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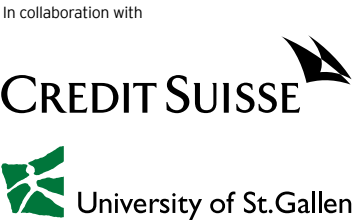
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# EY Family Office Guide

Pathway to successful family and wealth management





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## About us

### EY Global Family Business Center of Excellence

EY is a market leader in advising, guiding and recognizing family businesses. With almost a century of experience supporting the world's most entrepreneurial and innovative family firms, we understand the unique challenges they face – and how to address them.

Through our EY Global Family Business Center of Excellence, we offer a personalized range of services aimed at the specific needs of each individual family business – helping them to grow and succeed for generations.

The Center, the first of its kind, is also a powerful resource that provides access to our knowledge, insights and experience through an unparalleled global network of partners dedicated to help family businesses succeed wherever they are.

For further information please visit [ey.com/familybusiness](http://ey.com/familybusiness)

### EY Family Office Services

Our services for families and family offices are a reflection of our broad range of expertise and a symbol of our commitment toward family businesses around the world.

Our comprehensive and integrated approach helps families to structure their wealth and preserve it for future generations. Our goal is to unlock the development potential of the family through a multidisciplinary approach that scrutinizes operational, regulatory, tax, legal, strategic and family-related aspects.

For more information about the full range of our family office services please visit [ey.com/familyoffice](http://ey.com/familyoffice).

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### The Center for Family Business – University of St. Gallen

The Center for Family Business of the University of St. Gallen (CFB-HSG) focuses on research, teaching, and executive education in the context of family firms and at international level.

The CFB-HSG's work involves initiating, managing, promoting and running training and transfer programs, research projects and courses.

At the St. Gallen Family Office Forum, representatives of German-speaking single family offices meet twice a year in a discrete and trustful setting. The aim is an intensive exchange of experiences, best practice, and ideas.

# Foreword

Dear Reader,

We are delighted to present the first definitive and comprehensive guide on setting up a family office and best practices within the sector. Entitled *Pathway to successful family and wealth management*, this report provides an analysis of the most important topics and issues to consider when deciding whether to set up, or restructure, a family office.

A large number of family offices have been set up over the last 10 years all over the world. The common triggers for establishing a family office include: ensuring that wealth is transferred to future generations; preserving family wealth; consolidating assets; dealing with a sudden influx of liquidity; solving family conflicts; and increasing wealth management efficiency. Family offices have also gained prominence because of wealth-holding families' desire for greater control over their investments and fiduciary affairs, as well as lifestyle management. Indeed, this desire for control has gained even more resonance since the 2008-09 financial crisis, as more families have taken control of their financial affairs. As wealth grows, particularly in the emerging markets, there is little doubt that family offices will play an even bigger role in the management of substantial wealth in the years ahead. This guide, certainly one of the most comprehensive and in depth ever published, is designed as a learning tool to provide guidance to families considering setting up a family office. They include business families who wish to separate their family wealth and assets from the operating business, and successful entrepreneurs looking at structuring liquidity gained from a highly profitable sale in order to further grow and preserve their wealth.

While compiling this report, EY worked extensively with Credit Suisse, the University of St. Gallen and family offices themselves, a few of which have provided illuminating case studies throughout the report. All these organizations and individuals have provided invaluable insights into family offices and their concerns, and the report would not have been possible without their help.

We hope that you will find this report helpful and illuminating for your decision-making as you plan a path for your family into the future.



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### What is a family office?

Family offices have their roots in the sixth century, when a king's steward was responsible for managing royal wealth. Later on, the aristocracy also called on this service from the steward, creating the concept of stewardship that still exists today. But the modern concept of the family office developed in the 19th century. In 1838, the family of financier and art collector J.P. Morgan founded the House of Morgan to manage the family assets. In 1882, the Rockefellers founded their own family office, which is still in existence and provides services to other families.<sup>1</sup>

The expression "family office" covers all forms of organizations and services involved in managing large private fortunes. These can be organized either as family-owned companies, in which the family wealth is pooled, or as companies or bank departments that provide financial services for these clients, while the family retains decision-making powers. Many family offices were originally a "single family office". In these cases, the family is the owner of the organization and uses its services exclusively for itself. In order to avoid one family having to bear the very high operational costs of a single family office, families often decide to offer the services of their family office to other families. When a family office opens up its services to other families it becomes a "multi family office".

Since the individual services of a family office are tailored to the clients, or the family, and are correspondingly costly, the amount of family wealth under management is generally at least US\$100m. It is more revealing, however, to calculate the minimum wealth under management in the light of return expectations and targets, and the resulting costs of the family office. This shows that there is no clear lower limit for a family office. The costs of the family office, plus the return target, must be achievable with the chosen asset allocation and structure.

Family offices are arguably the fastest-growing investment vehicles in the world today, as families with substantial wealth are increasingly seeing the virtue of setting one up. It is difficult to estimate how many family offices there are in the world, because of the various definitions of what constitutes a family office, but there are at least 3,000 single family offices in existence globally and at least half of these were set up in the last 15 years.

1. For more information see [rockefellerfinancial.com](http://rockefellerfinancial.com).

The increasing concentration of wealth held by very wealthy families and rising globalization are fueling their growth. Particularly important in the years ahead will be the strong growth of family offices in emerging markets, where for the most part they have yet to take hold – despite the plethora of large family businesses in these economies.

This report attempts to define the family office in authoritative detail. It looks at issues such as: the reasons for setting up a family office; key staffing concerns; which services a family office should cover and which should be outsourced; how to optimize investment functions and to ensure they work for the benefit of the family. The report also looks at regulatory and tax issues in key markets, which anyone considering setting up a family office needs to know. It also addresses the relationship between the family and the external professionals who are brought in to run a family office. It is crucial for a family office to establish a balance between these two groups if it is to function well.

A number of case studies, including the personal experiences of family office practitioners, are used to help to bring the detailed analysis in this report to life.

Family offices are complex organizations that require deep knowledge – not just of investment variables, but also a host of other factors. This report is a detailed handbook for those planning to set up a family office and also for those looking to set benchmarks of best practice within their existing family office.

As wealth grows, particularly in the emerging markets, there is no doubt that family offices will play an even bigger role in the management of substantial wealth in the years ahead.

# 1

## Why set up a family office?

As concerns about wealth preservation and succession planning within family businesses continue to rise, wealthy families are increasingly evaluating the benefits of setting up a family office.

### The reasons why

There are many reasons why setting up a family office makes sense, but at the root of these is the desire to ensure smooth intergenerational transfer of wealth and reduce intrafamily disputes. This desire inevitably increases from one generation to the next, as the complexity of managing the family's wealth grows. Without being exhaustive, the following points set out the reasons why a family office makes sense:

#### ► Governance and management structure

A family office can provide governance and management structures that can deal with the complexities of the family's wealth transparently, helping the family to avoid future conflicts. At the same time, confidentiality is ensured under the family office structure, as wealth management and other advisory services for the family members are under a single entity owned by the family.

#### ► Alignment of interest

A family office structure also ensures that there is a better alignment of interest between financial advisors and the family. Such an alignment is questionable in a non-family office structure where multiple advisers work with multiple family members.

#### ► Potential higher returns

Through the centralization and professionalization of asset management activities, family offices may be more likely to achieve higher returns, or lower risk, from their investment decisions. Family offices can also help formalize the investment process, and maximize investment returns for all family members.

#### ► Separation

Family offices allow for separation, or at least a distinction, between the family business and the family's wealth or surplus holdings.

#### ► Centralization of risk

Family offices allow for operational consolidation of risk, performance management and reporting. This helps the adviser and principals to make more effective decisions to meet the family's investment objectives.

#### ► Centralization of other services

Family offices can also coordinate other professional services, including philanthropy, tax and estate planning, family governance, communications and education, to meet the family's mission and goals.

### Why might there be doubts about setting up a family office?

The establishment of a family office is a big undertaking, and there have been cases when family offices have not met the family's expectations. Some of the potential doubts and concerns about setting up a family office are:

#### ► Cost

The cost of regulatory and compliance reporting remains high, which means that the level of assets under management that a family office needs to underpin needs to be high in order to offset its fixed costs.

#### ► Market, legal and tax infrastructures

Family offices function better when operating from centers where there are sophisticated markets and legal and tax structures. The absence of these in emerging markets has undermined the development of family offices there. This has often meant that there has been little connection between the huge level of wealth in some emerging markets and the number of family offices. Much of the wealth in emerging markets is still controlled by the first generation. This has also inhibited the growth of family offices, because many are launched during a wealth transition from one generation to the next.

### Main types of family offices

#### Single Family Office (SFO)

In its purest sense, a single family office is a private company that manages the financial affairs of a single family. Typically, a fully functional SFO will engage in all, or part of the investments, fiduciary, trusts and estate management of a family; many will also have a concierge function.

#### Multi Family Office (MFO)

A multi-family office will manage the financial affairs of multiple families, who are not necessarily connected to each other. Like a single family office, an MFO might also manage the fiduciary, trusts & estate business of multiple families as well as their investments. Some also will provide concierge services. Most MFOs are commercial, as they sell their services to other families. A very few are private MFOs, whereby they are exclusive to a few families, but not open to other families. Over time, SFOs often become MFOs. This transition is often due to the success of the SFO, prompting other families to push for access. Economies of scale are also often easier to achieve through an MFO structure, promoting some families to accept other families into their family office structure.

#### Virtual Family Office (VFO)

Families looking to achieve the benefits of a family office managing their financial and other affairs, but who don't want to set up an actual company to do so, can opt for a virtual family office. This can be achieved by outsourcing all services to external providers of services and consultants.

# 2

## Family office services

### ► The multi family office offering

To address the problem of the high operating costs of a family office, families often set up multi family offices (MFOs), in which several families pool their wealth together. Often these MFOs will be directed by the “lead” family that initiated the office. In MFOs, all assets are managed under one umbrella. But MFOs typically cater for a range of family size, wealth and maturity levels. This means that families can run the risk of not receiving the personalized advice that they would have done in a dedicated family office setup.

When considering establishing a family office, some can see potential positives as negatives. This tends to be particularly prevalent in the following areas:

### ► The preference for privacy

Some families may be hesitant about consolidating their wealth information through a centralized family office structure.

### ► Trust of external managers

Setting up a family office is typically contingent on the level of trust and comfort families have with external asset managers. However, trust typically stems from long-standing relationships with external managers.

### ► Expectations on returns

Ultimately, family offices rely on their longevity through ensuring wealth preservation. This difficulty of securing market returns in recent years has led to some tension in this respect. Furthermore, during generational transitions, family office structures are tested, often to the point of destruction, as the next generation presses for different goals and objectives to manage the family's wealth.



At the heart of any family office is investment management, but a fully developed family office can provide a number of other services, ranging from training and education to ensuring that best practice is followed in family governance. This section looks at the full range of services a mature family office could potentially provide (see Figure 2.1). These include:

### Financial planning

#### Investment management services

Typically, this will be the main reason for setting up a family office, as it is central to ensuring wealth preservation. These services will include:

- Evaluation of the overall financial situation
- Determining the investment objectives and philosophy of the family
- Determining risk profiles and investment horizons
- Asset allocation – determining mix between capital market and non-capital market investing
- Supporting banking relationships
- Managing liquidity for the family
- Providing due diligence on investments and external managers

#### Philanthropic management

An increasingly important part of the role of a family office is managing its philanthropic efforts. This will include the establishment and management of a foundation, and advice on donating to charitable causes. These services would typically involve:

- Philanthropic planning
- Assistance with establishment and administration of charitable institutions
- Guidance in planning a donation strategy
- Advice on technical and operational management of charities



- ▶ Formation of grant-making foundations and trusts
- ▶ Organizing charitable activities and related due diligence

### Life management and budgeting

Some of these services are typically defined as “concierge” in nature, but they are broader in scope, inasmuch as they also include budgeting services. Services under this heading will include:

- ▶ Club (golf, private, etc.) memberships
- ▶ Management of holiday properties, private jets and yachts
- ▶ Budget services, including wealth reviews, analysis of short- and medium-term liquidity requirements and long-term objectives

## Strategy

### Business and financial advisory

Beyond the asset management advisory, family offices will also provide advisory services on financing and business promotion. These will include:

- ▶ Debt syndication
- ▶ Promoter financing
- ▶ Bridge financing
- ▶ Structured financing
- ▶ Private equity
- ▶ Mergers and acquisitions
- ▶ Management buyouts
- ▶ Business development

### Estate and wealth transfer

Family offices will be involved in business succession and legacy planning, enabling the transfer of wealth to the next generation. These services will include:

- ▶ Wealth protection, transfer analysis and planning related to management of all types of assets and income sources

- ▶ Customized services for estate settlement and administration
- ▶ Professional guidance on family governance
- ▶ Professional guidance regarding wealth transfer to succeeding generations

### Training and education

Much of this revolves around the education of the next generation on issues such as wealth management and financial literacy, as well as wider economic matters. These services will include:

- ▶ Organizing family meetings
- ▶ Ensuring family education commitments
- ▶ Coordination of generational education with outside advisers

