



**Tax and structuring
considerations**

Family investment partnerships



Content

Family Investment Partnerships (“FIP”) can help families address their collective and individual investment goals while offering significant benefits, which may be absent when family members invest separately. Each FIP can be tailored to meet the short and long-term investment and liquidity needs of its investors. Before forming a FIP, it is important to understand the key considerations of structuring and maintaining one or more FIPs for the family.



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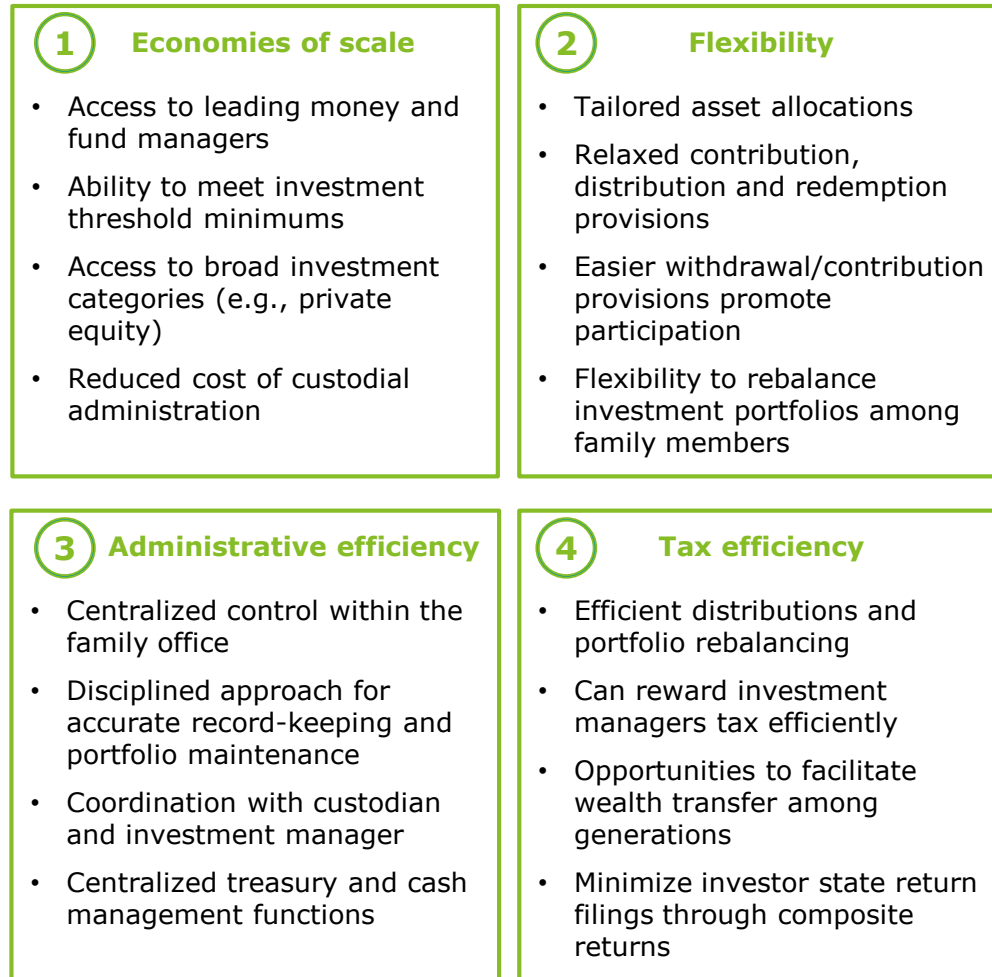
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Investment partnership basics



Figure 1: Benefits of an investment partnership



Pooling investment resources using partnerships continues to gain favor among wealthy families. FIPs are tools that allow families to strengthen financial connections across multiple generations, while garnering access to best in class investments and advice. Investing through FIPs can increase the ability to centralize management and investment decision making, efficiently manage diversified holdings across several asset classes, and obtain economies of scale needed to access favorable investments and investment managers at reduced costs. These benefits can be achieved without compromising the flexibility that individual family members desire to customize their portfolio to meet their investment goals.

An advantage of using partnerships for federal income tax purposes is that the income generated from the FIPs flows directly to its partners, resulting in only a single level of tax at the partner level. Each partner typically receives and is taxed on the income based upon its share of the investment in the partnership relative to all other partners' investments. While most states do not subject FIPs to entity level taxes, additional analysis should be performed to assess your family's situation.



