THE INTERPLAY OF BEHAVIORAL ECONOMICS AND PORTFOLIO MANAGEMENT WITH THE EXAMINATION OF FAMILY PARTNERSHIPS BY THE TAX COURT

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1. <u>Introduction</u>

For decades, estate planners have used variations of the family limited partnership (FLP), family limited liability company, and family corporation to achieve federal estate tax (estate tax) savings through valuation discounts in computing client's taxable estates. Since the early 1990s, the use of the investment FLP as a sophisticated estate tax reduction technique has grown. Along with this increased usage has come heightened scrutiny and vigorous attack by the Internal Revenue Service (IRS).

Because the IRS has been unsuccessful in its attempts to effect a change in the law to prevent valuation discounts, it has focused its efforts on challenging such discounts on audit and, when appropriate, through litigation. One of many arguments that the IRS typically raises in these situations is that the valuation discount should not be permitted because the investment FLP has no economic substance or purpose apart from estate tax savings.

To this point, the courts – including the U.S. Tax Court (Tax Court) - have rejected this argument. Nonetheless, there is some evidence that the Tax Court is warming to the idea, which in turn could lead to eventual adoption either directly or indirectly.[1]

The purpose of this article is to argue that there are substantial justifications from both a behavioral economics and portfolio management perspective for creating investment FLPs in all settings. Consequently, even if the courts embrace a "economic substance or

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[1] ~~See *Strangi* decisions.~~ For a discussion of the Tax Court's view on this issue, see *infra* notes ___- ___ and related text.

purpose" test, directly or indirectly,[2] ~~;~~ valuation discounts in the investment FLP context should withstand challenge on this front.

The article begins by detailing the estate tax benefits of an investment FLP. Next, it discusses whether an investment FLP needs a defensible purpose other than estate tax savings from the perspective of the IRS and the Tax Court. Finally, it explores the non-tax economic justifications of the investment FLP, and argues that these are compelling justifications for the substantial contributor to a partnership not retaining a controlling general partnership interest from the beginning.

2. The Benefits of an Investment FLP from an Estate Tax Perspective

a. The Investment FLP: Sum of the Parts is Less Than the Whole

From an estate planning perspective, the investment FLP is designed to reduce the value of the underlying assets in the FLP for purposes of computing a client's taxable estate,

[2] For example, in certain fact patterns and cases, ~~like *Strangi* III, ____________________cite~~, the court may be so influenced by the lack of a reasonable non-tax justification of the ~~P~~partnership that it is influenced in its overreaching application of other code actions to the case to invalidate the partnership for tax purposes. For example, ~~I~~in Estate of *Strangi v. Commisioner*, T.C. Memo 2003-145 (2003), discussed *infra* at note ___ and related text, application of Section 2036 was too broad.

resulting in estate tax savings.[3] It does so by making certain interests in the FLP illiquid, and therefore entitled to a discount.[4]

The following fact pattern, which will be referred to throughout this article, is typical of an investment FLP situation:

1. Surviving spouse age 70 ("mom").

2. Has a marketable bond portfolio, laddered maturities, valued at $5,000,000, generating $200,000 of after-tax income.

3. Current annual cash expense needs of mom~~ther~~ are approximately $150,000, absent gifting.

4. Two children and 4 grandchildren.

5. Mom forms a FLP by contributing the entire bond portfolio, valued at $5,000,000; with daughter contributing $100,000. Mom takes back a

[3] The FLP can be used to reduce either gift or estate taxes. If the client, typically parents, intend to transfers limited partnership interests during their lifetimes, then the FLP is being used to reduce gift taxes. If not, then the FLP is being used to reduce estate taxes.

The practitioner often will not have the choice on reduction for estate or gift tax purposes. That determination generally depends on who has control of the entity, and this often depends on from where the equity is coming.

For example, if the parents are contributing most of the equity into a FLP, then it is professed by the Internal Revenue Service to be a *non sequitur* for them not to retain the general partnership interest. For example, what business reason can be provided for someone to finance 90% of an operation and not retain control? In 1997 and 1998, the Service issued a number of Technical Advice Memoranda (TAMs) attacking and invalidating partnerships for estate tax purposes under this fact pattern. ~~*Cite.*~~ See *infra note ___ and accompanying text.* If the parents retain controlling interests in an entity that has fractional ownership interests, along with non-controlling interests, such as non-voting ones, then this arguably may not achieve an estate tax discount. If one person can liquidate the entity, lack of minority and lack of marketability issues should not be applicable for estate tax purposes. The parents' interests at passing should equal their *pro rata* equity interests in the entity. Stated another way, they should equal the *pro rata* liquidation or sales value of the entity with no discounts. [But cf. *Adams* (petition costs?)]

To achieve or maximize the estate tax discount, the surviving parent should not hold the controlling interest. And to achieve this, the question is whether a partnership can be set up with the substantial contributor giving up control *i.e.*, not retaining general partnership interests. The intent of this article is to prove that the answer, from a non tax perspective, is legitimately yes.

