Economics of Structuring a Family Office

By
Brian S. Schimpf
Senior Quantitative Strategist
Advanced Planning Group

Brian Hans
Senior Income Tax Strategist
Advanced Planning Group

Advanced Planning Group

UBS

Ultra high net worth (UHNW) individuals and families frequently seek guidance from their trusted advisors about the possible benefits of setting up a family office to manage their wealth. The family may need a coordinated enterprise to carry out the administrative needs of numerous stakeholders while maintaining the wealth creator's vision and philosophy of how the family's wealth should be deployed. To this end, the family may consider creating a family office to manage the family's wealth while nurturing the family's identity and values across a wide range of areas, such as wealth management, wealth transfer, philanthropy, and family governance. For a more complete discussion of these topics, please see Ann Bjerke, David T. Leibell, and Brian Hans, *Building a Family Office to Steward Family Wealth and Values* (a publication of the UBS Advanced Planning Group and UBS Family Office Solutions) and Mark Tepsich and Nicole Sebastian, *Family Matters: The Family Focused Family Office* (a publication of UBS Family Office Solutions and UBS Family Advisory and Philanthropy).

And while the establishment of a formal family office may provide structure and simplicity to the administration and management of a complex balance sheet and family dynamic, oftentimes that may not be the initial consideration driving the family's decision to create the family office. Usually, but not always, the exploration of the establishment of a family office is led by a focus on tax efficiency. Families may fully understand the non-tax benefits referenced above, but they need to grasp the economic benefits as well in order to make an informed decision about whether the economic benefits of a single family office specifically designed to create tax-efficiency will outweigh the costs and administrative burden of establishing and maintaining the entities on an ongoing basis.

Are there certain rules of thumb that should guide the economic aspect of the decision to create or not create a single family office? We will analyze this question and some related issues here. As we will see in the case studies below, there is no panacea; each situation should be reviewed and analyzed independently, as there are many factors that can influence the results regarding the amount of tax-efficiency gained in a single family office structure. While the amount of potential tax savings that will warrant a single-family office structure varies from family to family, once expenses reach the million-dollar mark, a family may wish to take a closer look at the potential tax savings. Once family office expenses reach $1 million, the potential tax savings can begin to become significant and start to approach several hundred thousand dollars, depending on the specifics of the family's situation, as described more fully below.

Background

Under prior law, individuals, estates, and trusts were able to deduct miscellaneous itemized deductions (such as investment advisory fees) to the extent they exceeded 2% of adjusted gross income. This was suspended with the Tax Cuts and Jobs Act of 2017 for tax years 2018 through 2025, such that, under current law, individuals, estates, and trusts may no longer be able to deduct these types of expenses, including investment advisory fees. Depending on a family's specific situation (as discussed further below), the inability to deduct these types of expenses for income tax purposes may result in an increased income tax liability as compared to the environment under prior law.

However, under Section 162 of the Internal Revenue Code, an investment management enterprise that operates as a trade or business can still deduct its ordinary and necessary expenses (including investment management expenses) because the limitations under the Tax Cuts and Jobs Act of 2017 referenced above do not apply to enterprises that meet the definition of a trade or business. Recent case law has provided some authority and guidance for family offices to enable them to deduct investment management expenses if structured and implemented properly and if the family dynamics are appropriate to support the structure.[1] The following are some of the relevant factors which, among others, should be considered when assessing whether a single family office is properly characterized as a trade or business under section 162:

- whether ownership of the family office investment management company is spread among different family members or in different percentages relative to the owners of the investments being managed,
- whether compensation is structured such that the family office management company receives a profits interest and a separate management fee,
- whether the family office investment management company provides extensive services rather than only administrative or "back office" services,
- whether the family office investment management company has a sufficient number of clients (different family members and trusts, etc.), and
- whether the family office employs full time workers.

In addition to investment management expenses (fees paid to investment management professionals such as financial advisors and third-party investment managers such as private equity or hedge fund sponsors), the following additional expenses also may potentially be deductible by a family office:

1. Rent expense for the family office.
2. Utilities for the family office.
3. Office expenses for the family office (equipment, supplies, etc.).
4. Family office employee salaries.
5. Outside third-party professional fees for expenses related to the management of the family's assets (i.e., not related to personal items such as personal tax returns or personal planning).