Structuring an investment partnership



A FIP structure is typically comprised of one or more IPs through which its members may invest in marketable securities, hedge funds, private equity, real estate, venture capital and other illiquid alternative investments. The characteristics of these partnerships may vary depending on the asset classes in which any single FIP invests. In order for families to make the right structuring decisions, they should understand the following:

- Family investment and governance objectives
- Investors' financial goals
- Types of investments the family intends to make
- Level of flexibility family members desire to choose their investments
- Frequency of the need to access liquidity to support generational and lifestyle expenses
- Types of investors who will participate in the FIP structure
- Tax implications associated with the income from underlying investments

Next are four examples of structuring alternatives addressing unique family governance and investment needs. The structures vary based upon the chosen asset classes, level of desired investment flexibility, and the liquidity of underlying investment assets. Each example reflects how investments can be organized and how a partner's capital investment in various asset classes can be tracked. While there is no "one size fits all" FIP structure, the examples illustrate structures frequently formed by family groups seeking to invest across multiple investment strategies or asset classes.

Capital account

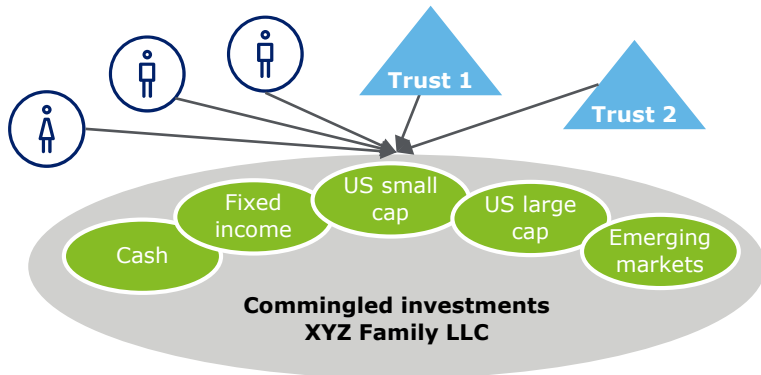
A partner's interest in a FIP is accounted for in a capital account maintained by the FIP. A capital account typically reflects a partner's contribution to, distributions from and its share of income or loss allocated to it in accordance with the partnership agreement.



Structuring an investment partnership (cont.)



Figure 2: Commingled asset classes



Alternative 1: One FIP with commingled asset classes

A potential structure for a family wishing to invest in a lockstep fashion across asset classes, chosen by the FIP manager and advisors, is to create one IP that holds commingled asset classes. A single capital account within the FIP is maintained for each partner. Any investment or withdrawal by a partner is of a proportionate share of the entire asset mix. Assuming that all partners invest at the same time and always receive pro rata distributions, each will achieve the same investment performance results. Lastly, each partner receives its share in economic and taxable income based upon its proportionate interest in the FIP from time to time.

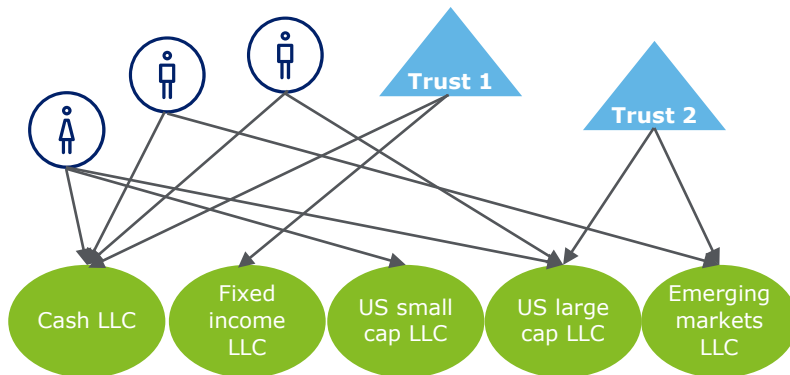
Advantages

Administrative simplicity
Simplifies tax compliance

Drawbacks

Less flexibility on how to invest capital
Limits investment choices for family members

Figure 3: Separate IPs for each asset class



Alternative 2: Each asset class category is a separate FIP

Several FIPs are formed each investing in a single asset class. This is a fairly traditional format for structuring FIPs. Separate tax returns are required to be filed for each FIP. A partner's investment performance is calculated separately and is dependent upon the IPs chosen and its relative investment in each. Economic and tax allocations are made to each partner only with respect to its proportionate share of the IP in which it has invested.