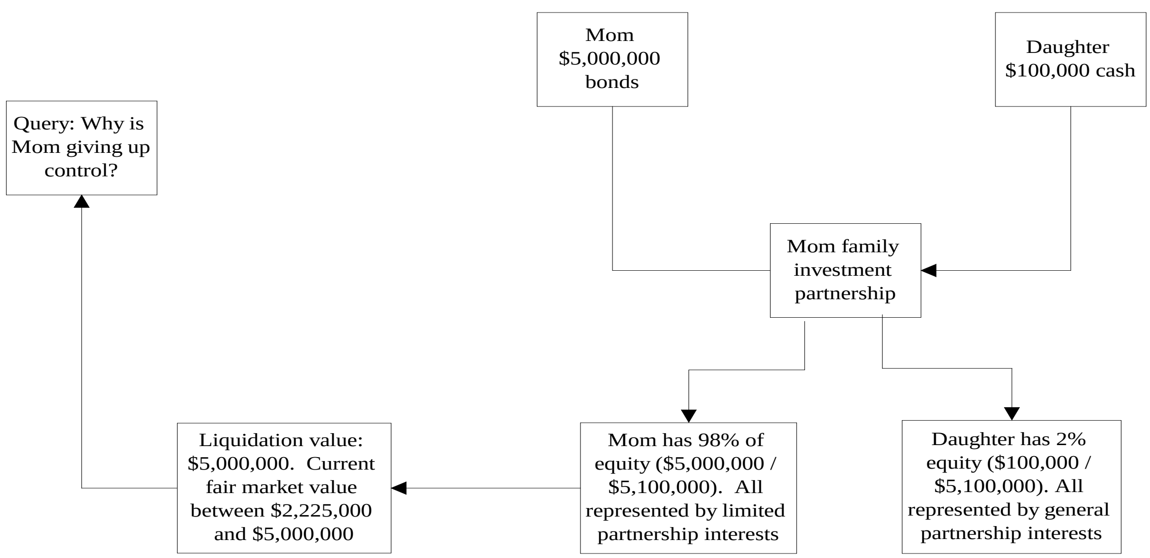
[4] The word "discount" is accompanied with the phrases, "lack of marketability," or "minority interest." Essentially, discounting means that the sum of the parts does not equal the whole. If the whole is $1, a division into parts may mean that the sum of the parts, valued independently of the whole, may total only 60¢.

98% limited partnership interest. Daughter takes back a 2% controlling general partnership interest.[5]

Immediately after the transfer, the value of mom's interest, because it is a limited partnership interest, is arguably less than the $5,000,000 contributed.[6] At a 40% discount, these limited interests would be valued at $3,000,000 [$5,000,000 – $2,000,000 ($5,000,000 x .40)]. As a result, the sum value of the parts, $3,100,000 ($100,000 general partnership interests plus $3,000,000 limited partnership interests) is less than the value of the contributed whole, $5,100,000.

The fact pattern can be illustrated as follows:

Fact Pattern: Illustrated



b. Structuring the Investment FLP

The investment FLP may be used to reduce the current value of any assets in the hands of the owner, including a business or publicly-traded securities. Interests in such assets

[5] ~~TMS~~ This type of fact pattern would be viewed as triggering estate tax retention under Section 2036 if retained at death. See ~~*Strangi III.*~~ Estate of *Strangi v. Commisioner*, T.C. Memo 2003-145 (2003), discussed *infra* at note ____ and related text,

[6] Could it be less or more? Yes; and our intent is not to focus on the level of discount, but merely to conclude that there is a discount for non-~~-~~control, non-~~-~~marketability, and a reduction from contributed value is defensible.

would be contributed by a client, typically a parent or parents, sometimes along with interests from other family members, to a FLP that is set up as a term partnership.[7]

Structurally, the majority of the equity in the FLP is represented by the limited partnership interests. For example, ninety percent or more (98% in our fact pattern) of the equity in the partnership could be represented by limited partnership interests. The minority of the equity is represented by the general partnership interests, typically less than ten percent (2% in our fact pattern).

To be effective from an estate tax standpoint, a substantial portion of the client's equity in the FLP must be represented by limited partnership interests. Why? The distinction between general and limited partnership interests is crucial to the efficacy of the FLP.

The general partners control the partnership through their ability to elect managing partners. The managing partners decide on when and if to make partnership distributions and whether to liquidate the partnership, sell assets, or merge the partnership with a third

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[7] Discounts in the estate tax area became more uncertain in 1990 with the introduction of Chapter 14, specifically Code section 2704. To avoid Section 2704(b), which essentially provides that the inability to liquidate an interest will not be respected at death if that liquidation restriction occurs in a family-control setting, either a term partnership or a state of organization that has a "perpetual partnership" as its default, is used. The term partnership has been approved by the Tax Court as a means to avoid Section 2704(b). *See, e.g.*, *Kerr*, 113 T.C.~~,~~ 449 (1999). Section 2704(b) can be avoided if the liquidation restriction does not come from an "applicable restriction." An inability to liquidate resulting from state law is not an applicable restriction. The argument has been successfully made that a term or, if mandated by state law perpetual partnership results in an inability to liquidate by the limited partners under state law, and therefore it is not an applicable restriction. [*Cite*. *Kerr*, *Strangi*.]

For example, under Section 603 of the pre-2000 Illinois Uniform Limited Partnership Act, a limited partner in a term partnership could not withdraw and obtain his or her fair value prior to dissolution or the expiration of the term. *[NOTE: P.A. 91-840 amended ILCS 210/603, effective as of January 1, 2001 to read as follows:*

> **Section 603.** Withdrawal of Limited Partner. A limited partner may withdraw from a limited partnership only at the time or upon the happening of events specified in writing in the partnership agreement and in accordance with the partnership agreement. Notwithstanding anything to the contrary under applicable law, unless a partnership agreement provides otherwise, a limited partner may not withdraw from a limited partnership prior to the dissolution and winding up of the limited partnership. Notwithstanding anything to the contrary under applicable law, a partnership agreement may provide that a partnership interest may not be assigned prior to the dissolution and winding up of the limited partnership.]

The default rule under the Uniform/Revised Limited Partnership Act is that a limited partner has no right to withdraw for fair value unless the document provides that right. [Rob, I think] This is similar to Delaware law and is a stronger argument to avoid section 2704 (b)(although the old statute arguably avoided section 2704(b) under the *Kerr* reasoning, discussed *infra*). [Fix – the above cite may be old law, not new law.]

party. The limited partners are entitled merely to distributions from the partnership, which may be sporadic or may even first arise upon sale or liquidation.

