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Family Offices Go Mainstream in Light of Tax Reform

- Kempe Multifamily Office Resources Extend Services to More Users -

Our multifamily office practice has for many years extended the services used by the very wealthy to those of more moderate wealth - $10 million dollars under management or greater. We are now available to assist families create their own office, whether by using our service platforms and models or in meeting the state and federal requirements associated with forming their own family office. Law firms are uniquely suited to assist families with the creation of family offices and in overseeing their legal, tax, and financial circumstances. This is particularly true of law firms staffed with lawyers specialized in tax law and estate planning, supported by teams of CPAs, paralegals, analysts, and support personnel dedicated to servicing the unique needs of families. The Tax Cuts and Jobs Act of 2017 ("2017 Tax Reform Act") has increased the demand for family offices, that are scaled to serve a wide range of family needs. This is the result of the elimination of the deductibility of certain investment and property management-type fees that are paid directly by family members or trusts. Properly structuring and organizing a family office, often affiliated with family partnerships, can simulate and preserve the deductibility of costs that are now nondeductible. The result is a decrease in net cost for these services by potentially in excess of 50%. Once a family office is properly modeled, families are routinely extending their knowledge and services to others within the family tree and to nonfamily members, often for profit.

The 2017 Tax Reform Act has eliminated the deductibility under IRC § 212 of a variety of investment and property management type fees for trusts and individuals through 2025. At that time, these changes to § 212 sunset and, unless extended, revert to prior law. The deduction of these fees can be viewed as reducing their cost by the taxpayer's highest marginal tax rate, which for individuals and trusts can exceed 50% (state and federal). An example of the savings using $10 million dollars under management and a management cost of 60 basis points (.60%) can be seen in the attached illustration. As miscellaneous itemized deductions, these fees were previously subject to a variety of limitations, including the 2% itemized deduction limitation, the "Pease" limitation (3% reduction up to 80% phaseout), and the alternative minimum tax. The likelihood is that should the sunset actually occur these limitations would remain. Properly structuring a family office to deduct investment and property management fees converts the expense from deductible under IRC § 212 to a trade or business expenses deductible under IRC § 162. This reallocation of expense to a trade or business expense, if done properly, would avoid not only the change under the 2017 Tax Reform Act but also the phase-out and other limitations under prior law. The method of conversion of itemized expenses into trade or business expenses was recently approved by the Tax Court in Lender Management, LLC v. Commissioner of Internal Revenue, T. C. Memo 2017-246.

Family offices historically evolve out of a family's need for routine services or expertise. As a family's wealth spreads to junior family members, economies of scale can be created in serving the common needs of family members in a uniform, consistent, and trustworthy manner. Asset protection and estate and tax planning are essential for adult family members. Financial planning, investment advice, business planning, accounting, and bookkeeping are generally desired. Legal and other professional services, such as trust counsel, health care advocacy, mentoring junior family members, and business and real estate advice are also often useful or required. Once a senior family member has undertaken these processes and acquired resulting knowledge and experience, that knowledge and experience has value that can be shared with others. This includes due diligence on service providers and others that may form the basis of the family office and the services it may offer. A common structure can be illustrated by this diagram.

Family's demand trust of and from their service providers and they prefer an organization where advice is not tied to selling financial products. In a single family office setting, these providers are often employees with a duty to one employer- the family. The family office may contract with lawyers, investment advisors, and others, but it coordinates and seeks to deliver the necessary services to the family it represents. A multi-family office does the same, but loyalty, duty, and time can be diluted by being spread amongst several families and thus are tailored to meet the demands of families who do not need the fulltime services of all of the needed service providers. Here, at Kempe, we do not sell investments or any products but offer our legal services and guidance to families, their offices, and in the creation of family offices. Our sole role is to advocate and represent our clients as their lawyer, while performing tax and accounting functions that are dictated by the legal structures and needs of families. In the role of lawyer, we are often asked to oversee family wealth, money managers, and investment advisors and to negotiate their fee structures, while benchmarking their performance against their peers.

The creation and operation of family offices can be rewarding and those rewards can be shared with others. Whether fulfilling the role of a family office using the resources of Kempe or creating your own single family or multifamily office, we have experience that can help you. Legal advice on business, trust, tax, and securities laws is often required, and we stand ready to assist you and your family.

Our Office Locations:
941 N Highway A1A
Jupiter, FL 33477
561-747-7300

1101 East Ocean Boulevard
Stuart, FL 34994
772-223-0700