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Choice of Entity: Analyzing the Decision in the Wake of the New Tax Act

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INTRODUCTION

Family offices established for, among other reasons, the centralized management of a family's investments and other economic affairs, provide a number of benefits, including economies of scale, privacy, and perpetuation of a common vision. However, their greatest benefit, arguably, is the ability to provide family members with a de facto deduction for investment management expenses. The 2017 Tax Cuts and Jobs Act (2017 tax act) has made this benefit all the more valuable as a result of altogether eliminating the deductions for investment management expenses that otherwise would have been available to taxpayers under §67,[1] in addition to prompting a renewed debate as to whether it is more beneficial to hold and/or manage pooled investment vehicles through flow-through entities (entities classified as partnerships[2] or S corporations for federal income purposes) or C corporations.[3] The 2017 tax act, coupled with the recent taxpayer victory in *Lender Management, LLC v. Commissioner*,[4] has made family office planning a major focus of 2018. This article provides a general overview of family offices and their use in planning for the deductibility of investment management expenses before offering some considerations regarding the proper organizational structure for family office entities and family investment funds.

FAMILY OFFICE OVERVIEW

The term "family office" may be used to describe a multitude of formal and informal structures that focus on the management and organization of a family's activities and investments. A family office may begin, for instance, with an employee of the family's operating business dedicating a portion of his or her time to the family's personal matters, and it may evolve over time (possibly in response to the growth of the family over multiple generations) to become a standalone entity employing its own specialized personnel to administer and manage family assets and other matters. Eventually, the family office may become a multigenerational enterprise aimed at sustaining the founding generation's legacy, through philanthropy, education, and perpetuating the family vision. This article focuses primarily on the more formal definition of a family office as a distinct entity and, in particular, examines perhaps the most common role of the family office, as a provider of investment management services.

Notwithstanding this somewhat limited view of the family office for purposes of this article, its role may be quite broad and may involve the coordination of a number of in-house and outsourced functions. Some examples include the following:

In-House Functions

- Investment Oversight

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[1] Pub. L. No. 115-97. All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[2] The term "partnership" is hereinafter used to refer to an entity that is classified as a partnership for federal income tax purposes, including an LLC, and "partner" is used to refer to an owner of such entity.

[3] Unless otherwise provided, the term "corporation" is hereinafter used to refer to a C corporation.

[4] T.C. Memo 2017-246.

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- Managing Professional Advisors
- Tax Planning/Return Preparation
- Record-keeping
- Philanthropy
- Real Estate Management
- Trust/Entity Administration

Outsourced Functions

- Investment Advice
- Legal
- Tax Planning
- Valuation Services
- Insurance
- Trust/Entity Administration
- Aircraft Operation

Among the variety of benefits offered by a family office are:

1. **Administrative Convenience**. Centralized management of family affairs ensures that everyone knows where to turn for answers and/or assistance and that activities are coordinated as necessary.
2. **Economies of Scale**. By pooling resources, family members may gain access to investments and expertise that would not be available to any one of them, and potentially at a lower aggregate cost than could be obtained as a result of everyone hiring their own advisers.
3. **Participation of Family Members**. A family office facilitates the involvement of family members in the administration of the family's investments and ownership structures.
4. **Privacy**. A family office provides a separate entity with a ''business presence,'' insulating family members from having to deal directly with vendors, service providers, and solicitations.
5. **Tax Efficiency**. As is detailed below, investment advisory fees and other professional fees incurred in connection with administering and managing the family's investment assets may be deducted in a more tax-efficient manner as a result of the implementation of a family office.
6. **Health Insurance Plans and Other Employee Benefits**. A family office may be utilized to provide access to employee health insurance plans and other benefit plans that may be unavailable or unaffordable for individual family members.

OVERVIEW OF EXPENSE DEDUCTIBILITY

Deductibility of Expenses: Generally

To understand the importance of the family office, it is necessary to first understand the deductibility of investment management expenses, both before and after the 2017 tax act. [5]

Deductions for individuals, estates, and non-grantor trusts[6] fall into two general categories:

> (1) ''Above-the-line'' deductions (including expenses arising from a trade or business) are generally enumerated in §62(a) and are subtracted from gross income in calculating adjusted gross income (AGI); and
>
> (2) ''Below-the-line'' or ''itemized'' deductions (including most expenses arising from profit-oriented activities other than a trade or business) generally include deductions not enumerated in §62(a) and are subtracted from AGI in calculating taxable income (on which a taxpayer's actual tax liability is calculated).

This distinction is meaningful because, as discussed below, below-the-line deductions are subject to certain limitations that do not apply to above-the-line deductions.

Prior to 1941, taxpayers and the Internal Revenue Service treated expenses arising from a trade or business and expenses arising from profit-oriented activities other than a trade or business as above-the-line deductions under the predecessor to §162, which on its face provided deductions only for expenses incurred in ''carrying on any trade or business.''[7] In 1941, however, the Supreme Court, in *Higgins v.*

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[5] For a more thorough analysis of the deductibility of trust expenses prior to 2018, *see* Domingo P. Such, III and Tina D. Milligan, *Understanding the Regulations Affecting the Deductibility of Investment Advisory Expenses by Individuals, Estates and Non-Grantor Trusts*, 50 Real Prop Prob. & Tr. J. 439.

[6] Unless otherwise provided, all references herein to ''trusts'' refer to non-grantor trusts, which are treated as distinct taxpayers under the Code. The income and expense items of grantor trusts, on the other hand, are consolidated with those of the trust's deemed owner (generally, the trust's grantor).

[7] Section 23(a) of the Internal Revenue Act of 1928 provided as follows:

> In computing net income there shall be allowed as deductions:
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> > . . . All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compen-

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Commissioner,[8] drew a clear distinction between profit-oriented expenses and trade or business expenses, rejecting the proposition that the petitioning taxpayer was engaged in a trade or business by virtue of managing his own investment portfolio, notwithstanding that the portfolio was large enough, and required enough attention, to warrant an office and administrative staff. Further, the Court held that the expenses of profit-oriented activities that did not rise to the level of a trade or business were not deductible under the predecessor to §162, reasoning that such an interpretation was contrary to the existing authority.

In 1942, in response to *Higgins*, Congress enacted the predecessor to §212 with the goal of, to some degree, restoring the equivalence between profit-oriented expenses and trade or business expenses.[9] The current version of §212 provides as follows:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year — (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.

Section 212 expenses may include: (l) investment advisory fees; (2) subscriptions to investment advisory publications; (3) qualifying attorneys' fees; (4) expenses of clerical help and office rent in managing investments; (5) fees to collect interest and dividends; (6) losses on deposits in insolvent or bankrupt financial institutions; (7) service charges on dividend reinvestment plans; and (8) trustee's fees for an individual retirement account if separately billed and paid.[10]

Although the predecessor to §212 was enacted to establish a measure of equality between profit-oriented expenses and trade or business expenses, the latter have always enjoyed preferential treatment as above-the-line deductions.[11] Profit-oriented expenses, on the other hand, generally constitute itemized deductions, and as a result of the 2017 tax act, the bias against profit-oriented expenses is stronger than ever.