Given this distinction, multiple arguments support the notion that the limited partnership interests are worth less than their *pro rata* liquidation value. First, 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. Second, the limited partners may be unable to sell their interests for value even close to their ~~limited partners~~ *pro rata*~~e~~ "liquidation" value in the partnership because a hypothetical willing buyer would be uncertain as whether the general partners would admit that buyer as a partner or whether the buyer would be restricted to being an assignee. Assignees may, under applicable state law, have no management rights, withdrawal rights, dissolution rights, or rights to review the books. Third, the limited partners may have taxable income in any given year without a corresponding cash distribution from the partnership.

c. Transferring FLP Interests for Estate Tax Savings

Discount planning with FLPs typically involves reducing estate taxes associated with the post-mortem transfer of limited partnership interests held by the client to other members of the client's family.[8] The transfer will reduce estates taxes if the client transfers the interest through the client's estate plan and the value of such interests for estate tax purposes is less than their *pro rata* liquidation value.

> Example: Suppose that mom in our fact pattern were to pass away after creation of the investment FLP, leaving all of the assets to her two children and four grandchildren, and that the value of the assets remain unchanged. For estate tax purposes, mom's taxable estate arguably would be valued at $3,000,000, reflecting the assumed 40% discount. Had mom not established the FLP and continued to hold the assets in her own name at her date of death, mom' taxable estate would be valued at $5,000,000. At a 48% marginal estate tax rate, the use of the FLP produces estate tax savings of $980,000 [($5,000,000 - $3,000,000) x .48].

3. Does a FLP Need a Defensible Purpose Other Than Estate Tax Savings?

a. IRS Position

[8] ~~The Service has vigorously, and mostly unsuccessfully, attacked these partnerships using a variety of arguments in addition to the Code Section 2704 one. Among these are sections 2703, 2306(a0(1), 2036(a)(2), 2704(a), lapsing rights, gift on formation, the step transaction doctrine, the 3 year rule (or some transmogrification of it), equitable principles, economic substance (building on the *ACM* decision in the income tax area), and general valuation principles along the lines of the willing seller concept. *See FSA 200049003, Strangi* and *Knight*, discussed *infra*.~~

In multiple TAMs ~~rulings~~, issued in 1997 and 1998,[9] respectively, the IRS attacked with a vengeance the FLP structure. The IRS ignored the FLP in valuing the underlying assets in these rulings, thereby disallowing discounts.

For example, in TAM 9719006, [10] ~~In doing so,~~ the IRS stated, *inter alia*, that:

(1) "[T]he only discernable purpose for the partnership agreement was to depress the value of the partnership assets as the assets pass through the decedent's gross estate..."[11]

(2) "It is well established that transactions having no purpose or effect to the transferor other than to reduce estate taxes are disregarded for federal tax purposes."[12]

(3) "[T]he transaction in this case lacks any indicia of an arm's length bona fide business transaction."[13]

(4) "Even assuming arguendo that there was some legitimate business purpose for these transactions, the facts evidence that the transaction, including the formation of the limited partnership, was contrived primarily (if not exclusively) for the purpose of artificially ~~versus naturally~~ reducing the value of the decedent's gross estate in order to reduce the estate tax liability." ~~[Now, that was for a partnership whose purpose was creditor protection.]~~

(5) ~~For a partnership whose purpose was to purchase, maintain, manage and invest partnership assets, the Service held that the transaction had "no purpose or effect to the transferor other than to reduce taxes" and was to be disregarded for tax purposes.~~"Accordingly, the existence of the partnership should be disregarded for estate tax valuation purposes."[14]

More recently, Field Service Advice 200049003 lists a series of issues that the IRS believes could be used to attack a FLP structure. These include Section 2703, whether a restriction on liquidation which requires the consent of a certain percentage of voting interests could be disregarded under Section 2704(b), the application of Section 2704(b)

[9] See, e.g., TAM 9719006 (5/9/97), TAM 9723009 (6/6/97) TAM 9725002 (6/20/97), TAM 973004 (7/25/97), and TAM 9842003 (10/16/98).

[10] TAM 9719006 (5/9/97).

[11] Id.

[12] Id. Interestingly, on that quote, the IRS cites to Estate of ~~the~~ *Murphy* v. Commissioner, T.C. Memo 1990-472~~case, cite~~, which could be successfully argued to be an aberration in the estate tax area.

[13] Id.

[14] Id.

to the conversion of transferred interests into assignee interests, whether Section 2036 might apply to the assets decedent contributed to the partnership, whether a gift on formation argument might apply, lapsing rights under section 2704(a), the lack of economic substance doctrine, and in the alternative to all of the foregoing, whether the amount of a discount could be challenged. ~~**(John, this is similar to footnote 5; should we consolidate?]**~~

These TAMS~~rulings~~ and part of the FSA clearly assert the Service's position: investment FLPs should not be respected because~~,~~ they ~~like a *raison d'etre*, specifically,~~ offer no economic or real substance or purpose beyond tax savings. This position has led to considerable litigation.

b. Tax Court Decisions

Three recent cases – ~~*Estate of*~~*Church*, *Strangi* ~~*I*~~, and *Knight* – shed considerable insight into the Tax Court's views on this issue.

The first case in the trilogy, *Church v. U.S.*,[15] ~~*Estate of Church*,~~ hinted that business purpose would be relevant to the validity of the partnership for tax purposes. *Church* involved a ranch which was contributed to a partnership. On October 22, 1993, two days before death, a family partnership was established. The decedent died on October 24. The court, though skeptical, found ~~-~~that by restructuring ownership interests to remove control, this in itself constituted a sufficient business purpose to form the partnership ~~foundation~~:

> "The character of the interests owing a majority of the R~~r~~anch changed dramatically as a result of the P~~p~~artnership. Prior to its formation [taxpayer] and their descendants would have owned undivided interest in the R~~r~~anch, with each interest carrying~~having~~ the right to use ~~it~~ and enjoy the property, or force a partition ~~-petition~~ or ~~a~~ possible sale. The P~~p~~artnership eliminated these individual rights and placed ownership of a majority of the R~~r~~anch in a P~~p~~artnership that was not controlled by a single person."[16]

[15] 85 AFTR 2nd 2~~,~~000-804 (2000). On equitable principles this is understandable due to the timing of the formation and date of death.

