



Tax Savings and Other Benefits of a “Family Office”

A family office, if properly structured, can provide meaningful tax savings and other benefits.

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The Tax Cuts and Jobs Act (TCJA),¹ passed in late 2017, led to numerous changes within the Internal Revenue Code (IRC). For higher-income earners and businesses, the changes were mostly beneficial, including a new Qualified Business Income (QBI) deduction, lowered individual and corporate income tax rates, and increased federal transfer tax exemption amounts. Most (but not all) of these changes are scheduled to automatically expire after 2025, a consequence of the TCJA’s passage through Congress.

To decrease the budgetary “cost,” the TCJA included revenue offsets. The most prominent of these was the limitation of the previously uncapped state and local tax deduction, commonly referred to as the “SALT” deduction, to \$10,000 per household for federal tax purposes. An additional change was the elimination of “Miscellaneous Itemized Deductions” deductible above a 2% of adjusted gross income (AGI)

floor, including unreimbursed job expenses paid as an employee, tax preparation fees paid, and investment advisory fees. Today, accountant fees and advisory fees paid are no longer deductible to taxpayers, unless incurred as expenses pursuant to a qualified trade or business under Section 162. The focus of this article is on how a family office, if properly structured, can serve as a qualified business and provide meaningful tax savings, among other benefits.

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What is a “family office”?

A family office allows for the integration of additional services, improved efficiency, and cost savings for ultra-high net worth (UHNW) households by coordinating the family’s key advisors – CPA, attorney, financial advisor, etc. These professionals provide their services collaboratively and in further scale and scope than would be feasible in isolation. The scale of services provided by a family office, along with whether those services are provided in-house or outsourced to outside professionals, will vary depending on the family’s overall goals, resources, and complexity. A common, but non-exhaustive, list of services includes:

- Oversight and management of professional advisors.
- Accounting and finance functions and reporting (including bill pay services).
- Family governance and education.

- Philanthropic administration and planning.
- Investment management.
- Legal, estate, and tax planning.

Single-Family Office (SFO) vs. Multi-Family Office (MFO)

As the name implies, Single-Family Offices (SFOs) serve the needs of a single family, often centered around a business and the resulting wealth from that business. Historically, most, if not all, family offices were SFOs, with some of the most notable started by the families of JP Morgan, Henry Ford, and the Rockefellers, for example. Understandably, SFOs were, and remain today, very closely linked to the family that started them. This can allow for tremendous flexibility and value but are more expensive in nature and can lead to complications when the reigns are passed to successor generation(s).

Multi-Family Offices (MFOs), rather than serve a single family, allow multiple families to pool their resources and wealth together. Some MFOs result from single-family offices expanding and opening their doors to others so as to share expenses. Given the more diverse client base and larger sizes of MFOs, they tend to have a level and depth of resources not typically available with an SFO. Put differently, MFOs have a mandate to serve multiple families with varying needs and goals, often resulting in staff and expertise reflecting that.

When does a family office make sense?

An SFO can be advisable for UHNW households with: (1) \$300 million-\$500 million plus of net worth (a sizeable portion of that being liquid)

and \$1 million plus of annual legal/advisory/accounting expenses, (2) annual investment income that can support family office costs, after lifestyle expenses, and (3) significant financial complexity. Financial complexity matters, perhaps more so than just net worth alone. An entrepreneur with a single illiquid business worth \$500 million making up most of his/her net worth, some cash, and a single home likely does not need an SFO. A former business owner worth \$400 million consisting of multiple homes and dozens of private investments, along with major philanthropic goals and a lengthy and geographically diverse family tree, is a better candidate.

Those under the net worth, expense, and complexity considerations for an SFO could find an MFO is better suited to their needs. The \$400M former business owner discussed above might find an MFO a superior fit, with its existing infrastructure, staff and expertise, lower pooled expenses, and lack of a need to build everything from “scratch.”

Note that for the purposes of the remaining paragraphs, the term “family office” will refer to an SFO.

