

## Tax Issues for Family Offices: Structuring Options, Income Tax Planning, Allocations, Investments

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Today's faculty features:

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# Structuring Family Offices: Tax Issues, Allocations, Planning

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## Aaron P. Borden, J.D., CPA

Aaron leads Grant Thornton's Private Wealth Services practice in Dallas. Aaron and his team provide a full range of compliance and consulting services to high-net-worth and ultra-high-net-worth clients. Representative services include income, estate, and gift tax compliance; succession, legacy, estate and asset protection consulting; and services in support of family offices.

Aaron has more than 15 years' experience finding solutions to complex tax problems for his clients. Currently his work is focused on assisting business owners and entrepreneurs in achieving their desired legacy and succession planning goals. His work in this area often involves advising on estate plans, charitable giving strategies, multi-generational planning, and other matters that often go beyond the tax aspects client goals. In recent years, Aaron has also assisted his clients in connection with foreign and domestic trust issues, family limited partnerships, private annuity transactions, like-kind exchanges, opportunity zone investments, private foundations, charitable trusts, conservation easements, personal use of corporate aircraft, employee stock ownership plans, and retirement planning.

Prior to joining Grant Thornton, Aaron practiced as a Board Certified Tax Lawyer in Dallas. His law practice also involved resolving tax disputes and obtaining court-ordered modification and interpretation of trusts. His work on these engagements took him to probate court, the State Office of Administrative Hearings, the United States Tax Court, and federal district courts where he tried multiple cases to a verdict. In his role as a tax lawyer, Aaron also obtained complete IRS concession in a number of administrative cases, including: full waiver and abatement of \$1.3 million in penalties assessed for failure to file information returns, full relief from Employer Shared Responsibility Payments in multiple cases, full innocent spouse relief in multiple cases, and full relief from trust fund recovery penalties. In addition, Aaron represented multiple clients in no-change IRS audits.



## Joshua M. R. Becker, J.D.

Josh is a Manhattan based tax attorney. Josh works on matters involving federal, state and local tax issues, in particular the tax aspects of mergers and acquisitions; partnerships and other strategic relationships; debt and equity financings; and workouts and restructurings. He regularly advises clients on international tax planning, real estate investment structures, and family office tax planning.

Josh is a graduate of the University of Miami School of Law, *Magna cum Laude*, and is admitted to the New York State bar, the Connecticut State Bar, and the US Tax Court.

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# Structuring Family Offices: Tax Issues, Allocations, Planning

1. Family Office Structures – Tax Considerations
2. 2020 and Beyond - Legislative and Regulatory Update and Biden Tax Plan
3. Current Compliance Issues