Advantages

Segregation of asset classes
Increased flexibility on how capital is invested

Drawbacks

Each FIP must file a tax return
Increased economic reporting and tax compliance costs



Structuring an investment partnership (cont.)



Alternative 3: One IP to accommodate and track multiple liquid asset classes

The FIP is organized with multiple divisions or “side pockets” allowing investors to choose how to invest across multiple asset classes within the same FIP. The side pocket concept is one similar to that used in many traditional hedge fund structures.

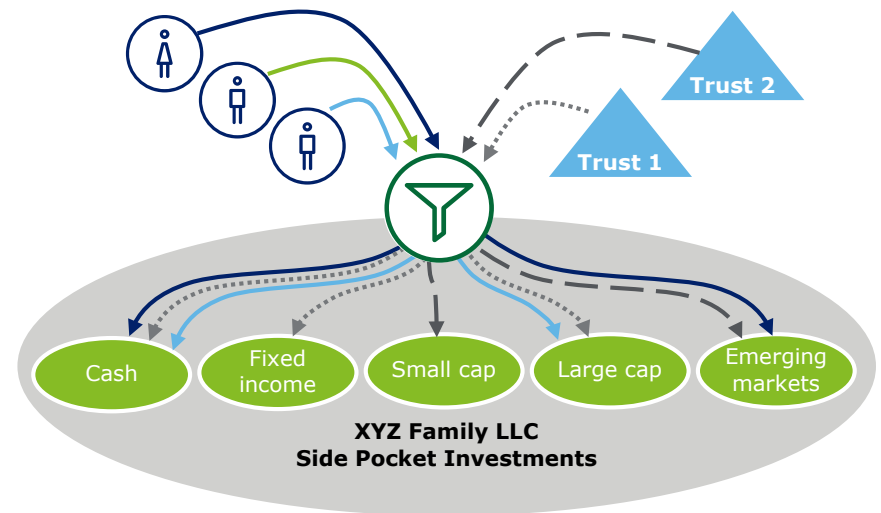
Each investor has the ability to decide whether to invest in a side pocket and the amount of capital to invest in each. A separate side pocket capital account is maintained for each partner. Allocations of side pocket economic and taxable income or loss are made only to those partners that have designated a portion of their investments to the side pocket.

Because a side pocket is not treated as a separate legal or tax entity, only one federal partnership income tax return is filed, combining the activity of each side pocket. The benefits of employing side pockets include reduced tax compliance costs and increased flexibility to periodically rebalance investments—typically quarterly or monthly – within a single investment vehicle.

Side pocket

A division within a FIP where the economic activity related to the chosen investments are accounted for separately. It is not intended to be treated as a separate partnership for federal or state income tax purposes.

Figure 4: Multiple liquid asset classes



Advantages

Flexibility in allocation of capital for investment

Reduced tax compliance costs

Drawbacks

Cost of administration

Fixed schedule for portfolio rebalancing costs



Structuring an investment partnership (cont.)



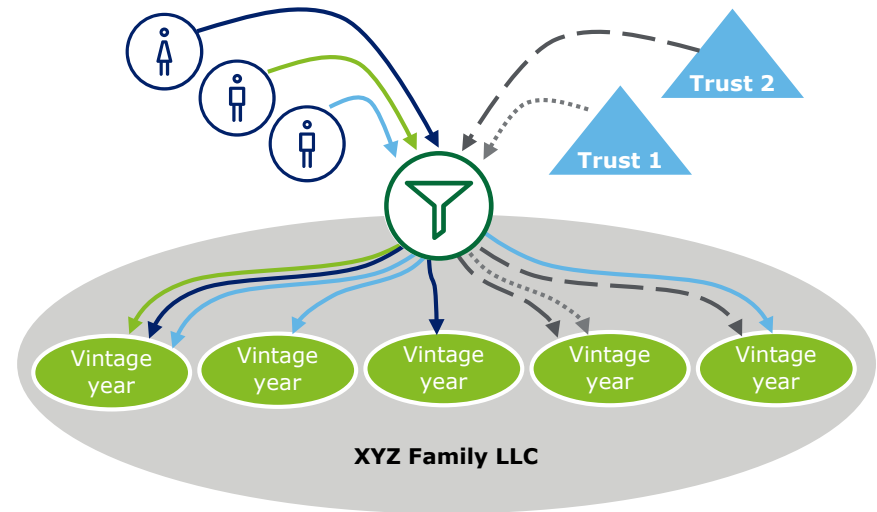
Alternative 4: One IP to accommodate and track multiple vintage year investment options

Rebalancing is rarely an option for illiquid asset classes, such as private equity and real estate, but using “vintage accounts” to hold illiquid assets yields benefits similar to those for side pockets.

