Family investment partnerships

By Kevin A. Bormann
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Family Investment Partnerships

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For many families, the accumulation of wealth is a multi-decade endeavor culminating in the lucrative sale of a family business and resulting in multiple generations owning investable assets.

Some families choose to preserve autonomy and privacy by having family members independently manage assets. Others may pool the assets and centralize wealth management efforts. Pooling resources can result in decreased asset management fees, increased access to investments requiring large account minimums and other benefits from efficiencies resulting from centralized control, enhanced estate planning and greater creditor protection.

For example, suppose a large family has experienced a liquidity event. Thirty of the owners, including entities and individuals, were each funded with cash totaling $150 million. At the time of sale, family members were highly optimistic about the future. All 30 of these owners wanted their own investment management accounts to receive the funds, and these individual accounts had to be managed for reporting, asset allocation, benchmarking and performance.

As time went on, some of the family members became overwhelmed and frustrated by the complexities of managing significant wealth. Their time was eaten up by the day-to-day activities that are necessary to oversee wealth for current and succeeding generations. In addition, they discovered that information was not well-disseminated within the family, they were missing wealth-generating opportunities and management fees were excessive. They wanted a way to make their lives easier and to hold on to more of their assets.

This family could have benefited from a Family Investment Partnership.

The family mentioned above might realize a savings of approximately $500,000 per year by using a Family Investment Partnership.

Family Office Exchange Research, 2008
The Family Investment Partnership (FIP) structure is gaining wide popularity among investment professionals as a highly effective tool to accommodate multiple family interests and take advantage of economies of scale, flexibility and increased access to investment types. The FIP differs significantly in purpose from the commonly used Family Limited Partnership (FLP). An FLP is typically created to further a family’s WEALTH TRANSFER objectives, while an FIP is commonly used to further a family’s INVESTMENT objectives.

Defining an FIP

An FIP is a legal entity created to hold investment assets for the benefit of the entity’s owners. Types of FIPs often include:

- Partnerships
- Limited Liability Companies
- S Corporations

These types of entities share the same characteristics, including:

- Pass-through taxation
- Limited liability for owners
- Flexibility

Common asset types owned by FIPs include, but are not limited to:

- Stocks
- Bonds
- Hedge Funds
- Private Equity
- Real Estate

Reasons to Use an FIP

FIPs can either be formed to hold many different asset classes in one entity or can be formed for each entity to hold a specific asset class. If the family mentioned above had chosen to pool their assets into four FIPs holding specific asset classes such as U.S. Equity, International Equity, Fixed Income and Alternatives, the centralization would have made for a much more efficient process, as all 30 owners would have shared the same set of managers. Additionally, benchmarking and performance measurement would have been needed only for the four streamlined FIP accounts rather than 30 separate accounts. Centralized control would have simplified reporting, asset allocation, benchmarking and performance.
Multigenerational families can centralize wealth management needs by establishing a family office, hiring a wealth management firm or adopting some combination of the two. Effective estate planning will then divide the wealth into trusts, LLCs or partnerships. At this point, the FIP becomes a viable financial instrument to assist families in defining investment policies for multiple generations of family members, each of whom may have different time frames, objectives and risk tolerances.

For example, consider a family of first-generation wealth creators who have four children and 10 grandchildren, each of whom has two trusts. The example below depicts what this family may look like from a trust standpoint:

MULTI-GENERATIONAL FAMILY TRUST STRUCTURE

In cases such as these, strategic oversight becomes paramount if each of these trusts owns liquid investable assets.

Advantages of using an FIP

Using an FIP or multiple FIPs can create powerful synergies for wealthy families including:

- Economies of scale
- Increased access to investment types
- Centralized control
- Enhanced estate planning
- Creditor protection

The FIP becomes a viable financial instrument to assist families in defining investment policies for multiple generations of family members, each of whom may have different time frames, objectives and risk tolerances.
Economies of scale
By pooling assets into one or multiple FIPs, families may experience a material decrease in asset management fees. Family Office Exchange Research (2008) lists the pooling of assets into an FIP as a Top 20 Best Practice for family offices. The research indicates that an account with $10 million pays a median management fee of 75 basis points, whereas an account of $50 million pays a much lower median fee of 47.5 basis points. Accordingly, by aggregating five $10 million accounts into an FIP, a family could save $137,500 in management fees annually, as the following graphic indicates.