Two hypothetical families: the Montagues and the Capulets

For purposes of the discussion which follows, we have assumed that a bona fide family office has been created which would be respected for federal income tax purposes as a trade or business under section 162 and would meet all other requirements to deduct its expenses incurred in the operation of its daily activities.

The Montagues

The Montagues had a liquidity event several years ago: the family sold a business to a strategic buyer in an all-cash deal. The family resides in Florida where there is no state income tax. The family's assets are

[1] *Lender Management LLC v. Commissioner,* T.C. Memo. 2017-246.

allocated in a diversified portfolio with 70% global equities, 10% municipal bonds, and 20% alternative investments. Altogether, the $250-million portfolio generates about $4.5 million in annual income, mostly in the form of dividend income and realized capital gains, but also tax-exempt municipal bond interest and ordinary income (see breakdown below). Altogether, estimated federal income taxes on portfolio income is approximately $935,000 per year.

At the moment, the Montagues do not have a family office. The family works with a financial advisor but hasn't hired any other investment professional to formally manage and evaluate investments on behalf of the family. The family does incur $2 million in annual investment management fees. They pay 40 basis points in fees on the $250 million under management (0.4% × $250 million = $1 million), in addition to a 2% asset management fee to various third-party alternative investment managers (2% × $50 million = $1 million). As described above, under current law the family is not able to deduct these investment management expenses. The family is considering establishing a formal family office structure where a portion of the portfolio income can be allocated to the family office in the form of a profits interest which may allow for greater income tax efficiencies.

Recap of the Montagues' situation

- State of residence: Florida
- Liquid investment asset base: $250 million.
- Investment allocation:
  - 10% municipal bonds
  - 70% global equities
  - 20% alternatives
- Investments generate estimated annual income as follows:
  - 250,000 ordinary income
  - $3.5 million long-term capital gain/qualified dividend income
  - $750,000 tax-exempt municipal income
- Investment management fees: $2 million (40 basis points on $250,000,000 plus 2% to alternatives managers)
- Other potentially deductible expenses: none currently

In the "No Family Office" scenario,

Below is an example of the after-tax and expense cashflows for the Montagues under current circumstances (No Family Office) or if a formal family office were established (Family Office):

	No Family Office	Family Office	
	Personal	Personal (LP Interest)	Family Office (GP Interest)
Ordinary Income	250,000	138,889	111,111
Long-Term Capital Gains/Qualified Dividends	3,500,000	1,944,444	1,555,556
Municipal Income	750,000	416,667	333,333
State Taxes	-	-	-
Federal Taxes	(935,000)	(519,444)	-
Investment Management Fees	(2,000,000)	-	(2,000,000)
Other Expenses	-	-	-
Net Income	**1,565,000**	**1,980,556**	-

after the payment of income taxes and investment management fees, the family is left with $1.565 million of net income. In the “Family Office” scenario, a portion of the income (in the form of a profits interest) is allocated to the family office entity on a pro-rata basis. In our example, for illustrative purposes only, the amount allocated to the family office is exactly enough to offset the investment management expenses, which will be completely borne by the family office. These expenses are deductible by the family office against the income allocated to the family office. Meanwhile, the family’s income on the personal side of the ledger has been reduced by the $2 million of profits interest allocated to the family office. Under the “Family Office” scenario, taxes are now $519,000, as compared to $935,000 in the “No Family Office” scenario, a difference of $416,000.

The Capulets

The Capulets, a family living in upstate New York, currently have $500 million of assets, but, other than a small allocation to municipal bonds (10%), the family’s wealth is held in equities. The family is interested in reducing their risk and diversifying into other asset classes, such as alternatives. Their current investment management fees total $1.25 million per year.