# Family Office Structures: Tax Considerations

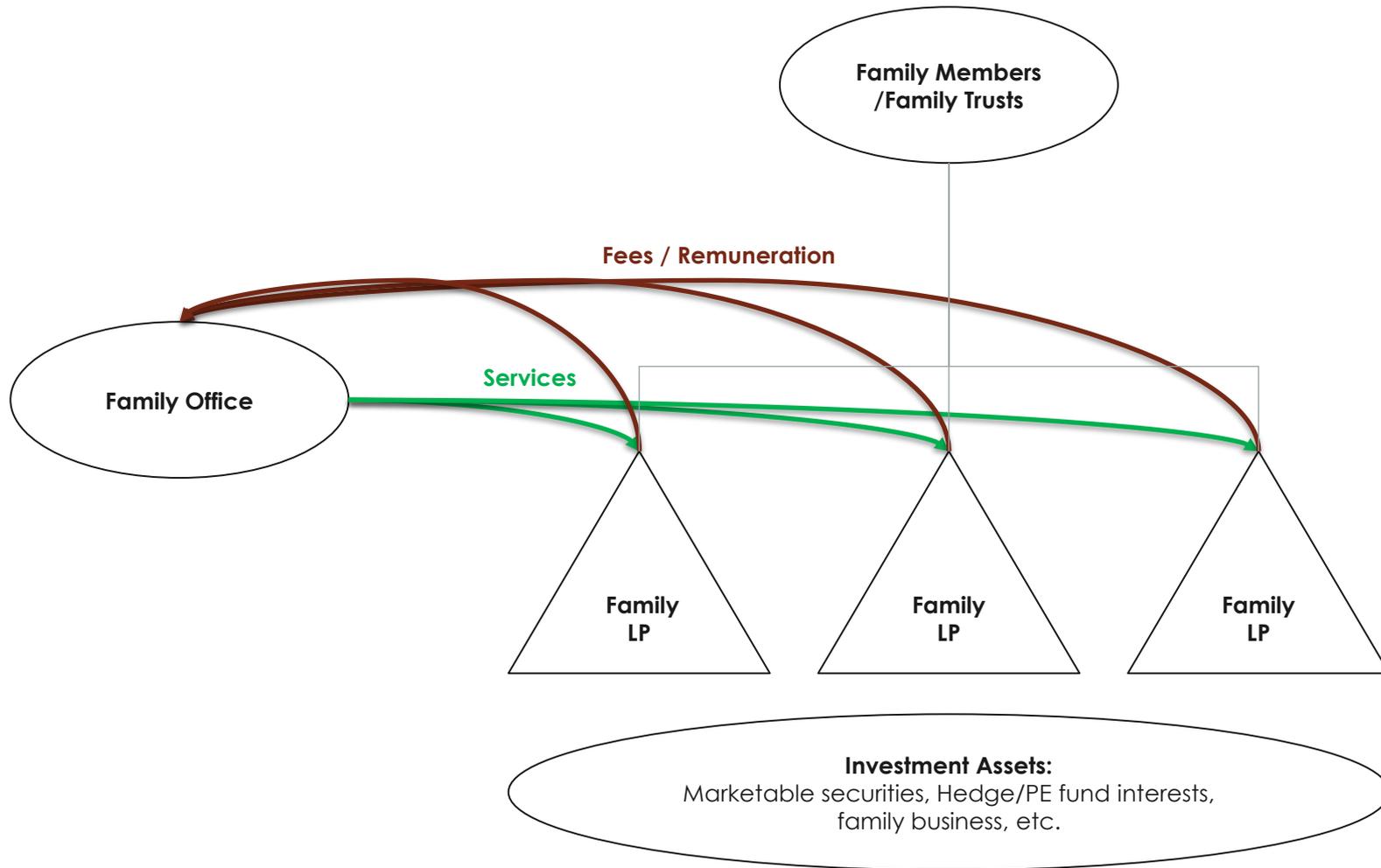
# What is a Family Office?

- A family office is a privately held company that handles investment management and wealth management for a wealthy family, generally one with over \$100 million in investable assets. Generally, the primary goal of a family office is to grow and transfer wealth across generations.
- While the foregoing may provide a simple and straightforward definition, in practice, family offices come in many different shapes and sizes.

# Different types of family offices

- **Single family office.** Dedicated to one family, perhaps with multiple households and generations.
- **Multi-family office.** Independent entity that manages the wealth of several families; it may be a small enterprise (at times growing out of a single family office), or it could be a division within a large bank or financial services firm.
- **Virtual family office.** Many services are outsourced. The office may have a few administrative or accounting staff, while outsourcing investments, legal, accounting, technology and other services.
- **Embedded family office.** In practice, this is usually the same as a single family office except the family office is not a separate legal entity. Instead, its employees/service providers are employees of a family operating business who wear “two hats.”

# Basic Schematic



# A changing tax landscape: key tax changes in 2017

- The Tax Court, in *Lender Management v. Commissioner*, held that a multi-generational family office was a trade or business and could take above-the-line deductions for some of the operating expenses it incurred.
- Congress passed the 2017 Tax Act (commonly known as “TCJA” ) which disallowed investment expenses (i.e., Section 212 deductions).
  - Before the TCJA, the alternative minimum tax often reduced the full tax benefit of 212 deductions.