Greater access to investment types
Many high-performing money managers, hedge funds and private equity funds have account minimums of $1 million to $5 million. Additionally, most hedge funds and private equity funds are not permitted to be available to the public. These funds are generally available only to accredited investors (an investor with at least $1 million in net worth or a minimum annual income of $200,000\(^1\)) or qualified purchasers (an investor with at least $5 million in net worth\(^2\)). While all individual investors in an FIP must meet the above thresholds, individual family members or trusts may not find it feasible to allocate a high percentage of an individual or trust account to one manager. However, if assets from multiple beneficiaries are pooled into FIPs, there is a much higher likelihood that an allocation of $1 million to $5 million would be a prudent investment.

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\(^1\) Securities Act of 1933, Regulation D, Rules 501(a)(5) and (6).  
\(^2\) Investment Company Act of 1940, Rule 2(a)(51)-1.
Centralized control
For many families, a primary benefit of utilizing FIPs is the centralized control enabled by the pooling of assets. Centralization simplifies asset management, reporting, asset allocation, benchmarking and performance functions for the family.

Enhanced estate planning
**Asset transfer** – Upon death, an individual’s assets are transferred from his or her estate, which may result in administrative complications when multiple investment accounts are involved. Additionally, when transferring investments in hedge funds or private equity funds, the new beneficiaries must be requalified under the “accredited investor” or “qualified purchaser” rules described in the previous section. Assets held in an FIP may avoid many of the traditional pitfalls, and effective transfer may be as simple as executing a pre-established transfer document.

**Discounts** – The structure of the FIP can lend itself to valuation discounts for ownership interests when compared to the entity’s underlying asset values, which may allow assets to be transferred to family members at lower valuations. Discounts are generally granted for two reasons:

1. Lack of control
2. Lack of marketability

Because no single owner has exclusive control over the entity, the respective interests may be discounted. Similarly, since no public market exists for the purchase or sale of the interests in the FIP, there is often a discount available for lack of marketability. Combined, these discounts typically range from 5 percent to 40 percent or more, depending on the specific set of facts and circumstances and the underlying assets.

Creditor protection
Several categories of protections may be available under an FIP structure depending on the type of entity chosen to hold the assets. Due to the complexity involved, families should work with experienced legal counsel for their specific situation.

Considerations of using an FIP

Setup and administration
Because of the complex nature of the initial setup and ongoing annual tax strategies, operating an FIP may come with many considerations. Clients should plan on incurring upfront legal, tax and accounting fees. The structure of multiple investors owning interests in an FIP requires an ongoing relationship with a seasoned tax professional(s) to manage the tax and recordkeeping duties. Clients also should prepare to invest the time necessary for extensive

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planning discussions with all FIP participants. Oftentimes, multiple agendas surface during preliminary discussions, and further exploration is necessary to ensure the needs of all parties are considered. With advancements in reporting technology and proper planning, many of these complexities can be overcome in an accurate and cost-effective manner.

Privacy
Privacy can be an extremely important and sensitive issue for those contemplating an FIP. Pooling assets in FIPs creates an environment in which it can become necessary for information to be shared with fellow investors. The family office or board commissioned to manage the FIP, and possibly all other family investors, may have access to participants’ investment balances and results. Many privacy concerns may be overcome through thoughtful creation of entity agreements and by-laws.

Restrictions
Restrictions regarding the timing and frequency of distributions and/or loans from the entity may be built into the FIP agreements. These restrictions could potentially limit any investor’s access to cash in emergencies or other time-sensitive opportunities. Due to these types of restrictions, it is recommended that investors retain access to liquid assets outside the FIP.

Creation of an FIP
Choice of entity
Three primary characteristics must be considered when choosing an FIP entity:
1. Pass-through taxation
2. Flexibility
3. Limited liability for the investors
Structures satisfying all of the above are limited liability partnerships, limited liability companies, S corporations and regulated investment companies. It is highly recommended that families work with legal counsel who have knowledge of the applicable state laws in the location the entity is domiciled.