Vintage accounts are generally organized with fixed commitments to illiquid asset classes over a designated period of time—from one to three years. Vintages may also separate alternative asset classes such as private equity, real estate, or oil and gas. A partner’s level of investment and percentage of ownership may vary between vintage accounts, but typically will remain constant within any given account until it is liquidated. A separate vintage capital account is maintained for each partner.

Although side pockets and vintage accounts may increase flexibility, such benefits must be weighed against the increase in administrative complexity, as the number of investment choices or side pockets increase.

Figure 5: Multiple vintage year investment options



Advantages

Increased flexibility for investment selection

Reduced tax compliance cost

Drawbacks

Potential for increased administrative costs

May compress timing of tax compliance



Structuring an investment partnership (cont.)

Other considerations

While choosing the right FIP structure is an important consideration, there are many other areas that should be considered during the design process to meet the family's objectives including:

- Deducting the costs of managing investments
- Estate and gift tax considerations
- Incentivizing family office managers in a manner consistent with the family's goals
- Implementing deferred compensation plans
- Forming partnerships to aggregate cash and facilitate liquidity needs



Tip



For families with philanthropic endeavors, careful planning is required when co-investment opportunities arise between the family office, family members, trusts and a private foundation. Reviewing the rules ahead of time can provide a framework for structuring that protects the interests of the family and private foundation.



Managing an investment partnership



Efficient management practices drive the success of a FIP structure. It is important from the outset to thoughtfully communicate with various stakeholders, including the family, attorneys, custodians, accountants, investment advisors and tax professionals, about how the FIP structure will be administered. Committing these procedures to writing, either in the operating agreements or procedures manual, is a leading practice. Deciding who will maintain the FIP accounting, including capital account maintenance, is one of those decisions.

Figure 6: Factors key to successful management and operation

Regulatory considerations

If a family office is providing investment related services to its clients, the possibility of Securities and Exchange Commission (SEC) oversight may be a consideration. Many families structure their family offices to qualify under the “family office rule” and are thus not required to register as an investment adviser under the SEC rules. Another regulatory matter is whether all family investors are considered accredited investors for purposes of participation in certain investments. SEC counsel should be engaged to address these regulatory issues.

A clear and simple message to family members of the goals, purpose and possible limitations of the FIP structure



An understanding between the family, family office and its service providers of the roles and responsibilities for the ongoing maintenance of the FIP

A consistent approach to managing cash flow and movement of assets among family investors, entities, and the FIPs

A simple and practical protocol for gathering data and reporting investment and tax results to family investors



Managing an investment partnership (cont.)