## Governance

### Reporting and record keeping

The maintenance of records and ensuring there is a strong reporting culture is another core part of a family office's services. Key to these services is:

- ▶ Consolidating and reporting all family assets
- ▶ Consolidating performance reporting
- ▶ Benchmark analysis
- ▶ Annual performance reporting
- ▶ Maintaining an online reporting system
- ▶ Tax preparation and reporting

### Administrative services

Administrative services, or back-office services, are essential to the smooth running of a family office. These services will include:

- ▶ Support on general legal issues
- ▶ Payment of invoices and taxes, and arranging tax compliance
- ▶ Bill payment and review of expenses for authorization
- ▶ Opening bank accounts

- ▶ Bank statement reconciliation
- ▶ Employee management and benefits
- ▶ Legal referrals and management of legal firms
- ▶ Public relations referrals and management of public relations firms
- ▶ Technology systems referrals and management of these vendors
- ▶ Compliance and control management

### Succession planning

Ensuring a smooth succession and planning for future generations is integral to the long-term viability of the family office and the family it serves. These services will include:

- ▶ Continuity planning relating to unanticipated disruptions in client leadership
- ▶ Evaluation of the strengths, weaknesses, opportunities and threats (SWOT analysis) of senior executives both within and outside the family
- ▶ Re-evaluation of family board regarding roles of non-family directors
- ▶ Structuring of corporate social responsibility platforms and programs
- ▶ Development of formal knowledge sharing and training programs
- ▶ Implementation of intergenerational estate transfer plans
- ▶ Adoption of a family charter or constitution, specifically aiming to:
  1. Formalize the agreed structure and mission of the family business
  2. Define roles and responsibilities of family and non-family members
  3. Develop policies and procedures in line with family values and goals
  4. Determine process to resolve critical business-related family disputes



## Advisory

### Tax and legal advisory

Tax, in particular, has become a much more important issue for family offices in recent years and as such has assumed a more important part of the functions of a family office. Legal matters are also important. A family office will typically employ a general counsel and/or a chartered or certified accountant, or several accountants and tax experts. These professionals usually provide the following services:

- ▶ Construct a tax plan to best suit the family
- ▶ Design investment and estate planning strategies that take into account both investment and non-investment income sources and their tax implications
- ▶ Ensure all parts of the family office are tax compliant

### Compliance and regulatory assistance

Family offices need to ensure strict compliance with regulations pertaining to investments, assets and business operations. These services will include:

- ▶ Providing auditing services for internal issues
- ▶ Establishing a corporate governance mechanism
- ▶ Ensuring a high level of staff hiring
- ▶ Group performance monitoring and compliance
- ▶ Offering recommendations on independent and board advisory formation
- ▶ Strengthening the regulatory investment process

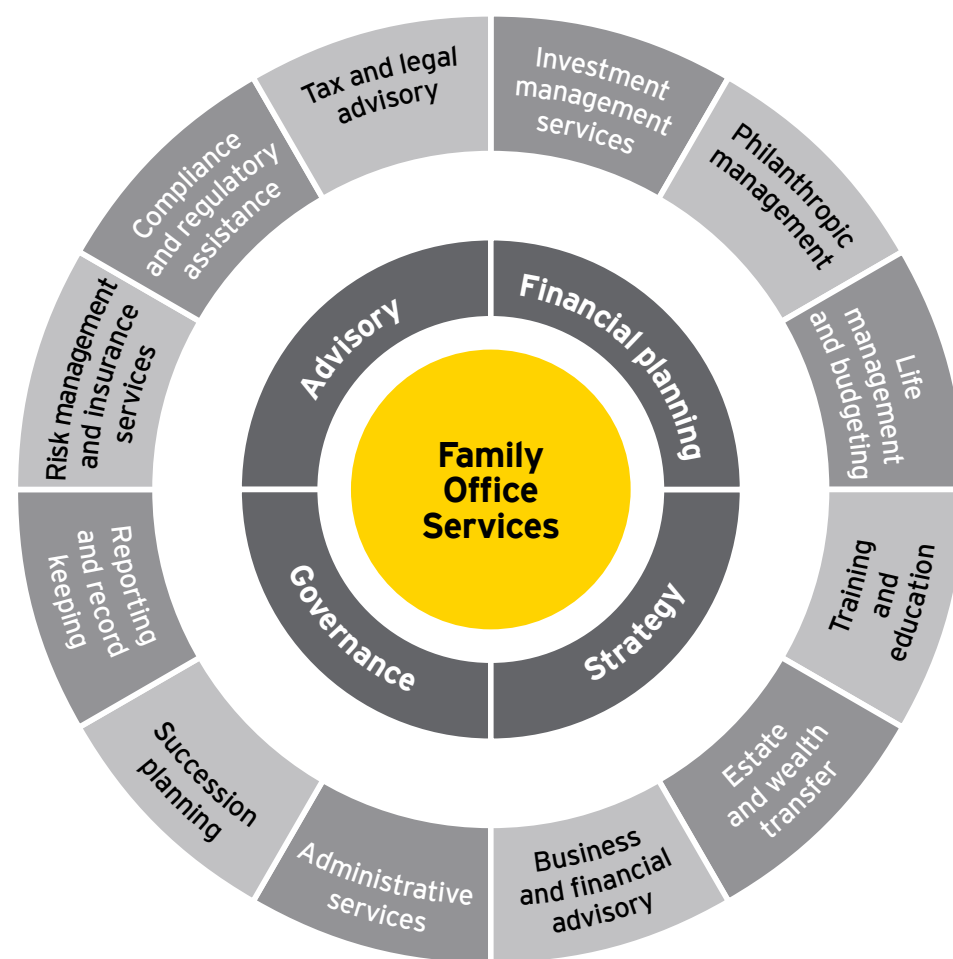
# 3 Determining servicing priorities: the make-or-buy dilemma

## Risk management and insurance services

This is a service that has assumed a more important role in recent years because of the financial crisis of 2008-09 and the subsequent fallout. It will be a crucial service for family offices in the future as well. These services will include:

- ▶ Risk analysis, measurement and reporting
- ▶ Assessment of insurance requirements, policy acquisition and monitoring
- ▶ Evaluation of existing policies and titling of assets
- ▶ Evaluation of security options for clients and property
- ▶ Formulation of disaster recovery options and plans
- ▶ Protection of assets, which could involve the use of offshore accounts
- ▶ Development of strategies to ensure hedging of concentrated investment positions
- ▶ Physical security of the family
- ▶ Data security and confidentiality
- ▶ Review of social media policy and development of reputation management strategy

Figure 2.1. Family office services



Even the largest family office in terms of assets under management will need to assess whether or not to outsource services. Outsourcing certain services can be beneficial from a cost-efficiency and know-how perspective, offering advantages to family offices that include:

- ▶ Reduced costs and overheads, and improved staff productivity
- ▶ Economies of scale, particularly for high-value professional services, thus enabling lower prices for related services
- ▶ The benefits of objective advice from experienced professionals who possess specialized skills
- ▶ Help with defending the family office's regulatory independence when outsourcing investment management, by allowing investment decisions to be made by external providers
- ▶ Due diligence and continuous monitoring can be carried out by the directors of the family office to ensure performance and security against risk

On the other hand, a number of key services are usually kept in-house. The advantages of this are mostly related to confidentiality and the independence of the family office, and include:

- ▶ Higher levels of confidentiality and privacy
- ▶ Assurance of independent and trusted advice
- ▶ Consolidated management of family wealth
- ▶ Development of skills specifically tailored to the family's needs
- ▶ Greater and more direct family control over its wealth
- ▶ Keeping investment knowledge within the family
- ▶ Assurance of optimal goal agreement, along with the avoidance of conflicts of interest with external providers

Given these considerations, it is crucial to obtain the right balance and to identify those services best suited for management in-house. Many factors involved in the make-or-buy decision are specific to the setup chosen for the family office, in particular:



- ▶ The size of the family and how many family members want to use the family office

▶ The net worth and complexity of the family wealth

▶ The family's geographical spread

▶ The variety of assets, both liquid and illiquid, under management

▶ The existence of a family business and the link between this and private wealth management

▶ The skills and qualifications of family members

▶ The importance of confidentiality and privacy

▶ The consideration of whether the family office should be a cost or a profit center
- ▶ Who should be the beneficiaries of the family office and what is the overall strategy of the family to secure and expand its wealth over generations?

▶ Is the family's priority traditional asset management of liquid funds, with or without a portfolio of direct entrepreneurial investments? And where does philanthropy fit into the mix, if at all?

▶ Should the family office act as the asset manager for all family members, or should it just be an adviser for some specific services to selected family members?

▶ Is the family office's core task that of a financial adviser, or more that of an educational facilitator for the next generation of family members?

This variety of factors highlights how vitally important it is for the family to clearly determine its expectations and address key questions prior to creating the business plan for the family office. These include priorities setting and scope definition for the services to be offered from the family office:

Table 3.1. Key determinants of the make-or-buy decision

Cost and budget	Escalating costs can pose a serious challenge to family offices. Clearly, it is unreasonable to insource the whole range of potential services without considering the economic benefits. Appointing an outside provider can ensure quality, and possibly cost savings, as the family office would benefit from economies of scale.
Expertise	The priority services as defined by the family will most likely be covered in-house in order to ensure independent expert advice to the family. However, the family office will gain from outsourcing certain selected services that require specific expertise.
Regulatory restrictions	A family office should consider all regulations, depending on its distinct legal structure. In the absence of professional management, a family office runs the risk of serious fallout from negative publicity. Legal action could also be costly and harmful to reputations.
Technology and infrastructure	The technology employed by an external provider can serve the family office effectively. Buying in these services has become even more of a priority as financial operations become more complex.
Complexity	If the family's assets are substantial and complex, the family office will have to hire more staff or outsource services. At the same time, the in-house decisions on all matters have to be final – so internal staff have to maintain the ultimate overview and decision-making process.
Data confidentiality	If confidentiality is a prerequisite, then services where this is a priority should be brought in-house. Non-critical systems and infrastructure can be outsourced.

Although the make-or-buy decision must be based on the specific setup of the family office, some general considerations can help to determine the optimal solution. Best practice is based on the goal of obtaining the most effective services in an efficient way and avoiding potential operational risks.

The traditional model

Typically, financial planning services, asset allocation, risk management, manager selection, and financial accounting and reporting services tend to be provided in-house. Global custody, alternative investments and private equity, and tax and legal services are often outsourced.

However, families should be aware that the greater the level of outsourcing, the less direct influence the family will have over the decision-making process within the family office, and the less exclusive the products and services will be. Table 3.2 provides an overview of selected family office services, which can be categorized as in-house or outsourced based on market analysis.

Table 3.2. Family office services: in-house or outsourced

Type of services	Service category	In-house	Outsourced
Investment management and asset allocation	Financial planning	Basic financial planning and asset allocation decisions should be provided in-house	The more complex, specialized and diverse assets make outsourcing a practical option
Tax and legal advisory	Advisory	Selectively done in-house	Often outsourced to a trusted adviser to ensure state-of-the-art quality of services
Reporting and record keeping	Governance	Record keeping and documentation demand confidentiality and so this should ideally be done in-house	Basic reporting tools and software may be provided externally
Philanthropic management	Financial planning	In-house expertise should serve for assistance with philanthropic activities	Setting up a foundation and related activities often outsourced to a consultancy
Compliance and regulatory assistance	Advisory	Size of family office might require full-time legal and accountancy expertise	But generally full-time legal staff will be an unnecessary and costly addition to family offices, which are not large enough to require them; hence, such staff can be outsourced when needed
Risk management and insurance services	Advisory	Some risk management skills should be provided in-house, in order to ensure ultimate peace of mind	Can be outsourced as external risk and insurance professionals can offer trusted expert advice
Life management and budgeting	Financial planning	Should be done in-house if information confidentiality is a primary criterion	Only specialized services would tend to be bought in-house, less specialized services can be outsourced
Training and education	Strategy	Can be done in-house, as identifying suitable options for education is by its nature an internal process	Can be outsourced if expert opinion on higher education is required for training and development
Business advisory	Strategy	Often the general counsel or the finance director of the family business is involved in the setup of the family office	The services of an external expert can offer a competitive edge
Estate and wealth transfer	Strategy	In-house expertise is required as data confidentiality is vital	The family can consult external legal advisers for procedural and legal issues
Administrative services	Governance	Administrative services require daily monitoring and so can be done in-house	Outsourcing could lead to greater costs

# Case study

To outsource or not to outsource? That is the question ...

**Daniel Goldstein**  
Independent Family Office Advisor

There are several approaches to answering the question of whether to outsource or not. Unfortunately and unhelpfully, the answer is often: “It depends.”

There are some key points to consider in making these decisions, including:

There is the important consideration of comparing existing in-house capacity to available outsourced resources. There is the comparison of cost, quality and timeliness of service. There are other factors to evaluate, such as confidentiality, where data will reside, availability of consultation (24/7 or during regular business hours), time zone, geographical differences, and cultural sensitivities. For the purposes of this case study, I will focus on the specific issue of whether to build new internal capacity to meet an unmet need or to look to outsourced resources to fulfill that role.

