

# Trusts & Estates®

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## ESTATE PLANNING & TAXATION

### Justifying FLPs

Family limited partnerships are often sound investments. And that should give them enough "economic substance" to defend against IRS attack

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Since the early 1990s, use of the investment family limited partnership (FLP) as a sophisticated estate-tax reduction technique has grown. Almost universally, the Internal Revenue Service asserts in these situations that a valuation discount should not be permitted because the investment FLP has no real investment purpose and therefore no economic substance apart from estate-tax savings. The IRS employs this argument to pave the way for courts to be more liberal in their statutory applications to invalidate the FLP. As more cases have entered the Tax Court queue with fact patterns that have what the IRS and the Tax Court view as questionable economic justifications, the trend has been to ignore the formalities of the partnership structure, and hold against the taxpayer on the estate-tax side.

The environment has evolved to such a point that both courts and practitioners have come to believe that there are no real investment justifications for most FLPs. We intend to explode that myth. We believe that there are substantial economic justifications for creating investment FLPs—from the perspective of both behavioral economics and portfolio management.<sup>3</sup>

#### ESTATE-TAX PERSPECTIVE

The investment FLP is designed to reduce the value of the decedent's immediate interest in the FLP to less than the value the decedent would receive on its liquidation. This is

achieved by making the majority of interests retained by the decedent in the FLP illiquid (limited partnership interests) and therefore entitled to a reduction from liquidation value.<sup>4</sup> In that sense, the limited partners have no control, which among many other things, precludes them from obtaining the underlying value of the assets in the partnership. For example, the limited partner cannot withdraw from the partnership and obtain fair market value, has no put or similar rights, and cannot force any annual cash distribution. Moreover, recipients of the limited partnership interests become limited partners only if the other partners admit them as partners; otherwise, they are assignees. Under applicable state law, assignees may have no management rights, withdrawal rights, dissolution rights or rights to

review the books. In addition, limited partners may have taxable income in any given year without a corresponding cash distribution from the partnership.

Are investment FLPs respected for estate-tax purposes? Not if the IRS has its way.

The IRS has said in many technical advice memorandums and in Field Service Advice 200049003 that investment FLPs should not be respected because they offer no real investment substance or purpose beyond tax savings.<sup>5</sup>

What do the courts say? Often, they respect partnerships for transfer-tax purposes. The Tax Court's acceptance of the validity of partnerships as an entity, regardless of tax or other motivation, reached its strongest support in *Estate of Strangi (Strangi I)*. The fair market value of the property that was contributed to the partnership was about \$10 million. The decedent owned a 99 percent limited interest. In rejecting the IRS's "lack of economic substance" argument, the majority opinion specifically recognized that the family partnership was valid under state law. The sole requirement, the court said: "the formalities were followed, and the proverbial "i"s" were dotted and "t"s" crossed. The partnership, as a legal matter, changed the relationships between decedent and his heirs and decedent and actual and potential creditors. Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case."<sup>6</sup>

Unfortunately, it could be argued that a gift is made when a partnership is formed—if the holder of a substantial portion of the equity does not retain the general partnership interest. In *Shepherd v. Commissioner*, a father was a 50 percent partner in an Alabama general partnership in which his two children each were 25 percent partners. The partnership agreement listed the original capital as nominal: \$10 for father and \$5 for each son. The father also contributed stock and land to the partnership and acted as its managing partner. The Tax Court held that by rearranging the capital accounts in a way that did not reflect the reality of each partners' capital contribution, the father had made a gift of the property he had contributed to the sons before the partnership was formed.

An analogous argument could be made if an individual was the substantial contributor of capital to a FLP but did

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Practitioners and the courts have come to believe wrongly that there are no real investment reasons for most FLPs.



not retain control. Suppose a father contributed 99 percent of the capital to a FLP in exchange for limited partnership interests representing 99 percent of the FLP. The remaining 1 percent is represented by general partnership interests. That 1 percent, because it represents control, is worth more than 1 percent of the value of the FLP. Consequently, by not retaining the general partnership interest, the dad retains less than the 99 percent he contributed, resulting in some gift-on-formation value.