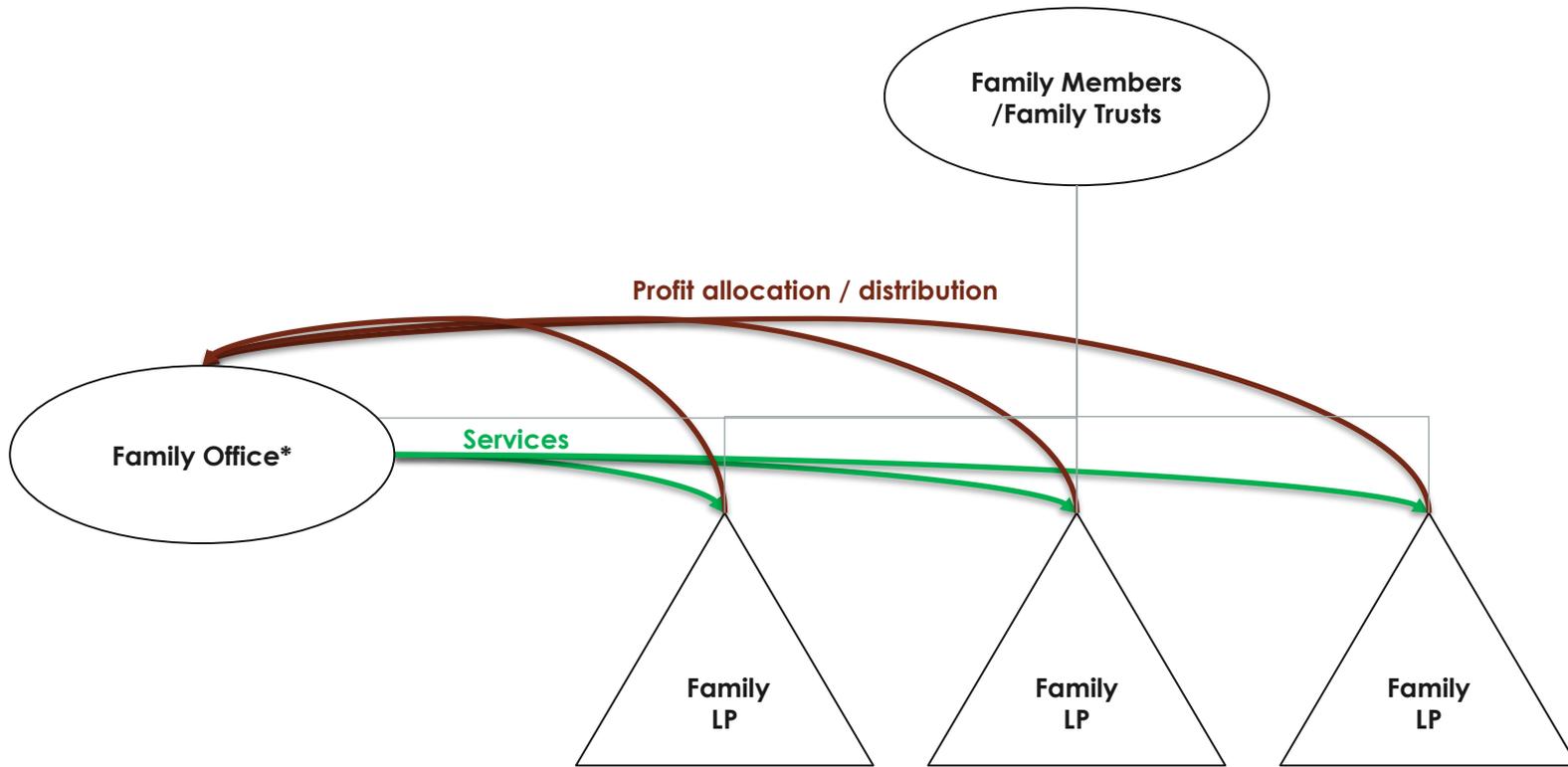
# Fundamental Tax Structuring Issues:

- Can the family limited partnerships deduct fees/remuneration paid to the family office?
- Is the Family Office engaged in a “trade or business” and thus able to deduct its operating expenses under section 162?

# Tax Structuring Issues: can a family limited partnership deduct fees/remuneration paid to a family office?

- If structured as a fee – no, a family partnership cannot deduct because a fee payment is likely considered a section 212 payment (not deductible until 2026).
- If structured as a bona fide partnership distribution of profits, yes, the family members/trusts benefit from what is effectively a deductible payment because the profit allocation/distribution reduces the taxable income of the family limited partnership that is otherwise allocable to the family members.

# Profits Interest Schematic



\*The family office is admitted to as a partner to the Family LPs

**Investment Assets:**  
Marketable securities, Hedge/PE fund interests, family business, etc.



# Structuring a profits interest: taxable upon receipt?

- Generally, service providers need to recognize taxable income equal to the fair market value of any property that they receive in connection with the performance of services.
- Historically, courts struggled with whether a profits interest is immediately taxable upon the grant of the interest.
- The IRS released a favorable Revenue Procedure in 1993 that created a safe harbor for partnerships granting profits interests. The Revenue Procedure said that “if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity,” the granting of a profits interest will not be a taxable event except in certain limited situations.

