Heighted Interest in the Profits Interest Structure

In light of the favorable tax court ruling in Lender Management, LLC v. Commissioner and the fact that miscellaneous itemized deductions (§212 deductions) are no longer deductible per the 2017 Tax Act, there has been an increase in interest in the profits interest structure.

In response, FOX hosted a webinar featuring FOX member, Keith Lender and his advisor Allan Zachariah along with Tom Ward from McDermott Will & Emery on March 6th where 158 participants heard, first hand, about the Lender case and gained an understanding of the impact of tax reform on the profits interest structure.

FOX also hosted a meeting on this topic for council members in Chicago on April 24th. The goal of this meeting was to provide members with an opportunity to learn about this structure and the case and have time to compare notes and ask questions of each other and the experts in a peer dialogue session.

Representatives from 28 council member offices joined us in Chicago for this meeting to hear Tom Ward from McDermott, Will & Emery and Domingo Such from Perkins Coie provide an overview of the structure and tax reform considerations, and FOX member, Keith Lender, share his experience with the case and important takeaways for any office with this structure.

This meeting summary is intended to provide you with some high level takeaways and important considerations related to the profits interest structure for you to discuss with your office staff, legal counsel, and accounting professionals. Every family office is unique and its structure should be designed to align with the goals and priorities of your family. **Nothing contained within this summary is intended to be considered as legal, tax or accounting advice.**

Meeting Agenda at a Glance

- Profits Interest Planning: Overview and Tax Reform Considerations
  Tom Ward, Partner, McDermott, Will & Emery
- Profits Interest Planning: Ownership, Succession, Transfer Tax and Other Considerations
  Domingo Such, Partner, Perkins Coie
- Lender Management v. Commissioner
  Keith Lender, President, Baldwin Street Management, LLC

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What is a Profits Interest?

"Profits interest (also known as a carried interest) refers to an equity right based on the future value of a partnership awarded to an individual or entity for their service to the partnership. The award consists of receiving a percentage of profits from a partnership without having to contribute capital. In effect, it is a form of equity compensation and is used as a means of incentivizing workers when monetary compensation may be difficult due to limited funds, such as with a start-up limited liability company (LLC)." - Investopedia

The profits interest structure is one way to fund a family office. Instead of receiving a fee based on assets under management (regardless of profit), a family office entity structured as a profits interest is compensated for its services through the receipt of a percentage of the profits. In years where the office does not achieve a profit, the family needs to secure alternative funding. Many offices use this structure to align the interests of the family office staff with the goals of the family office.

The profits interest structure is attracting interest because family office expenses and management fees incurred by the family office, a separate taxpayer engaged in a trade or business within the meaning of Section 162, are deductible, while fixed or AUM fees are treated as 212 expenses, which are not deductible per the 2017 Tax Act. This structure is not for everyone and should be carefully considered with counsel from your legal and accounting professionals.

Profits Interest Planning: Overview and Tax Reform Considerations – Income Tax

Tom Ward, Partner, McDermott, Will & Emery

Background on the Profits Interest and Legal Precedents

The profits interest or carried interest model is one that was borrowed from the Private Equity and Hedge Fund world, where partners in these investments receive compensation in the form of a share of the profits. In the family office context, the family office entity receives an allocation of the profits from the family investment partnership(s) as compensation for its services. The two key issues are operation as a trade or business and the ability of the profits interest to stand up to scrutiny. While "trade or business" is not defined in the Internal Revenue Service Code, generally there must be a regular and continuous activity with profit motive.

Historical case law on this topic includes:

- Higgins v. Commissioner which held that management of one's own assets is not considered a trade or business, no matter how much of one's time or one's employee's time it takes. This ultimately led to the creation of Section 212.
- Dagres v. Commissioner where a venture capital fund manager made a loan to an individual who provided access to investment opportunities. When that loan wasn't repaid entirely, the taxpayer claimed a bad business debt. The Tax Court held that Mr. Dagres' was engaged in a trade or business and that his skills produced the profits interest, which is different than a return on invested capital.
- The IRS focused on the Higgins Test in Lender Management v. Commissioner.

Structure Considerations – S, C or LLC?

There are three primary entity choices for a family office management entity and there are benefits and challenges with each. Some of the key considerations are outlined in the chart below.

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Trade or Business Considerations: Organization Structure

	Partnership/ LLC	S corp	C corp
Entity-level tax	No*	No*	Yes
Flow-through	Yes	Yes	No
Section 212 applicable	Yes	Yes	No
Special allocations permitted	Yes	No	No
Multiple classes of owners permitted	Yes	No (voting/nonvoting permitted)	Yes
Profits interest available	Yes	No**	No**
Governance flexibility	More	Less	Less

* May be state-level taxes (e.g., Illinois 1.5% replacement tax)
** However, a variety of incentive tools to be utilized, including equity appreciation rights, nonqualified plan and options

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When is a Profits Interest Fee Really a Fee?

