FAMILY OFFICE INCOME TAX PLANNING IN A CHANGING REGULATORY ENVIRONMENT

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AGENDA

1. Wyden Proposal
2. Ways & Means Proposal – Impact on Family Office Profits Interest Planning
3. Ways & Means Proposal – Impact on Key Employee Carry
4. Securities & Exchange Commission (SEC) Developments

WYDEN PROPOSAL

- Released September 10, 2021 – not reduced to legislative language but highly technical proposed changes to long-standing partnership tax concepts
- Based on Wyden's perception that partnerships are often used as tax-evasion devices and are seldom audited by the Internal Revenue Service (IRS)
- Specific proposals:
  - Repeal the "substantial economic effect" rules
  - Mandatory "partner's interest in the partnership" (PIP) for most partnerships
  - Require all "related party" partnerships to be pro rata profit/loss sharing based on contributed capital (effective for years after 2023)
    - No special allocations
    - No Chapter 14/Section 2701 (statutory) freeze partnerships
  - Mandatory Section 704(c) book-up any time the partners' economic arrangement changes

WYDEN PROPOSAL, *CONTINUED*

- Specific proposals:
  - Make the period for "mixing bowl rules" permanent (remove 7 year)
  - Clarify that disguised sale rules are self-executing, and repeal the exception for reimbursements of capital expenditures
  - Mandate use of the "remedial method" under Section 704(c) – accelerating recognition of income and gain for depreciable property (effective for contributions and book-ups after 2021)
  - Require partnership liabilities to be allocated according to the partners' profit shares

WAYS & MEANS – IMPACT ON FAMILY OFFICE PROFITS INTEREST PLANNING

- Basic Provisions Effects – Pros
  - Increase to highest marginal individual/trust ordinary income tax rates (increase from 37% to 39.6%) and long-term capital gains rates (from 20% to 25%) would have the effect of increasing the cost of Section 212 limitations
  - 3% surtax (on individuals, trusts, estates) further increases the cost of Section 212 limitations
  - If the concept of grantor trusts disappears, increases income tax ownership differences between the family office and the investment entities in structures in which a grantor trust holds an ownership interest in the investment entity

WAYS & MEANS – IMPACT ON FAMILY OFFICE PROFITS INTEREST PLANNING, *CONTINUED*

- Basic Provisions Effects – Cons
  - For family offices classified as a C-Corporations for tax purposes, net taxable income is taxed at a higher rate (26.5% plus state rate, instead of 21% plus state rate)
    - If taxable income up to $10M, subject to graduated rates of 18% on income up to $400K and 21% on income from $400K to $5M
    - Certain personal service corporations taxed at flat 26.5%
  - For family offices classified as pass-through entities (i.e., S-Corp or tax partnership), the permanent extension of Section 461(l) may be relevant

WAYS & MEANS – IMPACT ON FAMILY OFFICE PROFITS INTEREST PLANNING, *CONTINUED*

- Section 212 limitation – Not addressed in proposal
  - The proposal does not alter the Section 212 elimination through 2025, nor does it extend the elimination beyond 2025
  - Before 2017 tax reform, Section 212 allowed individuals to deduct expenses incurred in the production of income, subject to a 2% floor, phase-out and Alternative Minimum Tax (AMT) add-back
- Proposal allocates $78 billion to strengthen IRS enforcement activities of taxpayers with taxable income of $400K or more

WAYS & MEANS – IMPACT ON KEY EMPLOYEE CARRY

- Carried Interest Provisions:
  - Starting in 2022, the proposal would generally extend from 3 to 5 years the holding period required for gain attributable to an “applicable partnership interest” to qualify for long-term capital gain treatment
  - Expands scope of income to be recharacterized include qualified dividend income, gain from Section 1256 contracts and Section 1231 gains (i.e., any asset otherwise subject to long-term capital gains rates in a sale)
  - Holding period – does tacking still apply on contributions to a partnership
  - No clarity regarding whether carried interest legislation applies to family offices in the first place

WAYS & MEANS – IMPACT ON KEY EMPLOYEE CARRY, *CONTINUED*

- Employee Co-Investment:
  - Some Key Employees want to co-invest in a fund, but do not have the cash, so they receive a loan from the family to make a capital investment
  - The Final Regulations on carried interests generally do not apply to capital interests, except where those capital interests are funded with the proceeds of a loan made or guaranteed by the partnership, a partner, or a person related to the partnership or partner
    - There is an exception, however, where an individual service provider acquires a capital interest with loan proceeds if the individual service provider is personally liable for the repayment of such loan – which means (i) the loan is fully recourse to the service provider, (ii) the service provider has no right to reimbursement from any other person, and (iii) the loan is not guaranteed by any other person

SEC DEVELOPMENTS

- Currently, family offices are exempt from SEC registration if they:
  - Provide investment advice only to “family clients,”
  - Are wholly-owned by family clients and exclusively controlled by family members and family entities, and
  - Do not hold themselves out to the public as investment advisors
- Representative Alexandria Ocasio-Cortez proposed legislation (H.R. 4620) that would repeal the exemption for family offices with $750M or more in assets under management and implement additional restrictions and reporting requirements

SEC DEVELOPMENTS, *CONTINUED*

- Alternative Proposals
  - Require a family office to make a filing with the SEC to claim the family office exemption (currently no reporting required)
  - Permit the SEC to request portfolio information from family offices necessary to protect investors (information would be confidential and not disclosed to the public)
  - Amend the “Family Office Rule” to add in-laws to the definition of “family client” and include additional familial relations covered by Private Letter Rulings (PLRs)
  - Grant the SEC the power to ban individuals who are subject to final orders based on violations of state and federal banking, insurance and securities laws from trading in the securities markets

THANK YOU!

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