Recap of Capulets’ Situation

- State of residence: New York
- Liquid investment asset base: $500 million.
- Investment allocation:
  - 10% municipal bonds
  - 90% global equities
  - 0% alternatives
- Investments generate estimated annual income as follows:
  - $0 ordinary income
  - $6.75 million long-term capital gain/qualified dividend income
  - $1.5 million tax-exempt municipal income
- Investment management fees: $1.25 million (25 basis points on $500 million)
- Other potentially deductible expenses: currently none

	No Family Office	Family Office	
	Personal	Personal (LP Interest)	Family Office (GP Interest)
Ordinary Income	-	-	-
Long-Term Capital Gains/ Qualified Dividends	6,750,000	5,727,273	1,022,727
Municipal Income	1,500,000	1,272,727	227,273
State Taxes	(695,250)	(589,909)	
Federal Taxes	(1,606,500)	(1,363,091)	
Investment Management Fees	(1,250,000)	-	(1,250,000)
Other Expenses	-	-	-
Net Income	**4,698,250**	**5,047,000**	-

As can be seen from the above illustrations, although the Montagues have a smaller asset base ($250 million vs. $500 million for the Capulets), a single family office may result in greater tax savings for the Montagues (tax savings of $416,000 for Montagues vs. $349,000 for the Capulets). The reason for the greater tax efficiency in the Montagues' structure is due to the fact that they have a larger allocation to alternative investments, resulting in higher current investment management expenses. TheMontagues also have more ordinary income (also due to the nature of alternative investments) than the Capulets, which creates additional tax efficiency for the Montagues as they are allocating to the family office (and therefore not being taxed on) income that would be taxed at a higher rate.

Meanwhile, the Capulets are receiving certain benefits the Montagues are not—they avoid two levels of tax (both federal and New York state income tax on the amounts allocated to the family office) whereas the Montagues do not get additional state income tax savings as they do not pay income taxes in Florida. If the Capulets had the same overall expenses as the Montagues, their tax savings would be even more significant as both federal and New York tax would be avoided on the family's personal tax returns on the amounts allocated to the family office.

To illustrate this point, we look at an example where the Capulets incur an additional $750,000 of expenses, bringing their total expenses to $2 million. The Capulets have done some extensive estate planning to transfer wealth among various trusts for the benefit of different family members. The family decided it needed to hire some additional staff to manage the complex needs of multiple family members and trusts. With higher expenses, cashflow is reduced, but the potential benefit of creating the family office increases. Altogether, when factoring in the state income tax savings, the overall tax benefit for the Capulets of setting up the family office would be $558,000 vs. $416,000 for the Montagues for the same $2 million of total expenses.

	No Family Office	**Family Office**	
	Personal	Personal (LP Interest)	Family Office (GP Interest)
Ordinary Income	-	-	-
Long-Term Capital Gains/Qualified Dividends	6,750,000	5,113,636	1,636,364
Municipal Income	1,500,000	1,136,364	363,636
State Taxes	(695,250)	(526,705)	-
Federal Taxes	(1,606,500)	(1,217,045)	-
Investment Management Fees	(1,250,000)	-	(1,250,000)
Other Expenses	(750,000)	-	(750,000)
Net Income	**3,948,250**	**4,506,250**	-

Additional considerations
What other factors could influence the potential benefit of setting up a family office?

- The legal and tax advisory costs of establishing and administering a formal family office may be significant, perhaps in the nature of several hundred thousand dollars. Ongoing legal and compliance costs should be considered as well. Some of these costs may be deductible by the family office.
- It is unknown whether the suspension of the deduction of miscellaneous itemized expenses subject to the 2% floor will be lifted or extended (it is currently scheduled to sunset at the end of 2025). A reversion to the prior law could limit the benefit of establishing a family office. However, even under a reversion to prior law, a single-family office may still offer significant income tax savings when factoring in the alternative minimum tax and related limitations on the ability to deduct investment management expenses. Accordingly, an analysis of the potential tax savings should still be conducted.