Rev. Proc. 93-27 is "safe harbor" guidance on treatment of a receipt of a profits interest for services provided to or for the benefit of the partnership. Safe harbor does not apply if:

1. The profits interest relates to a substantially certain or predictable stream of income from partnership assets (e.g. high quality debt securities, high quality net lease).
2. If within two years of receipt, the partner disposes of the profits interest.
3. If the profits interest is a limited partnership interest in a "publicly traded partnership" under Code Section 7704 (b).

On July 23, 2015, the Treasury issued Proposed Regs that outline when the IRS will consider a profits interest a fee rather than a disguised payment for services. **The factor that is accorded the most weight is whether the interest is subject to significant entrepreneurial risk (SER) in relation to the overall entrepreneurial risk of the partnership.** The IRS considers the following a failure to prove SER, so you want to be certain that you avoid:

1. Capped allocations of partnership income.
2. An allocation for one or more years which ensures that the provider's share of income is reasonably certain.
3. Allocations of gross income.
4. An allocation that is predominantly a fixed amount, is reasonably determinable, or is designed to assure that sufficient net profits are likely to be available.
5. An arrangement in which the office waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

An arrangement with one or more of these features lacks SER and is therefore a disguised service payment unless other factors demonstrate SER by clear and convincing evidence.

There is no one right way to structure a profits interest. There are many variables to consider, and it's

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critical to do the math and modeling to understand what this looks like for your family in good years and in bad. It is critical to engage your accounting professionals in these conversations on the front end of the process.

Considerations for Analyzing Conversions From Flow-through to C Corporations

1. Effective tax rate on retained earnings (21% corporate v. 37% individual (subject to reduction to the extent that new Code Section 199A deduction applies))
2. Distribution/dividend policy – single v. double layer of tax
3. Deductibility (or lack thereof) of state/local taxes
4. Outside basis build-up
5. Employee/partner issue
6. Ability (or inability) to deliver a basis step-up to future buyer
7. Section 1202 (qualified small business stock) – only available for certain new issuances of "C" corporation stock
8. "Hassle factor" of flow-through structures (K-1s)
9. What if the law changes?

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Profits Interest Planning: Ownership, Succession, Transfer Tax and Other Considerations

Domingo Such, Partner, Perkins Coie

Domingo opened his presentation by talking about his concerns for the profits interest structure in light of the Lender case. While the case is great for family offices, he cautioned against rushing to "get a Lender structure" to achieve tax and other benefits. The profits interest structure only works if your family's fact pattern meets all of the complex requirements outlined earlier. The structure involves added complexity (e.g. partnership accounting) and doesn't work for offices where the senior generation of the family funds the office. Ownership of the structure cannot reside with one just party, and Domingo suggests that the office should be adequately capitalized to fund expected expenses for the next 12 – 18 months.

He then shared an example to give the group an understanding of how the profits interest works in practice. The image below shows the profits interest ownership structure with estate plan considerations.

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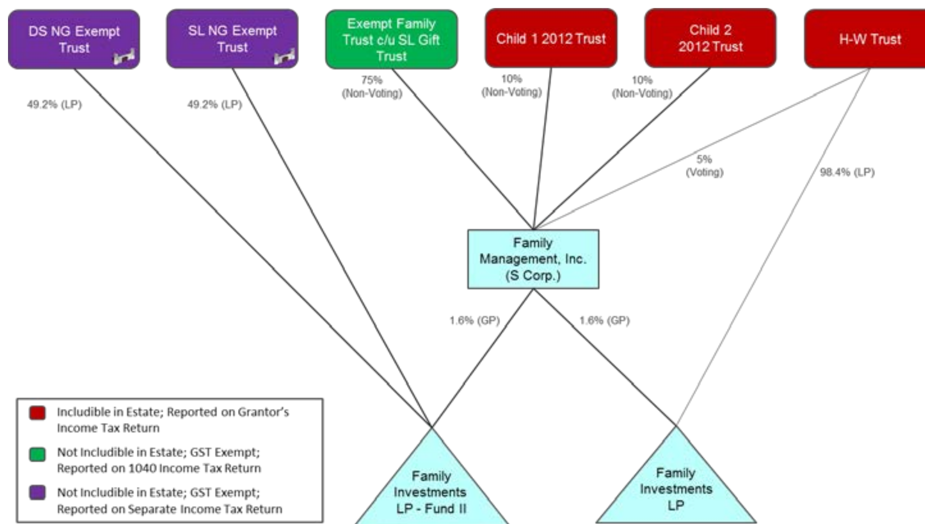
Example



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In this example, the Directors of Family Management, Inc. are grandparents and parents. The officers are a grandparent, parent, and two non-family employees. Family Management, Inc. is a general partner of Family Investments LP and Family Investments LP – Fund II.