Funding of the FIP
An FIP may be funded with a variety of assets including, but not limited to, stocks, bonds, cash, hedge funds, real estate and private business interests. Generally, the FIP opens an investment management account to hold any securities in the form of stocks, bonds, cash or hedge funds. These types of securities are typically transferred “in kind” from each contributing member’s investment accounts. Real estate, private business interests or other such investments commonly require a transfer document acknowledging the transfer to the new entity.
Tax Considerations

Capital Accounts
Upon funding, each partner’s capital account will be increased by the amount of cash and fair market value of the property contributed to the FIP. Generally, this capital account will be maintained throughout the tax year and will increase by additional contributions and allocated income. The account will decrease by the amount of any distributions and allocated losses.

Non-Recognition of Gain upon Contribution
In general, no gain or loss is recognized by a partner upon the contribution of the property to the FIP in exchange for a partnership interest.³ The income tax basis of the transferred property by the contributing partner becomes the income tax basis of the contributing partner’s FIP interest.⁴

Recognition of Gain upon Contribution
Under certain circumstances, a contribution of a portfolio of stocks and securities to an FIP may result in the contributing partner’s recognizing gain, but not loss, if the effect of the contribution results in a “diversification” of the contributor’s assets.⁵ If a gain is recognized upon contribution, the FIP’s basis in the contribution is equal to the fair market value on the date of contribution.⁶ This type of contribution may cause the FIP to be considered an “investment company” under tax regulations.

Conversely, if a portfolio is contributed that is “diversified” at the time of transfer and if the contribution is not part of a plan in which another investor contributes an “undiversified” portfolio, then the partnership may avoid the “investment company” rules noted above. A portfolio will be considered “diversified” if:

1. The stock or securities of any one issuer does not make up more than 25 percent of the value of assets contributed AND⁷
2. The stock and securities of five or fewer issuers do not make up more than 50 percent of the value of assets contributed.⁷

General
The tax issues associated with each family’s situation can vary widely. It is imperative to solicit the services of tax counsel to review the structure of proposed contributions PRIOR to funding.

³ Internal Revenue Code, Sec. 721(a).
⁴ Internal Revenue Code, Sec. 722.
⁵ Internal Revenue Code, Sec. 721(b).
⁶ Internal Revenue Code, Sec. 723.
⁷ Internal Revenue Code, Sec. 368(a)(2)(F)(ii).
The Single Investment Partnership is a single entity that often owns multiple assets in multiple asset classes.

Examples of FIP structuring alternatives

Two of the more common structures for an FIP include:

**Single Investment Partnership**

The Single Investment Partnership is a single entity that often owns multiple assets in multiple asset classes. The partnership is owned by multiple investors (family members), each of whom owns an interest in the FIP. Each investor will receive, proportionally, the same investment performance results. The primary benefit of the single-entity structure is its simplicity. The main drawback is its lack of flexibility due to all investors having the same asset allocation. Below is an example of a Single Investment Partnership with $200 million of assets:

![SINGLE INVESTMENT PARTNERSHIP STRUCTURE](image)

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percent Owned</th>
<th>Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner 1 (age 66)</td>
<td>20%</td>
<td>40,000,000</td>
</tr>
<tr>
<td>Partner 2 (age 63)</td>
<td>20%</td>
<td>40,000,000</td>
</tr>
<tr>
<td>Partner 3 (age 40)</td>
<td>12%</td>
<td>24,000,000</td>
</tr>
<tr>
<td>Partner 4 (age 38)</td>
<td>12%</td>
<td>24,000,000</td>
</tr>
<tr>
<td>Partner 5 (age 37)</td>
<td>12%</td>
<td>24,000,000</td>
</tr>
<tr>
<td>Partner 6 (Trust 1)</td>
<td>8%</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Partner 7 (Trust 2)</td>
<td>8%</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Partner 8 (Trust 3)</td>
<td>8%</td>
<td>16,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>200,000,000</strong></td>
</tr>
</tbody>
</table>
Multiple investment partnerships
The Multiple Investment Partnership structure is one in which each partnership invests in a certain asset class or style. In this case, each participant may receive different results based on how they allocate their ownership among the partnerships. The primary benefit of this structure is the flexibility for each investor to determine his or her respective asset allocations. The main drawbacks are related to increased cost and complexity. Below is an example of a Multiple Investment Partnership with $200 million of assets:

<table>
<thead>
<tr>
<th></th>
<th>Percent Owned</th>
<th>FIP US Equity</th>
<th>Percent Owned</th>
<th>Intern’tl Equity</th>
<th>Percent Owned</th>
<th>Fixed Income</th>
<th>Percent Owned</th>
<th>Alternatives</th>
<th>Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner 1 (age 66)</td>
<td>20%</td>
<td>$8,000,000</td>
<td>10%</td>
<td>4,000,000</td>
<td>60%</td>
<td>24,000,000</td>
<td>10%</td>
<td>4,000,000</td>
<td>40,000,000</td>
</tr>
<tr>
<td>Partner 2 (age 63)</td>
<td>20%</td>
<td>8,000,000</td>
<td>10%</td>
<td>4,000,000</td>
<td>60%</td>
<td>24,000,000</td>
<td>10%</td>
<td>4,000,000</td>
<td>40,000,000</td>
</tr>
<tr>
<td>Partner 3 (age 40)</td>
<td>35%</td>
<td>8,400,000</td>
<td>25%</td>
<td>6,000,000</td>
<td>20%</td>
<td>4,800,000</td>
<td>20%</td>
<td>4,800,000</td>
<td>24,000,000</td>
</tr>
<tr>
<td>Partner 4 (age 38)</td>
<td>40%</td>
<td>9,600,000</td>
<td>30%</td>
<td>7,200,000</td>
<td>10%</td>
<td>2,400,000</td>
<td>20%</td>
<td>4,800,000</td>
<td>24,000,000</td>
</tr>
<tr>
<td>Partner 5 (age 37)</td>
<td>50%</td>
<td>12,000,000</td>
<td>20%</td>
<td>4,800,000</td>
<td>0%</td>
<td>—</td>
<td>30%</td>
<td>7,200,000</td>
<td>24,000,000</td>
</tr>
<tr>
<td>Partner 6 (Trust 1)</td>
<td>50%</td>
<td>8,000,000</td>
<td>25%</td>
<td>4,000,000</td>
<td>15%</td>
<td>2,400,000</td>
<td>10%</td>
<td>1,600,000</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Partner 7 (Trust 2)</td>
<td>40%</td>
<td>6,400,000</td>
<td>30%</td>
<td>4,800,000</td>
<td>10%</td>
<td>1,600,000</td>
<td>20%</td>
<td>3,200,000</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Partner 8 (Trust 3)</td>
<td>60%</td>
<td>9,600,000</td>
<td>20%</td>
<td>3,200,000</td>
<td>10%</td>
<td>1,600,000</td>
<td>10%</td>
<td>1,600,000</td>
<td>16,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>70,000,000</strong></td>
<td><strong>38,000,000</strong></td>
<td><strong>60,800,000</strong></td>
<td></td>
<td><strong>31,200,000</strong></td>
<td></td>
<td><strong>200,000,000</strong></td>
<td></td>
<td><strong>200,000,000</strong></td>
</tr>
</tbody>
</table>

The Multiple Investment Partnership structure is one in which each partnership invests in a certain asset class or style.
Conclusion and recommendations

Wealth management professionals are increasingly meeting the needs of multigenerational high-net-worth families through the use of the FIP structure. For families considering a centralized approach to asset management, the FIP affords economies of scale, flexibility and increased access to funds through the pooling of assets. Advances in software technology continue to improve the ease of recordkeeping and tax accounting for these structures. Careful strategic planning at the outset will assist all investors with designing a vehicle that may help them accomplish their varying goals. FIP structures can be unique, with characteristics that are advantageous to families for a variety of reasons. However, due to the complexity of FIPs, it is critical for families to engage legal and tax counsel during the creation and ongoing planning of such an entity.
About the author

Kevin Bormann is a managing director for Ascent Private Capital Management of U.S. Bank in Minneapolis, Minnesota. In this role, he consults with families to customize strategies in the areas of risk and operational analysis of the financial enterprise, cash flow and liquidity management, strategic investment monitoring, and information management and reporting. Kevin earned an M.S. and B.S. in accounting from Texas A&M University and is a CPA and CFA® charterholder.

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