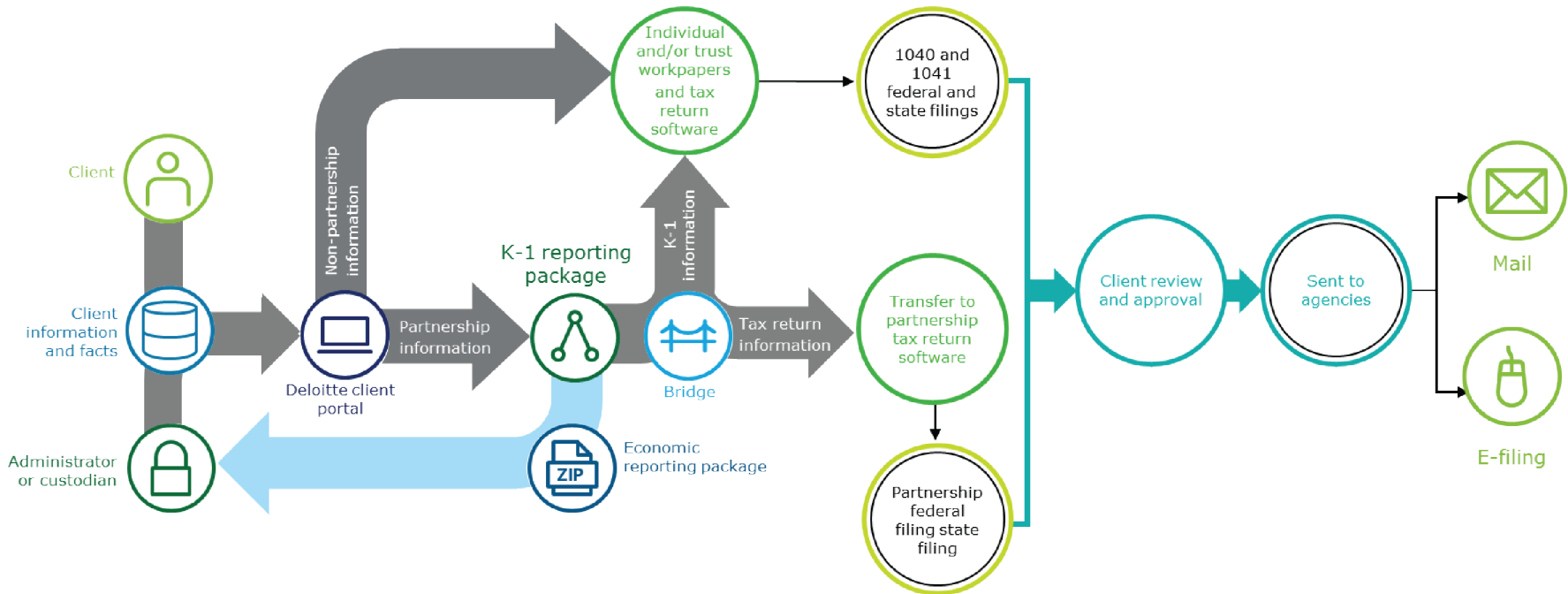


Leveraging technology from start to finish

It is important to evaluate which technology tools can best assist the partnership with data aggregation, partnership allocations, and capital account maintenance. We have developed technology tools to efficiently transfer Schedule K-1 information from the partnerships to the partners' tax returns. Automating the process to transfer Schedule K-1 information can address the challenges of completing a significant number of tax returns in a compressed period of time, and reduce the possibility of human error.

While there may not be one technology that can meet all of these needs, taking time to assess and identify the right tools for an investment partnership can improve investor calculations and reporting processes in the long run.

Figure 7: Integrated process from entity to end taxpayer return



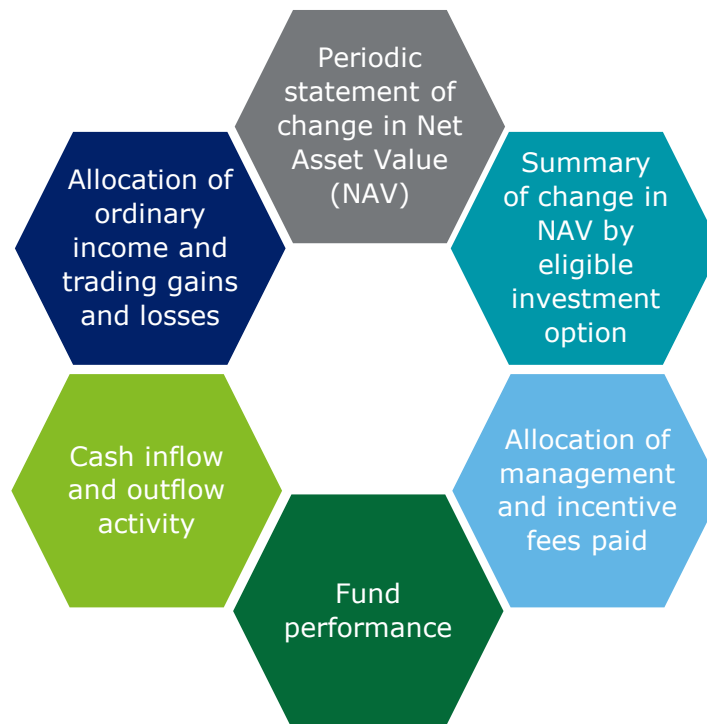
Managing an investment partnership (cont.)