Family Management, Inc. is compensated as a general partner via:

1. Management fee: each quarter, Management receives a fee equal to 2.5 basis points times the aggregate amount of each partner's Value Account (including its own) as of the last day of that quarter.
2. Profits Interest: At the end of each calendar year, taking into account the management fee for each quarter of that year, Management is allocated an amount equal to 12% of the "Fund Profits" for that year.
3. 1.6% GP Interest: Finally, Management is allocated 1.6% of Fund's profits, determined after the amounts described above have been paid.

This fee is paid as follows:

- Management is paid $500,000 per quarter ($2 million per year) for its expected profits interest and management fee.
- As the previous year's tax return is prepared and filed, the exact profits interest is calculated, and a true-up payment is made to cover any amount not covered by the quarterly payments.
- If the $2 million payment exceeds Management's profits interest, any excess is treated as an advance or payment of a previously earned amount (as applicable).
- As of December 31, 2016, Management earned management fees of $1.47M and received profits interest allocations of $3.58M since inception.

Impact of the Profits Interest Structure:

- In addition, through management fees and profits interest payments, over $5M has been shifted to Management, in which the next generation and the Exempt Family Trust hold 95% of the

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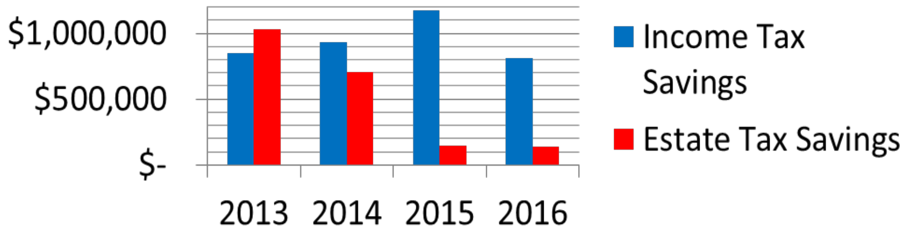
economic interests.

- The value attributable to the next generation and trusts will be excluded from grandparent and parents' taxable estates, resulting in a cumulative estate tax savings of $1.9M* from 2013-2016.



* Assumes: (1) 95% of value is attributable to non-voting stock, (2) 40% estate tax rate and (3) no remaining estate tax exemption.

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Following is an example of a hybrid corporate/partnership structure:

More complicated + tax-efficient: Hybrid Corporate/Partnership Structure

The family office is a corporate entity and general partner. Family members or trusts are limited partners. Profits matter

INSIGHTS

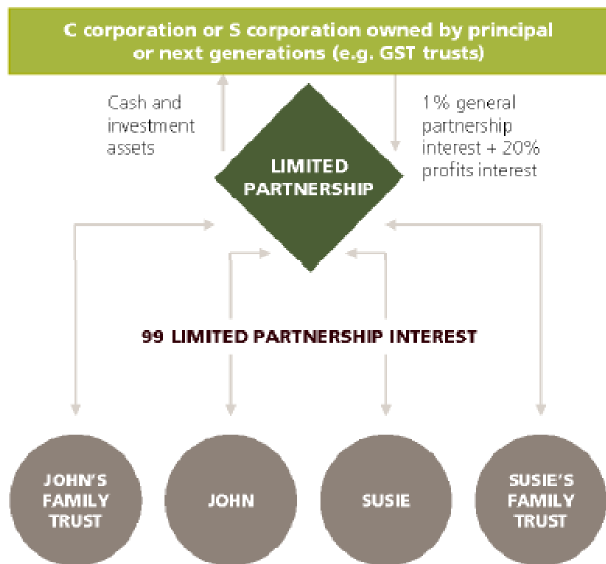
- Typically used with ESTABLISHED or INSTITUTIONAL operational models
- Appropriate for families using alternative investments

UPSIDE

- Can deduct expenses of managing family office and investments
- Facilitates structured and professional governance

DOWNSIDE

- More complex and costlier accounting and legal services
- Family office pays management costs regardless of performance– potential liquidity issues
- Only tax-efficient if profits interest generates enough income to cover investment management expenses
- Audit risk – should not force cash flows to match expenses



Technical Term
LIMITED PARTNERSHIP WITH PROFITS INTEREST

J.P. Morgan

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Limited partnership with profits interest: Blueprint and taxes

