The family office profits interest structure

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Everyone has heard the adage, "If you've seen one family office, you've seen one family office." Family offices are as diverse as the investors and families they represent in terms of structure, staff, mandate, and capabilities. While these differences often require tailored solutions, based on our deep experience working with a number of family offices and other private investment vehicles, we believe that there are, in fact, best practices to structuring and operating such investment vehicles, including basic structural features that can provide significant tax savings to a wide variety of family investment vehicles.

In response to the Tax Cuts and Jobs Act of 2017 (the "TCJA"), the family office profits interest structure has become one of the key ways for families to optimize structure for tax efficiencies. The basic model can be utilized for new and existing family offices that range from exclusively using third party investment advisers to those directly employing large professional investment teams.

Loss of miscellaneous itemized deductions as a result of the TCJA

Prior to the TCJA, family office clients who paid fees to a management company (i.e., the family office) for investment management services could deduct those fees as "miscellaneous itemized deductions," thereby reducing their individual tax liability. However, the TCJA eliminated miscellaneous itemized deductions for individuals. Depending on the services and assets under management, the elimination of these deductions resulted in significant economic implications for most family offices and private investment vehicles. Example 1 demonstrates how the loss of the miscellaneous itemized deduction could lead to a net loss to a family client through an increased tax liability each year, in this example $2m. Specifically, this hypothetical family client was unable to deduct the $3m in management fees and $2m in overhead expenses as miscellaneous itemized deductions after the TCJA.

Example 1

Example 1	Pre-TCJA	Post-TCJA
Earnings	$100m	$100m
Management Fees	($3m) (deductible)	($3m) (not deductible)
Overhead	($2m) (deductible)	($2m) (not deductible)
Adjusted Gross Income	$95m	$100m
Tax Liability (40%)	($38m)	($40m)
Net After-Tax Income	$62m	$60m

Source: Kirkland & Ellis

The family office profits interest structure as a solution

The family office profits interest structure is one potential solution we are helping family investors implement to recapture losses due to the elimination of the miscellaneous itemized deduction. Instead of clients paying non-deductible fees to the family management company, as is typically done, the structure is designed to fund the management company through a "profits (or carried) interest" in one or more flow through investment entities holding the family's assets. In Example 2, the client pays tax on only $95m of earnings by paying $5m in profits interest versus paying nondeductible management fees and overhead fees, and the family management company assumes the responsibility for paying the expenses, which are then deducted at the management company level. The profits interest fee structure results in a net savings and reduces tax liability each year, $2m in this example. It is important to note that in most circumstances a properly organized structure can also incorporate the management fees charged by private equity and hedge funds, an area where the structure often has meaningful impact. Overall, this structure reduces the taxable income of the family client, and therefore, their individual tax liability.

The management company is carefully structured through corporate entity type, ownership, and other factors, to ensure its investment management expenses are deductible as "trade or business" expenses under Section 162 of the Internal Revenue Code. While the management company may have some nondeductible expenses, such as payroll for household staff it manages on behalf of the family, hobby

Example 2

Example 2	Fee Structure	Profits Interest Structure
Earnings	$100m	$100m
Profits Interest (5%)	$0	($5m)
Management Fees	($3m) (not deductible)	$0
Overhead	($2m) (not deductible)	$0
Adjusted Gross Income	$100m	$95m
Tax Liability (40%)	($40m)	($38m)
Net After-Tax Income	$60m	$62m

Source: Kirkland & Ellis

activity expenses, or stock reacquisition expenses, this structure can nonetheless reduce the management company's overall tax liability. Although structuring the management company as a C-corporation for tax purposes may result in some loss of tax efficiency, a C-corporation is nonetheless a viable option given the corporate tax rate reduction under the TCJA and the fact that ultimately the profit of the management company is manageable.

Depending on the ownership and complexity of underlying investments, families typically have one or more different investment entities owned in varying percentages by family members, trusts or personal investment vehicles. The investments made by these vehicles are managed by the management company. A family may decide to divide assets by class if different profits interests are desired for different types of investments based on different levels of time and expertise required to manage such investments, what an outside investment manager would charge for managing such assets as well as evaluating historical returns. Accordingly, the profits interest may be different for each investment entity. The intent of the profits interest structure is that the Management Company will cover its expenses and be profitable over time, consistent with the expectations of a third party manager. These structuring features are a critical component of the structure because the management company, as a trade or business, must bear entrepreneurial risk. Additionally, the profits interest may not be recalculated on an ongoing basis or appear as a disguised fee. Proposed treasury regulations place dispositive weight on the existence of entrepreneurial risk in determining when an arrangement is a disguised payment for services. Arrangements structured without entrepreneurial risk constitute a disguised payment for services. Conversely, arrangements structured with entrepreneurial risk do not constitute a disguised payment for services unless facts and circumstances establish otherwise. Accordingly, family offices should take such structural considerations into account to ensure their profits interest structure is respected by the Internal Revenue Service.

Implementing this structure properly requires close coordination between families, professional staff, and outside advisors, such as attorneys, tax advisers, and third-party investment managers. By working closely with families' trusts and estates counsel, in particular, the profits interest family office structure can also be used as an effective estate planning and wealth transfer tool. Regardless of the family's goals, these are important to consider in order to avoid inadvertent consequences such as unanticipated gift taxes.

Considerations regarding the family office profits interest structure

While the profits interest structure can be used for a wide variety of family offices, it is important to consider whether it is right for your family office or your clients.

Cost of structuring/restructuring relative to savings: The costs of creating this structure for new family offices can vary depending on the complexity of the family's assets. While it does involve coordination between advisors, it can be a relatively straightforward process to design and implement. On the other hand, restructuring an existing family office may be more involved depending on the current structure. There may be significant transfer documentation, third party consents, and new subscription agreements involved in contributing the assets to newly formed investment entities by asset class. To make this determination, families should generally start by working with their legal and tax advisors to understand the structural alternatives and to see how much they are paying in investment management fees deductible to the management company (recall that not all expenses are deductible). Often, even a relatively small annual savings will merit the cost and effort of a one-time restructuring.

Predictability of profits: Certain assets lend themselves more readily to determining profits over time and setting an appropriate profits interest. For example, one can see average returns over time on portfolios consisting primarily of public market securities. Other investment assets, such as artwork, may be difficult to ascertain since their value depends on appreciation over time and they only generate a profit upon a sale. Assets that are difficult to value limit the utility of the family office profits interest structure; accordingly, these assets may be better managed pursuant to a fee arrangement, even if that results in decreased tax benefits.

Gift and estate tax issues: As previously mentioned, the structure should be analyzed with respect to estate plans and goals. There is a risk that the structure could result in "deemed gifts" for U.S. tax purposes where the younger generations own the family office that manages the assets of older generations.

In summary, the family office profits interest structure is certainly something that all family investors should be considering. But it is only one of a number of new and emerging considerations family investors should be reviewing, including uses of third party capital, management team incentives, and deal structuring. Now is a perfect time to challenge any historical view that family offices should be so distinct from one another. There are best practices and, at a minimum, sophisticated investors should understand the options available to them.