Any consideration of this issue must begin with the initial objectives. There are many questions that need to be asked, including: should in-house staff perform the asset allocation and stock selection for a family’s investment portfolio? If the objective of the family office is to build an investment business, particularly if that objective extends to offering services for a fee to third-party clients – either as an MFO or as an investment boutique – then the decision of whether to build in-house capacity or to outsource should be determined by the overall business plan of the investment business. If, instead, the family office is looking to construct a simple, lean, strategic investment portfolio that will not

become a core operating business, then the decision is very different.

There are some key points to consider in making these decisions, including:

### Time-cost-quality

There is little to add to the obvious consideration of time-cost-quality, except to emphasize that family offices are intended to be for significant wealth that implies multigenerational time horizons. Too many times, I have seen short-term cost considerations being far too influential in determining long-term goals. The cheapest up-front costs do not necessarily translate to a longer-term loss, but this certainly should be considered. Cost is a function not only of the up-front fee, but also of the total cost that will be seen in future years and in the future possible outcomes of immediate decisions. An up-front investment to either build in-house capacity or obtain higher quality (so, yes, more expensive) outsourced resources may well translate into a lower long-term total cost.

### Value of the function

There can be the temptation within family offices to give low-value tasks to high-paid staff. Family offices tend to be dynamic, but relationships often get in the way of the professional process, particularly when there is a very strong family principal – or indeed a group of very strong principals. Because there is a relationship of great

trust and social closeness between family principals and senior staff, family principals might begin calling on those senior staff to “take care” of personal favors. But this, of course, might not be the best use, and certainly not the most economically efficient use, of that person’s time. And applying cost-benefit analysis to a family office does not always work.

In this case, the benefit to the principal might be the assurance that the task will be completed as wanted because it is entrusted to a trusted senior staff member. The senior member of staff might see this as another means for proving reliability and thereby further cementing his or her relationship with the requesting family principal. There can be great value to both parties in not outsourcing these requests, but there can also be great danger that the senior member of staff becomes effectively an overpaid personal valet.

### Repetition of the function

A function that is performed on an irregular basis and requires detailed or technical know-how is most appropriately performed by contracting outsourced resources, rather than hiring in-house staff. For example, the onetime registration of a corporate entity in a foreign jurisdiction, with subsequent annual renewals and administrative submissions, would be better performed by contracting with a specialist rather than doing it in-house. Depending on the complexity of the process,

and the importance of the consequences, existing staff might learn from the outsourced resource how to take over this annual function.

At the other extreme might be the example of daily ongoing journal entries to an accounting system. The time-cost-quality evaluation of this function might show that it is better served by in-house staff, particularly as they will then be trained to the standards and culture of the family office, and be available in the manner and at the times desired by the family principals.

### Likelihood of change

Family offices are family businesses. All but a few family offices tend to be small-sized businesses that typically have close relationships between employees and family members. When it is probable that there will be a change in function, there is likely to be a need to change resources. So, when those resources are in-house members of staff, this means either having to rewrite job descriptions or cut jobs. Contracting the most appropriate outsourced resource allows the flexibility to change without having to either re-assign staff or dismiss them. Simply put, excellent partnerships can be built with outsourced resources and can be terminated or not renewed, as and when required, without feeling that a moral or ethical consideration must be made to account for a close employer-employee relationship within a small family business.

### Other external factors

As mentioned, not all family office in-house or outsource decisions can be made by cost-benefit analysis – other factors come into consideration. For example, privacy and personal security are factors that might be taken into consideration when determining whether to outsource travel arrangements or have an in-house personal assistant take care of them. On call availability may be a consideration in determining whether to outsource IT and domestic staff functions. The best solution always depends on the objective of the person who will measure the outcome. Ultimately, this will be what determines whether or not outsourcing is the best solution. ■



# 4 The costs of running a family office

Family offices are unique to the family that sets them up. As such, to define what an “average family office” should look like is not meaningful. Their size may vary from 1 employee to up to 50 or more, depending on the services provided, the number of family members to be served, and how the services are to be delivered.

Despite there being no standard definition of a family office, anecdotal evidence suggests that a full-service family office will cost a minimum of US\$1m annually to run, and in many cases it will be much more. This would suggest that for a family office to be viable, a family should be worth between US\$100m and US\$500m. Of course, a family office can be set up with US\$100m or even less, but the service range will probably be limited to administration, control of assets, consolidation and risk management. A fully integrated family office will require a great deal more wealth. Table 4.1 breaks this down in more detail.

**Figure 4.1. Family office types based on assets and costs**

Family office type	Assets (US\$m)	Overhead cost per year (US\$m)
Administrative	50 to 100	0.1 to 0.5
Hybrid	100 to 1,000	0.5 to 2.0
Fully integrated	> 1,000	1.0 to 10.0

Source: Cap Gemini: The Global State of Family Offices 2012.

1. *Family Office Primer*, Family Office Exchange, 2009.

## Staff costs

Research from consultancy Family Office Exchange has found that more than 60% of the total costs of a family office are allocated to staff compensation and benefits.<sup>1</sup>

Figure 4.2 illustrates this cost breakdown in more detail.

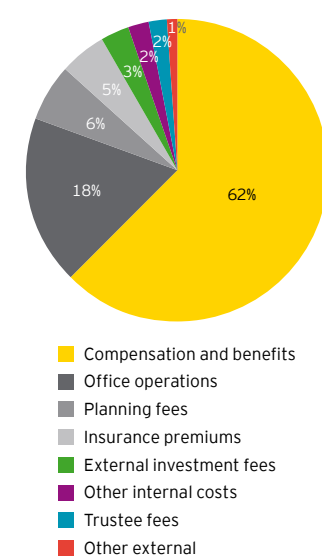
A fully integrated family office – providing most, if not all, of the services mentioned in section three – would have a typical staff structure represented in Figure 4.3.

Setup costs would also include the employment of headhunters for recruitment, compensation specialists, relocation costs, legal setup costs, and the search for infrastructure such as office space and technology solutions.

## Overall costs

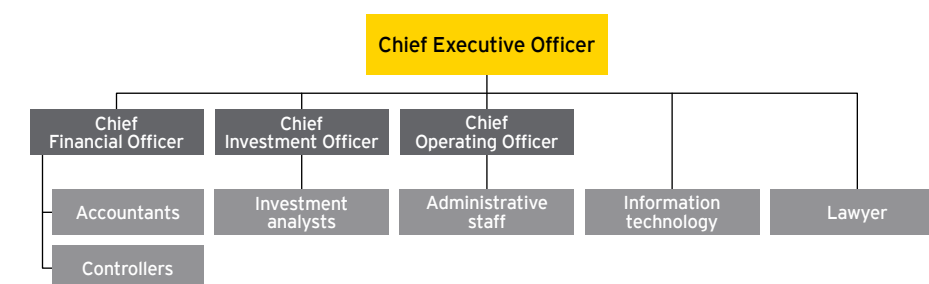
Family offices typically have operating costs of between 30 basis points and 120 basis points. Offices with the lowest running costs focus primarily on a limited number of wealth management services, such as handling real estate holdings. However, there is no strong correlation between the size of assets under management and the operating costs.

**Figure 4.2. US Family office costs**



Source: *Family Office Primer*, Family Office Exchange, 2009.

**Figure 4.3. Family office staff**



Source: *A guide to the professional family office*, Family Office Exchange, 2013.



# 5

## The internal-external conflict

One of the biggest conflicts that can arise within a family office is that between the family that owns the wealth (the principals), and the fund managers and external providers (the agents). The Credit Suisse Family Business Survey indicates that family businesses are not new to such conflict between principals and agents, with families typically encountering such problems as the business develops. But concerns about tension between principals and agents in family offices bring with them issues that are unique to delegated asset management.

A feature of this potential conflict is that principals and agents face different utility curves with respect to investment results. Most wealth owners face a diminishing marginal utility curve, which means that they value the next dollar slightly less than the one they already have. This is why investors typically derive more pain from losing money on an investment than joy from making a profit. But fund managers will tend to take more risks in their portfolios in order to beat benchmarks. This is because managers have more to gain from outperforming a rising market (through asset gathering) than they have to lose from underperformance in a declining market, since there are far fewer inflows. This mismatch of expectations implies that wealth owners setting up family offices face agency costs, and have to set up appropriate monitoring and compensation mechanisms to mitigate agency problems.

### Investment horizon conflicts

The length of investment horizon also imposes concerns about tension between principals and agents in family offices. While family offices tend to have a longer-term investment horizon, bonuses and other forms of compensation are typically determined more frequently, often once a year. This gives family office managers an incentive to ensure that the portfolios they manage perform well over that time frame, and can often discourage managers from making long-term investments that may perform differently from performance benchmarks.

Even if the incentives are pegged to the outperformance of benchmarks, the selection of appropriate benchmarks itself is a challenging exercise for many family offices.

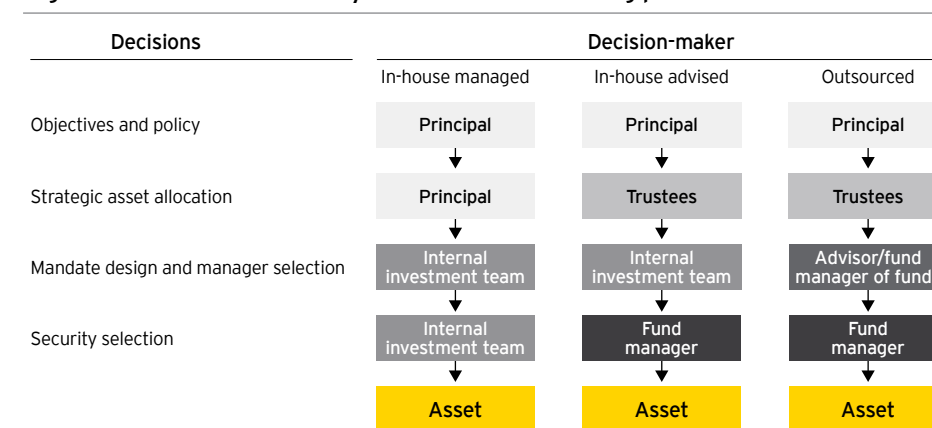
How fund managers *think* they will be evaluated also imposes decision-making constraints. In a highly outsourced family office setup, there is usually a long chain of investment decision-makers between the principal and the agent, with each layer bringing additional agency costs (and additional fees) for the principal. As one moves further away from the principal in terms of asset management, the principal carries less weight. As a result, they may prefer short-term “safer” investments to longer-term investments that could be volatile in the short run. The principal-agent conflict isn’t helped by the fact that it is often suggested that assets and funds managed externally tend to underperform those managed internally.

In terms of compensation, MFOs are still focused more on asset gathering, so compensation of asset managers is typically more sales-driven rather than based on investment performance. However, since the financial crisis, bonuses at family offices have generally been much more “locked-up” – i.e., dependent on longer-term performance criteria, rather than short-term, and subject to clawback options – in line with the broader trends in the financial services sector.

Another challenge that families face is balancing the trust-versus-expertise trade-off while selecting between in-house and external heads for family offices. The majority of family offices typically choose professionals from existing family businesses to head family offices, as they are familiar with the family business and the family in question. They have also established trust through years of working with the family business. On the other hand, some families specifically avoid hiring professionals from the family business, in order to create an explicit distinction between the family wealth and the family business.

In summary, successfully navigating concerns between principals and agents is not an easy task for families. But they can mitigate these tensions by implementing appropriate governance structures and incentive contracts. Selecting appropriate benchmarks is also important, as poorly designed benchmarks may cause fund managers and external partners to work against what families wish to achieve. Families should also consider establishing formal processes to make investment decisions, as this can help family offices to set clearly defined boundaries and goals, and avoid ad hoc decisions that are not in line with the broader mandate or long-term strategy.

Figure 5.3. Illustrative family office decision-making process



Note: The lighter the shade, closer are the principal-agents. Deeper shade indicates higher level of principal-agent concerns.  
Source: World Economic Forum, *Future of Long-term Investing*, 2011.

# 6

## Selection of family office professionals

### Recruiting, developing and incentivizing family office staff

Staffing is crucial for the success of a family office and a big challenge for them is to identify, attract and retain the best talent. In larger institutions this process is usually overseen by the human resources department, but family offices cannot rely on such infrastructure. Consequently, recruitment often becomes the responsibility of the wealth owners and their trusted advisers – both of whom are less trained to make these decisions.

When it comes to staffing the family office, one has to distinguish between members of the owning family, working for the family office and non-family professionals. While a recent study in Switzerland and Germany found that many of the investigated family offices are led by a family member,<sup>1</sup> we decided to focus our attention here on the process of recruiting non-family professionals.

Guidance on structuring the recruitment process, formulating incentive packages and then maintaining strong relationships with the new employees, is often necessary.

Despite the lack of formal recruitment structures, families can have advantages in attracting talent – often because they are able to offer more flexibility in compensation and incentive packages for senior recruits. They can also offer a working environment and culture that can appeal to the right candidate looking for a change from big-company culture.