[16] *Id*. at 2000-807

The court concluded:

> "I find as a matter of fact that the ~~p~~Partnership had ~~*a*~~*bona fide* business purposes and was not a sham as that term is used in estate taxation."[17]

The case's implied emphasis on business purpose was effectively undercut in *Knight* and *Strangi*.

[Lou: Should we even have a discussion of Knight in the article? Since this article is focusing on the non-tax justifications for FLP in an estate tax context, a discussion of Knight seems out of place given its focus on the gift tax. Do you think we should replace it with some other case, e.g., Thompson? Alternatively, perhaps this can be fixed through an explanatory footnote.)

A second case, *Knight v. Commissioner*,[18] concerned the creation of a limited partnership under Texas law and the transfer by a husband and wife of 22.3% each to each of two trusts for their two children. Before discounts, the value of the partnership assets was in excess of $2 million.

The taxpayer argued for a 44% discount based on the typical restrictive nature of the partnership agreement. The IRS~~Service~~ argued that the partnership form should be disregarded for gift tax valuation purposes, and that the assets should be valued allowing for discounts only for selling expenses and built-in capital gains taxes.

In a full Tax Court opinion, the majority ruled in favor of the taxpayer on the recognition of the limited partnership agreement. The Court refused to invoke an "economic substance" test (*i.e.*, business purpose). It found that the transferred interests were interests in a partnership under Texas law and stated specifically as follows:

> "We apply the willing buyer/willing seller test to value the interests in the partnership that petitioners transferred under Texas law. We do not disregard the partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it."[19]

[17] *Id*. at 2000-808.

[18] 115 TC 506~~No. 36~~ (2000).

[19] *Id.* at 514. The opinion noted that the indirect gift analysis was not raised by the IRS~~Internal Revenue Service~~ in this case and therefore was not considered. Having found that the partnership was enforceable under state law and was not to be disregarded, the Court then rejected most of the testimony of the taxpayer's expert and allowed only a 15% discount for minority interest and lack of marketability. The 15% discount represents a paltry discount when compared to the projections given by many and supported by appraisers. The opinion of the Tax Court in this case might signal a sea change in the amount of a

Judge Foley's concurring opinion pointed out that the economic substance doctrine should not be applied in a case to disregard a validly created entity under state law. He stated that the economic substance doctrine has been applied in the transfer tax context generally only where the taxpayer has attempted to disguise the transferor or transferees.

> "Generally, the economic substance doctrine, with its emphasis on business purpose, is not a good fit in a tax regime dealing with typically donative transfers. Business purposes will oftentimes be suspect in these transactions because estate planning usually focuses on tax minimization and involves the transfer of assets to family members. If taxpayers, however, are willing to burden their property with binding legal restrictions that, in fact, reduce the value of such property, we cannot disregard such restrictions. To do so would be to disregard economic reality."[20]

The third case in the trilogy, *Estate of Strangi v. Commissioner (Strangi I)*,[21] involved a Texas limited partnership that was created about two months before the decedent died. The fair market value of the property that was contributed to the partnership was about $10 million and the decedent owned a 99% limited interest. There was a corporate general partner, of which the decedent owned a 47% interest, the remaining 53% interest being owned by the decedent's four children. Bottom line: decedent gave up control of the partnership even though the decedent contributed over 99% of the equity value.[22]

The court considered and rejected the usual IRS arguments, including the lack of business purpose (phrased as "lack of economic substance" by the court). In rejecting the "lack of economic substance" argument, the majority opinion specifically recognized that the family partnership was valid under state law, the sole requirement:

> The formalities were followed, and the proverbial "i's" were dotted and "t's" were 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

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discount that could be available in litigated cases when limited partnership interests are transferred among family members.

[20] *Id* at 522. Judge Beghe's dissenting opinion cited his dissenting opinion in *Estate of Strangi v. Commissioner*, 115 TC No. 35 (2000). He reiterated his estate depletion theory and said that he would have valued the gifts at 100% of the value of the assets transferred to the partnership, reduced by the value of the partnership interests that the two donors received and retained.

[21] 115 TC 478~~No. 35~~ (2000).

[22] When the partnership was created the decedent was incapacitated and the decedent's participation was effected through a power of attorney held by the decedent's son-in-law.

> 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.[23]

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 read of the rest of the case, including dicta, point out the rough waters that lied ahead. The storm awaited in *Strangi III*.[24]

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. [25] The Court stated that because: (1) it did not believe that decedent gave up *de facto* control over the assets even if decedent gave up some control, (2) the decedent's beneficial interest in the assets exceeded 99%, and (3) the decedent's contribution was allocated to his own capital account, there was very little value given up:

> "[I]n 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. *See Kincaid v. United States*, *supra* at 1224."[26]

Even if it were to assume that the decedent's asserted business purposes were real (and the majority was skeptical of any business purpose of the partnership), the Court did not believe that the decedent would give up over $3 million in value to achieve those business purposes.

However, more troubling is the following dicta:

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[23] *Id.* at 487 [emphasis added]. The majority opinion also rejected the application of Code Section 2703(a)(2). In rejecting the 2703 argument, the Court, among other things, noted the Western District of Texas case, ~~*Estate of*~~ *Church v. United States*, 85 AFTR 2d 2000-804 (2000), discussed *supra*~~*infra*~~. It concluded that congressional intent was not to subject partnership assets to a convoluted reading of S~~s~~ection 2703.

[24] (insert discussion of *Strangi III's* holding against taxpayer and how ugly it was.)

[25] The Internal Revenue Service argued unsuccessfully that because the decedent received assets worth far less than that which was contributed, the difference was a gift on the formation of the partnership.