# Structuring a profits interest: taxable upon receipt?

- The granting of a profits interest will trigger tax:
  - (1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
  - (2) If within two years of receipt, the partner disposes of the profits interest; or
  - (3) If the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of section 7704(b) of the Internal Revenue Code.
- Generally not an issue for family limited partnership structures, but it should be considered when asset composition may create issues, especially with respect to (1) above.

# Structuring a profits interest: can the profits interest be recharacterized as a guaranteed payment under section 707?

- Under section 707, profits interest can be recharacterized, in whole or in part, as a guaranteed payment.
- Guaranteed payments are amounts paid to a partner without regard to the income of the payor partnership and thus, in substance, treated as payments to a third party/non-partner as remuneration for services rendered.
- Guaranteed payments are treated as fees subject to section 212 and thus not deductible – partners of the family partnership are essentially taxed on gross income (not net of payment to family office).

# Structuring a profits interest: can the profits interest be recharacterized as a guaranteed payment under section 707?

- In 2015, Treasury released proposed regulations under section 707(a)(2)(A) which maintained that the IRS would apply a facts and circumstances test to evaluate whether a profits interest would be respected and not characterized as a guaranteed payment.
- Although these regulations have not been finalized, they offer the most authoritative guidance as to when the IRS may recharacterize a profits interest as a guaranteed payment.

# Structuring a profits interest: can the profits interest be recharacterized as a guaranteed payment under section 707?

- The regulations list six factors for the test, with the most important factor being whether the arrangement has “significant entrepreneurial risk,” which the taxpayer must show with clear and convincing evidence.
- A profits interest that lacks significant entrepreneurial risk will likely not be respected as a profits interest and will instead be recharacterized as a payment for services.

# Structuring a profits interest: what is entrepreneurial risk?

- The regulations list five arrangements that lack significant entrepreneurial risk:
  - (i) Capped allocations of partnership income if the cap is reasonably expected to apply in most years;
  - (ii) An allocation for one or more years under which the service provider's share of income is reasonably certain;
  - (iii) An allocation of gross income;
  - (iv) An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the longterm future success of the enterprise); or
  - (v) An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

# Structuring a profits interest: is the family office required to make a capital contribution?

- Minimum capital contribution (ensuring the family office is admitted to the family partnerships).
- No set amount; different practitioners have different opinions on what amount of cash (if any) should be contributed by the family office.
- Percentage v minimum dollar value.

# Structuring a profits interest: are there gift tax consequences?

- A profits interest may trigger a “deemed gift” under section 2701.
- This deemed gift applies when the taxpayer retains a preferred equity interest and transfers a subordinate equity interest to another family member.
- In such a scenario, section 2701 could potentially turn a bona fide profits interest into a deemed taxable gift under a complex valuation formula by valuing the transferor’s retained interest at zero.

## Structuring a profits interest: are there gift tax consequences?

- Under section 2701, a senior family member could potentially be deemed to have made a taxable gift (subject to immediate gift tax) of some or perhaps even all of his/her retained LP interests in the investment entity upon the issuance of the profits interest to the junior family member (directly or by way of a trust and/or entity).
- Some practitioners believe that section 2701 should not apply to a profits interest (see Richard L. Dees, Profits Interests Gifts Under Section 2701: 'I Am Not a Monster', 123 TAX NOTES 707 (May 11, 2009) (arguing that a "simple partnership profits interest" should not be subject to gift tax under section 2701 because a "corporate equivalent" of that structure would not be taxed under the statute)).

# Family office structure: is the family office engaged in a trade or business?

- So a family office is compensated, in whole or in part, through a bona fide profits interest in underlying family limited partnerships – now what?
  - The family limited partnerships enjoy what is effectively a deductible payment, thereby reducing taxable income allocable to the family members/trusts.
  - But can the family office deduct its expenses?
    - Often third party service providers will provide services through the family office: examples:
      - Legal, accounting, financial advisory.
    - If the family office is not engaged in a “trade or business” it cannot deduct its expenses.
    - **If a family office cannot deduct its expenses, the efficiency of a profits interest structure is essentially lost.**

## Family office structure: is the family office engaged in a trade or business?

- Trade or business determination is based on facts and circumstances.
- Courts look for "regular, continuous, and considerable" profit motivated activities. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).
- Although profit oriented, the management of one's own assets is not a trade or business. *Higgins v. Comm'r*, 312 US 212 (1941); *King v. Comm'r*, 89 T.C. 445 (1987); *Beals v. Comm'r*, T.C. Memo 1987-171 (1987).