Internal Revenue Code Section 2036 has been interpreted to mean that retaining the general partnership interest can result in the disallowance of a discount for the limited and general partnership interests held by the decedent at death. In the second Tax Court review of the *Strangi* case, *Estate of Strangi (Strangi II)*,<sup>10</sup> Judge Mary Ann Cohen applied Section 2036 to look through the partnership structure in valuing the decedent's interest, and to include the underlying assets of the partnership, sans discount, in the decedent's gross estate.

But the result in *Strangi II* can be avoided. Leaving aside whether Cohen's decision is correct (which we strongly doubt), the question for practitioners is how best to deal with its implications. Many subtle differences in facts might help.<sup>11</sup> One interesting highlight in the opinion, intentional or not, is the need for the decedent not to have a controlling (or perhaps any) general partnership interest.

This raises a planning conundrum: How can a planner establish an investment FLP in which the decedent is the substantial contributor to the FLP but retains no general partnership interests, while not running afoul of the *Shepherd* implication (hinted at in *Strangi I*)? Stated another way, how can an investment FLP be justified when on the surface it appears that there is no investment justification?

#### NON-TAX JUSTIFICATIONS

As it happens, there is a way. Behavioral economics and good portfolio management provide a rather straight-forward answer to this conundrum.

Most clients that use investment FLPs for estate-tax planning tend to be older, financially well-off and retired or near retirement. Experience with planning for such individuals indicates a high level of consistency in goals or behavioral traits with respect to their assets. These include:

- Making sure there is enough income currently and in the future to provide adequate cash flow for anticipated expenses.
- Achieving a good nominal return on their assets.
- Avoiding strategies that may make the assets within the portfolio decrease in nominal value.
- Creating enough surplus funds in the future to leave heirs a sizeable inheritance or funds for charity.

Consider the following scenario: A 70-year-old surviving spouse, a mother, owns a marketable bond portfolio, laddered maturities, valued at \$5 million and generating \$200,000 of after-tax income. She needs approximately \$150,000 cash annually for expenses, not including gifts to her two children and four grandchildren.

Say that she forms a FLP by contributing the entire bond portfolio, with her one daughter contributing \$100,000. Mom then takes back a 98 percent limited partnership interest and her daughter takes back a 2 percent controlling general partnership interest.

Immediately after the transfer, the value of Mom's interest, because it is a limited partnership interest, is arguably less than the \$5 million contributed. At a 40 percent discount, these limited interests would be valued at \$3 million [\$5 million minus \$2 million (\$5 million times .40)].<sup>12</sup> As a result, the sum value of the parts, \$3.1 million (\$100,000 general partnership interests plus \$3 million limited partnership interests) is less than the value of the contributed whole, \$5.1 million.

The key feature in this hypothetical is that Mom, as 98 percent contributor, retains 98 percent of the equity through only limited partnership interests, not general partnership interests. On the surface, it seemingly conflicts with the commonly held belief that ceding control is unnecessary when investment management is the purpose of an investment FLP. (In lieu of an investment FLP, the argument goes, the contributor could instead give funds to an investment manager, while still retaining discretion to hire or fire that manager.)

But assume Mom has the following goals: She wants to make sure she has enough income to cover her anticipated expenses while also achieving a good nominal return on assets and creating enough surplus to leave a sizeable inheritance. Can she do this by controlling her portfolio herself? Or is she better off transferring control to a trusted advisor, like her daughter? Frequently, the answer is the latter.

Many older investors tend to favor fixed income investments, such as bonds and certificates of deposit (CDs).<sup>13</sup> This strategy may lead to unintended, unwanted results.

Returns on fixed income investments fluctuate, sometimes dramatically, over time. In our scenario, Mom is currently generating \$200,000 of after-tax income and cash flow, representing a 4 percent after-tax return (\$200,000 divided by \$5 million). This is sufficient to cover her \$150,000 of current expenses. But, as the bonds mature and are reinvested in new fixed-income investments, it is possible that after-tax returns may be lower. If, for example, after-tax returns drop just 1.5 percent, from 4 percent to 2.5 percent, her after-tax income and cash flow, \$125,000 (\$500,000 times .025) will be insufficient to cover her cash expense needs.