Family office as a “qualified business”

A family office can serve as a qualified business, allowing deductions, as bona-fide business expenses, for costs that otherwise could not be deducted under current law. A recent Tax Court decision involving the Lender family² provides important factors to consider in properly establishing and structuring a family office so that it may qualify as a qualified business in the eyes of the IRS.

In the Lender case, the family office was compensated primarily through a “profits interest” for its services. A profits interest is the right to receive or share in an allocation

of the underlying entity’s income, and therefore growth, over a certain time frame. This method of compensation is common within private equity and hedge fund investments and is meant to reward the risk taken and allow an investor to have upside potential. Importantly though, a “profits interest” is not a guaranteed payment.

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There are additional details covered by the Lender case beyond the scope of this article that are important in creating a family office. Careful planning with an experienced legal, advisory, and accounting team are critical here and well worth the expense.

Example of tax savings

To keep the math simple, consider the Smith family with a \$2 million portfolio in a joint revocable trust that generated \$100,000 of taxable investment income through a combination of realized capital gains, interest, and dividends taxed at a 25% effective federal tax rate. The Smiths pay a 1% investment man-

¹ P.L. 115-97, 12/22/2017.

EXHIBIT 1

Example – Calculation of Income Without Family Office

	Smith Joint Revocable Trust
Taxable Income	\$100,000
Tax (25%)	\$(25,000)
Investment Management Fee (1%)	\$(20,000)
After-Tax Income	\$55,000

agement fee based on their \$2 million portfolio. Their after-tax income would be \$55,000, calculated as in Exhibit 1.

Assuming the same facts as in Exhibit 1, the Smith family decides to form an SFO. They contribute their \$2 million of joint revocable trust assets into the Smith Family LLC that John and Jane own equally. They also form the Smith Family Office, which takes a 20% profits interest in the annual gross income earned by Smith Family LLC. Their after-tax income would now be \$60,000, calculated as in Exhibit 2.

Assuming it is properly structured, the Smith Family Office is able to deduct investment management and other professional fees without

EXHIBIT 2

Example – Calculation of Income With Family Office

	Smith Family LLC	Smith Family Office
Gross Income	\$100,000	\$ -
Profits Interest Allocation (20%)	\$(20,000)	\$20,000
Investment Management Fee (1%)	\$ -	\$(20,000)
Taxable Income	\$80,000	\$ -
Tax (25%)	\$(20,000)	\$ -
After-Tax Income	\$60,000	\$ -

limitation under Section 162. The Smiths are now left with an after-tax income that is \$5,000 higher, reflecting the tax benefit of deducting the investment management fees (25% x \$20,000). Of course, this analysis did not consider the impact of state taxes and other factors that should be considered.

C corporation vs. pass-through entity (partnership, S corporation)

One of the important factors to consider in establishing a family office is the selection of an entity structure. Because of the TCJA and resulting lowered 21% flat income tax rate, a C corporation structure is increasingly attractive. However, because distributions out of a C corporation are taxed again at the individual level as dividends, it is prudent to aim to offset income with expenses when using a C corporation structure. There are additional tax considera-

tions to navigate and the potential for a C corporation tax hike currently under discussion by the Biden Administration.

A family office structured as a pass-through entity, including a partnership, S corporation, or limited liability company (LLC) making an S corporation/partnership election, would avoid the “double-taxation” issue discussed above. It would require additional complexity and tax reporting. Ultimately, many factors will help inform an entity selection decision, including character of the family’s income, timing and frequency of distributions, state tax rates, and anticipated future federal income tax rates.³

Conclusion

A family office can bring not only better professional coordination and additional service scope, but also meaningful tax savings. ■

² *Lender Management, LLC*, TCM 2017-246.

³ See a whitepaper from Perkins Coie LLP for a deeper dive into the subject. <https://www.perkinscoie.com/images/content/2/1/v3/218352/Tax-Management-Estates-Gifts-and-Trusts-Journal-Bloomberg.pdf>