Family Investment Partnerships: Structure, Design, Issues, And Problems (Beyond The Valuation Discount)

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A very common estate planning vehicle has some very complex consequences, and compelling planning opportunities.

I THINK IT IS SAFE TO STATE that the family limited partnership (FLP) has become the most ubiquitous estate planning vehicle in the United States. The primary tax reason for using a FLP (for publicly traded investments or other assets) is the valuation discount for transfer tax purposes. The valuation discount, the surrounding cases, and the various theories that the Internal Revenue Service (IRS) has used to (successfully and unsuccessfully) invalidate or reduce it are covered extensively by other authors, so that is not of primary importance for this article.

Furthermore, the Obama administration has proposed that certain "disregarded restrictions" will be ignored in valuing interests in family-controlled entities that are transferred to family members, particularly if such restrictions will lapse or can be removed by the transferor or the family. Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals*, Feb. 2010. A number of bills have been circulating recently that would eliminate or severely limit valuation discounts on interests in family-owned entities, in particular, with respect to passive assets held by such entities. For example., H.R. 436 (January 9, 2009) which provides that the "value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets)." The bill specifically provides that "passive assets" (including, cash, stock, profits interest, capital interest, option, debt, derivative, etc.) will generally be considered nonbusiness assets unless those assets are required for working capital needs of a trade or business.

For the foregoing reasons, this article will focus less on the valuation discount benefits of investment FLPs and will concentrate on the following:

- Reasons families use entities to hold publicly-traded investments of family members.
- Different design structures used by families (for example, single-share class partnership vs. preferred partnerships vs. profits partnerships).
- The Chapter 14 implications of different family investment partnership structures and transfers.
- The tax and partnership accounting issues that arise when families create and administer family investment partnerships.
- The investment implications of different family investment partnership structures.

Reasons For Choosing A FLP

- Control;
- Centralized (and hopefully competent) management of family investments;
- Reduction of expenses;
- Expanded investment opportunities;
- Creditor protection;
- Platform for resolution of family disputes;
- Facilitation or enhancement of other estate planning techniques (including taking advantage of applicable valuation discounts and separating assets for community property purposes).

Choice Of Entity

From a choice of entity standpoint, family investment partnerships come down to three primary desired characteristics: pass-through taxation, flexibility (with respect to structuring the beneficial ownership of the family members, determining the taxation of the family members, and handling the family investments), and limited liability for the investors. As such, business entities or arrangements like joint ventures, general partnerships, and C corporations are not often the entity of choice for centralizing family investments.

Furthermore, with the limitations that may be set out in a trust agreement and the higher fiduciary duties required of trustees, trusts (whether simple or complex) have less flexibility than those entities that do provide all or most of the desired characteristics, including: partnerships and limited liability companies, S corporations, and regulated investment companies.

Partnerships And Limited Liability Companies

With the Treasury Department's adoption of the "check-the-box" Treasury Regulations in 1996, limited partnerships and limited liabilities companies have become the entity of choice for "family investment partnerships." Both limited partnerships and limited liability companies, when taxed as a partnership for tax purposes, have pass-through taxation, limited liability, and flexibility in determining how the partners/members share in the underlying investment portfolio.

Since limited liability company statutes have now been enacted in all 50 states in the United States, often the choice between a limited partnership or a limited liability company depends on the state law differences in which the entity is being formed.

The Series LLC

A "new" form of business entity has recently been enacted in a few states, most notably Delaware. See Del. Code Ann. tit. 6, §18-215. The "series" limited liability company is essentially a single, master limited liability company that has separate series or cells which are internally created within the entity and which are considered separate from each other (for liability and other purposes). It can issue shares that control or own a specific portion of each separate series or cell to the exclusion of the other classes.

By way of example, Delaware provides, "[a] limited liability company agreement may establish or provide for the establishment of 1 or more designated series of members, managers or limited liability company interests…hav[ing] separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective." Del. Code Ann. tit. 6, §18-215(a).

In the family investment partnership context, an operating agreement could issue different classes of shares to its family members, with different classes being attributable to different investment strategies or portfolios. For example, Class A: U.S. equities, Class B: non-U.S. equities, Class C: taxable bonds, Class D: municipal bonds, Class E: hedge funds, etc. This would allow family members to personalize their own asset allocation by having one family member hold shares in Classes A, B, D and E, while another family member might hold Class A and C shares.

This type of capital structure is often used in the regulated investment company context and is often referred to as a series company or fund. If an investment company wishes to offer a range of investment strategies or asset classes, instead of establishing a separate company for each investment strategy, it will create a single company with multiple classes of ownership, each of which relate to the assets of the separate portfolios within the company. In the regulated investment company context, the Code treats each "fund" of a series fund as a separate corporation. §851(g). (Note, this Code section has been redesignated several times from §851(q) and §851(h).) (Section references throughout are to the Internal Revenue Code of 1986 as amended, unless otherwise indicated.) For these purposes, a "fund" means a segregated portfolio of assets, the beneficial interests of which are owned by the holders of a class or series of stock of the regulated investment company that is preferred over all other classes or series in respect of such portfolio of assets. §851(g)(2). It is important to note that each fund then must obtain a separate tax identification number and there can be no offsetting capital gains and losses among the portfolios at least for Federal tax purposes. State tax laws, on the other hand, may continue to treat a series fund as a single entity. It is unclear, at this point, how a series LLC in the family investment context would be treated for tax purposes. In all likelihood, each series or cell will be treated as a separate partnership for Federal tax purposes.