Given these factors, Family Office Exchange believes the following examples of best practice can help to underpin a successful recruitment process:

- ▶ Job description. This can be flexible, but must capture the key elements and essence of the role. Family office executives are often involved in multiple projects.
- ▶ Interview committee. The responsibility of hiring for roles such as CEO and CIO should not be undertaken by one person. Sharing the process and risk of the hire is advisable.

1. Sieger, Philipp; Zellweger, Thomas: *Entrepreneurial Families: From a Family Enterprise to an Entrepreneurial Family*; Credit Suisse AG, 2013.

- ▶ Checking references. The recommendation from a trusted adviser or family member is valuable, but more extensive checks should be made. The process should be rigorous in order to ensure objectivity.

### Retaining talent

The key to retaining people once they have been recruited depends heavily on compensation and the feedback process. Here is a useful checklist:

#### 1. Compensation

- ▶ Conversations. The feedback process must be performance-based, consistent, and incorporate an element of long-term compensation.
- ▶ Incentives can include things such as phantom stock (future cash payment based on market value of shares), co-investment opportunities, transaction bonuses and, in some cases, partnerships. Incentive plans often reflect the standards in the industry that created the family's wealth, so packages vary by industry.
- ▶ Benchmarks for compensation: a CEO's base salary in the UK ranges from US\$240,000 to US\$630,000, while in Switzerland CEOs managing multi-jurisdictional wealth receive between US\$450,000 and US\$720,000 as a base.

#### 2. Feedback

- ▶ Delivery  
Many executives move from a highly structured corporate environment and can feel uncertain about their performance and the family's satisfaction with their role due to a lack of meaningful feedback. Family members may be unused to having to satisfy this need for feedback, but attempts should be made at a fair and thorough assessment of performance where possible. It has been observed that CEOs at family offices often feel unimportant, largely because of a lack of feedback, rather than concern over compensation.

- ▶ Receptiveness

A big challenge when staffing a family office is how family office executives and family members can maintain a sense of partnership, without the impartiality of the executive being affected by the family. Family office executives must be open to giving and receiving feedback so that an environment of honesty and openness can flourish. This process of feedback is in itself dependent on the long-term commitment to the family, cultivated by appropriate incentive planning and personal chemistry – an unquantifiable element in the process!



# 7

## Constructing a business plan

After the family determines their vision of the family office, the next phase can be described as the design phase, in which a detailed business plan will be developed, including the choice of the most suitable jurisdiction, the services provided, staff requirements, the office location and infrastructure, the anticipated capital, the breakdown of operating costs, the measurable benchmarks, and the funding to be used.

One of the underlying determinants of the business plan and the family office is the question of whether the family office will be run as a profit center or as a cost center. It's equally important to determine whether or not there is any intention to open up the family office to other families as a multi-family office at a later stage, or if it is clearly intended to continue delivering services just for the founding family.

Other important factors to take into consideration when creating the business plan of a family office include:

### Family skills

An important question is: do some family members have the right skills and qualifications to run the family office or will external management be hired? When this decision has been made, the right level of family governance will need to be implemented to deal with the tension between principals and agents in the appropriate way. The need for an investment committee or a supervisory board with family representation will be part of the envisaged governance structure.

### Family business

Families that still own the family business, and may be active managers in that business, face distinctly different issues to those that have sold the business and are managing their private family wealth. In some cases, the company's chief finance officer, legal counsel or controller, advises the family on estate and investment issues and in others there may be an internal department in the family business that functions similarly to a family office.

### The entrepreneur and the family business

Entrepreneurial risk-taking in the family business should generally not be confused or combined with the approach to risk regarding the separated private assets and the private matters of the family. While a complete approach to wealth management across the private and business assets is required, personal affairs should best be dealt with in a discrete entity separate from the business, in order to meet the distinct ownership needs of individual family members. The investment and risk profiles of the family and individual family members should not be overwhelmed by larger corporate priorities, although clearly a total approach to the risk levels on both the business and private sides needs to be ensured.

### Operational model

The business plan should define the operating model of the family office, its functional setup and infrastructure, reporting and control systems, and the governance structure – including setting up relevant boards, such as the investment committee or the family council.

### Jurisdiction

The optimal jurisdiction and tax regime to operate the family office need to be chosen and planned in detail, based principally on the home jurisdiction of the family and the majority of its assets.

**The choice of jurisdiction, legal, regulatory and tax issues is addressed in Appendix 1 and 2.**

The most important make-or-buy decisions need to be made by looking at the potential savings if certain services are outsourced and the opportunity costs of outsourcing as against sourcing in-house. A detailed staffing plan needs to be created, and a salary structure needs to be put in place which provides sufficient motivation for talented staff to work in the family office. The key positions such as CEO, unless this role is carried out by a family member, CIO or tax advisor need to be filled by knowledgeable and trustworthy individuals. Alongside the personnel costs, another major block will be the infrastructure, including the office and IT infrastructure (see Section 10).



The result of the design phase, in which the business plan is prepared, should be a concrete action plan to build and finally set up the family office. All the relevant family members should be asked to commit in writing to the setup of the office.

Alongside the financial projections, the business plan also needs to provide a short-term and long-term timeline, detailed job descriptions and performance goals for employees.

The business plan should also outline qualitative goals such as:

- ▶ Details on current wealth structure and intended asset allocation
- ▶ Review process evaluating the achievement of the family office's goals
- ▶ Employee hiring plan and compensation model (employee stock option plan or other)
- ▶ Contingency plan
- ▶ Investment guidelines, expectations for investment returns and benchmarks to be included – once the CIO is on board



The process for setting up a family office

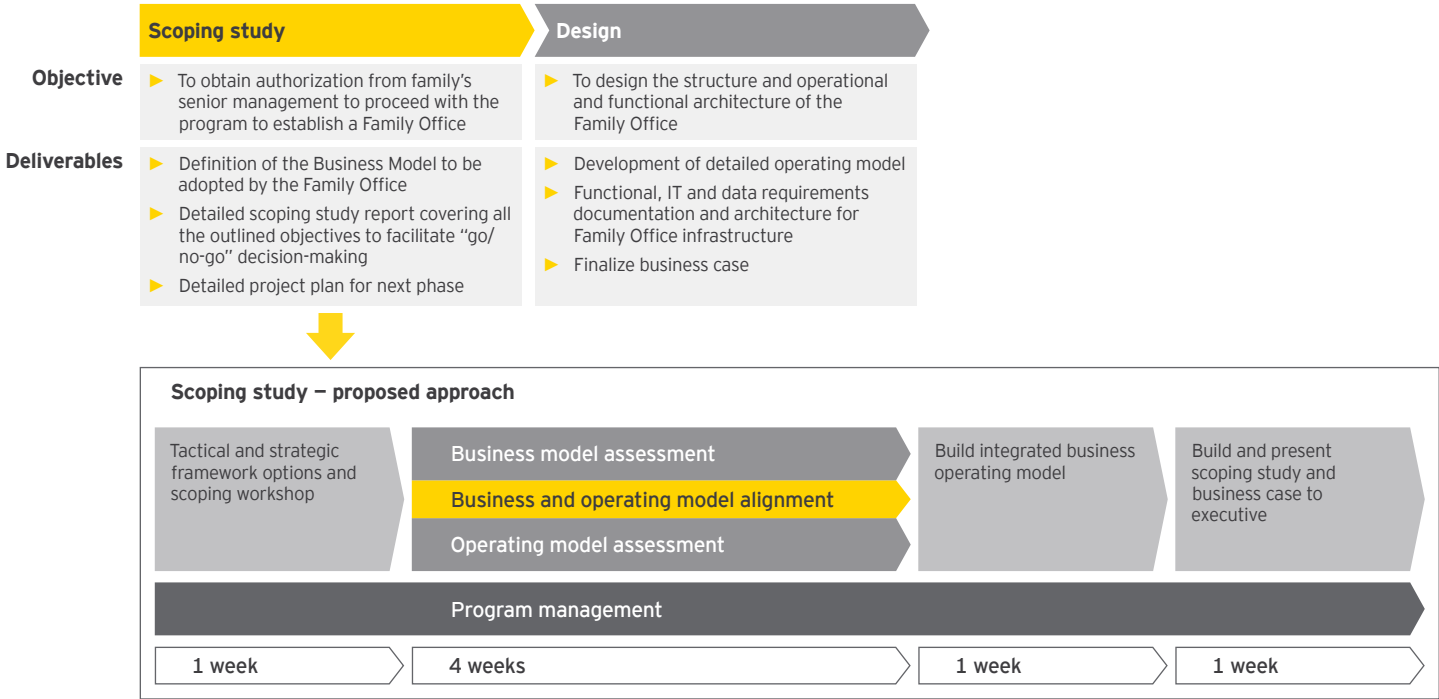
We recognize that the typical process for establishing a family office includes the following phases: **scoping, design, build, test and deploy**. Stringent and professional project management is

key to the process and should involve external advisers with the appropriate know-how to assist the family throughout the process (see Figure 7.1).

See the tables below for more details about the two most critical phases of business planning: scoping and design.

To find out more about the other phases of the EY methodology for setting up a family office, beyond the ones aimed at building a business plan, please contact us directly at [familyoffice.services@de.ey.com](mailto:familyoffice.services@de.ey.com) or visit our website [ey.com/familyoffice](https://ey.com/familyoffice).

Figure 7.1. The phases of business planning



Step 1	<b>Scoping</b> What are the family's vision and expectations? Who are the beneficiaries of the family office? What does the family want to do with its wealth, family business, philanthropy, talents and children? Which part of the family wealth shall be allocated to the family office? Which services are needed and for whom?
<div>Key priority functions of the family office to be considered:</div> <ul style="list-style-type: none"><li>▶ Investment strategy: will the family office take on a purely advisory function or act as an asset manager?<ul style="list-style-type: none"><li>▶ Confidentiality, assets in a family office or held by individuals, liquid versus illiquid assets</li><li>▶ Develop investment regulations and define benchmarks</li><li>▶ Consider dividend levels and payout ratios</li><li>▶ Controlling function in-house versus external</li></ul></li><li>▶ Administration of wealth: separation of private from business assets<ul style="list-style-type: none"><li>▶ Strategic and tactical asset allocation: day-to-day wealth management</li><li>▶ Governance issues (investment committee and other boards)</li></ul></li><li>▶ Tax at individual family member level: level of service for beneficiaries</li><li>▶ Holistic accounting and tax advisory for all assets, whether or not managed by the family office</li><li>▶ Acquisition and management of private assets</li><li>▶ Should the family office cover philanthropic issues and family education?</li></ul>	

Step 2	<b>Design</b> Development of a detailed business plan, including the most suitable jurisdiction, services provided (i.e., wealth management, estate planning, philanthropic, personal services, etc.), employee skills required, space needed, anticipated capital, operating costs, measurable benchmarks and funding.
<ul style="list-style-type: none"><li>▶ Define operating model: functional setup, reporting, board structure, governance<ul style="list-style-type: none"><li>▶ Separation of private assets from business assets</li><li>▶ Consider level of operational versus investment risks</li></ul></li><li>▶ What is the optimal jurisdiction and tax regime in which to set up the family office?<ul style="list-style-type: none"><li>▶ Which tax, legal, regulatory framework: GSA, Luxembourg, Liechtenstein, the UK (including the Channel Islands), Dubai/the UAE, Singapore, Hong Kong, the US, offshore (including the British Virgin Islands and the Cayman Islands)</li><li>▶ Depending on the level of services offered</li></ul></li><li>▶ Draft detailed business plan:<ul style="list-style-type: none"><li>▶ Level of in-house services – consider make or buy, opportunity costs, potential savings if outsourced</li><li>▶ Staffing and recruiting: which roles are required in the family office? CIO, tax adviser, controller, bookkeeper?</li><li>▶ Outline necessary infrastructure: IT, security, office space</li></ul></li><li>▶ Result of this step: concrete action plan to build family office (e.g., family information document – to be signed by all family members – obtain commitment of all family members to go ahead)</li></ul>	

# 8

## Risk management

The maintenance of family wealth across generations is an extremely complex task. The recent global economic difficulties have been unprecedented, and families with significant business assets or private wealth obviously have a desire to stabilize their wealth against this background. For wealthy families in Europe, the uncertainty and volatility coming from legal, fiscal and political difficulties, coupled with the weakness of the euro, have added to their problems. Many of them have been concerned with risks such as the permanent loss of capital, counterparty and credit risk and lack of liquidity.<sup>1</sup> Consequently, with the aim of securing their family legacy over generations they have changed their perception of risk and the definition of risk itself.

The financial crisis of 2008-09, and the fallout from it, has led families to reconsider their approach and behavior toward risk. In broad terms, there has been a shift from too much risk-taking before the crisis to too little after the crisis. Such subjective perceptions of risk can only be avoided through a stringent and structured risk management process focusing on long-term goals. Furthermore, there is today a greater requirement for additional due diligence procedures for large investments, as well as a desire for more transparency during the investment process.

Against this background, family offices are tasked with complementing their existing standard risk measures with additional techniques, often resulting in additional portfolio analysis tools combined with scenario analyses for the different asset classes. The risk management function within the family office is increasingly moving away from a mere controlling role to a time-critical strategic advisory role. This trend also has a significant impact on make-or-buy decisions in the family offices.