How can this problem be rectified? One possibility is for Mom to meet the cash-flow shortfall by consuming a portion of her principal (that is to say, selling a part of her bonds). But by reducing principal, future after-tax returns and cash flows will be correspondingly reduced, making this an unattractive option.

Another possibility is to place the investments outside of Mom's control, as would occur if she went with an FLP. In doing so, she removes her bias toward fixed-income investments and reluctance to consume principal by placing investment decisions in the hands of her daughter, the general partner. The daughter then would be able to invest the portfolio for total portfolio returns, in such a way so as to maximize the likelihood that Mom's cash-expense needs would be met, now and in the future. These needs will be met through cash distributions from the FLP, which can include income and principal, including capital gains.

#### PORTFOLIO DIVERSITY

A family's investment assets are often diverse, but not necessarily diversified, and rarely unified in their philosophy. Suppose that the investment philosophies of the mother and daughter represented extremes of these strategies: Mom is invested entirely in CDs (not bonds), and the daughter is entirely invested in growth, small-capitalization technology stocks. Held individually, these strategies pose great risk. Mom's investment is inadequately hedged against current and future inflation. In all likelihood, she would experience a negative after-tax rate of return.<sup>14</sup> But the daughter's strategy poses substantial investment risk, because she is invested in only one sector of the stock market.<sup>15</sup> Moreover, the daughter may not be able to rely on the traditional wisdom that stocks earn an 8 percent premium over risk-free investments over long periods of time.<sup>16</sup>

How can this mother and daughter reduce the risks associated with their individual investments? One possibility would be to diversify their portfolios. Unfortunately, an individual's bias toward holding particular investments often can make such diversification difficult or impossible.<sup>17</sup>

Another possibility is to divest absolute control by pooling the

It's key to have the majority contributor retain that majority of the equity through limited, not general, partnership interests.



family's investment assets in a FLP.<sup>21</sup> Once this is done, the general partner can develop an investment philosophy for the pooled assets that will consider the short-term cash needs of the mom, the long-term growth desires of the daughter, the risk-and-loss aversion of the mom, and the daughter's preference for risk. Balancing these competing interests requires a diversified investment portfolio. This reduces the chance that the portfolio will decline more than the overall market and increases the likelihood of higher returns.

#### STABLE MANAGEMENT

In a down market, an investor may blame the investment manager, although the loss is attributable to the market.<sup>22</sup> Because of this fundamental attribution error, the investor may change managers—which, in turn, may result in greater trading costs. But these costs have an adverse affect on returns, putting a crimp in the investor's ability to meet investment goals.

In our scenario, suppose that Mom experienced a decrease in her after-tax income and cash-flow returns from 4 percent to 2.5 percent. This decrease may well be consistent with a general decrease in market returns for bonds of similar quality. If Mom erroneously concluded that the decrease was the result of poor buy recommendations from her investment advisor, she might change advisors. The new advisor, aware that Mom is not pleased with her current returns, may recommend that she purchase bonds that promise greater returns, but carry greater risk. This has at least two possible negative consequences. Because these bonds are riskier, they may result in default, eroding Mom's principal. Second, the trading costs associated with selling the higher-quality bonds and purchasing the lower quality bonds may offset or even overtake the higher potential return of the riskier bonds.

Or Mom could think that she could achieve better market returns by constantly trading. One study concluded that households with discount brokerage accounts trade common stocks with great frequency, the average household turning over more than 75 percent of its common stock portfolio annually.<sup>23</sup> There is evidence that the net return performance of households with high turnover will be lower than that of households with low turnover. The study's authors determined that high-turnover households underperform low-turnover ones by at least 5.5 percent a year, and as much as 9.6 percent a year.<sup>24</sup>

There is also evidence that even professional investment managers have difficulty achieving better-than-market returns. One study conducted in the 1990s concluded that mutual funds underperformed the market by roughly the magnitude of their investment expense.<sup>25</sup>

The use of an FLP corrects these negatives. By placing the investment portfolio in the hands of the general partner, Mom removes her bias toward constantly changing investment managers or frequent trading.