# Lender Management: can a single family office be engaged in an investment trade or business?

- Traditional categories:
  - Dealer = section 162 trader or business;
  - Trader = section 162 trade or business;
  - Investor = section 212.
- Hybrid between dealer and trader: private equity and venture capital funds – such funds do not fall neatly within either the dealer or trader definition.
- In **Lender Management**, the Tax Court found that the family office was engaged in a trade or business. *Lender Mgmt., LLC v. Comm’r*, T.C. Memo. 2017246, 114 T.C.M. (CCH) 638 (2017).

# Lender Management: can a single family office be engaged in an investment trade or business?

- Different parties. While all parties were members of the Lender family, the owners of family office substantially differed from the owners of Investment Entities.
- Arm's length/commercial relationship. Investors could withdraw their investments at any time if they were dissatisfied with the management services.
- Full-time employees. Family office had five full-time employees and paid salaries to its full-time employees.
- Suite of service. Family office provided investment advisory services and financial planning services to entities, individuals and certain third-parties (controlled by the family partnerships).

## Hellmann: can a single family office be engaged in an investment trade or business?

- Brought before the Tax Court, settled out of court.
- Same issue as Lender: whether family office was engaged in a trade or business.
- Factual differences from *Lender*:
  - Family office was managed and owned by four family members;
  - Same family members were the owners of underlying family partnership (through trusts);
  - No “outside” investor characteristics.

# Family office structure: is the family office engaged in a trade or business?

- Ownership (note: also relevant for section 2701 purposes)?
- Employees v outsourcing?
- Commercial terms – can the investors leave?
- Underlying investment asset class and level of management activity – it is regular, considerable, and continuous?
- Other financial arrangement with family members (loans, etc.)?
- Tax treatment of family office entity
  - Presumption that a C corporation has a trade or business (Revenue Ruling 78-195).
  - But consider:
    - Personal Holding Company rules;
    - Accumulated Earnings Tax.



# **2020 and Beyond: Legislative and Regulatory Tax Update and Biden Tax Plan**

# 2020 Legislative and Regulatory Highlights

- CARES Act:
  - NOL carry back rules;
  - Temporary suspension of charitable deduction limits;
  - PPP forgiveness.
- New GILTI high tax regulations represent another planning option along with:
  - Section 962 election;
  - Domestic blocker structure;
  - Check-the-box structure.
- Section 1061 proposed regulations:
  - Treasury has requested guidance regarding family office exemptions;
  - Ability to transfer APIs to grantor trusts (relevant for family office structures of fund managers).

# 2020 Legislative and Regulatory Highlights (continued)

- QOFs:
  - Market trends;
  - Timing relief
    - Deadline for investing cap gains: April 1 – December 31, 2020;
    - 90% Asset Test for QOFs – relief from April 1 – December 31, 2020;
    - Extension of 30 month substantial improvement period – April 1 – December 31, 2020 disregarded;
    - Tolling of working capital timeline – up to 24 months (may still need to show actual delay);
    - Reinvestment period for 90% test – additional 12 months.
- State Tax Residency Issues:
  - Possible changes to state tax obligations of family office employees and family members.

# Biden Tax Plan

- Increase corporate rate to 28%;
- A minimum 15% tax rate on corporate book income;
- Increasing GILTI rate and changing its application;
- Changes to retirement savings;
- Increase individual rates; cap itemize deductions and phaseouts;
- Social security tax changes;
- Reduction of estate tax exemption to historic norms;
- Green incentives;
- Onshoring initiatives.

# Other Possible Biden Changes Impacting Family Offices

- Changes to grantor trust tax provisions;
- Restrictions on valuation discounts;
- Limitations on long-term trusts;
- Increased restrictions on GRAT transactions;
- Per-donor limitation on the exempt annual gifting.

# Current Compliance Issues: Update on Family Office Tax Compliance Issues

# Current Compliance Issues

- Virtual currency transactions;
- Tax basis capital account reporting;
- Noncash charitable contribution reporting on Form 8283;
- IRS permitted SALT deduction workarounds.