This new demand for risk transparency has led to the desire to invest more in direct investment opportunities and in real assets, rather than complex financial capital market products. How easy investment products are to understand, proximity to the investments and the possibility to have a real influence on the investment are more sought after now than ever before. Long-term investments with lower volatility and a moderate expected return

are more often combined with short- to mid-term investments with a significantly higher risk profile to achieve outperformance. As part of this process, a further professionalization of family office services is taking place in processes such as manager selection and due diligence of direct investments, or a more stringent controlling of portfolio managers.

Consequently, risk management and investment reporting and controlling have gained importance following the financial crisis. Market participants typically say that an optimal diversification or asset allocation strategy, combined with active and highly flexible portfolio-management, are the cornerstones of a solid risk management process.

### Key risk areas

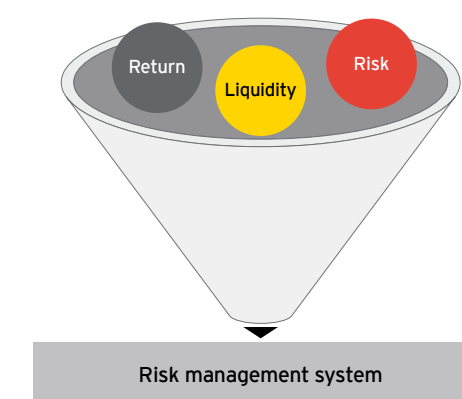
Systemic and global risks clearly impact family wealth in a significant way. The following parameters provide the core of a portfolio risk analysis framework:<sup>2</sup>

- ▶ Identify which factors could destabilize your portfolio and affect your diversification
- ▶ Capture “blind spots” and “hidden” diversification risks
- ▶ Avoid the case of seemingly uncorrelated assets moving in the same direction during corrections
- ▶ Focus on “imperfect” knowledge
- ▶ Initiate critical analysis and reflections of potential impact on asset allocation decisions

### Risk management systems

Risk, return and liquidity are the foremost issues to be considered in any investment decision and asset allocation process (see Figure 8.1). These prerequisites will be the basis for the risk management system, which in itself will cover risk mitigation and cost reduction and may lead to value creation. These factors include:

**Figure 8.1. Risk management system**



### Risk mitigation

- ▶ Identify and address key risk areas that matter
- ▶ Effectively assess risks across the family office, driving accountability and ownership
- ▶ Manage and mitigate mission-critical risks
- ▶ Establish comprehensive risk frameworks

### Cost reduction

- ▶ Cost-efficiencies are a critical part of setting up a family office
- ▶ Implement an automated risk management process to materially improve the cost structure
- ▶ Reduce cost of control spend through improved use of automated controls
- ▶ Streamline or eliminate duplicative risk activities
- ▶ Improve process efficiency through continuous monitoring

1. *Back to Business, Family Offices Adapt to the New Normal*, UBS/Campden Wealth, 2012, p.40.

2. *Building a Family Enterprise Plan to Deal with Future Uncertainty*, Family Office Exchange, 2012, p.22.

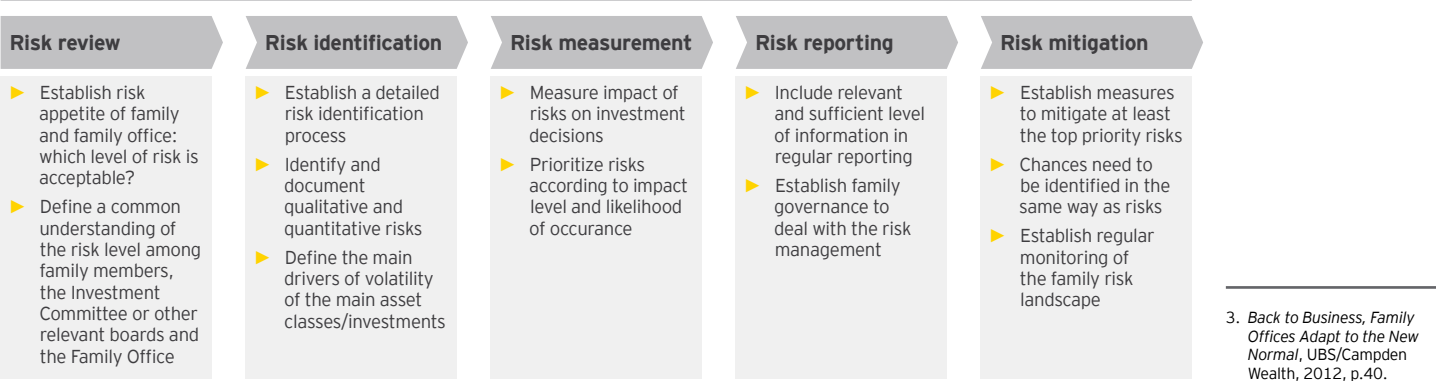
Value creation

- ▶ Achieve superior returns from risk investments
- ▶ Improve control of key processes
- ▶ Combine risk and control management to improve performance
- ▶ Use analytics to optimize the risk portfolio and improve decision-making

Family office CEOs, CFOs or CIOs increasingly perceive enterprise risk management as adding value to the family office operation. According to the European Family Office Survey 2012, family offices worry most about investment risks, family reputation, banking/custody risks and political/country risks.<sup>3</sup> After the financial crisis, risk management has developed further toward a risk-return based optimization model (see Figure 8.2).

A risk management process is vital to the family office structure in order to formalize the approach to risk relating to the family wealth.

Figure 8.2. Risk management process



Turning risks into results

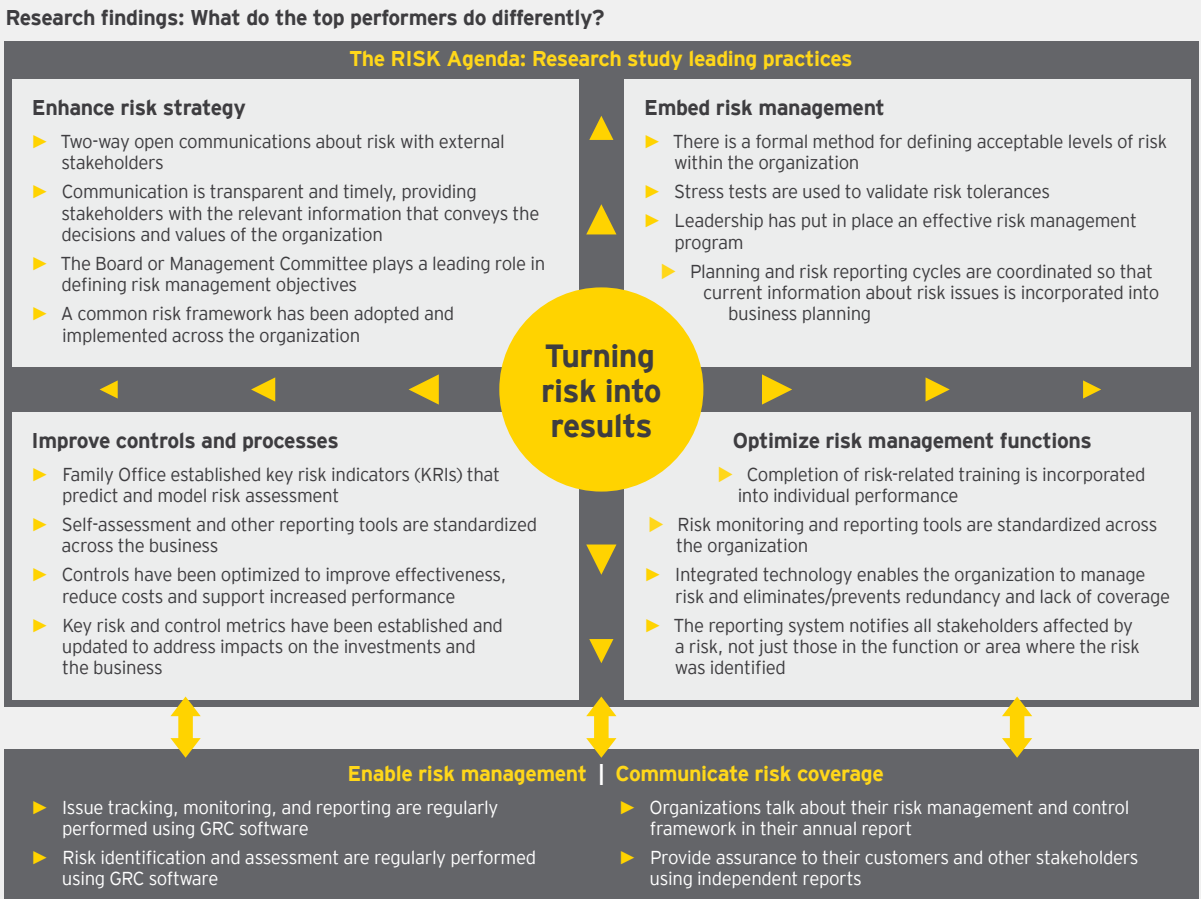
What differentiates the top performers?

The EY study, *Turning risks into results*, found that while most organizations perform the basic elements of risk management, the top performers do more.

We found specific risk practices that were consistently present in the top performers (i.e., top 20% based on risk maturity) that were not present in the bottom 20%. These risk practices can be organized into the challenge areas, as depicted in the chart here below.

The companies that are successfully turning risk into results are concentrating on all five challenge areas of the RISK Agenda.

Figure 8.3. The key risk areas that drive results



Source: *Turning risk into results: How leading companies use risk management to fuel better performance*, EY, 2012.



# Case study

JMH Capital is a single family office established to safeguard and grow the assets of its Principals. The family had made its wealth by acquiring, turning around and growing a construction solutions company that was previously owned by BP plc. The strong cash flows generated by this asset have enabled the JMH Group to buy a handful of niche luxury goods companies, as well as a large stable of racehorses and various properties. With the majority of the family's wealth tied up in these illiquid assets, it is essential that the capital in the remaining portfolio is preserved and remains reasonably liquid, but not at the expense of returns.

This sets the scene for a conundrum that is no doubt troubling most CIOs at present: where can a family office find respectable returns within the structure of a wealth preservation investment framework, and yet still provide the family with adequate liquidity on an ongoing basis?

The inevitable distortion in various asset classes that has come as an undesired side effect of the numerous rounds of quantitative easing have made the investor's role more fraught with risk than ever before. The risks of capital loss in traditional "safe-haven" assets, such as Group of Seven sovereign bonds have, in JMH Capital's eyes, consigned the traditional 60/40 equity/debt portfolio structure to the history books for the foreseeable future.

In this respect, JMH has allocated the majority of its portfolio into uncorrelated, and in many cases somewhat niche asset classes. Given the small size of the team and the high level of specialist knowledge required to succeed in these niches, JMH invests almost entirely through specialist funds. These include direct lending (including trade finance), equity-linked debt,

merger arbitrage, reinsurance, litigation finance and late-stage bankruptcy claims. What these funds have in common is that they provide a relatively steady return, while being largely uncorrelated to each other and also to global equity and bond markets. It is only by assembling this diverse range of assets that JMH reckons it is able to achieve an 8% annual return but, importantly, with a considerably lower level of volatility or risk. The consequently high Sharpe Ratio indicates that the rate of return exceeds the risks assumed in seeking that reward.

As noted, JMH is not averse to venturing into less traditional funds in search of returns and an asymmetric risk profile, so long as it can control the overall risk within the portfolio. Indeed, as part of this investment philosophy, JMH has made direct investments in Sub-Saharan Africa, but only after doing a considerable amount of research and finding the right people to work with.

Given that the majority of companies in Africa are either private or government owned, it quickly became apparent that the best way to get proper exposure was through the private markets. However, private equity was, in JMH's view, in danger of becoming a crowded market and exits an ever prevalent risk. JMH therefore went about sourcing a team with a more innovative and appropriate way of investing in Africa. They joint ventured with a team of UK educated, experienced local financiers.

As JMH saw it at the time, they were only ever going to invest in Africa if they could mitigate the risk. The team needed to be of local origin and based locally; so JMH set up offices for them in Lagos and Nairobi. To protect the downside risk, investments needed to be debt-based rather than equity based – and always heavily asset backed.

## Risk management

**Benedikt von Michel**  
Chief Investment Officer  
JMH Capital Management

And finally, JMH needed to get paid for taking the Africa risk, by way of the equity kicker. 46 Parallels, a joint venture between JMH and TIA Capital Management, were the only team that could effectively manage those risks. So in June 2011 JMH brought the team on board, financed the full set-up costs, and started investing its own money and some co-investment funds into the region. After all, what better due diligence is there than actually having the team on board and working with them to create what is in JMH's view the best risk/reward balance to investing in emerging markets?

The JMH family office believes that it has created a unique portfolio of niche fund assets able to generate very steady, low-volatility returns regardless of the overall market environment. The key to this has been following a strategy of investing into a diversified basket of genuinely uncorrelated asset classes. By splitting the portfolio between 30% liquid assets (i.e., those with greater than weekly liquidity) and 70% illiquid assets (a broad range, but still averaging less than a year), JMH Capital is able to provide its principal with liquidity at very short notice, yet still giving a solid return at minimal risk.