#### THE LONG VIEW

Older investors sometimes focus myopically on short-term portfolio returns in order to raise cash. This leads to at least two problems. First, a short-term focus may help meet pressing needs, but almost certainly will fail to achieve long-term goals. For example, in our scenario, Mom's focus on fixed-income investments may produce sufficient after-tax income and cash flow to satisfy her current and short-term needs, but in all likelihood it will not cause the principal to appreciate sufficiently to leave substantial funds to her two children and four grandchildren at her death. To accomplish that goal, her funds need to be invested in a more diversified portfolio that has the potential of producing significant appreciation in principal.

Second, a short-term focus raises the specter of loss aversion—the notion that the harm of losing a certain amount of money is much greater than the possible benefit of gaining that same amount.<sup>26</sup> Put another way,

it means that individuals tend to be more sensitive to reductions in their levels of well-being than to increases. This concept may explain why an investor who needs liquidity and holds both capital gain and loss assets, sells the gainers and not the losers. Despite the fact that there is a federal income tax benefit to recognizing tax losses and detriment to recognizing capital gains, often an investor cannot stand the idea of having losses. Deluding themselves that the loser will turn around, the investor ends up retaining the loser and selling the winner.<sup>27</sup> The result is a portfolio that emphasizes short-term over long-term gains.

An investor can address both of these problems with a FLP. By placing her investments in the hands of the general partner, Mom can eliminate her bias toward the short-term. Free, the general partner can invest the portfolio to maximize the ability to meet both Mom's short-term and long-term goals, as well as effectively balance the need for both short-term and long-term gains.

Undoubtedly, the IRS will continue to vigorously attack investment FLP structures. But practitioners can fight back by developing arguments proving non-tax investment justifications for their FLPs. Once courts recognize that there are numerous non-tax investment justifications for an FLP, they will be forced to honestly apply statutory rules.

When this occurs, most FLPs should withstand challenges from the IRS. ■

The business purpose for giving up general partnership control: to mitigate that contributor's investment biases.

#### Endnotes

1. "Investment FLP" refers to an intra-family partnership funded either substantially or exclusively by publicly traded stocks and bonds and other readily marketable public securities.
2. In addition to *Strangi II*, the IRS has successfully used IRC Section 2036 in several recent Tax Court cases, including *Estate of Harper*, TCM 2002-121 and *Estate of Thompson*, TCM 2002-246, and in a U.S. District Court case, *Kimbell v. U.S.*, 91 AFTR 2d 2003-585 (N.D. Tex. 2003). All section references are to the Internal Revenue Code of 1986, as amended.
3. That justification revolves around the need for clients to exercise self control in their investment decisions, which often means putting those decisions outside of their immediate control and influence.
4. The word "discount" is accompanied with the phrases, "lack of marketability," or "minority interest." Essentially, discounting means that the sum of the parts does not equal the whole. If the whole is \$1, a division into parts may mean that the sum of the parts, valued independently of the whole, may total only 60 cents.
5. TAMs 9719006 (May 9, 1997), 9723009 (June 6, 1997) 9725002 (June 20, 1997), 9730004 (July 25, 1997) and 9842003 (Oct. 16, 1998).
6. 115 TC 478 (2000). See also *Estate of Church*, 85 AFTR 2d 2000-804 (W.D. Tex. 2000).
7. *Ibid.* at 487. The majority opinion also rejected the application of Section 2703(a)(2). In rejecting the 2703 argument, the court, among other things, noted the Western District of Texas case, *Church v. U.S.* It concluded that Congress did not intend to subject partnership assets to a convoluted reading of Section 2703. Immediately after issuance of the court's holding in favor of the taxpayer, commentators focused merely on this holding, concluding that no "business purpose" was necessary in forming a partnership for estate tax reduction purposes. But a careful reading of the rest of the case, including dicta, points out the rough waters that lay ahead: the storm awaited in *Strangi II*.
8. 115 TC 30 (2000).
9. This gift-on-formation issue was hinted at in *Strangi I*. The partnership succeeded in discounting immediately the value of the decedent's interests. The decedent contributed approximately \$10 million of property to the partnership and received in return for this contribution partnership interests that the taxpayer claimed were worth over \$3 million less than the value of the assets contributed. The court found very little value was given up because: (1) the decedent did not give up *de facto* control over the assets even if he gave up some control, (2) the decedent's beneficial interest in the assets exceeded 99 percent, and (3) the decedent's contribution