The 2% Floor: §67

Section 67(a) requires that taxpayers further divide their itemized deductions (including most deductions for profit-oriented activities) into (1) "miscellaneous itemized deductions" and (2) all other itemized deductions. Section 67(b) provides that all itemized deductions other than those specified therein are miscellaneous itemized deductions. Accordingly, because they are not mentioned in §67(b), investment advisory expenses, tax preparation, and other professional fees generally constitute miscellaneous itemized deductions.

Prior to 2018, a taxpayer's miscellaneous itemized deductions were allowed only to the extent that their aggregate value exceeded 2% of a taxpayer's AGI.[12] Put differently, the deductions were added together and then reduced (but not below zero) by 2% of AGI. This limitation has often been referred to as the "2% floor." Miscellaneous itemized deductions that were disallowed as a result of the 2% floor were permanently lost, as they could not be carried forward to future tax years.

An Exception to the 2% Floor: §67(e)

Section 67(e) directs that certain deductions of a trust or estate that would otherwise be miscellaneous itemized deductions be treated as above-the-line deductions. Specifically, §67(e) provides that "deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" are to be deducted in computing AGI of a trust or estate. Accordingly, these deductions are not subject to the 2% floor.

Reg. §1.67-4 (Regulation), effective for tax years beginning on or after January 1, 2015, clarifies that an expense is not subject to §67(e) if it "commonly or

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sation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

[8] 312 U.S. 212 (1941).

[9] *See* §23(a)(2) of the Internal Revenue Code of 1939. Section 23(a)(2) provided as follows: [In computing net income, there shall be allowed as deductions:] "In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income." *See also* S. Rept. 1631, 77th Cong., 2d Sess., reprinted in 1942-2 C.B. 504, 570 (stating that amendment allows a deduction for "the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, **whether or not such expenses are paid or incurred in carrying on a trade or business**") (emphasis added).

[10] *See* Temp. Reg. §1.67-IT(a)(1)(ii); see also IRS Pub. 529, Miscellaneous Deductions (2014).

[11] *See* §62(a).

[12] *See* §67(a).

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customarily would be incurred by a hypothetical individual holding the same property'' and that ''it is the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service, that is determinative.''[13] This latter distinction is in keeping with the Supreme Court's decision in *Knight v. Commissioner*,[14] in which it held that a trust's investment advisory costs were miscellaneous itemized deductions because it is common for individuals to hire investment advisors, notwithstanding that an individual, acting in his or her individual capacity, would not have the fiduciary duty of a trustee and could not incur **trust** investment advisory fees.

The Regulation provides the following nonexclusive list of the types of costs that are commonly and customarily incurred by individuals: (1) costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust, (2) ownership costs; (3) tax preparation fees; (4) investment advisory fees; and (5) appraisal fees.[15] Specifically excluded from this category of expenses are certain fiduciary expenses, such as probate court fees and costs, fiduciary bond premiums, legal publication costs of notices to creditors or heirs, the cost of certified copies of the decedent's death certificate, and costs related to fiduciary accounts.[16]

The proposed version of the Regulation also indicated that the cost of products or services related to the following items would be considered ''unique'' to an estate or trust: (1) fiduciary accountings; (2) judicial or quasi-judicial filings required as part of the administration of the estate or trust; (3) fiduciary income tax and estate tax returns; (4) the division or distribution of income or corpus to or among beneficiaries; (5) trust or will contest or construction; (6) fiduciary bond premiums; and (7) communications with beneficiaries regarding estate or trust matters.[17] This list was nonexclusive and was ultimately omitted from the final version of the Regulation following the *Knight* decision and the resulting shift in the standard of evaluation from ''uniqueness'' to whether a cost was ''commonly and customarily incurred by individuals.'' Nonetheless, the list remains instructive.

Generally, the Regulation requires that if an estate or trust pays a single fee, commission, or other expense for both types of costs (and if the costs that would be subject to the 2% floor are more than de minimis in amount), the taxpayer must allocate the payment using ''any reasonable method'' between the costs that are subject to the 2% floor and those that are not.[18] If a bundled fee is not computed on an hourly basis, however, only the portion of that fee that is attributable to investment advice is subject to the 2% floor; the remaining portion is not subject to the 2% floor.[19] Additionally, out-of-pocket expenses billed to the estate or non-grantor trust are treated as separate from the bundled fee and are not subject to allocation.[20] In contrast, ''payments made from the bundled fee to third parties that would have been subject to the 2[%] floor if they had been paid directly by the estate or non-grantor trust are subject to the 2[%] floor, as are any fees or expenses separately assessed by the fiduciary or other payee of the bundled fee (in addition to the usual or basic bundled fee) for services rendered to the estate or non-grantor trust that are commonly or customarily incurred by an individual.''[21] Among the facts that may be considered in determining whether an allocation is reasonable are: (1) the percentage of the value of the corpus subject to investment advice; (2) whether a third party advisor would have charged a comparable fee for similar advisory services; and (3) the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.[22]

Overall Limit on Itemized Deductions: §68

Prior to 2018, §68 further reduced the itemized deductions that would otherwise have been deductible by an individual under §67 to an amount equal to the lesser of:

(1) 3% of the excess of the taxpayer's itemized deductions over $261,500 (in the case of single taxpayers) or $313,800 (in the case of married taxpayers filing joint returns) and

(2) 80% of the taxpayer's otherwise allowable itemized deductions.

Exclusion of §212 Expenses from Alternative Minimum Tax Calculation: §56

For purposes of the alternative minimum tax (AMT), ''[n]o deduction shall be allowed for any mis-

[13] Reg. §1.67-4(a), Reg. §1.67-4(b)(1).
[14] 552 U.S. 181 (2008)
[15] Reg. §1.67-4(b)(1)- §1.67-4(b)(5).
[16] Reg. §1.67-4(b)(6).
[17] Prop. Reg. §1.67-4(b).
[18] Reg. §1.67-4(c)(1).
[19] Reg. §1.67-4(c)(2).
[20] Reg. §1.67-4(c)(3).
[21] *Id.*
[22] Reg. §1.67-4(c)(4).

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cellaneous itemized deduction (as defined in section 67(b)).''[23] Accordingly, these deductions, including deductions for §212 expenses, would be added back to AGI to arrive at alternative minimum taxable income, likely resulting in an increase in the taxpayer's AMT calculation.

The New §67(g) and §68(f)

To this framework, the 2017 tax act adds the new §67(g), which provides that ''no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.'' As a result, any portion of a taxpayer's expenses that previously would have been subject to the 2% floor is disallowed. The IRS has clarified, however, that §67(e) expenses, which were not previously subject to the 2% floor, are not disallowed.[24]

New §68(f), also added by the 2017 tax act, provides that the overall limitation on itemized deductions under §68 shall not apply to any taxable year beginning after December 31, 2017, and before January 1, 2026. With respect to investment management expenses, however, this change provides little solace, as any such expenses to which §68 previously could have applied are now denied in full by §67(g).

DEDUCTIBILITY OF FAMILY OFFICE EXPENSES

Notwithstanding the complete denial of investment management and related deductions through 2026 and the return of the §67 and §68 limitations thereafter, a properly structured family office can permit taxpayers to obtain the equivalent of an unlimited deduction for their investment management expenses. To understand why, consider the following example.