In what is projected to be a "new normal" of low returns for the foreseeable future, JMH believes that the family office has gone some way to providing a robust solution to the risk/return/liquidity conundrum – something that all family offices should aspire to. ■



# The investment process

## Background

How do family offices invest their principals' money? There are no fixed investment regulations that apply. Family offices tend to follow their own individual investment policies, because, unlike banks and other financial service providers, they are generally subject to the more relaxed regulations applicable to companies, trusts and foundations. However, the degree of freedom enjoyed by family offices is reduced in proportion to the level of services provided by third parties and the number of families served by the family office.

Family offices can often diversify their assets very broadly, much more than institutional investors can, thanks to the amount of assets under management. Family offices are also generally better able to think and invest on a more long-term basis, and they primarily pursue wealth preservation in order to pass on assets to the next generations.<sup>1</sup> Many prefer direct investments, and where organizations have an entrepreneurial principal, they are more likely to get directly involved in the investment process. More than a third of those surveyed would be glad to contribute to the planning stage of their investments.<sup>2</sup>

Many family offices take an open approach to their investment policy and try to avoid conventional investment paths. This can be seen in the way that many invest in alternative investments, such as yachts, horses, art, forests and farmland, or car, wine or watch collections. This enables them to spread risks while reflecting the personal preferences and passions of family members.

The growth of family offices is a relatively new trend, and because of the diverse origins of many family fortunes and the different backgrounds of CIOs, it is difficult to pinpoint a uniform family office investment process. Very broadly, the process should first set out an investment "road ahead", listing goals and risk tolerance, and resolving issues relating to business shareholdings and family member stakes. The next phase is to establish the portfolio structure (i.e., how much in equities, real estate, etc.) to deliver the risk/return trade-off the family requires. Implementation and governance then follow – finding the appropriate investments to make up the portfolio, and overseeing their performance.

1. Credit Suisse, *Family Business Survey*, September 2012.  
2. Ibid.

Role of the family

The crafting of an investment process is heavily dependent on legacy issues. In what economic sector has the family made its money, to what extent is the family still actively involved in the business and what is the background of the CIO of the family office? Each of these factors has a tendency to produce a strong behavioral bias on how a family’s wealth is invested and on the subsequent need to produce a diversified portfolio for the long term.

Another issue that is also important is the composition of the family. For example, a family office that is set up by a first-generation entrepreneur would probably be very different in its aims to one that is established by a large fourth generation family. As a result, the behavioral, financial and legal issues involved in structuring the investment process of a family office are complex and fascinating.

Credit Suisse’s *Family Business Survey 2012* suggests that most family businesses, even those at the third generation and older, do not yet have a family office. Cost and complexity are two contributing factors here, though it is also clear that the rate of growth of family offices is accelerating, and that the need for a transparent, independent and structured investment process is a key reason for this.

Setting investment goals

For most investment funds, whether they are sovereign wealth funds, endowments or family offices, the first step is to establish clear investment objectives and risk profiles. These different investment structures can have varying goals and objectives, and there is also variety in how these objectives are constructed. For example, some institutional investors work with inflation-related return objectives, others might not.

An important distinction can also be made at this stage between liquid assets, such as tradable securities, and illiquid assets, such as direct investments, private equity and real estate – the latter being difficult to value and often requiring some support in terms of funding. From a conceptual point of view, many CIOs tend to

view illiquid assets in a different way, when it comes to returns and investment horizon, to liquid asset portfolios.

Examining prior investment styles and questionnaires can help to identify the family’s tolerance to risk. In addition, scenario testing that illustrates and draws out important sensitivities to risk and portfolio drawdowns can be useful. In some cases, the discussion of the investment process is led by the CIO. In others, it can entail a more collective discussion involving family members, and cover any desires they have to establish charities or philanthropic initiatives alongside the family office.

Once an asset allocation recommendation has been reviewed, understood and accepted, the family should formalize their investment plan in an investment policy statement. Such a statement is a road map that is the focus for all parties involved in the client relationship, including investment advisers, investment managers and trustees. It also provides a course of action to be followed in times of market dislocation when emotional reactions may result in imprudent courses of action.

Once the specific investment goals and the risk profile of the family office have been established, the next step is to structure an overall portfolio and then bring to bear the necessary investment tools to drive the investment process. In some cases, historical asset return data is used to give a sense of what future returns might look like, but, as recent stock market history has shown, the past is not a great guide to the future.

Tax considerations

Selecting the most efficient combination of assets for the family requires an adjustment to portfolio optimization that takes into consideration the ultimate after-tax return that they would expect to receive. For each asset class, the expected return should be deconstructed to reflect the income yield from interest and dividends versus return from capital appreciation. Based on the level of turnover typical for each asset class, it is possible to estimate the percentage of asset appreciation that comes from

realized versus unrealized capital gains, and also the extent to which realized capital gains would be treated as short-term as against long-term tax liabilities. Providing asset allocation analysis on an after-tax basis presents a realistic view of the return the family can expect from its portfolio investments, as well as an optimal mix of investments tailored to a family’s specific tax situation.

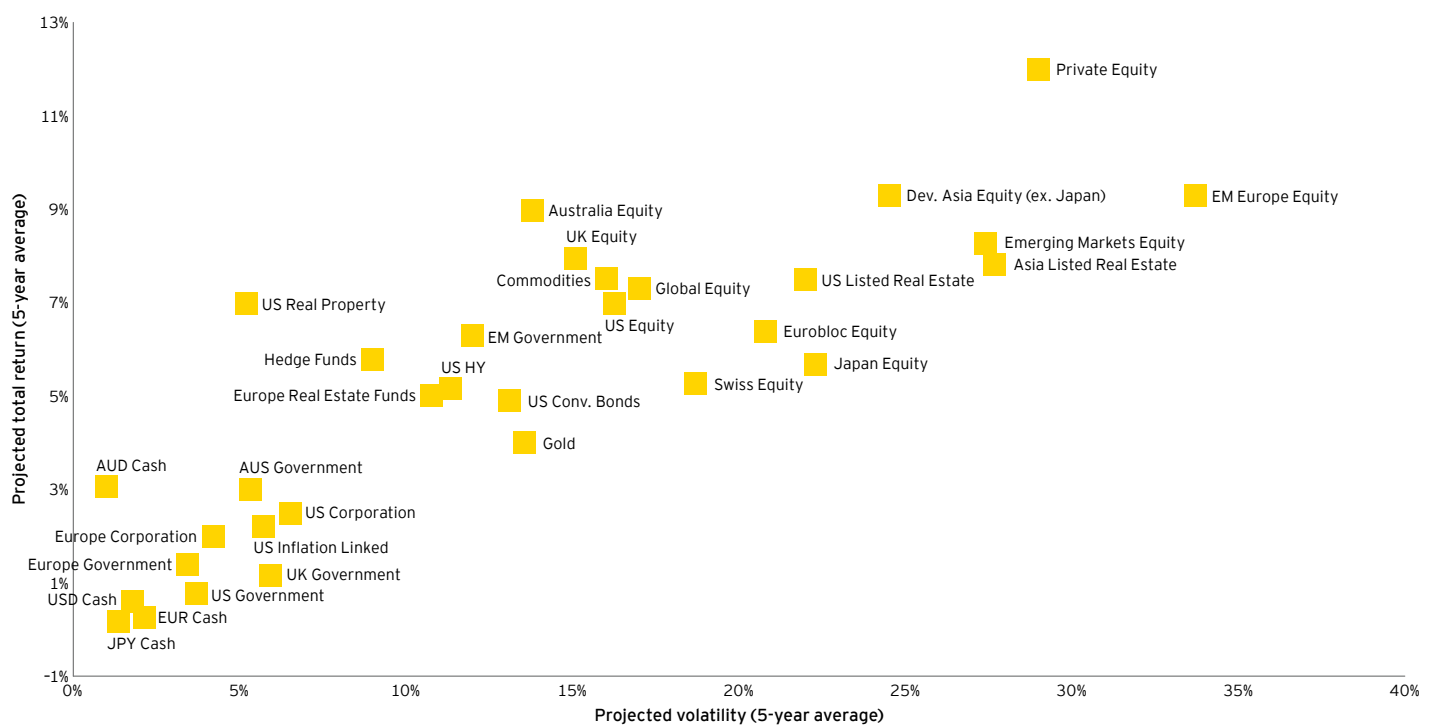
Stress testing and modeling

Once an initial portfolio shape is in place, several further exercises can be useful, such as stress testing the return profile of the portfolio to demonstrate to family members how the portfolio might behave during periods of volatility. In performing this type

of analysis, it is sensible to examine all the family’s wealth, not just their investment portfolio. Modeling the core business holding of a family as a form of private equity or direct equity holding, and then analyzing and optimizing other components of a family’s wealth with respect to this, is a difficult but necessary task.

In the context of family businesses, one common outcome of this part of the process is to show that the initial investment portfolio of the family office could be better diversified, since it often has a large holding in the underlying family business or, in some cases, legacy investments that tend to be over-concentrated in certain asset classes (e.g., private equity). There are several different ways to achieve a more diversified portfolio for the family office (see Figure 9.1).

Figure 9.1. Projected total return and volatility of various asset classes



# 10

## IT, trading tools and platforms

### The importance of cash flow

Family offices are different from other organizations, in that there is often a greater and more irregular call on the investment portfolio. Family members request funds for business-related or private equity stakes, philanthropic and impact investments, or ongoing expenses. In this respect, being able to model the impact of cash flows on an overall investment portfolio is important, and experience suggests that the focus on yield and cash flow tends to be higher for family offices than for other client types. Accordingly, families should consider their overall liquidity needs carefully during the portfolio construction process.

### Implementation and governance

The implementation and governance quality is crucial. From an investment point of view, how a portfolio is implemented must be consistent with its objectives and portfolio structure. Having a formal investment policy statement in place is an important step in maintaining an appropriate governance structure. In addition to reviewing the family's goals and objectives, it is vital to review asset allocation. This can be done by re-running asset allocation diagnostics on portfolios at least once a year, in order to make sure that they perform as initially prescribed. Governance and transparency are also very important, and regular meetings and calls between principals, the family office staff and external advisers will help to clarify broad macro views, turning points in strategy, and issues relating to implementation.

In summary, while the family office space is growing and evolving quickly, several building blocks can be identified as forming the key components of a family office investment process. These are:

- ▶ Consideration of how legacy issues determine the starting point of the fund
- ▶ Objective setting and creation of an investment policy statement
- ▶ Mapping risk tolerances
- ▶ Building a portfolio structure across all liquid and illiquid assets
- ▶ Implementation using strategic and tactical investment tools to ensure that investment solutions fit the goals and objectives and meet cash flow needs
- ▶ Governance
- ▶ Rebalancing



Technology plays an important role in creating an efficient family office. Furthermore, finding the right individuals to manage these platforms is crucial. Technology helps a family office to navigate core objectives, manage legacy changes and adhere to industry updates. It is important that a family office identifies its core technology needs before choosing or creating solutions. Automation is an excellent way to keep costs under control and to mitigate risk. IT tools and platforms that a family office should consider are:

- ▶ Custody platform (bank, brokerage or trust company)
- ▶ Consolidated reporting
- ▶ Trading and portfolio management tools
- ▶ Risk management tools
- ▶ General ledger and accounting software
- ▶ Client Relationship Management (CRM) tools
- ▶ Tax preparation software

The selection of IT should be well thought out and designed in order to provide efficient reporting, trading, portfolio management and accounting. The technology can range from off-the-shelf products to highly sophisticated, customized solutions. Much of this can be outsourced or provided for low cost from service providers, freeing up the family office resources to focus on growing the wealth. The following sections examine a selection of the various platforms in more detail.