[26] *Id.* at 490.

> Realistically, in this case, the disparity between the value of the assets in the hands of decedent and the alleged value of the partnership interest **reflects on the credibility of the claimed discount** applicable to the partnership interest. It does not reflect a taxable gift.[27]

A brief concurring opinion by Chief Judge Wells, which was joined in by Judge Foley, argued that the economic substance doctrine should not apply to disregard a validly formed entity where the issue is "value" for federal gift and estate tax purposes of the interest transferred in that entity. The Judges argued, however, that the discount issue could be impacted.

Exhibiting a judicial schizophrenia, there were many dissenting opinions. Judge Parr's dissenting opinion would disregard the partnership because in the Judge's view the written partnership agreement had no relationship to the reality of the decedent's ownership and control of the assets contributed to the partnership. In his opinion, a person who maintained control over the ultimate disposition of the property was, in practical effect, in a position similar to the actual owner of the property, and the Court should not allow a discount where the taxpayer was not in fact limited by the terms of the written instruments.

A second dissenting opinion, by Judge Beghe, would look through the partnership arrangement via the application of a version of the step-transaction doctrine to treat the underlying partnership assets as the property to be valued for estate tax purposes. Simply stated, the Judge felt that if there was no business purpose, there was no partnership.

~~The problems allude to in *Strangi I*, because of the lack of a judicially perceived real purpose to the partnership, came to the fore in *Strangi III*, Cite. There, ______________. [new discussion.]~~The problems allude to in *Strangi I*, because of the lack of a judicially perceived real purpose to the partnership, came to the fore in *Strangi III*, Cite. There, ______________. [new discussion.]

Despite the *Strangi I* and *Knight* cases and their dismissal of the economic substance test, there are several key unresolved issues, including the following:

1. Will Federal Appellate Courts uphold the Tax Court's position? And, as important, how much [bed?] is in the Tax Court's reasoning in *Strangi I* – see for example, *Strangi III*?

[27] *Id* at 490 (emphasis added).

2. Will section 2036(a)[28] continued to be used by the courts, citing lack of economic or~~e~~ real substance as the reason for the retained interest argument being successful?[29]

3. Does the lack of economic substance influence the courts' equities tilt toward the IRS, thereby leading indirectly to lower discounts?[30]

It is the position of the authors that there are numerous, valid and non-tax justifications for the use of investment~~marketable asset~~ FLPs. Many of these justifications always apply to family investment partnerships, whether they are set forth in the Agreement or not. Because of this, it is appropriate to remove "economic purpose" or "purpose in any context" as a meaningful variable in assessing the validity of the FLP structure.

4. Non-Tax Justifications for the FLP

Undoubtedly, based on our fact pattern, the IRS would attack the FLP structure because, despite providing substantial funding of the FLP, mom receives limited partnerships interests but no general partnership interests.[31] To the extent that mom's estate utilizes discounts related to her transfer at death of the limited partnership interests to reduce estate taxes, the IRS would undoubtedly assert that the FLP should be disregarded – thereby denying any discounts - because it has "no economic substance or purpose" other than tax savings.[32]

On surface, the IRS's argument seems valid. There appears to be no real reason for mom - the 98% contributor to the FLP - to "give up control;" that is, by forming a FLP and not retaining the controlling general partnership interest. Commentators have suggested that if investment management is the purpose of the partnership, then giving up control is not necessary. For example, in lieu of a FLP, the contributor could give funds to an investment manager, while still retaining discretion to hire or fire that manager.[33]

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[28] Section 2036 provides that when an assets is transferred, and enjoyment from or control over that asset is retained by the transferor, the full value of the assets including in the transferor's gross estate for federal estate tax purposes.

[29] *See Thompson*. *Strangi III*.

[30] *See* fn ___, *infra*.

[31] If successful would this structure avoid the holding in *Strangi III* ? Maybe. (insert *Strangi III* quote).

[32] [Cite to fn. With *Strangi* and TAMs]

[33] *See Harrison*, "The Aggressive Use of Family Partnerships for Estate Planning Purposes" (Illinois Institute of Continuing Legal Education's 1999 Estate Planning Short Course). Debondt and Thaler, "Financial Decision Making in Marketing Firms: A Behavioral Perspective," Chapter 13 in R. Garro edition, Handbooks in OR and MS (1995) ("People display over-confidence in their own judgment" with regard to investments.)

But a close look below the surface reveals substantial non-tax reasons why mom may, and undoubtedly would, desire to do so that are grounded in both behavioral economics and portfolio management. Simply stated, behavioral economics demonstrates that individuals do not take all actions merely to maximize economic returns. Aspects of portfolio management emphasize that minimizing trading costs and fees (e.g., trading less frequently) while investing "in the market" could enhance a portfolio. As a result of these two factors, an individual may not want to be in a position to control or otherwise "tweak" their investment portfolio. The importance of a person's retaining control in all economic situations is greatly overstated and proved to the contrary by empirical research.

a. <u>Behavioral Economics</u>

Most clients that use investment FLPs 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:

1. Making sure that there is enough income currently and in the future to provide adequate cash flow for expected expenses.

2. Achieving a good nominal return on their assets.

3. Avoiding strategies that may make the assets within the portfolio decrease in nominal value.

4. Creating enough surplus funds in the future to leave heirs a sizeable inheritance or funds for charity. In sophomoric terms, making sure there is something left over.

Can an investor, like mom in our fact pattern, achieve these goals in the most beneficially economic manner by controlling her portfolio herself, or by transferring control to a trusted advisor, like daughter in our fact pattern? Frequently, behavioral economics would suggest the latter.