BLUEPRINT	TAX IMPLICATIONS
CREATE: • LLC or corporation, taxed as S or C corporation, to act as family office • Family office, as general partner of investment partnership:	**FAMILY OFFICE IS ABLE TO DEDUCT EXPENSES FOR:**
Must be engaged in a "trade or business" to claim a deduction for investment management expenses (i.e., needs to engage in activities with the goal of generating a profit)	**Investment management**
Provides services to family members (including trusts and other entities)	**Personnel/ Payroll**
Must be obliged to pay any investment management expenses that it claims as a deduction and needs sufficient income	**Office administration**
Has income from 2 sources: 1. Management Services Agreements – Flat fees for providing management and administrative services to family members and trusts (e.g. 1% of total assets value) 2. Profits interest (e.g. 20% of profits earned)	

Technical Term
LIMITED PARTNERSHIP WITH PROFITS INTEREST

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The 2017 Tax Act and recent taxpayer victory in the Lender Management, LLC decision have created exciting and imperative planning opportunities. The new flat tax rate of 21% on C corporation income is the centerpiece, and many family offices are reevaluating their office structure. However, the analysis is not clear cut. In order to realize the benefits of the lower tax rate, they may need to consider:

- The 20% accumulated earnings tax applicable to a corporation that retains earnings and profits beyond its reasonable business needs
- The 20% personal holding company tax applicable to certain closely held corporations of which at least 60 percent of gross income is passive
- Differences in state income tax on individuals and corporations
- The 3-year holding period for long term capital gains treatment
- Shareholder/Employee cash needs

Lender Management v. Commissioner

Keith Lender, President, Baldwin Street Management, LLC

Our very own Owner Operator Council member, Keith Lender, was kind enough to share his family story and experience in Tax Court.

Family and Office Background

In 1927, Keith's grandfather, a baker, emigrated from Poland to New Haven. In 1929 his wife

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and three children joined him, and they had three more children. Lender's Bagels started as his grandfather selling bagels out of the back yard (on Baldwin Street, the current name of the family office). Keith's grandfather died in 1960 and left the business to his three sons, Sam, Murray, and Marvin (Keith's father). In the 1960s frozen foods were new to supermarkets, and Lender's bagels joined the freezer section. They bought a competitor and went global. In 1976 Marvin and Murray bought out Sam, and in 1984 they sold the company to Kraft.

Marvin started the family office and ran it for many years. Keith joined the family office in 2004. In 2006, Keith outsourced the back office to Pathstone. The current staff includes Keith (CEO), a CFO/Controller, and Marvin still serves as Chairman and Advisor to the office. The office currently provides a full menu of services from investment decisions to cashflow management to family education and special projects to 24 second and third generation family members from two branches. The family office adopted a profits interest structure in 2004 to be able to better implement individualized asset allocation for its clients; deductibility was originally just a bonus.

Audit History

The office was audited in 2004, 2005 and 2006. In each case, the Court accepted the status of Lender Management as engaged in a trade or business.

In 2007, the IRS audited the individual tax returns filed by Marvin and Helaine Lender for 2004, 2005 and 2006 and determined that the expenses were correctly reported as business expenses on Schedule C "Profit or Loss from Business."

In 2011, the IRS audited Lender Management's business expenses on the 2008 U.S. partnership return. Again in 2012 and 2013, the IRS audited Lender Management's Partnership Return for 2009, and accepted the return as filed by issuance of a no change letter. Throughout this time, Keith and Pathstone worked to educate the IRS agents, who were not familiar with the profits interest structure.

In Lender v Commissioner, 2017, the IRS again challenged Lender Management as a trade or business and requested that 162 deductions be 212 deductions. At no time did the national IRS office get involved; everything was handled locally. In December of 2017, the U.S. Tax Court found Lender Management, LLC to be engaged in the trade or business of providing investment management services. As a result, the family office was entitled to deduct all of the ordinary and necessary expenses paid or incurred in carrying on that trade or business as business expenses under Section 162.

Lender Facts as a Guide for Any Family

The following facts of the Lender case provide a guide for any family considering the profits interest structure:

- The office provided investment advice and monitoring, cash flow management, and other services that the Court deemed to be beyond those of an investor and comparable to services a hedge fund manager would provide.
- To the extent that it successfully managed its clients' investments and the net assets under management increased in value, the family office received its compensation

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through an allocation of net profit.
- The family office held a relative small capital interest in the underlying investment LLCs. However, the profits interest structure was viewed as an incentive for the office to maximize returns.
- The family office received payment for its services only if the investment LLCs earned net profits (SER).
- The CIO owned less than 10% of the underlying investments, and was, therefore, not managing its own money.
- Only two of five G2 families were clients of the office.
- Investment choices were based on the clients' needs.
- Clients could withdraw funds at any time if they were not satisfied with the results.
- The clients of the LLC were geographically dispersed and didn't always get along. Each client was treated as an individual.

FOX is grateful to Tom, Domingo and Keith for sharing their wisdom and experience with the FOX community. Hopefully this information helps you to understand both the benefits and the complexity of the structure and gives you many questions to ask and issues to consider with your legal and accounting professionals.

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