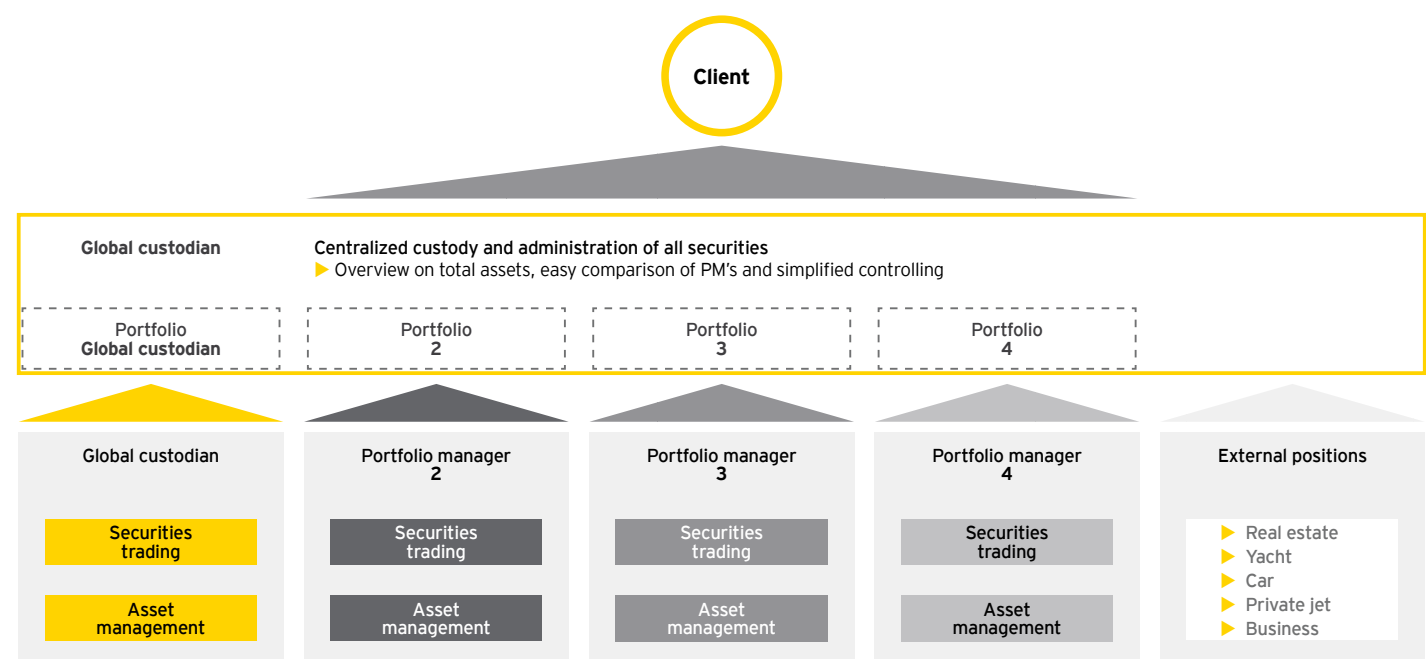
### Custody platform

The use of multiple custodians creates the obligation to consolidate the assets. This can be done for a fee by a third-party vendor, in-house with the proper investment in systems, or by the use of a global custodian.

The custody of bankable assets is the safekeeping and servicing of assets, either with one or multiple custodians or banks (see Figure 10.1). Global custody refers to the custody and administration of assets with one custodian, which offers many advantages such as:



Figure 10.1. Structure with global custody



Source: Credit Suisse, *Global Custody Pitchbook*, 2013.

- ▶ The consolidation of all bankable securities, financial instruments, and liquid assets, so that the time-consuming work of consolidation resides with the global custodian and not the family office<sup>1</sup>
- ▶ The provision of a comprehensive, transparent overview of the performance of all the assets at all times via a consolidated investment report (providing a uniform format and standards for all assets)

- ▶ The assets can be managed either by the custodian bank, an external asset manager, or the client himself (i.e., the client selects its preferred asset manager with no restrictions, and the asset manager is free to select the brokers for securities trading)
- ▶ The opportunity to include some non-bankable assets, such as direct real estate investments, mortgages, third-party derivatives, art collections and yachts

1. A survey by Family Office Exchange in November 2012 showed that family offices spend one third of their time producing accounting and financial reporting.

### Consolidated reporting

A proper design of this process early on will allow families to understand their investments, identify risks and strengthen their confidence in their family office. Consolidated reporting has been proven to be the most valuable tool of all for a family office, and is highly recommended.

### Trading and portfolio management tools

Some family offices employ an asset allocation model, which they give to fund managers. Others make their investments in-house, in which case portfolio management and trading systems become more important.

Various modules can be added to the infrastructure to deal with the increased scale and complexity. These can include:

- ▶ **A portfolio management system**  
This provides the backbone of a fund's operational infrastructure and acts as the internal books and records.
- ▶ **An execution management system**  
An electronic trading platform that provides Direct Market Access trading connectivity as well as direct connectivity to broker algorithms.
- ▶ **Order management system**  
This provides the main trading platform for the firm. Like an execution management system, it also provides Direct Market Access trading and broker connectivity. Other key functions include compliance (pre- and post-trade), rebalancing, order staging and allocations, and portfolio modeling.

### CRM tool

A CRM tool is vital for a family office to manage critical information, such as that relating to family members, in one central location. Information retained in a CRM database should include: family contact information, family discussions regarding services or major family events, the structure of the family, and third-party contacts such as legal counsel, accountants and insurance contacts.

### Human capital and technology

When choosing technology for a family office, it is imperative to have the right individual(s) in place to manage and operate the software. Such individuals, who may be in dual operational roles, should have an understanding of performance analysis and of accounting principles. They should be "detail oriented", have the ability to leverage technology for integration purposes and have basic Excel skills. Depending on the size and technical complexity of the IT system, some family offices may hire a Chief Technology Officer. This person would be responsible for support, updates, communication and software training.

The implementation of IT in a new or existing family office may require additional resources. These resources might involve external consultants, who can provide advice and support with respect to integration, implementation and the verification of input and output data.

### Implementing technology

Once the core needs have been identified and the appropriate solutions chosen, it is vital to implement them effectively. Appropriate implementation may include the following:

- ▶ Conceive a detailed project plan, setting out the responsibilities of each vendor
- ▶ Agree the data import processes with each vendor
- ▶ Create data and functionality test scripts for each platform
- ▶ Hire an external consultant for data output testing
- ▶ Hold frequent meetings with each vendor on progress and on project plan milestones

# Appendix

# 1

## The legal setup

### Setting the scene

Since a family office is a business, the question of which jurisdiction provides the best environment for such activities often arises. Legal and tax structures will have a big impact on the structure and operational performance of the family office and as such need to be given substantial consideration.

Given that the family is at the center of the family office, choosing a location close to the family, or at least to the central members, would appear to be much more important than a tax-optimized choice of location. Nevertheless, legal, tax and regulatory aspects relevant for the setup, as well as for the operations of a family office, have to be checked carefully. Depending on the framework provided by the jurisdiction, there are normally many aspects that must be considered in order to optimize the individual situation within the given set of legal or tax frameworks. This section examines some of these considerations in more detail.

### Asking the right questions on location

As outlined above, the most crucial aspect of choosing a location for a family office is not the legal and tax environment. Nevertheless, there are obviously a few jurisdictions that stand out as centers of family office excellence. Below we give overviews of these jurisdictions. But first, we explore some of the other relevant aspects of location choice. It is important to establish which questions have to be asked – and answered – in the process of setting up a family office.

### Regulatory environment

The regulatory environment of the jurisdiction chosen has to be carefully checked and so too does the level of services provided by the jurisdiction. The requirements that need to be met in order for the office to perform the chosen services under the laws of the location must also be checked. In many countries, special registrations or permits are required to give investment advice or to act as an attorney or trustee on behalf of the principal family or certain family members.

Those setting up a family office need to be aware that in some countries non-compliance with such rules is a criminal offense, with severe consequences for those who have not followed the correct procedure. Furthermore, there may be restrictions regarding the provision of legal and tax advice that may only be offered by certified professionals and registered professional service firms. In some jurisdictions, such professional services might be incompatible with the tasks covered by the family office, such as financial services.

In view of these potential limitations, the scope of work for the family office always has to be matched with the regulatory framework in the relevant jurisdiction. For services that cannot (or will not) be provided by the family office itself, other trusted advisers should be identified.

Regulatory aspects also impact the choice of personnel, especially senior management. Several jurisdictions require employees to have certain personal skills before they will grant and maintain permits

to provide investment advice and other services – services that might potentially be provided by the family office.

Once the family office is established and all regulatory requirements have been met, operations may start. In this context, the legal and contractual basis for the family office services has to be considered. This does not only include the type of agreement between the family and its individual members with the family office, but also – and much more importantly – the extent of the family office's liability. In this context, the respective legal framework as well as possible measures of limitation of liability should be scrutinized. The same applies for insurance against financial damages.

Below, we examine these issues in detail as they apply in Germany, Switzerland, Austria, the UK and the US.

### Germany

#### Regulatory environment

The most important law regarding the regulatory environment for family offices in Germany is the German Banking Act (Kreditwesengesetz – KWG). This sets out the regulatory terms and conditions for giving investment advice and similar services.

To what extent regulatory restrictions have to be respected depends on the structure and the specific tasks of the family office. Nevertheless, the following aspects have to be considered:

- ▶ If the family office is structured as a company (corporation or partnership) that actually owns the family wealth (with the family members as shareholders or partners) its investments qualify as *Eigengeschäft*,

which do not require a special permit and are not subject to further regulatory requirements. Consequently, the family office's personnel do not require special permits.

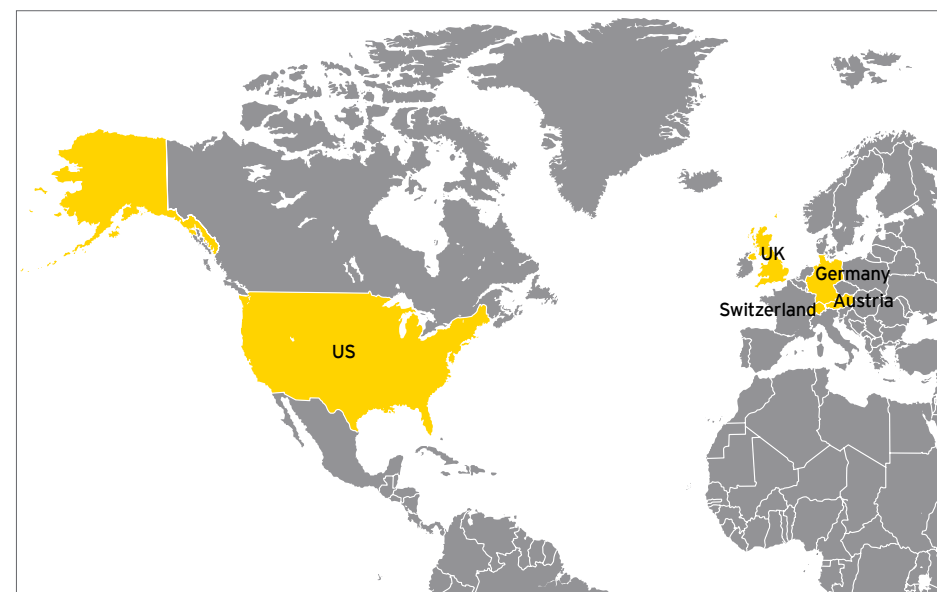
- ▶ If, on the other hand, the family office acts as an adviser to the family or family members on how to invest their assets, or if the family office performs the investments on behalf of the respective owner of the funds, such activities require special permission from the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin).
- ▶ Whether or not the European Alternative Investment Fund Managers Directive (AIFM) and the domestic law based upon this guideline, which both became effective on 22 July 2013, will deviate from the above and impose further restrictions is not clear. There is reason to believe that AIFM is not principally aimed at family offices. Nevertheless, further developments have to be closely monitored.

#### Limitation regarding legal and tax advice

Under German law, legal tax services may only be administered by lawyers and by certified tax advisers. If a company performs these professional services, such a company has to be registered as a law firm or a tax consultancy practice. Thus, the provision of professional services by a family office is only possible within the aforementioned limitations.

#### Limitation of liability

The extent of possible liability for professional mistakes is dependent on the structure of the family office and on the legal nature of its services.



If the family office actually holds the family assets (as the legal owner) its management is only accountable within the limits of directors’ and officers’ liability.

Financial losses are losses of the family office itself and cannot be claimed as damages by the family directly. If on the other hand, the family office acts as an adviser to the family (still owning the assets according to legal definition) any shortcomings in the quality of the advice resulting in financial losses may be claimed as damages. Normally the liability is – and should be – limited by contractual agreement to gross negligence and/or capped at a certain amount. A total exclusion of liability, even for gross negligence, is not permissible under German law. Furthermore, it is advisable to cover such risks by using financial-loss insurance.

**Switzerland**

**Regulatory environment**

Given that family offices do not normally accept deposits from the public on a professional basis, family offices do not require a banking license. Asset management is a standard activity of many family offices. Asset management as such – i.e., acting in the name and for the account of the family – is not subject to licensing in Switzerland. However, asset managers are subject to licensing under the Anti-Money Laundering Act, or must become a member of a recognized anti-money laundering self-regulation organization.

If the family office acts as an asset manager of a Swiss collective investment scheme supervised by the Swiss Financial Market Supervisory Authority (FINMA),

the family office would have to comply with the statutory licensing requirements set out under the Collective Investment Schemes Act and the Collective Investment Schemes Ordinance.

**Limitation of liability**

A family office would normally be established as a share corporation and not as a partnership. This is also to avoid, to the greatest possible extent, personal liability of the board and the managers of the family office. If the family office is part of the family business and holds the family assets (as the legal owner), the board and the management of the family office are only accountable to the company, its shareholders and creditors within the limits set in the Swiss Code of Obligations for any losses or damage arising from any intentional or negligent breach of their duties.

If the family office is separated from the family business and therefore acts as a contractual adviser to the family and its companies, the general liability rules for obligations and the rules for agency contracts apply. Under Swiss law, the family office would be liable for any fault, without any limitation as regards to the amount. As a matter of course, the liability is limited by contractual agreements to gross negligence and willful misconduct or capped at a certain amount for slight negligence.

**Austria**

**Regulatory environment**

Under Austrian law, legal and tax services may only be offered by lawyers (admitted to the bar) and by certified tax advisers. If a company performs such professional services, it has to be registered as a law

firm or a tax consultancy practice. Thus, the provision of such professional services by a family office is only possible within the aforementioned limitations.