- was allocated to his own capital account: "In view of decedent's continuing interest in [the family partnership] and the reflection of the contributions in his own capital account, he did not transfer more than a minuscule proportion of the value that would be "lost" on the conveyance of his assets to the partnership in exchange for a partnership interest."
10. TCM 2003-145. The IRS appealed the decision of the Tax Court in *Gulig*, 89 AFTR 2d 2002-2977 (5th Cir. 2002) (*Gulig* was the independent executrix acting on behalf of the estate). There, in addition to the arguments it raised in *Strangi I*, the IRS sought to have the circuit court reverse the Tax Court's denial of leave to amend a claim that under Section 2036, the estate should include the value of the limited partnership assets transferred from the decedent. Concluding that the Tax Court's denial was an abuse of discretion, the Fifth Circuit reversed and remanded for consideration of the Section 2036 claim. It affirmed all other conclusions made by the Tax Court, but with the proviso that the Tax Court may revisit its valuation ruling after considering the Section 2036 claim.
  11. Section 2036 provides: "GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
    - (i) The possession or enjoyment of, or the right to the income from, the property, or
    - (ii) The right, either alone in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."
  12. For example, the decedent should not transfer all assets, and the FLP should behave like a partnership and not own personal residences or pay for individual partners' daily support items. The partnership should make distributions pursuant to the same themes as an investment partnership, adhere to formalities, and distribute cash pro rata.
  13. Could it be less or more? Yes. Our intent is not to focus on the level of discount, but merely to conclude that a discount for non-control and non-marketability, and a reduction from contributed value is defensible.
  14. For a convincing case that most individuals have far too high a percentage of their retirement funds in fixed-income investments and too low a percentage in stock, see Shlomo Benartzi and Richard Thaler, "Myopic Loss Aversion and the Equity Premium Puzzle," 110 *Quarterly Journal of Economics* 73 (1995).
  15. See Richard Thaler, *The Winner's Curse: Paradoxes and Anomalies of Economic Life*, Princeton University Press (1992) at 102-103, in which the author discusses a study done by George Loewenstein and Nachum Sicherman that demonstrated that there is a preference for an increasing stream of income over one's life. If principal is consumed, an increasing stream of income is impossible unless returns on the principal increase commensurately.
  16. In the family partnership, typically there is no requirement that cash flow be distributed. So fundamentally there seems to be an inconsistency between this recognition of continual cash flow and the directives of the partnership. Further, *Strangi II*, *Estate of Thompson*, and *Kimbell v. U.S.*, all illustrate the danger of distributions being construed as retained interests under Section 2036. However, if the partnership is established as a total return investment portfolio, with the concept that a percentage of all returns, realized or unrealized, will be distributed to the partners, this is quite different than the retained interest problems identified in *Strangi II* and its predecessors. In the investment scenario, it will be recognized up-front under the terms of the partnership that periodic distributions will be made consistent with the long term investment goals of the partnership. Although there is a thin three-dimensional line that segregates mandating distributions, avoiding Section 2036, and still achieving valuation discounts, all three variables can be satisfied if the rules are set forth astutely under the terms of the partnership agreement.
  17. For example, assuming a rate of inflation of 3 percent and one-year CD with a 2 percent after-tax nominal yield, the real after-tax rate of return is a negative 1 percent.
