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The Profits Interest Family Office Structure

Recapturing the Economics of Lost Deductions

High-net-worth individuals and families, hedge fund and private equity managers, technology entrepreneurs, real estate investors, and other private investors are increasingly creating and staffing "family offices" to invest and manage their family capital. Since each family has its own unique needs and goals, family office structures are as varied as the families that use them. Kirkland's Private Investment & Family Office practice works closely with individuals and families to form new, and restructure existing, family offices to achieve our clients' overall goals while taking advantage of certain tax efficiencies that can be gained through careful structuring.

Notably, the Tax Cuts and Jobs Act's recent elimination of "miscellaneous itemized deductions" for individuals has made investment management expenses — including management fees paid to a family office management company in a traditional family office structure — non-deductible. However, under appropriate circumstances, a family office can recapture the economics of the lost deductions and achieve significant tax efficiencies by utilizing a "profits interest" structure.

What is the "Profits Interest" Family Office Structure?

While there is no one-size-fits-all approach, the profits interest family office structure is an increasingly attractive option for family offices. The profits interest family office structure is best understood as a "model" structure that can be tailored to accommodate a family's unique needs and existing family office arrangement.

In the model profits interest structure, various family members (and trusts for their benefit) contribute assets to a variety of limited partnerships ("**Investment Entities**") in exchange for limited partner interests in such Investment Entities. The Investment Entities generally are organized based on the class of assets (e.g., fixed income, private equity, real estate) in which they invest, and family members can have varying interests in the different Investment Entities (and in different investment assets held by the different Investment Entities).

A "**Management Company**" (i.e., the family office) acts as the manager or general partner of the Investment Entities and, in that capacity, manages and invests the Investment Entities' assets. Interests in the Management Company typically are held by one or more family members, family trusts or other vehicles, and sometimes by younger generations. If the Management Company is formed as a limited partnership or other flow-through entity for U.S. tax purposes, tax considerations dictate that ownership of the Management Company be significantly different from ownership of the assets under management. When such diversity of ownership is not possible, the Management Company may be formed as a C-corporation and still achieve many of the benefits of the structure. Although a corporate structure results in some loss of tax efficiency, the corporate tax rate reduction under the Tax Cuts and Jobs Act has made this a viable option for some family offices.

A key feature of the model profits interest family office structure is that, in lieu of non-deductible management fees, the Management Company is compensated for its advisory services by receiving equity interests in the Investment Entities. These "profits interests" entitle the Management Company to a share of the profits of the Investment Entities and thereby reduce profits taxed to the owners of the Investment Entities. The Management Company's profits interests may be different for each Investment Entity, depending on the time and expertise required to manage its investments (i.e., the share of profits for a fixed income portfolio of investments may be different than the share of profits for private equity investments). Each profits interest is intended to produce income (profits) over time that, on a cumulative basis, approximates what an outside investment manager would charge to manage the Investment Entity's assets.

What are some Potential Benefits and Risks of this Structure?

A properly structured profits interest family office arrangement can produce significant tax efficiencies. For example:

- Unlike management fees or salaries paid to investment managers of a family office that are no longer deductible by individual owners of the Investment Entities, the Management Company's profits interests are excluded from the income of the owners of the Investment Entities.
- Profits representing long-term capital gains retain their character when allocated by the Investment Entities to the Management Company in respect of its profits interests (subject to applicable "holding period" requirements).
- The Management Company's expenses related to its investment management services are expected to be deductible by the Management Company as "trade or business" expenses.

Although this structure offers numerous benefits, like all family office arrangements it also carries with it certain potential challenges, including:

- Gift and estate tax issues, including the risk that the structure will result in "deemed gifts" for U.S. tax purposes where the younger generations own the Management Company and the Management Company manages the assets of older generations.
- Depending on the size of the family office and number of existing entities, implementing the profits interest family office structure can be complicated, although the benefits usually well outweigh the cost.
- An improperly structured profits interest arrangement may result in the loss of the intended benefits.

Is the Profits Interest Structure Right for My Family Office?

The manner in which a Management Company is owned, managed and compensated, both on paper and in practice, is a critical component of successful profits interest family office planning. Among other things, the Management Company cannot operate as a mere "cost center," nor can it simply be an "alter ego" of related Investment Entities. These and other considerations — including estate tax planning, family cohesion and investment philosophies, regulatory compliance and existing family office structures — need to be carefully analyzed to determine whether this model is appropriate for your family office.

If you have questions about the topics addressed in this *Private Investment & Family Office Insights*, please contact familyoffice@kirkland.com or one of the attorneys listed below.

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