In such cases, the use of a FLP as an investment vehicle can be very positive and justifiable, regardless of the disappearance of value on creation because of restrictions on fund availability and transferability. In our fact pattern, mom's giving up control by not retaining the general partnership interest in the FLP may be explained by numerous factors, including her desire to:

1. Ensure a consistent and sustainable cash flow not tied strictly to accounting income.

2. Prevent overconfidence as to the "correct" investment philosophy and from locking in investment decisions.

3. Achieve her goal of leaving substantial funds for her two children and grandchildren -by -minimizing short-term focus on portfolio returns.

4. Restrict her ability to ~~make~~ frequently change~~s~~ her ~~to~~ investment advisor, thereby putting investment decisions beyond her control.

A detailed discussion of these reasons follows.

i. Ensure Cash Flows Not Tied Strictly to Accounting Income

Because of a desire to ensure sufficient income currently and in the future to provide adequate cash flow to meet expenses, older investors tend to favor fixed income investments, such as bonds and CDs.[34] This focus may lead to unintended, undesired results.

Returns on fixed income investments fluctuate, sometimes dramatically, over time. In our fact pattern, mom is currently generating $200,000 of after-tax income and cash flow, representing a 4% after-tax return ($200,000 ÷ $5,000,000) - sufficient to cover her $150,000 of current cash expense needs. 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%, from 4% to 2.5%, her after-tax income and cash flow, $125,000 ($500,000 x .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 (i.e., 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 to mom.[35] Another possibility is to place the investments outside of mom's control, as would occur with the FLP structure.

In doing so, mom 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, free of such bias and reluctance, would then be able to invest the portfolio in such a way so as to maximize the likelihood that mom's cash expense needs will be met, now and in the future. These needs will be met through cash

[34] [To be inserted.]

[35] One study demonstrated that there is a preference for an increasing stream of income over one's life. Thaler, "Mental Accounting and Consumer Choice," *infra* at note 26. *See also* Thaler, "Towards a Positive Theory of Consumer Choice," Journal of Economic Behavior and Organization, 39 (1980). If principal is consumed, an increasing stream of income is impossible unless returns on the principal increase commensurately.

distributions from the FLP, which can include income and principal, including capital gains.[36]

ii. Prevent Over-Confidence

A family's investment assets are often diverse (but not necessarily diversified) and not unified in their philosophy. For example, as discussed in the prior section, the older generation may prefer fixed income, while the younger generation may be willing to accept greater risk for the greater potential return associated with growth equities.

In ~~the context of~~ our fact pattern, suppose that the investment philosophies of mom and daughter represented extremes of these strategies: mom is invested entirely in CDs (not bonds) and daughter is entirely invested in growth, small capitalization technology stocks. Held individually, these strategies pose great risk. Mom's investment is not adequately hedged against current and future inflation. In fact, in all likelihood, mom would experience a negative after-tax rate of return.[37] Daughter's strategy poses substantial investment risk because she is invested in only one sector of the stock market. Moreover, daughter may not be able to rely on the traditional wisdom that says that stocks earn an 8% premium over risk-free investments over long periods of time.[38] [For example, from the years 1983 through 1992, small stocks earned 7% less annually than large capitalization stocks.[39]]***[Rob: maybe too tough on this point. Does fn. really support it?]***

How can mom and daughter reduce the risks associated with their individual investments? One possibility would be for each of them to diversify their portfolios. Unfortunately, an individual's bias toward holding particular investments will often make such diversification difficult or impossible to achieve.[40] Another possibility is to divest absolute investment control by pooling the family's investment assets in a FLP.

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[36] 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. But the partnership is a family partnership, so conceptually the principal investor has to recognize that should a need arise for greater cash flow, the general partner most certainly will be receptive to the idea of making greater distributions, assuming that the long term investment goals of the partnership are not hindered.

[37] *See infra* note 25.

[38] *See* John Cochran, "Where is the Market Going? Uncertain Facts and Novel Theory," – Federal Reserve Bank of Chicago __________ (________).

[39] "The Dimensions of Stock Returns," Dimensional Fund Advisers Inc. (1992) (Segregating Out Data from 1963 to 1983). "Dimensional Fund Advisers," 1993, Harvard Business School Case No. 3383 (October 6, 1993). Keim, "An Analysis of Mutual Fund Design: The Case of Investing in Small-Cap Stocks," Journal of Financial Economics 51 (1999).

[40] In "Mental Accounting Consumer Choice," 4 Marketing Science 3 (1985), Thaler discusses both prospect theories and mental accounting to discuss individuals focus on marginal increases and

Once done, the general partner can develop an investment philosophy for the pooled assets that will consider the short-term cash needs of mom, the long-term growth desires of daughter, the risk and loss aversion of mom, and the risk preference of daughter. To balance these competing interests, a diversified investment portfolio would be required. Such a portfolio reduces the chance that the portfolio will decline greater than the overall market and increases the likelihood of higher returns.

iii. Minimize Short-Term Focus on Returns

Because of immediate and short-term needs to meet cash expenses, older investors may focus myopically on short-term portfolio returns. This leads to at least two problems.

First, a short-term focus may achieve the goal of meeting pressing needs, but almost certainly will fail to achieve long-term goals. For example,~~in the context of~~ our fact pattern, 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 produce appreciation in principal sufficient to meet her goal of leaving 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. Loss aversion refers to the notion that the disutility of losing a given amount of money is much greater than the utility of gaining the same amount.[41] 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 that needs liquidity and that holds both capital gain and loss assets, sells the gainers and not the losers. Despite the fact that there is a~~n~~ federal income tax (income tax) benefit to recognizing tax losses and an income tax 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. The result is a portfolio that emphasizes short-term gains over long-term gains. [Insert cite.]

An investor can address both of these problems with a FLP. By placing her investments in the hands of the general partner, mom in our fact pattern can eliminate her bias on the short-term. Free of this bias, the general partner can invest the portfolio to: (1) maximize the ability to meet both mom's short-term and long-term goals and (2) effectively balance the need for both short-term and long-term gains.