Only a few other states, including Iowa, Illinois, Nevada, Oklahoma, Tennessee and Utah, have enacted similar statutes, and a number of unresolved questions exist, including whether the separation of series will be respected in other states. The California Franchise Tax Board has ruled that each series in a Delaware Series LLC is considered a separate LLC and each must pay its own annual tax and fee. Debbie Newcomb, *What is FTB's Position on Delaware Series LLCs?*, Cal. Franchise Tax Board's Tax News (Mar./Apr. 2006).

Except as otherwise noted, the term "family investment partnership" or "FLP" in this article includes both limited partnerships and limited liability companies ("LLCs"), and the terms "partner" and "general partner" include a member and manager of an LLC and the term "partnership agreement" includes the "limited liability company agreement," as the case may be.

S Corporations

Less often, family investments are consolidated and managed in and through an S corporation. This is often a result of legacy family business (often in C Corporation form at one point) or investment holdings having been liquidated and otherwise converted into stocks, bonds, or other publicly-traded investments.

While S Corporations provide for pass-through taxation under subchapter S of the Code, they have a number of significant restrictions, especially in the investment context. S Corporation shareholders must be limited to 100 and to U.S. citizens, resident aliens, estates, or certain trusts or tax-exempt organizations. §§1361(b)(1)(A), 1361(c)(1), 1361(b)(1)(B) and 1362(d)(2). The capital structure of an S Corporation investment is limited to one class of stock (so alternative structures that might include preferred interests are not possible). §1361(b)(1)(D).

S Corporations with accumulated earnings and profits from prior C Corporation status are subject to a corporate level tax on "excess net passive income" (25 percent of gross receipts), and if the 25 percent gross receipts limitation is exceeded for three consecutive years, S Corporation status may be terminated. §§1362(d)(3) and 1375. (Please note, former §1372(e)(5) provided that a subchapter S corporation with or without subchapter C earnings and profit would terminate its S Corporation status if more than 20 percent of its gross receipts came from passive income sources.)

S Corporations do not have an analogous election to correct inside and outside basis disparities as partnership do under section 754 (discussed below).

Regulated Investment Companies (Mutual Funds)

A small number of large and very wealthy families have migrated away from using private FLPs to hold family investments. To avoid securities issues and family disputes centered around indirect transfers of wealth to different family members because of valuation discounts, some families consolidate their investments in a regulated investment company.

For purposes of this outline, a "regulated investment company" (§851(a)) is a domestic corporation that is registered (at all times during the year) under the Investment Company Act of 1940 (15 U.S.C. §§80a-1, et al.) (the "Investment Company Act") either as a unit investment company or a management company. Note that a domestic corporation includes an "association," so a trust (in particular, a business trust, which is common in this area), partnership, LLC, and other entities can qualify for regulated investment company status as long as it is treated as an association for tax purposes. §7701(a)(3). *See* Treas. Reg. §1.851-1(a). Note also that investment companies are entities that are generally organized under a trust indenture, custodial agreement, or similar instrument that calls for the issue of redeemable securities only, which represent an undivided interest in a unit of specified securities. §4(2) of the 1940 Act. Management companies are defined generally as "any investment company other than a face-amount certificate or a unit investment company." §4(3) of the 1940 Act.

Regulated investment companies generally issue one class of shares, but the IRS has ruled that an investment company may issue both preferred and common shares and still qualify as a regulated investment company. Rev. Rul. 74-177, 1974-1 C.B. 165.

From a tax character standpoint, the IRS has ruled that regulated investment companies with multiple class shares must distribute tax items in a proportionate manner, so that items of ordinary income cannot be allocated to one class of shares and capital gain to another class of shares. Rev. Rul. 89-81, 1989-1 C.B. 226.

The relevant characteristics of ownership through a mutual fund are: (1) partial pass-through taxation of income to its shareholders, although the taxation does not always follow the economic understanding of those shareholders; and (2) free transferability of interest in the mutual fund.

CHAPTER 14 • A discussion regarding designs and structures of family investment partnerships cannot start without considering Chapter 14 of the Code, particularly section 2701.

Section 2701 provides that in determining whether a gift has been made, and the value of such gift, when a person transfers interest in a corporation or partnership (or LLC) to a "member of the transferor's family" (§2701(a)), the value of any of the following rights shall be treated as zero (an "applicable retained interest"):

- A distribution right, if immediately before the transfer, the transferor and "applicable family members" have "control" of the entity. (§2701(b)(1)(A)). For purposes of determining control, "applicable family members" includes the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor and any lineal descendant of any parent of the transferor or the transferor's spouse. §§2701(e)(2) and 2701(b)(2)(C). In other words, it expands the definition to capture siblings of the transferor and the transferor's spouse and their descendants. If the entity is a partnership (which would be the most likely choice of entity for a family investment entity), control means: (a) holding at least 50 percent of the capital or profits interests in the partnership, or (b) in the case of a limited partnership, the holding of any interest as a general partner. §2701(b)(2)(B).
- A liquidation, put, call, or conversion right. §2701(b)(1)(B).

Transfer Defined

It is important to note that a "transfer" is broadly defined and is deemed to include "a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership." §2701(e)(5). However, these would not be considered a transfer if "the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical." §2701(e)(5).

Exceptions

Certain transfers or retained interests are exempt from section 2701. If an exception applies to either the transfer or the retained interest, then normal gift tax rules apply to such transfer.

Market Quotation Exceptions

Section 2701 does not apply to the "transfer of any interest for which market quotations are readily available (as of the date of transfer) on an established market." §2701(a)(1). In addition, section 2701 does not apply to any right with respect to an *applicable retained interest* if market quotations are readily available (as of the date of transfer) on an established securities market. §2701(a)(2)(A).