Tracking and reporting a partner's investment

The responsibility to periodically report investment and tax results to family investors typically rests with the family office. Reports generated by the family office are likely to be one of the few regular and continuous touchpoints that a family office has with the majority of the family members, their advisors, and trustees. Reporting on a timely and accurate basis requires attention to detail and an understanding of complex legal agreements and tax rules. This function frequently stretches the resources and competencies of many family offices.

Figure 8: Common reports and data points used by family offices

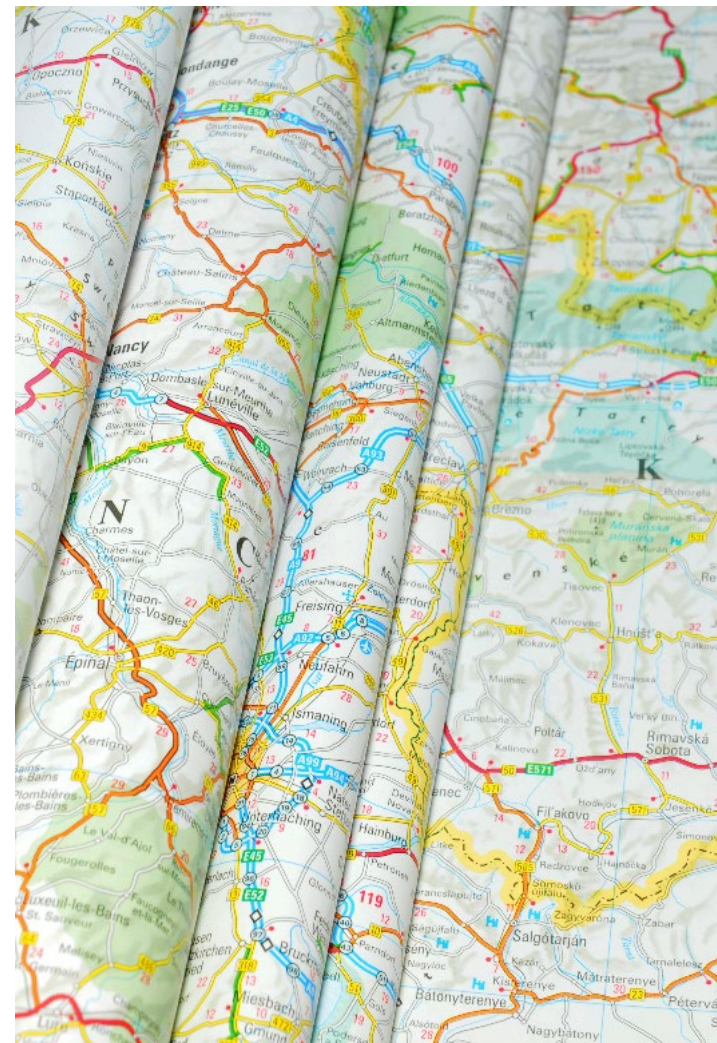


Investment partnerships and global families



Families and investment opportunities are increasingly global. Financial success provides individuals the freedom to choose the place they will live, raise a family, invest and accumulate wealth. IP structures frequently try to accommodate families with members residing and investing in multiple jurisdictions. Serving the needs of increasingly mobile families and their global investment portfolios creates additional administrative and regulatory burdens. It is critical to evaluate structural alternatives to accommodate the needs of global families. Some of the critical issues include:

1. Choice of the appropriate entities and jurisdictions to accommodate non-U.S. investors and investments
2. Foreign and state income tax filing requirements
3. U.S. and state income tax withholding on foreign or nonresident investors
4. Effective planning for the use of foreign tax credits to reduce the impact of investing in multiple jurisdictions
5. Risks associated with investments denominated in currencies other than the dollar
6. Foreign bank and financial account reporting
7. Foreign estate, gift and wealth taxes



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Deloitte can field a world-class team to guide family offices through these critical conversations and clear a path forward. We have a global team of 1,800 professionals across the Deloitte Touche Tohmatsu Limited network of member firms who focus solely on the specialized needs of the ultra-affluent, including families with multigenerational wealth, entrepreneurs, family offices, and fiduciaries. Our professionals provide advice and deep experience in a wide range of specialized areas — from tax technical to cyber risk management — and have access to a global network and emerging markets.

Please visit us at www.deloitte.com/us/familyoffice to learn more about how Deloitte can help family offices from formation throughout the life cycle of its operations.



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