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decreases to wealth versus long-term monetary value of wealth in the aggregate. People are just not capable of avoiding mental accounting problems (marginal utility and disutility gains and losses and annuitizing their wealth over a period of time using reasonable discount rates). [*fn. does not match up but there is one that says we are biased towards holding positions.]*

[41] "Loss aversion is the property that says that "reduction in wealth, relative to the current reference point, are weighted much more heavily than increases in wealth."

iv. Prevent Constant Changing of Investment Managers

In a down market, an investor may attribute the loss to the investment manager, when in fact the loss is attributable to the market.[42] Because of this fundamental attribution error, the investor may change investment managers which, in turn, may result in greater trading costs.[43] Because of their adverse affect on portfolio returns, such trading costs make it difficult for the investor to achieve short-term and long-term goals.

In our fact pattern, suppose that mom experienced a decrease in her after-tax income and cash flows returns from 4% to 2.5%, as suggested earlier. This decrease may well be consistent with a general decrease in market returns for bonds of similar quality. If mom, however, erroneously concluded that the decrease was the result of poor buy recommendations from her investment advisor, she may well change to a new advisor. 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. First, being riskier, such bonds may result in default, in which case mom's principal is eroded. 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.

The use of an FLP addresses these negatives. By placing the investment portfolio in the hands of the general partner, mom removes her bias toward constantly changing investment managers.

b. Portfolio Management

As noted earlier in the discussion of behavioral economics factors, the FLP can help to reduce trading costs and facilitate portfolio diversification. A more detailed examination of these elements as they relate to the concept of portfolio management follows.

i. Reduce Trading Costs by Pooling

Trading costs have a negative effect on portfolio returns. To get a sense of the possible magnitude of this effect, investors need to be aware that there are several types of such costs. The two most common - the ones that many investors strictly associate with the term - is commissions and income taxes on capital gains. Commissions related to the purchase or sale of investments result in a 3% round trip trading cost for trades valued over $1,000. Capital gains on the sale of investment results in income taxes imposed at the investor's normal marginal tax rate, except that long-term capital gains are subject to a maximum preferential tax rate. But there are at least three other types of trading costs that are not as obvious: (1) the difference between the bid/ask spread on the investment, (2) price impact, and (3) opportunity cost.

[42] [To be inserted]

[43] *See infra* at ____.

How does the bid/ask spread result in a trading cost? If one were to purchase a stock and sell it on the same day, the purchase price and sales price would not be equivalent; rather, the purchase price would tend to be closer to the ask price, and the sale price would be closer to the bid price (assuming no other movement of the stock that day as to price). The spread between the bid price and the ask price represents a trading cost – a loss – to the investor. This [round trip?] trading cost is anywhere between 0.52% of price for highly liquid stocks to 6.55% for small stocks.[44]

Price impact is the trading cost that arises when an investor purchases so much or sells so much of a particular investment that the price of the investment moves against the investor. [45] Thus, the increased demand resulting from purchases may cause the price of the investment to increase. Conversely, the increased supply from sales may cause the price of the investment to decrease. Although this cost is difficult to quantify, it is clearly present with certain large trades.

Opportunity cost is the trading cost associated with not acting quickly enough. In this context, it arises when an investor fails to purchase or sell a stock as quickly as desired. To the extent that the price of the investment increases from the time that the investor desires to purchase it to the time that the investor actually purchases it, the investor incurs a trading cost equal to the difference. Similarly, to the extent that the price of the investment decreases from the time that the investor desires to sell it to the time that the investor actually sells it, the investor incurs a trading cost equal to the difference. Although it would be easy to compute the opportunity cost associated with a specific trade, there are no known market averages to that quantify this variable. Nonetheless, in specific cases, it is undoubtedly substantial.

The degree to which an investor incurs trading costs depends on trading frequency. As trades increase, trading costs increase, and portfolio returns decrease.

> <u>Example</u>: Jane has $1,000,000 invested in a diversified individual stock account, with an income tax basis of $200,000. She reviews her portfolio frequently, and for a variety of reasons that she is confident are correct, trades frequently, while still maintaining diversification, and at the end of the first year, has had a 100% turnover. Her sister, Sari, also has $1,000,000 invested in a diversified stock account, with an income tax basis of $200,000. Sari, a "buy and hold" investor, makes no trades in the year. On average, the market returned 10% to large cap stock investors, and Jane, despite the odds to the contrary, was able to garner 10.5% because of her trading. Sari's portfolio was a bit worse with a return of

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[44] Aswath Damodaran, "The Hidden Cost of Trading," Chapter 11, <u>Investment Management</u>. (____).

[45] In the tax context, this is often referred to as "blockage," and results in a discount. *See Chenoweth*, 88 TC 1577 (1987). *See* Damodaran for a discussion of the price impact in the economic sense.

> 9.5%. Who is better off at the end of the year? The answer is Sari. Sari has $1,095,000 of value [$1,000,000 x 1.095)]. Jane incurred .07% of commissions, or $700 ($1,000,000 x .007) on the turnover. She had capital gains of $800,000 ($1,000,000 - $200,000) taxed at a maximum rate of 15%, resulting in income taxes of $120,000 ($800,000 x .15). Her round trip trading costs were about .47% of $1,000,000, or $4,700. Her total costs were therefore $125,400. Jane's portfolio, net of trading costs, is only $979,600 [($1,000,000 x 1.105) - $125,400], or $115,400 lower than Sari's portfolio. The costs associated with the Jane's frequent trading negatively affected her return.

Given the fact that there are several types of trading costs and that such costs, cumulatively, can be significant, one would expect individual investors to trade fairly infrequently. The facts suggest otherwise, however. For example, households trade common stocks with great frequency, with the average household turning over more than 75% of its common stock portfolio annually. (Cite) If trading frequency increased returns enough to offset trading costs, then it could be justified – but that is not typically the case.