Conclusion

The decision of whether to create a family office or not goes well beyond the financial impact. If the family dynamics and administrative needs warrant the exploration of establishing a formal structure to help manage the family's assets, a few key characteristics stand out as drivers of the ultimate tax savings that the family office structure may afford:

- Amount of ordinary income generated by the investments (all else equal, a dollar of ordinary income allocated to the family office has a greater tax benefit than a dollar of income taxed at long-term capital gains/qualified dividends rates).
- Amount of private fund investments (these assets tend to have higher fees, which can be paid through the family office to offset income allocated to the family office)
- Amount of other business-related expenses the family office may incur, such as salaries, rent, and equipment.
- Income tax jurisdiction of the family, family trusts and the family office itself (all else equal, a higher state tax rate increases the benefit of setting up the family office structure vs. not setting up the family office).

As the examples above show, the specifics of the family will dictate how large of an impact any one factor will have on the family's decision to establish a family office. Working closely with a team of advisors highly experienced in weighing the various considerations can help the family make an informed decision.

About the Advanced Planning Group

The Advanced Planning Group consists of former practicing estate planning and tax attorneys with extensive private practice experience and diverse areas of specialization, including estate planning strategies, income and transfer tax planning, family office structuring, business succession planning, charitable planning and family governance.

The Advanced Planning Group provides comprehensive planning and sophisticated advice and education to ultra high net worth (UHNW) clients of the firm. The Advanced Planning Group also serves as a think tank for the firm, providing thought leadership and creating a robust intellectual capital library on estate planning, tax and related topics of interest to UHNW families.

Disclosures

Purpose of this document.
This report is provided for informational and educational purposes only. It should be used solely for the purposes of discussion with your UBS Financial Advisor and your independent consideration. UBS does not intend this to be fiduciary or best interest investment advice or a recommendation that you take a particular course of action. The information is current as of the date indicated and is subject to change without notice.

Personalized recommendations or advice.
If you would like more details about any of the information provided, or personalized recommendations or advice, please contact your UBS Financial Advisor.

Conflicts of interest.
UBS Financial Services Inc. is in the business of establishing and maintaining investment accounts (including retirement accounts) and we will receive compensation from you in connection with investments that you make, as well as additional compensation from third parties whose investments we distribute. This presents a conflict of interest when we recommend that you move your assets to UBS from another financial institution or employer retirement plan, and also when we make investment recommendations for assets you hold at, or purchase through, UBS. For more information on how we are compensated by clients and third parties, conflicts of interest and investments available at UBS please refer to the "Your relationship with UBS" booklet provided at **ubs.com/relationshipwithubs**, or ask your UBS Financial Advisor for a copy.

No tax or legal advice.
UBS Financial Services Inc., its affiliates and its employees do not provide tax or legal advice. You should consult with your personal tax and/or legal advisors regarding your particular situation.

Important additional information applicable to retirement plan assets (including assets eligible for potential rollover, distribution or conversion).
This information is provided for educational and discussion purposes only and are not intended to be fiduciary or best interest investment advice or a recommendation that you take a particular course of action (including to roll out, distribute or transfer retirement plan assets to UBS). UBS does not intend (or agree) to act in a fiduciary capacity under ERISA or the Code when providing this educational information. Moreover, a UBS recommendation as to the advisability of rolling assets out of a retirement plan is only valid when made in a written UBS Rollover Recommendation Letter to you provided by your UBS Financial Advisor after a review of detailed information that you provide about your plan and that includes the reasons the rollover is in your best interest. UBS and your UBS Financial Advisor do not provide rollover recommendations verbally.

With respect to plan assets eligible to be rolled over or distributed, you should review the IRA Rollover Guide UBS provides at **ubs.com/irainformation** which outlines the many factors you should consider (including the management of fees and costs of your retirement plan investments) before making a decision to roll out of a retirement plan. Your UBS Financial Advisor will provide a copy upon request.

Important information about brokerage and advisory services.
As a firm providing wealth management services to clients, UBS Financial Services Inc. offers investment advisory services in its capacity as an SEC-registered investment adviser and brokerage services in its capacity as an SEC-registered broker-dealer. Investment advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate arrangements. It is important that you understand the ways in which we conduct business, and that you carefully read the agreements and disclosures that we provide to you about the products or services we offer. For more information, please review the client relationship summary provided at **ubs.com/relationshipsummary**, or ask your UBS Financial Advisor for a copy.

Approval code: IS2401462
Expiration date: 03/31/2025