CAN I BE A GOOD BUSINESS PARTNER?

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Many years ago, I was practicing law at a large international law firm where my father was also practicing. At that time he was the head of the firm's corporate law section. I was asked by a client to establish a partnership for him and went to see my father to obtain a form of partnership agreement. I had no sooner asked him for such a form when he said, "Sit down for a minute and let's discuss this." He turned to me and said, "Have you asked your client whether he is ready to be a partner?" Frankly, I hadn't, and my experience over the last 25 years is that most professional planners never ask this question of their clients, yet it is the only relevant question as to whether a partnership can be successfully governed.

Every business day, somewhere in the United States, a Family Limited Partnership (FLP) or Limited Liability Company (LLC) comes into being. An FLP is a partnership whose membership is limited, by written agreement or tacit consent, to the members of a specific family. The partnership has either a corporation or an individual as its general partner, with unlimited liability to third partners. All of its other members are limited partners whose liability is limited to their investment in the partnership. Families frequently use these partnerships to pool their interests in specific investment categories such as real estate, private equity, oil and gas, and less frequently, for direct investment in bonds or equities.

An LLC is another type of legal entity that provides family members the opportunity to invest with limited potential liability if the investment goes poorly. An LLC may choose to be taxed either as a partnership or as a corporation. LLCs are frequently used by families to hold their interests in operating businesses in real estate and in other joint investments. Ownership of an LLC is evidenced by shares, rather than partnership interests, thereby affording easier family governance and simplicity of transfer of interests among family members.

Until five years ago, families seldom created limited liability entities such as an FLP or an LLC. The principle market force behind the creation of these entities is gift and estate tax minimization. These investment vehicles facilitate discounted valuations for later gifts or inheritance of interests. However, if tax minimization were the only purpose for these entities, they would probably become less desirable and would eventually be abandoned.

For a planning technique to be of long-term advantage to a family, it must create wealth for the family or, as I prefer to put it, be on the revenue side of a family's balance sheet. Taxes are a liability of a family and must, like all costs of doing business, be managed; but saving taxes does not generate revenue. If tax minimization is not a sufficient reason for creating one of these entities, one might ask: Is there a fundamental family wealth-preserving reason for a family to create such an entity? The answer is "yes" if a family, as a whole, is seeking a means to pool a portion of the individual assets of its members to take advantage of investment opportunities. Today, many of the world's finest investment managers have set minimum requirements for individual investments in their best funds of $1 million, and in some cases as much as $5 million. For most family members, minimums are beyond their total balance sheets. For the few family members who might be able to invest such an amount, the investment would normally violate their individual asset allocation plans by ignoring the goal of diversification. Pooling of individual assets to create a single family investor offers a way for all family members to participate in the family's best investments by permitting each individual member to make an appropriate asset allocation policy for his or her own assets.

Pooling of financial assets by families to achieve investment opportunities is a time-honored way of meeting family wealth preservation goals. This is the method by which the Rothschilds, the Rockefellers, and others of the great wealth-preserving families have maintained their fortunes. Pooling provides a means for the youngest, who are frequently the least financially wealthy members of a family, to take advantage of the family's best investment managers at the earliest opportunity. Empowering these youngest members' financial balance sheets in this way offers a higher probability that they will be financially stable during their entire lifetimes than if they were limited early in their lives to the investment opportunities their balance sheets permitted. Many families include their family trusts in the family's investment pools. The inclusion of such trusts provides more funds in general with which to reach minimums, and more important, brings the family's trustees into the family decision-making process regarding the investment of the family's entire financial balance sheet.

Although the revenue-generating benefits of these FLPs and LLCs provide an excellent reason for their creation, problems of governance can offset these benefits. Ineffective family governance often causes dissipation of a family's wealth. Sometimes the proverb "Shirt sleeves to shirt sleeves in three generations" describes the reality that families often do not successfully preserve their wealth.

FLPs and LLCs represent partnership systems of governance. As such, each member of the legal entity obtains legal rights and obligations which, by law, cannot be taken away. Perhaps the most important right each partner obtains is to ask questions of the person or persons managing the entity. These questions can deal with the nature and value of the assets in the entity, with the manager's decisions regarding investment of the entity's assets, and about their retention. When older generation founders of FLPs and LLCs create these entities and introduce their many family members into them as participants, they seldom understand how broad this right to ask questions is or how long it will last.

Asking whether the participants (and particularly the founders) are ready to be "partners" will help answer whether an FLP or an LLC is a good idea for the client.

FLPs and LLCs are powerful legal tools for the growth of a family's assets and the reduction of its estate and gift tax liabilities, if they are governed properly. If not, they can, and do, create fissures within family relationships that more than offset any benefits. Use these tools: they help; but use them wisely. Have your clients ask themselves, when considering the formation of one of these entities, "Can I be a good partner?" If they can answer this question affirmatively, their chances of successful wealth preservation using these tools are high.

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