Best practices for the family office tax function

A best-in-class family office tax function goes beyond preparing timely tax returns to drive tax strategy and reduce the overall income, gift, and estate tax burden across generations. In leading family offices,the tax function is integrated into all aspects of operations. Given the role taxes have on most families, it's imperative for the family office to ensure it has the proper infrastructure and resources to understand, plan, and strategize from both the tax planning and compliance standpoint.

Historically, family offices hired individuals with previous public accounting experience, many of whom were tax professionals, to build a successful tax function. Although this is still a common practice for many family offices, the complexities and changing tax environment have led family offices to consider alternative approaches to meet the tax needs of the family. But in order for a family office to maintain the necessary software, provide appropriate levels of review, and stay abreast of tax law changes, the internal tax function must do one of two things: have the capacity to scale or take a "skinny" aka **hybrid approach**. The hybrid approach is growing among family offices due to the many challenges of keeping current with both technology and tax law changes.

The following examples show how such a hybrid approach will often look:

The family office internal team prepares tax returns and an outside certified public accountant (CPA) reviews.

The family office internal team prepares selected tax returns and outsources more complicated returns to an outside CPA.

But whether a family office chooses to build an internal tax team, utilize a hybrid insource/outsource approach, or outsource the tax function entirely, the well-established family office still plays a key role in the tax process. The family office should be working with its tax advisors to proactively identify and address the risks and opportunities inherent in a family office as well as staying attuned to legislative changes.

While a family's tax situation can differ for any number of reasons — size and wealth of the family enterprise, specific types of investments, active and passive management of investments, complexity of income and estate planning strategies, state tax implications, international exposure — the tax function within the family office is typically organized around three categories: income, gift, and estate tax planning; entity structuring; and compliance. Let's take a look at each.

Income, gift, and estate tax planning for the family office

Proper proactive tax planning is essential since the family office, along with its outside tax advisors, is often faced with numerous tax matters, including:

- *Tax impact of investment strategy.*
- *Funding the family office in a tax-efficient manner.*
- *Deductibility of certain family office expenses.*
- *Multistate & international tax exposure for family members and trusts.*
- *Philanthropy discussions and the tax impact of charitable giving strategies.*
- *Estate & gift tax considerations.*
- *Emerging issues, including cryptocurrency & digital assets.*

Family offices are often tasked with understanding the tax implications of various transactions, understanding certain structures and strategies, and monitoring and tracking these strategies within the family office enterprise. The role the family office plays in income, gift, and estate tax planning will vary depending on the expertise and backgrounds of the family office professionals. A family office following best practices will meet frequently with family office decision-makers, investment advisors, and tax professional to ensure proper tax implications are considered as part of the family office decision-making.

Entity structuring and the family office tax function

Entity structuring is another important aspect of the tax function often undertaken by the family office tax team in coordination with outside accountants and legal counsel. Proper entity structuring can provide many benefits, including opportunities with income and estate tax planning and flexibility of ownership and compensation structures within the family office. In **"Direct investment function,"** we describe some common structures family offices use as they look to build out their direct investment portfolio.

However, creating the proper structure only does so much within a family office. The need for proper controls and processes to honor and maintain the structures in place is crucial. Improper maintenance can nullify the purpose of the entity, impact tax or estate planning opportunities, and call into question the validity of the structure with the IRS or other regulatory agencies. For example, a common estate planning strategy, such as the sale of LLC units to a defective grantor trust, requires the family office entities to properly report the sale, document and respect the promissory notes, and properly reflect ownership in the books and records of the various entities being reported by the family office. Failure to maintain the true spirit of the transaction may cause issues under IRS examination and ultimately undermine the planning.

The team responsible for the tax function within the family office, as well as the outside tax advisors, should fully understand the purpose and the use of the various entities. It's imperative that the tax team and advisors work cohesively to ensure accounting and reporting is accurate — and consistent with the family's intent.

Compliance and reporting for the family office tax function

Compliance is a critical function within the family office, particularly as recent enhancements to required reporting provide better information to the IRS. The compliance function not only focuses on filing tax returns but on the processes by which data is maintained, tracked, and reported.

Selecting and using appropriate technology and the ability to automate the tax compliance and reporting process is key to running an efficient tax function within the family office. Our article, **"Enterprise software selection,"** describes the unique functionality necessary for a family office that historically has been managed by highly customized applications, spreadsheets, side systems, and manual processes. Selection of an enterprise solution that combines these functions with tax reporting reduces human error and is best practice. Many enterprise software packages provide an integrated function to scan documents, categorize expense activity (by family member, entity, or trust for example), maintain tax-basis records, and provide detailed income and expense reporting by entity on a monthly or quarterly basis.

The right enterprise software solution allows the end-user to prepare returns containing hundreds of Schedule K-1s and 1099s in an efficient and organized fashion, providing a clear view of each layer of data embedded within tax returns' line-item totals. The use of technology reduces both time and the risks of error inherent in manual data entry processes. In addition, for family offices with significant private equity or alternative investment activity, the software solution can assist in providing tax information relating to K-1 delivery, capital calls and distributions, tax-basis reporting, and international and state reporting. This information is vital to maintaining proper records and ensuring accurate data for making both estimated tax payments and annual tax filings.

Legislative changes that impact the family office tax function

Recent legislative trends and IRS initiatives indicate increased tax enforcement, which will add to the complexities around income tax compliance and reporting. Risks inherent in improper reporting could subject the family to unnecessary audits and IRS scrutiny. This results in additional resources spent on compliance matters , including potential fines and penalties, rather than on other needs within the family office.

Ongoing changes in the law and tax code are requiring family offices to be more cognizant and diligent in their efforts to properly comply with the various rules and regulations. Within the past five years alone, there have been numerous tax law changes that have added significant complexities to federal, state, and international compliance requirements. Successful family offices have been able to mitigate the impact of these changes by increasing the use of technology, properly consulting with outside tax advisors, and building the necessary infrastructure around tax processes and functions.

In addition to continuous changes in the law and tax code, substantial legislative proposals have also been put forth, which can lead to a panic to understand implications. In 2021, U.S. Treasury released the much anticipated “Green Book.” Among other things, the Green Book was a reflection of the Biden administration’s recommendations for proposed tax legislation, which included significant changes to income and estate tax as well as tax planning. While comprehensive tax changes didn’t occur, quickly analyzing and understanding the implications takes considerable resources and knowledge of the tax code. If a family doesn’t have those resources and expertise internally or through trusted external advisors, it’s impossible to proactively plan.

Final thoughts

The tax function plays a key role in the overall strategy and success of the family office. It’s essential to have proper controls and processes in place to handle everything from data collection, risk mitigation, reporting, and monitoring for the compliance function to more comprehensive and holistic tax planning for the family. Whether a family office utilizes internal resources, outsources to a qualified CPA firm, or uses a hybrid model, it’s important that the tax team both understands and proactively plans for the impacts of taxes on investment strategy, charitable giving, gift and estate, and other areas important to the family.

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