EXAMPLE: Each of three brothers (Alan, Bob, and Charlie Smith) owns a portfolio of marketable securities worth $33, while the Smith Family Trust (created for the benefit of the descendants of the Smith Brothers' parents) owns a portfolio worth $1, among other assets. If the portfolios generate a 10% gross return, consisting of income taxed at a weighted average rate of 30%, and if each of the Smith Brothers and the Smith Family Trust pays an investment management fee of 2% of assets under management, their net after-tax return would be $5, calculated as follows:

	Brothers	Trust	Total
Taxable Income	$9.90	$0.10	$10.00
Tax (30%)	($2.97)	($0.03)	($3.00)
Investment Management Fee (2%)	($1.98)	($0.02)	($2.00)
Net After-Tax Return	$4.95	$0.05	$5.00

Assume that the Smith Family Trust instead establishes a family office entity, Smith Management LLC (Smith Management), to offer investment management services to the Smith Brothers and to the greater Smith Family, funding the entity with its securities portfolio and cash. The Smith Brothers and Smith Management then contribute their securities portfolios to a new investment fund, Smith Investments LP (Smith Investments). Each partner of Smith Investments receives a capital interest in proportion to the value of his or its securities portfolio, and in exchange for agreeing to provide investment management services, Smith Management is granted a 20% profits interest, or ''carry,'' which for purposes of this example will mean that Smith Management receives an allocation of 20% of the increase in Smith Investments' net asset value during the year. If Smith Management is properly structured, it may deduct without limitation investment advisory fees and other professional fees incurred in connection with administering and managing the investment assets (under §162). Accordingly, if Smith Management's operating expenses are equal to 2% of assets under management, the after-tax results of this structure would be as follows:

	Brothers	Trust	Total
Gross Income	$9.90	$0.10	$10.00
Profits Interest Allocation (20%)	($1.98)	$1.98	-
Investment Management Fee (2%)	-	($2.00)	($2.00)
Taxable Income	$7.92	$0.08	$8.00
Tax (30%)	($2.38)	($0.02)	($2.40)
Net After-Tax Return	$5.54	$0.06	$5.60

Despite that the cost of managing the assets is unchanged relative to the previous scenario, the net after-tax return of each of the Smith Brothers and the Smith Family Trust have increased. The overall benefit of the family office structure is $0.60, which reflects the deductibility of the investment management expenses (30% of $2.00). While the Smith Brothers did not receive a deduction for their share of the investment management expenses, they instead benefitted in the form of reduced income allocations which, unlike the investment management fees that they paid in the previous scenario, reduce their taxable incomes.

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[23] §56(b)(1).

[24] *See* Notice 2018-61. Practitioners had feared that because §67(e) generally addresses the treatment of miscellaneous itemized deductions and because there is no clear statement either in that section or in Reg. §1.67-4 indicating that §67(e) deductions are not miscellaneous itemized deductions, §67(e) deductions would be disallowed under §67(g). The Notice makes clear, however, that because §67(e) deductions are above-the-line deductions, they are not itemized deductions and thus are not impacted by §67(g). The authors thank Kimberly N. Harris for her diligent research in this area.

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STRUCTURING THE FAMILY OFFICE

Of course, obtaining the above benefit is not simply a matter of filing entity formation documents and routing payments for services through a passive intermediary. Rather, the family office entity must qualify as a ''trade or business'' for purposes of §162, and the profits interest through which it is compensated must be respected as such under the tax law.

Trade or Business

First, in order for the family office to be entitled to deduct its expenses under §162, it must qualify as a trade or business. Put differently, in contrast to the taxpayer in *Higgins*, the entity must do more than manage its own investments or the investments of its owners. Further, it must be operated in a manner consistent with an arm's length enterprise. The Tax Court's recent decision in *Lender Management*,[25] where it considered the deductibility of the expenses of a family office entity that acted as the manager of two family investment funds, is illustrative in this regard. As to the issue of whether Lender Management was simply managing its assets or the assets of its owners, the Tax Court found that there was sufficient diversity of ownership where:

- Lender Management owned, at one point, upwards of 8% of one entity and 6% of the other;
- The 99% owner of Lender Management indirectly held up to an additional 10% and 4% interest in the respective entities; and
- The remaining 1% owner of Lender Management indirectly held up to an additional 5% and 11% interest in the respective entities.

The Tax Court further stated that although Lender Management's interests in the funds exceeded the 1% interests that had previously been upheld in another case,[26] the receipts attributable to these interests were less than it could have if it had been compensated with a profits interest, the owners of Lender Management represented only two of a number of family members who were invested in the funds, and most of the managed assets were owned by other parties.

As to whether the business was being operated at arm's length, the court emphasized the following facts:

- Lender Management's profits interest in each fund (2.5% of net asset value, plus 25% of the increase in net asset value) was payable only to the extent that the fund generated net profits and was consistent with a service business rather than a typical investor's return.
- Lender Management provided individualized investment advisory services and managed investments for each of its clients (the Lender family members) individually, as opposed to acting on behalf of the larger family group collectively. Clients were geographically dispersed, many did not know each other, and some were in such conflict with others that they refused to attend the same business meetings.
- Lender Management also managed downstream entities in which one of the funds held a controlling interest, and investors in some of these downstream entities were not members of the Lender family.
- There was no requirement or understanding among the family members that Lender Management would act as manager of the funds indefinitely, and clients understood that they could withdraw their investments in the funds at any time, subject to liquidity restraints, if they became dissatisfied with how they were managed.
- Lender Management employed five employees during each of the relevant tax years, with a payroll in excess of $300,000 in each year, and operated out of rented office space.
- Lender Management engaged a third-party provider to prepare its tax returns and provide investment advice, but did not always follow the advice.
- A non-family member served as Lender Management's CFO, COO, and controller during the relevant tax years.
- The managing member of Lender Management:
  - Possessed the appropriate educational background and work experience for his role, and pursued appropriate continuing education opportunities;
  - Spent significant time (approximately 50 hours per week) and effort evaluating proposals, selecting investments, and meeting with third party managers;
  - Received wages (as a typical employee would) before becoming a member of Lender Management and thereafter received a guaranteed payment (consistent with the IRS position that a partner cannot be an employee of a partnership in which he owns an interest);
  - Made himself available to Lender Management's clients during nonbusiness hours; and

[25] T.C. Memo 2017-246.

[26] *See Dagres v. Commissioner*, 136 T.C. 263 (2011).

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- Scheduled and attended annual meetings with clients that were available and willing to meet with him, including the end-level investors in the funds.

Substantiation of Profits Interest

In addition to the family office being determined to be a trade or business, in order to realize the de facto deduction described earlier, the family office's profits interest must be respected as such. As a technical matter, a profits interest is a right to receive an allocation of a partnership's periodic income (but not to share in a return of capital upon liquidation of the partnership). Because the allocation of partnership income is a zero-sum game, a greater allocation in favor of one partner will necessarily result in a reduced allocation to another partner. It is also crucial that partnership income generally retains its character (as a capital gain, ordinary income, etc.) when allocated to a partner, meaning that if an allocation pursuant to a profits interest includes long-term capital gains, the recipient partner will generally receive the benefit of the preferential income tax rate thereon.[27]

In contrast, a disguised fee payment would be treated as a guaranteed payment or a payment to the family office other than in its capacity as a partner. In either circumstance, the family office would realize ordinary income, either at the time of grant or as partnership income is realized, and the other partners would be subject to the aforementioned limitations on the deductibility of investment management expenses.

