding sentence, a partner shall be treated as holding any interest in the partnership which is held (directly or indirectly) by any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to such partner.

(C) Qualified expenses and interest.--For purpose of this paragraph, the term "qualified expenses and interest" means any expense or interest incurred by the partnership with respect to low-income housing held by the partnership but--

(i) only if the amount of such expense or interest (as the case may be) is unconditionally required to be paid by the partnership not later than 10 years after the date such amount was incurred, and

(ii) in the case of such interest, only if such interest is incurred at an annual rate not in excess of 12 percent.

(D) Low-income housing.--For purposes of this paragraph, the term "low-income housing" means--

(i) any interest in property described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B), and

(ii) any interest in a partnership owning such property.

(6) Cross reference.--

For additional rules relating to partnerships, see section 707(b).

(f) Controlled group defined; special rules applicable to controlled groups.--

(1) Controlled group defined.--For purposes of this section, the term "controlled group" has the meaning given to such term by section 1563(a), except that--

(A) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a), and

(B) the determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of section 1563.

(2) Deferral (rather than denial) of loss from sale or exchange between members.--In the case of any loss from the sale or exchange of property which is between members of the same controlled group and to which subsection (a)(1) applies (determined without regard to this paragraph but with regard to paragraph (3))--

(A) subsections (a)(1) and (d) shall not apply to such loss, but

(B) such loss shall be deferred until the property is transferred outside such controlled group and there would be recognition of loss under consolidated return principles or until such other time as may be prescribed in regulations.

(3) Loss deferral rules not to apply in certain cases.--

(A) Transfer to DISC.--For purposes of applying subsection (a)(1), the term "controlled group" shall not include a DISC.

(B) Certain sales of inventory.--Except to the extent provided in regulations prescribed by the Secretary, subsection (a)(1) shall not apply to the sale or exchange of property between members of the same controlled group (or persons described in subsection (b)(10)) if--

(i) such property in the hands of the transferor is property described in section 1221(a)(1),

(ii) such sale or exchange is in the ordinary course of the transferor's trade or business,

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(iii) such property in the hands of the transferee is property described in section 1221(a)(1), and

(iv) the transferee or the transferor is a foreign corporation.

(C) Certain foreign currency losses.--To the extent provided in regulations, subsection (a)(1) shall not apply to any loss sustained by a member of a controlled group on the repayment of a loan made to another member of such group if such loan is payable in a foreign currency or is denominated in such a currency and such loss is attributable to a reduction in value of such foreign currency.

(4) Determination of relationship resulting in disallowance of loss, for purposes of other provisions.--For purposes of any other section of this title which refers to a relationship which would result in a disallowance of losses under this section, deferral under paragraph (2) shall be treated as disallowance.

(g) Coordination with section 1041.--Subsection (a)(1) shall not apply to any transfer described in section 1041(a) (relating to transfers of property between spouses or incident to divorce).

Appendix C Advisory Opinion 2000-10A

July 27, 2000

Hugh Janow	2000 - 10A
Janow & Meyer, LLC	ERISA SEC.
One Blue Hill Plaza	4975(c)(1)
P.O. Box 1606 Suite 1006	
Pearl River, N.Y. 10965-8606	

Dear Mr. Janow:

This is in response to your request for an advisory opinion under section 4975 of the Internal Revenue Code (Code). Specifically, you ask whether allowing the owner of an IRA to direct the IRA to invest in a limited partnership, in which relatives and the IRA owner in his individual capacity are partners, will violate section 4975 of the Code.[1]

You represent that the Fetner Family Partnership is a New York general partnership that is an investment club (the Partnership), in which Mr. Adler, through a general partnership known as Esponda Associates (Esponda), and various relatives of Mr. Adler invest. Through his investment in Esponda, which is a pass-through partnership, Mr. Adler owns a 12.11 percent interest in the Partnership. Mr. Adler presently owns a 30.38 percent interest in Esponda. The only other partner in Esponda is David Geiger, who is unrelated to Mr. Adler. Esponda currently owns a 39.85 percent interest in the Partnership.

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The other current partners of the Partnership are as follows: Steven Adler (Mr. Adler's son) — 5.25%; Jack Fetner (Mr. Adler's father-in-law) — 13.44%; Adam Nadel (Mr. Adler's son's brother-in-law); Fay Nadel (Mr. Adler's mother-in-law) — 25.55%; Andrea Raskin (Mr. Adler's daughter) — 5.33%; Lois Zoldon (Mr. Adler's sister-in-law) — 7.57%.
The Partnership's assets are managed by Bernard L. Madoff Investment Securities (Madoff), which is unrelated to Mr. Adler. Madoff requires entities to maintain a minimum capital account. You represent that the Partnership currently has an account with Madoff and has not received any notice that its does not meet minimum capital requirements for investment management by Madoff. The IRA's assets are not necessary for the Partnership to continue its account with Madoff.

You represent that Leonard Adler intends to open a self-directed individual retirement account (IRA) in the amount of approximately five hundred thousand ($500,000.00) dollars through Retirement Accounts, Inc. of Denver, Colorado. At the time Mr. Adler directs the IRA investment, the Partnership will become a limited Partnership. Mr. Adler will be the only general partner in the Partnership and will own 6.52%. Mr. Adler will not have any investment management functions with respect to the assets of the Partnership.

The limited partners and their percentage ownership interests will be as follows: Andrea Raskin — 1.35%; Steven Adler — 3.07%; Jack Fetner — 3.94%; Fay Nadel — 18.1%; Adam Nadel — 1.77%; Lois Zoldon — 5.55%; David Geiger — 20.31%; IRA of Leonard Adler — 39.38%. Messrs. Adler and Geiger will invest directly in the Partnership in the same percentages as they would have invested through Esponda, instead of investing through Esponda. Esponda will no longer invest in the Partnership.

