► **Greycourt White Paper**

White Paper No. 18 – *Family Investment Partnerships*

Many wealthy families are familiar with family limited partnerships used to discount the value of intra-family gifts. But limited partnerships can also be used as investment vehicles, and this strategy offers many advantages. This white paper discusses family *investment* partnerships, which represent a kind of private, family "mutual fund" for family members and other family units such as trusts or foundations.

FIPs

Family investment partnerships, or FIPs, are simply limited partnerships[1] through which family members structure their investment portfolios. The advantages of investment partnerships can be considerable over medium and longer investment time horizons. Consider a family in which the senior generation has $100 million to invest but where the middle and youngest generations have only modest portfolios. If all members of the family contribute their investment funds to a limited partnership, taking back partnership interests in a pro rata manner, the family investment partnership itself becomes one very large investor.

Advantages of FIPs

From the point of view of money managers, the client is not the individual family units but the partnership itself. Hence, the partnership is able to meet the high minimum account sizes demanded by many of the best managers. The middle and younger generations of the family mentioned above could not otherwise have obtained access to these managers. In addition, of course, the family partnership is able to take advantage of fee break points, giving all members of the family the advantage of lower investment costs. Finally, by investing through separate account managers, rather than mutual funds, even younger family members can tax-manage their portfolios, significantly enhancing their net returns. The family can leverage these advantages by involving the middle and younger generations in meetings with money managers and other advisors, helping educate them about investment issues.

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[1] In many states limited liability companies will prove to be more flexible vehicles than limited partnerships. In an LLC all members have limited liability, even those who participate in the management of the LLC, while in limited partnerships the general partner will have unlimited liability. Some states are more well-disposed toward LLCs than others, so check with legal counsel.

Asset class FIPs

In establishing FIPs, families can take the route of forming a single master partnership that has unitized funds corresponding to each asset class: US large cap equity, US small cap equity, foreign equity, fixed income, cash, hedge funds, private equity, etc. Each family member or entity can then allocate across these strategies. The advantage is that only one Form 1065 and K-1 needs to be prepared. The disadvantage is that the 1065 cannot be completed until each asset class is finalized. Thus, a family member invested only in fixed income must wait until the 1065 is complete – which can't occur until the private equity K-1s have come in – in order to file his tax returns.

The way single-partnership FIPs handle customized asset allocation strategies for different family units sounds more complex than it actually is. The family will establish informal "pools" for each asset class the family is expected to need. These pools will be unitized, so that each family unit's values and tax cost basis can be tracked. To keep the illustration simple, let's assume the family plans to use only US large cap stocks, municipal bonds and cash. Those three pools will be established and family members can allocation their funds among the pools as they see fit. The senior generation might emphasize bonds and cash, while younger generations might emphasize equities. Within these broad asset class pools, the general partner (or manager, if an LLC) may subdivide the pools into, for example, manager styles (having both growth and value in large cap), durations (intermediate and long durations in munis) or otherwise. At year-end each asset class strategy prepares synthetic K-1s, which are sent to the main partnership, which then prepares the Form 1065 and issues true K-1s to the family units.

An alternative is to establish separate partnerships for each asset class in which the family intends to invest. There are several advantages to this approach. The first is that it makes it quite easy for separate family units to adopt quite different asset allocation strategies (by putting for example, a higher percentage of their assets into the US large cap partnership and a lower percentage into the foreign equity partnership).

A second advantage of asset class partnerships pertains to alternative investments. Many private equity and hedge fund vehicles require that investors be "accredited." (Accreditation definitions vary widely depending on the nature of the investment vehicle.) An unaccredited investor does not become accredited merely by investing through a partnership that otherwise meets the accreditation standards. Instead, there is a "look through" at the qualifications of the individual investor. By establishing a separate private equity and/or hedge fund partnership, families can enable wealthier members to access alternative investments while still permitting smaller family investors to benefit from the advantages of "pooling" the family's traditional investment assets.[2]

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[2] Of course, the assets are not "pooled," strictly speaking. Each partner has his or her own partnership account or accounts, but from the point of view of the money managers the partnership is the client.

Of course, creating numerous asset class partnerships also creates a level of complexity that will have to be managed. A form 1065 and a K-1 will have to be prepared for each of the partnerships, for example.

Accounting issues

When Smith family members pooled their investment funds in one investment partnership, the partnership inherited the obligation to account to the partners for those funds, properly allocating dividends, interest, gains and losses, sending out K-1s and filing partnership returns on Form 1065. In particular, it is crucial that tax cost basis be allocated properly among the partners in the investment partnership, and this can be a very complex issue. Fortunately, tax software is available to ease this task.[3] In some cases the family's master custodian will perform this task, while in other cases it will be the family's accounting firm or the family office.

Combining FIPs and FLPs

There is no reason why a traditional family limited partnership designed for discounting purposes cannot also serve as a family investment partnership. Indeed, there can be special advantages to doing so. When the IRS challenges family limited partnerships it will traditionally argue that there was no reason for the formation of the partnership other than avoiding taxes. If one reason for forming the partnership was to pool family investment assets, that can be a compelling business reason for a partnership that also claims discounted values for gift and estate tax purposes.

On the other hand, the cohort of family units that is appropriate to participate in a family limited partnership formed for discounting purposes may be quite different from the cohort of family units that would be appropriate for a family investment partnership. Each family will have to work these issues out depending on the identity of the various family units and the identity and investment needs of the various family investment units.

Miscellaneous issues

Privacy. Some families will encounter privacy issues when they attempt to "pool" assets in a FIP. These issues can generally be overcome, depending on how the family members feel about the senior generation or a family office having access to everyone's investment strategies and results. (The general partner, or manager if an LLC, will have access to all family member strategies and results, but no one else should have access to this information.) These issues should be addressed at the very beginning of the process of deciding whether or not to form a FIP and the structure to be used.

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[3] Probably the most widely used software was developed by SS&C Technologies, Inc., www.ssctech.com, 800-234-0556. Families can track cost basis information in simpler FIPs on a spreadsheet. Many custodian banks have an Excel template they can supply to clients.

Loans. Many families include in the FIP partnership documents a provision permitting partners to use their partnership interests for collateral on loans (as they could have done with their securities if they had not invested through the FIP).

Gains on withdrawal. If a family member or unit wishes to – or must – withdraw funds from an FIP, provisions should be made for ear-marking the taking of gains and losses. Otherwise, all partners will suffer tax consequences upon the withdrawal of any partner.

We will be happy to discuss this memo at your convenience.

GREYCOURT & CO., INC.
April 2002

(This paper was written by Gregory Curtis, Greycourt's Chairman.)