Whether a partnership interest qualifies as a profits interest rather than disguised compensation is determined based on a facts and circumstances analysis, but the Treasury's proposed regulation on this topic, issued in 2015,[28] places the most weight on whether the interest possesses significant entrepreneurial risk (SER) relative to the overall entrepreneurial risk of the partnership, indicating that an arrangement that possesses SER generally would not be treated as a payment for services unless other factors establish otherwise.[29] On the other hand, the presence of any of the following facts and circumstances would create a presumption that the arrangement lacks SER and should be treated as a disguised payment for services unless other facts and circumstances establish the presence of SER by clear and convincing evidence:

- Capped allocations of partnership income if the cap is reasonably expected to apply in most years;
- An allocation for one or more years under which the service provider's share of income is reasonably certain;
- An allocation of gross income;
- An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or
- An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is nonbinding or fails to timely notify the partnership and its partners of the waiver and its terms.[30]

Each of the first four items above, to varying degrees, can be thought of as assuring the family office of a positive allocation (possibly in an amount that may be known in advance) without regard to the success of the underlying fund, while the final item is aimed at preventing investment managers from being entitled to elect to convert fixed management fees (taxable as ordinary income) to variable profits interests (taxable to at least some extent as capital gains) after the amount of the potential profits interest allocation is known.

Reg. §1.707-2 goes on to cite the following factors as indicative of a disguised payment for services:

- The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration.
- The service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment.
- The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity.
- The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.
- The arrangement provides for different allocations or distributions with respect to different ser-

[27] *But see* below regarding the impact of the 2017 tax act on capital gains allocated pursuant to a profits interest.

[28] Prop. Reg. §1.707-2.

[29] Prop. Reg. §1.707-2(c).

[30] Prop. Reg. §1.707-2(c)(1).

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vices received, the services are provided either by one person or by persons that are related. . ., and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.[31]

Within the above parameters, there exists a potentially unlimited variety of ways to structure the profits interest and the family office's overall compensation structure. For example, rather than calculating the profits interest based on changes in net asset value, it may be calculated based on net cash flows or taxable income. Additionally, rather than evaluating the partnership's performance on a year-over-year basis, the allocation may be calculated based on cumulative ''profits'' since a particular date, or on a rolling average, and the investment manager may or may not be subject to a ''clawback'' (i.e., repayment obligation) with respect to its distributions in the event of future losses. Moreover, while an investment management fee calculated as a percentage of net assets, for instance, does not produce the same income tax advantages of a profits interest,[32] it is possible (and indeed common) to combine these two methods of compensation, effectively trading a portion of the benefit of the profits interests for a more consistent stream of payments in order to improve the long-term viability of the family office.

IMPACT OF THE 2017 TAX ACT ON THE STRUCTURE OF FAMILY INVESTMENT ENTITIES

While the 2017 tax act's complete denial of miscellaneous itemized deductions clearly increases the value that can be generated by a properly structured family office, it introduced a number of other reforms that have generated a great deal of discussion as to whether a family office should be organized as a flow-through entity or a corporation, and whether existing family offices that were organized as flow-through entities prior to 2018 should now be converted.

Prior to the 2017 tax act, the ability of investment managers to take advantage of preferential rates on long-term capital gains received pursuant to a profits interest (as opposed to being treated as having received ordinary compensation income) was a hotly debated topic. The new §1061 provides that if a profits interest in a partnership is granted in exchange for investment management services,[33] any capital gains allocated pursuant to that profits interest are taxed as short-term capital gains (i.e., at the rate applicable to ordinary income) unless the asset giving rise to the gain was held by the partnership for more than three years, up from the one year requirement that applies to capital gains allocated to other partners.[34] A partnership interest held by ''a corporation'' was specifically exempted, with the lack of specificity prompting some commentators to question whether an S corporation might be utilized to preserve both the lower one-year holding period requirement without sacrificing flow-through taxation. Nevertheless, the IRS subsequently advised that partnership interests held by S corporations are, in fact, not exempt from the extended holding period requirement.[35] As a result, only C corporations, which are generally subject to the same rate on all income types in any event, are exempt from the extended holding period requirement.

Notwithstanding the significant impact of the aforementioned reforms, the Act's centerpiece was the reduction of the federal corporate income tax rate[36] from 35% to 21%. At the same time, it reduced the top individual tax rate on ordinary income from 39.6% to 37% while keeping the top individual rate on qualified dividends[37] and long-term capital gains at 20%. Assuming the application of the net investment income tax,[38] then, the corporate rate would be 21% (as corporations are not subject to the tax), and indi-

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[31] Prop. Reg. §1.707-2(c).

[32] Such a fee would be treated as a guaranteed payment, meaning that it would be taxed to the recipient as ordinary income, and its deductibility by the other partners would be subject to the aforementioned limitations on miscellaneous itemized deductions.

[33] Specifically, the investment management services must relate to securities (e.g., stocks or bonds), commodities, real estate held for rental or investment, cash or cash equivalents, options, or derivative contracts with respect to the foregoing, or interests in a partnership to the extent of its proportionate interest in any of the foregoing.

[34] While further guidance will presumably be issued in this regard, many practitioners believe it to be the case that the recipient of the profits interest will also be required to have held the profits interest for more than three years in order for any related gains to be treated as long-term.

[35] *See* Notice 2018-18.

[36] Unless otherwise specified, ''tax rate'' is hereinafter used to refer to the relevant federal income tax rate, and it is assumed that taxpayers pay tax at the highest marginal rate applicable to the relevant class of income.

[37] For purposes of the analysis that follows, any dividend payment is assumed to be a qualified dividend. Generally, a qualified dividend is a dividend paid by a domestic corporation on stock that has been held for more than 60 days of the 121-day period beginning 60 days before the ex-dividend date with respect to the stock. *See* §1(h)(11).

[38] The net investment income tax applies to individuals with modified adjusted gross income over $250,000, if married filing jointly. To the extent the individual's modified adjusted gross income exceeds the threshold, any net investment income will be subject to an additional tax of 3.8%. Generally, investment income includes interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and businesses

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vidual rates would be 40.8% and 23.8%. As detailed below, corporate dividends will generally also be taxable upon receipt by shareholders, but setting this aside for the moment, the potentially wide gulf in relative tax rates raises the question of whether corporations might now be the more tax-efficient form for investment entities, including family offices. The considerations discussed below, while not an exhaustive list, provide a starting point for this analysis.