You further represent that Mr. Adler believes that Madoff would effectively manage assets for the IRA, but that Mr. Adler's IRA does not meet the minimum capital requirements (currently $1 million) for investment management by Madoff. You represent, however, that Madoff will manage the IRA's assets if it invests with Madoff through the Partnership, even though the IRA by itself otherwise would not meet the minimum capital requirements. You further represent that all of the assets of the Partnership are liquid marketable securities. You also represent that none of the funds contributed by the IRA is required to be used, or will be used, to liquidate or redeem any other partner's interest in the Partnership.

Finally, you represent that Mr. Adler does not and will not receive any compensation from the Partnership. He likewise will not receive any compensation as a result of the acquisition by the IRA of its limited partnership interest.

You ask whether the investment by the IRA in the Partnership will give rise to a prohibited transaction under section 4975 of the Code. Section 4975(e)(1) of the Code, in relevant part, defines the term "plan" to include an IRA, described in section 408(a) of the Code. Section 4975(e)(2) of the Code defines "disqualified person," in relevant part, to include a fiduciary, a relative, and a partnership, of which (or in which) 50 percent or more of the capital interest or profits interest of such partnership is owned directly or indirectly, or held by a fiduciary. Section 4975(e)(3) of the Code defines the term "fiduciary," in part, to include any person who exercises

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any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control regarding management or disposition of its assets. In order for a prohibited transaction to occur under section 4975 of the Code, there must be a transaction involving a disqualified person with respect to a plan. Where none of the relationships described in section 4975(e)(2) of the Code are found to exist, an entity would not be a disqualified person with respect to a plan.

Section 4975(c)(1)(A) of the Code prohibits any direct or indirect sale or exchange or leasing, of any property between a plan and a disqualified person. Section 4975(c)(1)(D) of the Code prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. Section 4975(c)(1)(E) of the Code prohibits a fiduciary from dealing with the income or assets of a plan in his or her own interest or for his or her own account. Section 54.4975-6(a)(5) of the Pension Excise Tax Regulations characterizes transactions described in section 4975(c)(1)(E) as involving the use of authority by fiduciaries to cause plans to enter into transactions when those fiduciaries have interests which may affect the exercise of their best judgment as fiduciaries.

As a trustee with investment discretion over the assets of his IRA, Mr. Adler is a fiduciary, and therefore, a disqualified person under section 4975(e)(2) of the Code. Mr. Adler is also a disqualified person in his capacity as the general partner of the Partnership to the extent he exercises discretionary authority over the administration or management of the IRA assets invested in the Partnership. In addition, although Mr. Adler, his son and his daughter are disqualified persons, you represent that the investment transaction is between the Partnership itself and the IRA, and not with Mr. Adler and his family, except as fellow investors in the Partnership. Mr. Adler owns only 6.5 percent of the Partnership, and therefore the Partnership itself is not a disqualified person under section 4975(e)(2)(G) of the Code which defines a disqualified person to include a corporation, partnership or trust or estate of which 50 percent or more of the capital interest is owned directly or indirectly, or held by persons described as fiduciaries.

Based solely on the facts and representations contained in your submissions, it is the opinion of the Department that the IRA’s purchase of an interest in the Partnership would not constitute a transaction described in section 4975(c)(1)(A) of the Code (prohibiting any direct or indirect sale or exchange or leasing of any property between a plan and a disqualified person).

Whether the proposed transaction would violate sections 4975(c)(1)(D) and (E) of the Code raises questions of a factual nature upon which the Department will not issue an opinion. A violation of section 4975(c)(1)(D) and (E) would occur if the transaction was part of an agreement, arrangement or understanding in which the fiduciary caused plan assets to be used in a manner designed to benefit such fiduciary (or any person which such fiduciary had an interest which would affect the exercise of his best judgment as a fiduciary).

In this regard, the Department notes Mr. Adler does not and will not receive any compensation from the Partnership and will not receive any compensation by virtue of the IRA’s investment in the Partnership. However, the Department further notes that if an IRA fiduciary causes the IRA to enter into a transaction where, by the terms or nature of that transaction, a conflict of interest

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between the IRA and the fiduciary (or persons in which the fiduciary has an interest) exists or will arise in the future, that transaction would violate either 4975(c)(1)(D) or (E) of the Code. Moreover, the fiduciary must not rely upon and cannot be otherwise dependent upon the participation of the IRA in order for the fiduciary (or persons in which the fiduciary has an interest) to undertake or to continue his or her share of the investment. Furthermore, even if at its inception the transaction did not involve a violation, if a divergence of interests develops between the IRA and the fiduciary (or persons in which the fiduciary has an interest), the fiduciary must take steps to eliminate the conflict of interest in order to avoid engaging in a prohibited transaction. Nonetheless, a violation of section 4975(c)(1)(D) or (E) will not occur merely because the fiduciary derives some incidental benefit from a transaction involving IRA assets.

Moreover, the Department notes that by virtue of the contemplated investment by the IRA in the Partnership, there will be significant investment in the Partnership by benefit plan investors. *See* 29 CFR § 2510.3-101(f). Accordingly, the Partnership will hold "plan assets" within the meaning of that term in the Department's regulations at 29 CFR § 2510.3-101. As a result, any person who exercises discretionary authority or control with respect to assets of the Partnership will be fiduciary of the IRA and subject to the restrictions of section 4975(c)(1) of the Code, except to the extent a statutory or administrative exemption applies.
This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of
Fiduciary Interpretations
Office of Regulations
and Interpretations

[1] Under Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor and the Secretary of the Treasury is bound by the interpretations of the Secretary of Labor pursuant to such authority.

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