There is evidence that individual investors are incapable of "beating the market" through the timing of their trades.[46] One study concluded that the net return performance of households with high turnover will be lower than that of households with low turnover. Specifically, based on their testing, the study's authors determined that "the high turnover households under[-]performed the low turnover households by about 46 basis points (bps) per month."

There is also evidence that even professional investment managers have difficulty in achieving better-than-market returns. One study conducted in the '90s concluded that mutual funds, before consideration of transaction costs and expense ratios, out-performed the market by an average of only 19 to 62 bps.[47] However, most funds under-performed the market by about the magnitude of their investment expense.[48] For example, one commentator notes:

> "This article offers only very slight evidence consistent with skill or informed mutual fund managers . . . the higher expected performance for

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[46] Campbell and Shiller, "Valuation Ratios in the Long-Run Stock Market Outlet," ____ The Journal of Portfolio Management (_____), indicating that it is questionable whether conventional dividend to price ratio forecast future dividend movements; thereby leading to the conclusion that forecasts for short-run predictions are extremely difficult. ***__insert 8__

[47] *See* Carhart, *infra* note 41, on page 77, Table VI.

[48] Returns on mutual funds reflect portfolio returns minus expenses. Expenses include trading costs, and administrative fees, and loads. Expenses were said to reduce returns by 1.15%; turnover by .65%. Carhart, Table VI, shows that most of the excess returns are negative once trading costs are added in; *i.e.*, they under-perform benchmarks with no costs.

high-alpha funds is only relative, since these funds do not earn significantly positive expected future alphas. The evidence is consistent with the top mutual funds earning back their investment expenses with higher gross returns . . . . Expense ratios appear to reduce performance a little more than one for one . . . I also find that expense ratios, portfolio turn over and load fees are significantly and negatively related to performance."[49]

Another study concluded that a fund's ability to pick the right stocks adds a 0.79% return annually to portfolios. But costs of as high as 2%, independent of taxes, more than offset this incremental return.[50]

Given the fact that trading is hazardous to an investor's wealth, why do investors trade too much? Undoubtedly, the answer is multi-faceted and complex, but two key reasons appear clear. First, investors who suffer from myopic loss aversion[51] may review their portfolios more frequently, leading to more frequent trades. Second, and perhaps more important, is that investors trade frequently because they are overconfident about their abilities to "beat the market." As noted by one study: "We believe that these high levels of trading can be at least partly explained by a simple behavioral bias: People are overconfident, and overconfidence leads to too much trading."

The FLP provides a solution to these problems. A family member, who on their own, may be biased to frequent trades, no longer controls the investments within the FLP. The pooling of investments that occurs within the FLP will tend to reduce overall trades because decisions as to types of investments and frequency of trade within the portfolio would be made by the general partner. Thus, in our fact pattern, if mom were inclined to frequent trading, she could effectively remove this bias by putting her investments beyond her control through the FLP structure.

b. <u>Preventing Momentum Investing</u>

Momentum investing refers to the phenomenon that investors tend to chase returns by purchasing investments that have most recently produced the highest returns. For example, in the last bull market, individuals often wanted the "hot" initial public offering (IPO) stock because of the momentum factor, knowing that the value of such stocks

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[49] *See* Carhart, *infra* note 41, at 369.

[50] Daniel, Grinblatt, Tittman and Weirmers, "Measuring Mutual Fund Performance with Characteristic-based Benchmarks," Volume 52, THE JOURNAL OF FINANCE 3 (1997) ("The evidence presented in this article suggests that the average mutual fund does, in fact, succeed along this dimension [of out performing index funds]. However, we find that the amount by which the average mutual fund beats a mechanical strategy is fairly small (under 100 bps) and is approximately to the average management fee. Aggressive growth and growth funds, which exhibit the highest performance, probably also generate the largest costs").

[51] *See* note 27, *infra*.

would increase substantially after the IPO. Like lemmings to the coast, these individuals wanted to ride the momentum up of these individual stocks but often found themselves tumbling down the stock price slide.

There are at least three problems that stem from momentum investing. First, the trading costs associated with momentum buying often offset the gains associated with the momentum purchases, so net gains are not frequent.[52] Second, selecting a stock at the end of its momentum life can be dangerous, as reversals are also correlated with stocks that have gained substantially because of momentum.[53] Third, momentum investing increases the odds that an investor's portfolio will not be adequately diversified.

In our fact pattern, mom may well have invested entirely in bonds because in recent years the returns from bonds have generally exceeded the returns on equities. This, however, is not likely to remain the case in the future, frustrating mom's ability to achieve her short-term and long-term goals. With a FLP, mom can eliminate her ability to momentum trade by placing control of the investments with the general partner.

5. <u>Conclusion</u>

The IRS continues to consistently and vigorously attack FLP structures. One of its arguments is that FLPs serve no valid economic purpose other than estate tax savings. The courts have not literally accepted the IRS's stance, but in recent cases like *Kimball*, *Thompson* **[Lou: We never discuss this case earlier so it seems out of context. Should we add a brief discussion earlier in the article? If so, where?]** and *Strangi III*, appear to be influenced by this argument.

Despite a surface appeal to the IRS argument, it is not correct. A well-diversified portfolio that minimizes trading costs is a wise investment strategy for producing the highest possible returns. Individually, this strategy may be difficult for investors to achieve because of the various behavioral economics and portfolio management factors discussed in this article. In a FLP, when control is beyond the unilateral decisions of any one individual, a diversification strategy -can more likely be implemented. Thus, FLPs are justified investment vehicles, even when the investments lose their "liquidity" in the process; and even when the substantial contributor loses ~~the~~actual control of the investments in the process.

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[52] *See*, *e.g.*, "Numeric Investors, LP," Harvard Business School Case No. 9-258-012 (1997). For example, one estimate has trading as reducing performance by approximately .95% of the trade's market value. *[maybe not.]*

[53] Carhart, *infra*.