  18. Although small capitalization stocks have provided greater returns than large capitalization stocks over long periods of time, such greater returns have been the reward for taking greater risk. See Harvard Business School Case No. 3383, "Dimensional Fund Advisers: 1993" (Rev. Oct. 6, 1993). See also Donald Keim, "An Analysis of Mutual Fund Design: The Case of Investing in Small-Cap Stocks," 51 *Journal of Financial Economics* 173 (1999), and Eugene Fama and Kenneth French, "The Cross-Section of Expected Stock Returns," 47 *Journal of Finance* 427 (1992).
  19. See John Cochran, "Where is the Market Going? Uncertain Facts and Novel Theory," 21 *Economic Perspectives* 3 (1997).
  20. For a discussion of various studies that have demonstrated the strong tendency of individuals to remain at the status quo, referred to as the "status quo bias," see Thaler, supra note 15, at pp. 68-70.
  21. Care must be taken to avoid the gain-recognition rules under Sections 721 and 351. As long as the practitioner focuses on this area, the investment holding company rules under these sections can be avoided.
  22. In attribution theory, the fundamental attribution error (sometimes referred to as the actor/observer bias) is the tendency of individuals to overestimate person-based causes of events and underestimate the contributions of situations. See Max Bazerman, *Judgment in Managerial Decision Making*, John Wiley & Sons (5th Ed. 2002), at p. 67. As the conceptual bedrock for the field of social psychology, the fundamental attribution error has been documented in numerous research studies. See, for example, Harold Kelley, "The Process of Causal Attribution," 28 *American Psychologist* 107 (1973); Richard Nisbett, Charles Caputo, Robert Legant and Jeanne Marecek, "Behavior as Seen by the Actor and as Seen by the Observer," 27 *Journal of Personality and Social Psychology*, 154 (1973); and Michael Morris, Richard P. Larrick and Steven Su, "Misperceiving Negotiation Counterparts: When Situationally Determined Bargaining Behaviors are Attributed to Personality Traits," 77 *Journal of Personality and Social Psychology* 52 (1999). In questioning whether markets are always efficient, researchers in economics and finance have increasingly relied on psychological theories, such as attribution theory, to explain the behavior of investors and other market participants. See, for example, Michael Mikhail and Richard Willis, "Do Security Analysts Improve Their Performance With Experience," 35 *Journal of Accounting Research* 131 (1997); Sarah Bonner and Susan Young, "Sophisticated and Unsophisticated Investors' Reactions to Analysts' Revisions Conditional on Factors That Are Associated With Forecast Accuracy," working paper, University of Southern California (2001); Gilles Hillary and Lior Menzly, "Does Past Success Lead Analysts to Become Overconfident," working paper, University of Chicago (2002).
  23. See Brad Barber and Terrance Odean, "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors," 55 *The Journal of Finance* 773 (2002), at 775.
  24. *Ibid.* at 792.
  25. See Mark Carhart, "On Persistence in Mutual Fund Performance," 52 *The Journal of Finance* 57 (1997), Table VI, "Excess Return" column, at 77. "I . . . find that expense ratios, portfolio turnover, and load fees are significantly and negatively related to performance. Expense ratios appear to reduce performance a little more than one for one," at p. 80. See also Kent Daniel, Mark Grinblatt, Sheridan Titman and Russ Wermers, "Measuring Mutual Fund Performance with Characteristic-Based Benchmarks," 52, *The Journal of Finance* 1035 (1997). "The evidence presented in this article suggests that the average mutual fund does, in fact, succeed along this dimension [of out-performing mechanical strategies, such as reflected by index funds]. However, we find that the amount by which the average mutual fund beats a mechanical strategy is fairly small (under 100 basis points) and is approximately equal to the average management fee. Aggressive growth and growth funds, which exhibit the highest performance, probably also generate the largest costs." *Id.* at 1056.
  26. For a general discussion of loss aversion, see Thaler, supra note 15, at 63-78. See also Thaler, "Mental Accounting and Consumer Choice," 4 *Marketing Science* 199 (1985); Benartzi & Thaler, supra note 14.
  27. For a discussion of the tendency of investors to hold losing investments too long and sell winning investments too soon, see Odean, "Are Investors Reluctant to Realize Their Losses?" 53 *The Journal of Finance* 1775 (1998).