New Family Office and Tax Considerations

Like many others who have been monitoring the latest tax proposals, we are of the view that there will be little certainty as to the direction of tax law changes until after the November election, if then. Over the last ten years, we’ve seen the estate tax exemption change six times, tax rates change nine times, the estate and gift tax exemptions made consistent and then inconsistent, and, last but not least, the repeal and re-enactment of the estate tax and the generation-skipping tax.

As for where we are now, most clients know that the current federal gift, estate and generation-skipping tax exemption of $5,120,000 (less amounts previously used) and maximum tax rate of 35% are now scheduled to expire at the end of this year. Although there’s a reasonable possibility Congress will be able to agree on an extension of the $5 million exemption through at least 2013, we believe it’s much less likely that the maximum tax rate will hold at 35% after this year.

While we wait to see what possible tax and other changes develop between now and the end of the year, there are a few items of particular note that don’t require a wait and see approach:

- a change in SEC registration requirements for certain family offices.
- proposed changes contained in the Administration’s Fiscal Year 2013 Revenue Proposals, commonly referred to as the “Greenbook.” Most surprising is a proposed change affecting trusts under which a parent or other individual who creates the trust retains the obligation to pay the tax on trust income, namely, “grantor” or “defective” trusts.
- an unexpected memorandum recently issued by the IRS calling into question the continued viability of a technique to make a gift to a trust that is ignored for gift tax purposes, but respected for income tax purposes. This type of trust is often used to avoid state income tax on trust income.

SEC Registration for Certain Family Offices:

Prior to the 2010 Dodd-Frank Act, a family office compensated for investment advice with respect to securities generally was exempt from SEC registration if it had fewer than 15 clients for the preceding twelve months and did not hold itself out to the public as an investment advisor nor advised any registered investment company.

Effective July 21, 2011, a family office that receives compensation for investment advice with respect to securities is required to register as an investment advisor with the SEC, regardless of the number of clients, unless it falls within the so-called “family office exemption,” meaning that the family office:

- provides investment advice exclusively to “family clients,” generally defined to mean: (i) you and your spouse, your descendants, such as children, grandchildren and great grandchildren, and the spouses of your descendants, (ii) trusts for any of the foregoing, (iii) key employees of the family office, and (iv) foundations or other charitable trusts funded exclusively by you, your spouse, or your descendants, including certain charitable remainder or charitable lead trusts, AND
- is wholly owned by family clients and controlled by family members, AND
- does not hold itself out to the public as an investment advisor.

This exception does not apply to a family office serving multiple families.
The elimination of the fewer than 15 client exemption therefore imposes a significant registration burden on a family office when it serves non-family clients. If the services do not involve investment advice with respect to securities, but are limited to other matters such as general business advice, tax return preparation, accounting, check writing, and concierge and administrative assistance, SEC registration should not be required regardless of whether non-family clients receive the benefit of those services.

It's also worth noting that beyond the family office exemption described above, Dodd-Frank created additional registration exemptions for an investment advisor, including a family office that does not otherwise qualify for the family office exemption, that advises only certain venture capital funds or only certain private funds with assets under management of less than $150 million.

**Trusts for Your Children and Grandchildren May Soon Have to Pay Their Own Income Tax:**

Most clients are aware that, for some time, current tax law has allowed the creation of a trust for one’s children that is permitted to grow, not only estate tax free, but income tax free by allowing the tax on trust income to be paid by the parent. To those who take pride in mastering the arcane language of tax lawyers, this involves the creation of a so-called "grantor" or "defective" trust. Like the favorable tax treatment for carried interest, however, some have considered the tax treatment for this type of trust to be so overly generous as to eventually require a day of reckoning. That day may soon be upon us. Under the Administration’s Fiscal Year 2013 Revenue Proposals, if a parent or other individual creates a trust, retaining the obligation to pay the tax on trust income, the trust automatically will be includable in the estate of that individual for estate tax purposes. This change would obviously defeat the estate tax savings benefit of this type of trust.

Fortunately, there are two positive aspects of this proposal:

First, the likelihood the proposal will pass is in doubt because there is a very credible argument it goes too far. If there is an abusive aspect to this type of trust, it is that the trust beneficiaries receive the benefit of having a parent or some other individual pay an income tax that would ordinarily be paid from the beneficiaries’ share of the trust income. This effectively allows a tax-free gift to the trust beneficiaries equal to the income tax paid. That result could easily be avoided by requiring the trust to pay the tax on its income, albeit at the parent or other individual's highest marginal income tax rate, instead of actually shifting the tax burden to the parent or other individual. This would be similar to the approach taken when computing the “kiddie tax” on the unearned income of a child under age 18.

Second, even if the Administration's proposal for grantor or defective trusts passes in its current form, it would only be effective for trusts created on or after the date of enactment, and for any contribution made on or after the date of enactment to a pre-existing trust. Thus, it appears there is still time to act.

Regardless of whether the proposal in its current form will be passed, the fact that the issue has been raised by the Administration at all makes it quite possible that some limitation on the benefit of grantor or defective trusts will be effective in the foreseeable future. Therefore, anyone contemplating the formation of a new grantor or defective trust, or an addition to an existing trust, should consider doing so as soon as possible.

**Other Estate Tax Savings Opportunities Proposed to Expire:**

The Administration’s Fiscal Year 2013 Revenue Proposals also recycle some previously mentioned limitations on popular estate planning strategies, although none as surprising as the proposal for grantor or defective trusts described above. Most notable are the denial of valuation discounts for interests in certain family-controlled entities, such as a family partnership or limited liability company, and a minimum ten-year term on grantor retained annuity trusts, both of which would apply to transfers made after the date of enactment. Therefore, anyone contemplating either of these transactions should consider implementing them sooner rather than later.
IRS Memorandum Addressing Gift Tax Consequences of a Trust Intended to be Disregarded for Gift Tax Purposes:

A somewhat common technique to avoid state income tax involves the creation of a trust, often in Delaware, by a resident of another state that imposes an income tax on its residents. Assets are contributed to the trust, and when later sold, avoid state income tax under Delaware law. This type of trust is often referred to as a “Delaware Intentionally Non-Grantor Trust” or DING Trust.

For this strategy to work, it is important that none of the trust income is taxable on the personal return of the individual creating the trust; otherwise the trust’s income will be subject to the tax of the state where he or she resides. It is also important that the transfer of the asset to the trust be ignored for gift tax purposes; otherwise a significant gift tax may be due that far outweighs any state income tax savings. Implementing a trust with both characteristics requires some artful drafting-- the individual creating the trust generally retains a limited power to modify trust distributions which, if exercised, is effective only at the individual’s death.

In a recently released memorandum, the IRS Chief Counsel’s Office has determined that this type of retained power will not allow the contribution to the trust to be entirely ignored for federal gift tax purposes, meaning that the creation of the trust may result in a significant gift tax liability. Pre-existing trusts of this type may not have the benefit of any statute of limitations on the assessment of gift tax if, as often happens, the transfer to the trust is not reported on a previously filed gift tax return.

It is quite possible the IRS will issue more guidance concerning the implications of this memorandum. Until then, if you have this type of trust in place, or plan to implement one, the impact of this IRS determination should be considered.