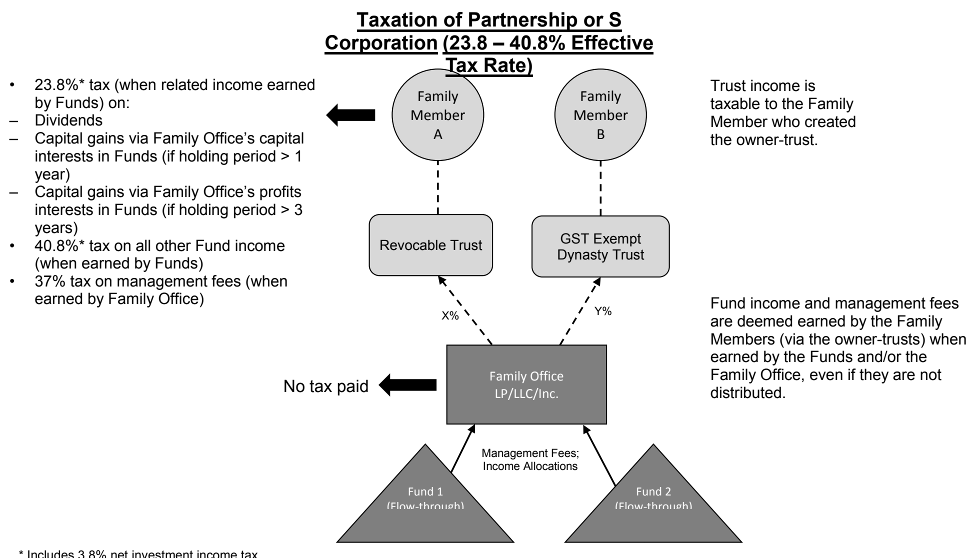
FLOW-THROUGH VS. CORPORATE TAXATION

Before delving deeper into the tax-related factors influencing one's choice of entity, it is first necessary to establish an understanding of the income tax regimes applicable to flow-through entities and corporations. The single biggest difference between the two regimes is that flow-through entities are generally not subject to an entity-level tax, and distributions of earnings by flow-through entities generally do not subject the recipients to tax. Rather, items of income, deduction, gain and loss are deemed to have been realized for income tax purposes by the owners of the flow-through entity when earned by the entity. Income and gains (as well as capital contributions) cause an owner's outside basis in the entity to increase, while deductions and losses (in addition to distributions) cause the owner's outside basis to decrease. Distributions by the entity are generally tax-free to the extent of the owner's remaining basis, with the result that an owner of a flow-through entity generally will not be subject to tax upon receipt of a distribution of the entity's earnings (on which the owner will have generally already paid tax) or returns of the owner's capital contributions, and in a sale of the owner's interest in the flow-through entity, the owner's gain generally will not reflect the value of the entity that is attributable to retained earnings.

A corporation, on the other hand, is subject to an entity level tax when income is earned, and shareholders are generally subject to their own tax when earnings are distributed. If a corporation earns $100 of income in 2018, for example, it will be left with $79 after paying a 21% tax. If it then immediately distributes the remaining $79 to its shareholders, they will owe $18.80 in taxes (23.8% of $79), leaving them with $60.20. Thus, the effective tax rate on immediately distributed corporate earnings would be 39.8%.

The following diagrams summarize the taxation of a family office and its owners when the family office is owned by grantor trusts.

that are passive activities to the taxpayer. *See* §1411. A C corporation's income is not subject to the net investment income tax, but dividends paid to shareholders are generally investment income.



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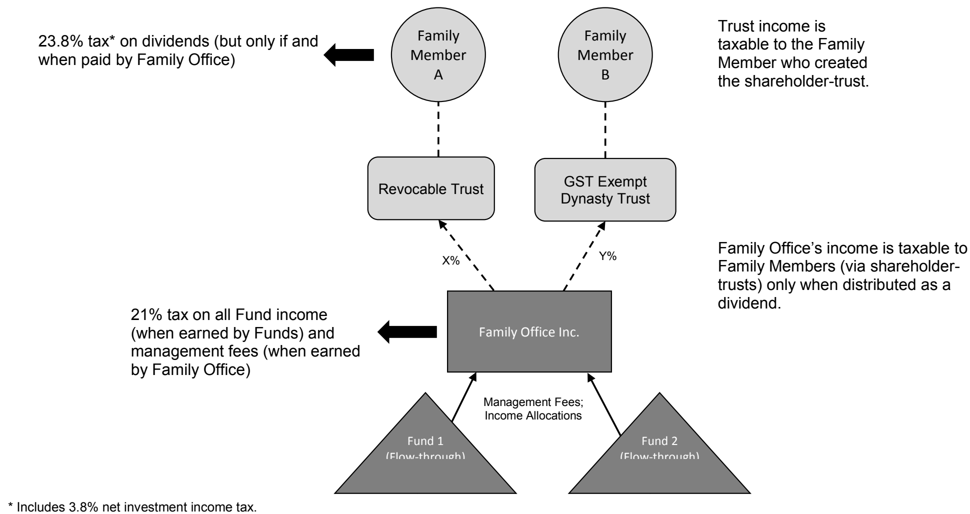

FACTORS IMPACTING CHOICE OF ENTITY

Character of Income

All other things being equal, the potential value of organizing an entity as a corporation is reduced as the income earned by the entity is weighted more heavily toward dividends and long-term capital gains. This is because, as mentioned above, income earned by a flow-through entity is taxed as if earned directly by the flow-through entity's owners, and individuals are subject to a preferential rate on dividends and long-term capital gains versus other types of income, while income earned by a corporation is subject to a flat corporate tax rate. Consider, for instance, an entity that has a policy of distributing all of its after-tax earnings in the year of receipt and earns $100 in 2018, consisting solely of either long-term capital gains or short-term capital gains:

Entity Type	Flow-through		Corporation	
Income Type	LTCG	STCG	LTCG	STCG
Entity-Level Tax	-	-	$21.00	$21.00
After-Tax Earnings	$100.00	$100.00	$79.00	$79.00
Owner-Level Tax	($23.80)	($40.80)	($18.80)	($18.80)
After-Tax Receipts by Owners	$76.20	$59.20	$60.20	$60.20
Effective Tax Rate	23.80%	40.80%	39.80%	39.80%

The effective tax rate on corporate income is 39.8% in all events, while the rate paid on the flow-through income can range from 23.8% to 40.8%. The above example also highlights an important consideration applicable to family office entities that are compensated through profits interests. As the proportion of the family office's allocation of capital gains that fail to meet the new three-year holding period requirement increases, such that the income would be subject to a 40.8% individual tax rate, organizing the entity as a corporation, which would be subject to a 21% tax rate, becomes increasingly attractive, especially when one considers that, as discussed below, the effective corporate tax rate can potentially be reduced through deferral of dividend payments.

Amount and Timing of Distributions

Because income earned by a flow-through entity is taxed as if earned directly by the flow-through entity's owners, and because distributions of that income are generally tax-free to the recipients, if we ignore such factors as the potential impact of a profits interest (at the fund level) and the possibility of a future disposition of the owner's interest in the entity, it may not matter from an income tax perspective whether the earnings of a flow-through entity are reinvested within the entity or distributed immediately to the owner for reinvestment. Consider, for instance, a flow-through entity generating only long-term capital gains. If it earns $100 of income in 2018, and if both it and its owners have the ability to reinvest its after-tax earnings to produce a 10% rate of return, consisting solely of long-term capital gains, then in terms of after tax-receipts by the entity's owners, it matters little whether the entity distributes all of its earnings in 2018 or distributes only enough to allow its owners to pay their income taxes and reinvests the remainder until 2019:

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2018			
		All Income Distributed	**Tax Distributions Only**
Entity	2018 Earnings	$100.00	$100.00
	Amount Distributed	$100.00	$23.80
	Amount Reinvested	-	$76.20
Owners	Taxable Flow-Through Income	$100.00	$100.00
	Taxes Paid (23.8%)	($23.80)	($23.80)
	Amount Reinvested	$76.20	-

2019			
		All Income Distributed	**Tax Distributions Only**
Entity	Retained Earnings	-	$76.20
	Current Earnings (10%)	-	$7.62
	Amount Distributed	-	$83.82
Owners	Revinvested Distributions	$76.20	-
	Earnings on Reinvestment (10%)	$7.62	-
	Taxable Income	$7.62	$7.62
	Taxes Paid (23.8%)	($1.81)	($1.81)
	Cumulative After-Tax Receipts	**$82.01**	**$82.01**

In the case of a corporation, however, deferring distributions is crucial to lowering the effective tax rate on earnings.[39] As was mentioned above, immediate distribution of earnings would lead to an effective federal tax rate of 39.8%, which is only slightly lower than the maximum rate that would apply to a flow-through entity earning no dividends or long-term capital gains. However, if, as an alternative to paying a dividend that will be invested by the shareholders to generate, e.g., a 10% rate of return consisting of income that would be subject to a weighted average tax rate of 39.8%, the earnings are instead similarly reinvested by the corporation, the benefit becomes clear:

2018			
		2018 Dividend	**2019 Dividend**
Corporation	Current Earnings	$100.00	$100.00
	Corporate Tax (21%)	($21.00)	($21.00)
	After-Tax Earnings	$79.00	$79.00
	Amount Reinvested	-	$79.00
	Amount Distributed	$79.00	-
Shareholders	Dividend Received	$79.00	-
	Tax on Dividend (23.8%)	($18.80)	-
	Amount Reinvested	$60.20	-

2019			
		2018 Dividend	**2019 Dividend**
Corporation	Retained Earnings	-	$79.00
	Current Earnings (10%)	-	$7.90
	Corporate Tax (21%)	-	($1.66)
	After-Tax Earnings	-	$6.24
	Amount Distributed	-	$85.24
Shareholders	Dividends Received	-	$85.24
	Tax on Dividend (23.8%)	-	($20.29)
	Amount Reinvested from 2018	$60.20	-
	Earnings on Reinvested Funds (10%)	$6.02	-
	Tax on Reinvestment Earnings (39.8%)	($2.40)	-
	Cumulative After-Tax Receipts	**$63.82**	**$64.95**

The $1.13 benefit attributable to the delayed dividend scenario represents the after-tax return attributable to the reinvestment of the $18.80 in shareholder-level tax that was deferred until 2019. The below illustration compares the results of a one-year of deferral by a corporation against the results of a flow-through entity over the same period of time, demonstrating that one year of deferral would reduce the effective tax rate on corporate income from 39.8% to 38.79%:

2018			
		Flow-through	**Corporation**
Entity	Current Earnings	$100.00	$100.00
	Corporate Tax (21%)	-	($21.00)
	After-Tax Earnings	$100.00	$79.00
	Amount Reinvested	$61.21	$79.00
	Amount Distributed	$38.79	-
Owners	Distribution Received	$38.79	-
	Individual Tax on Flow-through Earnings (38.79%)	($38.79)	-
	Shareholder Tax on Dividends (23.8%)	-	-

2019			
		Flow-through	**Corporation**
Entity	Retained Earnings	$61.21	$79.00
	Current Earnings (10%)	$6.12	$7.90
	Corporate Tax (21%)	-	($1.66)
	After-Tax Earnings	$6.12	$6.24
	Amount Distributed	$67.33	$85.24
Owners	Distribution Received	$67.33	$85.24
	Individual Tax on Flow-through Earnings (38.79%)	($2.37)	-
	Shareholder Tax on Dividends (23.8%)	-	($20.29)
	Cumulative After-Tax Receipts	**$64.95**	**$64.95**

[39] *But see* Section VII.H. below for the discussion of the potential application of personal holding company tax and accumulated earnings tax to corporations.

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Taking the above a step further, in order to match the results of a deferred corporate dividend, a flow-through entity's income will have had to have been subject to weighted average tax rate of 32.8% after 10 years, 30.9% after 15 years, and 28.4% after 25 years of deferral.

Exit Strategy

Because a flow-through entity's owners' outside bases in the entity increase as a result of income earned by the entity, the owners will generally be subject to a single level of tax upon exit, whether the assets of the entity are sold and the proceeds distributed in liquidation or the owners sell their interests in the entity. A shareholder's basis in corporate stock, however, is generally unaffected by corporate earnings or distributions, meaning that it may prove difficult for corporate shareholders to liquidate their interests without being impacted by two levels of tax. If the corporation sells its assets and distributes the proceeds to shareholders in liquidation, for instance, the corporation will be taxable on any gains realized on the sales, and the shareholders will realize capital gains to the extent of the excess of their share of the proceeds over their adjusted bases.[40] If the corporation alternatively were to distribute appreciated assets in kind, the corporation would be treated as having realized gain to the extent of the unrealized gain.[41] While the shareholders could potentially sell their stock without the corporation being subject to tax, any buyer would likely factor the potential exit cost into the price to be paid, and to the extent that the corporation holds depreciable assets, a buyer will prefer to instead purchase the assets in order to obtain a higher basis for purposes of the buyer's future depreciation deductions. Nevertheless, if a shareholder holds stock until death, such that its basis is stepped up to fair market value under §1014, the shareholder level tax may be avoided.

State Income Taxes

To this point, we have considered only federal income taxes, but of course, most states assess individual and/or corporate income taxes, and some assess income taxes or income tax equivalent taxes on pass-through entities. While state taxes are generally assessed at a substantially lower rate than federal taxes, they have the potential to greatly alter the above analysis because their relative rates generally are not in proportion to corresponding federal tax rates. For instance, while Florida has no individual income tax, its corporate income rate is 5.5%. Thus, after taking into account the related deduction of this tax for federal income tax purposes, the income of a corporation that is taxable in Florida would be subject to a combined state and federal tax rate of 25.35% rather than 21% upon receipt.

While individual income tax regimes vary greatly from state to state, it is not uncommon for a flat rate to be applied to an income figure that is based on federal AGI, meaning that the preferential rates on dividends and long-term capital gains are often lost at the state level. Moreover, the 2017 tax act imposed a $10,000 limit on the previously unlimited itemized deduction for individual state and local income taxes,[42] meaning that individual state and local income taxes tend to be more costly than corporate taxes imposed at the same rate. A number of high-tax states are exploring the possibility of blocking or working around the limitation, but the IRS has suggested that efforts by state legislatures to transform their taxes into charitable deductions for federal income tax purposes will not be respected.[43]

Anticipated Future Income Tax Rates

Although the above analysis assumes that federal income tax rates will remain constant, it is not surprising that before the 2017 tax act was even signed into law, commentators were speculating as to the potential impact of the 2020 presidential election on the longevity of its reforms. Given the 2017 tax act's drastic reduction of the corporate income tax rate, one may imagine that future reforms might cause it to shift back in the direction of the former baseline of 35%, a development that could prove disastrous for entities that were organized as or converted to corporations based on the belief that current rates would endure.

As has already been touched upon, there is generally no tax efficient way to unwind a C corporation. A conversion to a partnership or LLC results in a deemed liquidation, likely triggering two levels of tax.[44] If a corporation instead makes a subchapter S election, any unrealized appreciation in the corporation's assets at the time of conversion will be subject to tax at the highest corporate rate if realized within five years of conversion, in addition to the tax that would otherwise be imposed on the S corporation's shareholders.[45] Moreover, if the corporation became a C corporation as a result of a previous revocation of a Subchapter S election, a five-year waiting period

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[40] *See* §331.

[41] *See* §311, §336.

[42] *See* §164.

[43] *See* Notice 2018-54.

[44] *See* PLR 9701029.

[45] §1374.

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will apply before another Subchapter S election may be made.[46]

On the other hand, conversions of flow-through entities to C corporations are generally tax-free.[47] A partnership or LLC may simply make a ''check-the-box'' election on Form 8832 to be taxed as a corporation, resulting in a deemed contribution of its assets and liabilities to the corporation in exchange for stock, followed by liquidation of the partnership or LLC.[48] An actual conversion of the entity to a corporation under a state's formless conversion statute would be treated similarly.[49] Subchapter S elections can be revoked prospectively or retroactively[50] with the consent of shareholders owning more than half of the corporation's issued and outstanding shares by filing a revocation statement with the IRS.[51] Even after the election is revoked, it may be possible to make tax free distributions of cash for at least one year to the extent of undistributed earnings on which shareholders have already been taxed.[52]

Desirability of Entity-Level Tax

It is axiomatic that the payment of income taxes attributable to a grantor trust is equivalent to a tax-free gift by the trust's grantor to its beneficiaries. To the extent that the trust holds an interest in a corporation, however, the grantor will only be liable for taxes to the extent that earnings are distributed to the trust (which, as was previously detailed, may not be desirable in terms of the overall tax cost of the structure), and the corporation will pay taxes out of its earnings. In the worst case scenario, the payment of taxes by a corporation will depress its value relative to a flow-through entity owned by a grantor trust, and/or the grantor's reduced income tax liability will eventually lead to an increased gift or estate tax liability (at a 40% federal rate).

Administrative Burden of Flow-through Entity

The need for a flow-through entity to distinguish between separately stated and non-separately stated items on K-1s and for partners to similarly account for those items on their own returns, in addition to the potential imposition of additional state filing obligations on partners, has always caused the flow-through regime to be more complex for taxpayers to administer. In the case of a family office organized as a flow-through entity, the need to now administer the three-year holding period requirement related to capital gains allocated pursuant to profits interests simply adds to the complexity.

Personal Holding Company Tax and Accumulated Earnings Tax

In addition to the above considerations, C corporations (but not S corporations) are potentially subject to either personal holding company tax or accumulated earnings tax, each of which is an additional 20% entity-level tax. To the extent that either of these taxes applies, the effective tax rate on corporate income could thus be as high as 51.8%, making it highly unlikely that organization as a corporation would be tax efficient.

Personal Holding Company Tax

Subject to certain specified exceptions, if (1) at least 60% of a corporation's ''adjusted ordinary gross income'' in a given tax year is ''personal holding company income'' and (2) at any time during the last half of the tax year more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for five or fewer individuals, then it is classified as a personal holding company, and a 20% tax will be imposed on its undistributed personal holding company income.[53] This potentially implicates family investment entities because much of their income will constitute passive income that is classified as personal holding company income. It may be of particular concern to family offices, however, because due to the need for diversity of ownership between the family office and the funds that it manages, the number of owners will often be relatively small.

A corporation's ordinary gross income is its gross income less all capital gains and all gains from §1231 assets (property used in a trade or business).[54] Adjusted ordinary gross income is ordinary gross income reduced by certain deductions related to rents, mineral, oil, and gas royalties, and certain interest income.[55] Personal holding company income is adjusted ordinary gross income consisting generally of, among other items, dividends; interest; royalties; annuities; certain adjusted income from rents; mineral, oil, and

[46] §1362(g). The IRS may waive the waiting period (through a PLR) if 50% of the stock in the new corporation is transferred after making the election.

[47] This assumes that liabilities transferred to the corporation do not exceed basis.

[48] Reg. §301.7701-3(g)(1)(i). The election may be made up to 12 months in advance or 75 days retroactively.

[49] Rev. Rul. 2004-59. Rev. Rul. 84-111 governs conversions made under state law other than under formless conversion statutes.

[50] Within the first 2 1/2 months of the tax year.

[51] *See* §1362(d) and Reg. §1.1362-6. The corporation's and shareholders' bases and holding periods in their assets and stock will be unchanged.

[52] *See* §1377(b).

[53] *See* §541-§542.

[54] §543(b)(1).

[55] §543(b)(2).

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gas royalties; and some other similar items including personal service contracts under which someone other than the corporation has the right to designate the individual who performs the services.[56] Importantly, capital gains are excluded from both the numerator and the denominator in determining whether personal holding company income meets the requisite 60% threshold, and management fees paid to a family office that are taxed as ordinary income should not be treated as personal holding company income. Thus, it may be possible for a family office to avoid the personal holding company tax even if all of its income other than management fees is passive.

Undistributed personal holding company income is separately defined as taxable income of a personal holding company as adjusted by certain deductions.[57] Perhaps most notably, the taxable income of the personal holding company is reduced by the net capital gain for the taxable year, minus taxes applicable to the net capital gain, to arrive at the undistributed personal holding company income.[58]

Accumulated Earnings Tax

The accumulated earnings tax applies to ''every [C] corporation that is formed or availed for the purpose of avoiding the income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed.''[59] Importantly, however, the accumulated earnings tax does not apply to a personal holding company.[60] The accumulated earnings tax is of particular concern to family investment entities organized as corporations because their tax efficiency is likely to be dependent on its ability to defer income.

The fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is determinative of a purpose to avoid the income tax with respect to the shareholders, unless the corporation proves otherwise by a preponderance of the evidence. Additionally, the fact that a corporation is a mere holding or investment company is prima facie evidence of the purpose to avoid the income tax with respect to its shareholders.[61] A company is considered a holding company if it has practically no activities except holding property and collecting the income therefrom or investment therein. If the company's activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation is considered an investment company.[62] A corporation may be primarily a holding or investment company without being merely a holding or investment company.[63] For example, a company that had been a holding company for 22 years was not a mere holding company after it purchased a working interest in gas wells and was in the process of taking over an agent's responsibilities of managing and operating the wells.[64] Thus, although a family office arguably should not be classified as a mere investment company because it is compensated for providing investment management services rather than investing for its own account, this position could be strengthened by having the family office perform other services, such as tax preparation.

The accumulated earnings tax is a tax of 20% on the accumulated taxable income of a corporation.[65] Accumulated taxable income is essentially the corporation's taxable income, reduced by its taxes, charitable contributions, capital losses, net capital gains, capital loss carryovers, dividends paid deduction, and the accumulated earnings credit.[66] The accumulated earnings credit for a corporation that is a mere holding or investment company is limited to the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. [67] The accumulated earnings credit for a corporation other than a mere holding or investment company is equal to the earnings and profits of the corporation that are retained for the reasonable needs of the business, minus the deduction for net capital gains, but in no event will the credit be less than the amount by which $250,000 ($150,000 for certain service corporations) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.[68]

To claim an accumulation is for reasonably anticipated needs of the business, there must be ''an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans'' for the use of the accu-

[56] §543(a).

[57] §545(a).

[58] §545(b)(5).

[59] §532.

[60] §532(b)(1).

[61] I.R.C. §533.

[62] Reg. §1.533-1(c).

[63] *See Golconda Mining Corp.* 58 T.C. 139 (1972), supp op 58 T.C. 736 (1972), *rev'd on other issue* 507 F.2d 594 (9th Cir. 1974); *Dahlem Foundation Inc.,* 54 T.C. 1566 (1970).

[64] *Nemours Corp.,* 38 T.C. 585 (1962), *aff'd* 325 F.2d 559 (3d Cir. 1974).

[65] §531.

[66] §535(a)-(b).

[67] §535(c).

[68] *Id.*

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mulation.[69] In a closely held business, informal plans may be sufficient to demonstrate a reasonable business need; however, such plans must be supported by ''some contemporaneous course of conduct evidencing the asserted purpose.''[70] Corporate intentions declared subsequent to the accumulation, as a mere afterthought, will not prove the intended business purpose.[71]

Although not necessarily required for a closely held business, the best practice for all businesses would be to document (e.g., in the corporate minutes) the intended purpose of an accumulation, at or prior to the time the accumulation is recognized. Of course, documented plans should be followed by corporate action intended to achieve the planned purpose. It may also be important for a corporation to revise its documented plans on a periodic basis. Such revisions may help the corporation to establish that the original plans, although valid, were not thoughtlessly abandoned, but rather were assigned a lower priority to other business concerns.[72]

An accumulation greater than what a prudent businessman would consider appropriate for current business purposes and reasonably anticipated future needs of the business is in excess of the reasonable needs of the business.[73] The prudent businessman standard means that a court will look to the decisions of the officers and directors of the corporation, and will be hesitant to substitute its own business judgment for that of the officers and directors unless the facts and circumstances require the court to do so.[74]

Whether a particular ground or grounds for accumulation of earnings and profits suggest that the earnings and profits have been accumulated for reasonable needs of the business is a facts and circumstances analysis,[75] but the following non-exclusive list includes a number of grounds on which commentary has been offered, as well as other factors that have been cited as relevant to the analysis:

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[69] Reg. §1.535-1(b)(1).

[70] *C.E. Estes, Inc.*, T.C. Memo 1980-504 (1980). *See also Smoot Sand & Gravel Corp. v. Commissioner*, 241 F.2d 197 (4th Cir. 1957); *Doug-Long, Inc. v. Commissioner*, 72 T.C. 158 (1979).

[71] *See Smoot Sand & Gravel Corp.*.

[72] *See Gustafson's Dairy, Inc. v. Commissioner*, T.C. Memo 1997-519 (1997); *Empire Steel Castings v. Commissioner*, T.C. Memo 1974-34 (1974).

[73] Reg. §1.537-1(a).

[74] *See e.g. Snow Manufacturing Co.*, 86 T.C. 260 (1986); *Atlantic Properties, Inc. v. Commissioner*, 62 T.C. 644 (1974); *Faber Cement Block Co. v. Commissioner*, 50 T.C. 317 (1968).

[75] Reg. §1.537-2(a).

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Grounds for accumulation that may represent reasonable needs of the business (Reg. §1.537-2(b))	1. To provide for bona fide expansion of the business or replacement of a plant; 2. To acquire a business enterprise through purchasing stock or assets; 3. To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue; 4. To provide necessary working capital for the business, such as, for the procurement of inventories; 5. To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or 6. To provide for the payment of reasonably anticipated product liability losses.
Grounds for accumulation that may not represent reasonable needs of the business (Reg. §1.537-2(c))	1. Loans to shareholders, or the expenditure of funds of the corporation for personal benefit of the shareholders; 2. Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons; 3. Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations; 4. Investments in properties or securities that are unrelated to the activities of the business of the taxpayer corporation; or 5. Retention of earnings and profits to provide against unrealistic hazards.
Other factors supporting a finding that accumulation was for reasonable needs of the business	1. A consistent dividend policy combined with an absence of any indicated policy to accumulate earnings beyond the business needs;[76] 2. Retention of earnings to protect against economic uncertainties, particularly in the context of a business built on the life's work of the business's operating officers;[77] 3. The fact that a distribution would result in a minimal increase in the shareholders' tax liabilities;[78] 4. Competition of the business requires it to accumulate more earnings to modernize or relocate its facilities to meet the competition;[79] and 5. Retention of earnings to redeem stock if there are valid business reasons to redeem the stock (e.g., dissension among shareholders, preventing stock from falling into antagonistic hands, etc.).[80]
Other factors supporting a finding that accumulation was not for reasonable needs of the business	1. Dividends are never paid or are not paid in years in which the corporation has a large earned surplus;[81] 2. A distribution would result in a significant tax payable by the shareholders;[82] and 3. Dividends are declared only in a year when a dominant shareholder has offsetting losses.[83]

[76] *See American Lawn Mower Co. v. United States*, 63-2 USTC Para. 9779, 63-2 USTC 90,070 (S.D. Ind. 1963).
[77] *See Delaware Terminal Corp. v. Commissioner*, 40 BTA 1180 (1939).
[78] *See Charleston Lumber Co. v. United States*, 20 F. Supp. 83 (S.D. W.VA. 1937).
[79] *See Newman Machine Co. v. Commissioner*, 26 T.C. 1030 (1956);*Day, Inc. v. United States*, 46 AFTR 2d 80- 6029 (1980).
[80] *See Wilcox Mfg Co. v. Commissioner,*T.C. Memo 1979-92;*Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E. D. Ark. 1952).
[81] *See Factories Inv. Corp. v. Commissioner*, 328 F.2d 781 (2d Cir. 1964).
[82] *See Apollo Indus., Inc. v. Commissioner*, 358 F.2d 867 (1st Cir. 1966).
[83] *See Eastern Ry. & Lumber Co. v. Commissioner*, 11 T.C.M. (CCH) 229 (1952).

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CONCLUSION

While the family office has, in light of the significant restrictions placed on the deductibility of investment and related expenses prior to 2018, long been a powerful income tax planning tool for families with substantial assets and, in particular, those with substantial investment assets, the 2017 tax act's temporary suspension of miscellaneous itemized deductions increases its potential effectiveness even further. In addition to the traditional questions relating to the structure of the family office's compensation, its ownership, and the exact manner and scope of its operations, however, the 2017 tax act's other reforms, most notably the substantial reduction in the federal corporate income tax rate and the longer holding period requirement related to capital gains realized through profits interests by investment managers, are now prompting consideration of the choice of entity for new and existing family offices.

For the first time in many years, the C corporation is now a potentially viable form of organization for family offices and other family investment vehicles. Such a decision will be informed by a great many factors, some of which are new (e.g., the three-year holding period requirement for profits interests), some of which feel new in spite of being quite old (the application of the personal holding company tax and the accumulated earnings tax), and some of which (future tax rates, in particular) are largely unknowable. Thus, it will be interesting to see whether the 2017 tax act represents the dawn of a new day in this particular area or simply provides intriguing opportunities that are ultimately discarded in favor of established practice.

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