**Limitation of liability**

The extent of possible liability for professional mistakes depends on the structure of the legal form of the family office and on the nature of its services.

If the family office manages a company that actually holds the family assets (as the legal owner), the family office is only accountable within the limits of its directors’ and officers’ liability. Any financial losses are losses of the holding company itself and cannot be claimed as damages by the family as shareholder.

If the family office acts as an adviser to the family’s companies or the family members themselves, any shortcomings in the quality of the advice resulting in financial losses may be claimed as damages. Normally the liability is (and should be) limited by contractual agreement to gross negligence and/or capped at a certain amount. In any case it is advisable to cover such risks by using directors’ and officers’ insurance.

**The UK**

**Regulatory environment**

A family office can work at different levels – from being run by a small group of trusted individuals or family members, to being managed by a professional service provider. The laws governing a family office can vary depending on its structure. In the UK, investment advice is given either by a financial adviser or a stockbroker. Both have to be registered with the Financial Conduct Authority (FCA), and certain larger

institutions have to be registered with Prudential Regulatory Authority. The FCA is the independent body that regulates the financial services industry in the UK. With statutory powers given to them by the Financial Services and Markets Act 2000, the FCA has a wide range of rule-making, investigatory and enforcement powers.

**Limitation of liability**

Family offices can act as an unincorporated entity and thereby there is no limitation of liability. All investments remain owned by the principal, and employment laws and other public liability (and other litigation) will attach to the individual.

For those who wish to limit liability, there are three entities normally considered: Limited liability companies (Ltd), Limited Partnerships (LP) and Limited Liability Partnership (LLP). All, in general, protect the owner from financial penalty up to the level of equity invested in the family office entity. A limited company operates in the same way as in most territories. An LP is used primarily as an investment vehicle where the aim is purely asset holding, growth and income generation. An LP is normally distinguishable from an LLP because owners are generally not active within an LP business. Therefore, an LLP is most frequently seen where the entity is a trading concern or where owner is active in the business.

LPs are more frequently being used for UK based families as a vehicle which can be used to transfer wealth through the generations in a well governed and tax efficient manner over time.

Many international investors have a desire to use UK law as the governing law of

operation because of the independence and enduring stability of the UK judicial system.

An often perceived disadvantage of obtaining limitation of liability is the corresponding requirement to lodge financial information with the UK authorities which then becomes available to the public. Those wishing to keep their financial affairs private can however often take advantage of various opportunities to keep their profile private with appropriate structuring.

Many family offices are established in the UK as an advisory function but with ownership of assets held abroad. This is to take advantage of the financial expertise in London, but also because certain families, who are not citizens of the UK (although they may be tax residents), can take advantage of the UK tax system which allows income earned outside the UK to not be taxed in the UK unless brought into the country.

**The US**

**Regulatory environment**

It is important to remember that each of the 50 states, as well as the District of Columbia and individual US territories, has its own laws and regulations that may apply to family offices. This includes rules concerning business licenses, franchise taxes, and registration requirements for businesses conducted in certain forms, such as private trust companies.

**SEC Regulation of Family Offices**

The Securities and Exchange Commission (SEC) has regulatory authority over all professionals and businesses that offer investment advice for a fee, unless

specifically exempted. As noted below, family offices may be subject to registration, SEC oversight and information reporting under the Investment Adviser Act of 1940 (Advisers Act), unless they qualify for an exemption.

**Dodd-Frank Act**

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Dodd-Frank brought family offices under closer regulatory scrutiny. But it also instituted several new exemptions from registration and directed the SEC to write a specific family office exclusion (the Exclusion).

The initial SEC proposal for the Exclusion, as submitted for public comment, was very narrow and left many family offices facing registration. But the SEC acknowledged the “underlying rationale that recognizes that the Advisers Act is not designed to regulate families managing their own wealth.” This provided family offices with a clearer determination of the applicability of the Advisers Act, without necessitating the cost of an exempt order.

The SEC published their position that a family office may provide non-advisory services to non-family members without losing the Exclusion, but noted in January 2012 that “advisory services cover a broad range of activities and a family office should consider carefully whether any of the services it provides to non-family members are advisory services that make it subject to the Advisers Act.”

Under the SEC rules, a family office is excluded from the definition of “investment adviser” for purposes of the Advisers Act if it meets the following requirements:



- 1. It only serves clients that are considered “family clients”
- 2. It is wholly owned by “family clients” and is controlled exclusively by “family members” and/or “family entities”
- 3. It does not hold itself out to the public as an investment advisor

**The Internal Revenue Service**

The Internal Revenue Service (IRS) has no direct oversight of family offices. But the US Treasury Department publishes Circular 230, which presents the regulations applicable to those professionals who practice before the IRS. Circular 230 also contains rules of professional conduct and lists requirements for providing tax advice. Tax advisers who violate Circular 230 may be sanctioned, fined, or suspended from practicing before the IRS. Therefore, while the family office itself might not be subject to oversight by the IRS or the Treasury Department, employees involved in the tax function may be subject to Circular 230.

*Note: For a more detailed description of what the Dodd-Frank Act and the IRS means for family offices in the US, please see Appendix 2.*

**Family office structures and tax**

**Background**

This section looks at the potential legal structures that might be reasonable for family offices to adopt in the countries that they are most likley to operate from. It also looks at the major tax issues family offices in these main jurisdictions have to consider. In broad terms, the legal structures for famiy offices are either partnerships or corporations. But, depending on the applicable laws, trusts and similar structures might be suitable as well. The choice of a special legal structure may not only convey special legal consequences – such as unlimited or limited liability, differences regarding shareholder positions, or transfer of shareholder rights – but also a different tax treatment. The best way to analyze these aspects is to look at the specific jurisdictions in more detail.

**Germany**

**Legal structures**

Family offices may be structured in various ways in Germany. Normally, it would be advisable to establish an independent legal entity using a corporation (stock corporation – AG, limited liability company – GmbH) or a limited liability partnership (KG). The use of a partnership (without built-in limitation of liability) does not seem appropriate (but is also possible). From the point of view of corporate law, corporations (especially stock corporations) do not offer the same degree of flexibility as limited liability partnerships. But this effect is – more or less – limited to corporate matters, such as notarization of the articles of association and their amendments and (in case of stock corporations) notarization of other shareholder meetings. In view of the daily business there are no real differences between the relevant structures.

**Limited liability company**

A limited liability company (GmbH) requires a minimum share capital of €25,000. The GmbH is represented by its managing directors (*Geschäftsführer*) who are (only) internally bound to shareholder decisions, but can act independently, against explicit shareholder instructions, with legally binding effect.

**Stock corporations**

Stock corporations require a minimum share capital of €50,000. They are represented by their executive directors (Vorstand) who can also act independently. The executive directors are chosen by the supervisory board (Aufsichtsrat) whose members are elected by the shareholders. A direct supervision of the executive directors by the shareholders is legally not possible.

**Limited liability partnership**

The limited liability partnership is normally composed of a GmbH acting as a general partner, and one or more limited partners whose liability can be limited to any amount (but must be registered with the commercial register of the company). The partnership is managed by the general partner (that which is a GmbH by its managing directors). One or more limited partners may be managing directors of the GmbH (general partner). In view of the general partner’s power of attorney the same rules apply as for the GmbH.

It should also be mentioned that German law does not have structures comparable to common law trusts. The distinction between legal title and equitable ownership is totally alien to the German legal system.

**Tax issues**

From a tax point of view, the treatment of corporations and partnerships is totally different, at least regarding the taxation of profits. Corporations are (as such) subject to corporate tax (*Körperschaftsteuer*, 15%) and solidary surcharge (*Solidaritätszuschlag*, 5.5% on the corporate tax). Furthermore, trade tax (*Gewerbesteuer*, approximately 20% depending on the location of the business) is imposed on the company.

If a family office is set up as a corporation and actually holds the family assets, certain parts of the income (dividends and capital gains from the sale of shares in corporations) are nearly totally tax-exempt (only 5% of such income is deemed to be non-deductable expenses). This can lead to material economic benefits.

If, however, the profits of the family office get distributed to its shareholders

(individuals) this again may be subject to German income tax (and solidarity surcharge) if such shareholders are taxable in Germany. Normally a flat tax on 25% of the dividends is applicable.

Partnerships are not subject to corporate tax. Their income is split among the partners (without regard to whether or not a profit distribution is actually made) and taxed as their personal income. Such income of the partners is subject to income tax (*Einkommensteuer*), if the partner is an individual, or corporate tax, if the partner is a corporation. Dividend income and capital gains of the partnership may be partially tax-exempt; in this regard special rulings may apply (partially depending on the shareholder structure).

Additionally, a partnership can be subject to trade tax if it qualifies as a business establishment rather than an asset manager. To the extent individuals participate in the partnership, part of the trade tax paid by the partnership may be credited to their personal income taxes.

**Switzerland**

**Legal structures**

The legal form of a Swiss family office is neither driven by the complexity of its functions nor the family’s wealth structure. Given the unlimited personal liability of at least one partner, Swiss partnerships are not a common legal form for a family office. Swiss foundations are also seldom used, given their rigid rules in the Swiss Civil Code. In addition, Swiss law does not provide for legal forms comparable to common law trusts, although Switzerland has signed the Hague Convention of 1 July 1985 on the law applicable to trusts and on their recognition, which has been





in force in Switzerland since 2007. Finally, limited liability companies are often avoided, given the need to register company members with the register of commerce. Therefore, the usual legal form would be a share corporation.

More important than the legal form is the fundamental question of whether the family office holds the family assets; i.e., whether the family office is part of the family-run concern or whether the family office is separated from the family business. In practice, both setups exist. A separation is more often seen in large-scale, multinational family businesses with fully operational entities, whereas integration occurs where the business is smaller or the assets only consist of financial investments. A full separation, both legally and in terms of staffing, allows better control of the family office services and independent advice to the family, but requires sufficient financial means to fund the family office activities.

**Tax**

Due to Switzerland’s federal system, taxes are levied on three different levels, the federal, cantonal and communal level. Therefore, the taxation of similar legal structures varies from canton to canton as some of the applicable regulations, and in particular tax rates, are not harmonized.

In general, corporate taxation for family offices in Switzerland consists of the following aspects:

- ▶ Corporate income tax is levied at the federal, cantonal and communal level. Whereas the federal statutory tax rate is 8.5% of the net profit after tax, the cantonal and communal rates vary depending on the location of the

entity and the tax privileges available, if any. In case of ordinary taxation, the total effective maximum tax burden, consisting of federal, cantonal and communal taxes, ranges from approximately 12% to 25%. Provided a tax privilege is applicable, total effective maximum tax burden starts at approximately 8%.

- ▶ Capital tax on net equity is also due once a year and varies, as it is levied on the cantonal and communal level only, between 0.001% and 0.525% depending on the location of the entity and the tax privileges available, if any. Approximately half of the cantons foresee that the corporate income tax can be credited against the net equity tax.

Usually, family offices provide their services mainly to related parties in a closed environment. In order to avoid discussions with the tax authorities on the taxable profit, family offices should either prepare sufficient documentation on their transfer prices or reach a respective agreement with the authorities in an advance tax ruling. Such a ruling would generally define the taxable profit based on the cost-plus method, with a markup between 5% and 15%, depending on the value added of the operations in Switzerland.

In some specific circumstances, and providing certain prerequisites are fulfilled, it might be possible to benefit from tax privileges by establishing the family office either as a so-called domiciliary company, which is based in Switzerland only for administration purposes, without operating any kind of ordinary business, or as a mixed company that conducts its main business abroad with only rather marginal operations in Switzerland.

A one-time capital duty of 1% is generally levied on capital increases or contributions to Swiss incorporated companies. However, tax planning is available around exemptions for (i) qualifying mergers, reorganizations and financial restructurings and (ii) other contributions within incorporations and capital increases up to the first CHF1m.

In addition, a securities turnover tax on the sale or exchange of taxable securities may apply if: (i) the family office qualifies as a securities dealer in the capacity of a broker or dealer or (ii) trades on the family office's own account, provided it holds more than CHF10m of taxable securities. The tax rate is 0.15% for Swiss securities and 0.3% for foreign securities.

Economic double taxation, such as taxation of the corporation and the taxation of the shareholder, according to his or her distribution, should also be considered. But it may be reduced or avoided by mitigating provisions similar to the partial taxation of dividends distributed to Swiss residents or the participation exemption applicable to Swiss corporate shareholders, provided they hold in both structures a minimum share of 10% in the family office. For the participation exemption, an alternative fair market value of the participation of a minimum of CHF1m is sufficient.

Also, it is worth mentioning that due to the Hague Convention of 1 July 1985 on the law applicable to trusts and on their recognition, in force in Switzerland since 2007, Swiss-based family offices acting as trustee or protector should generally not trigger negative tax implications in Switzerland, as both are not the beneficial owners of the trust assets, although the trustee holds the legal title.

**Austria**

**Legal structures**

The legal form of a family office in Austria is mainly defined by the family’s wealth structure. Complex structures and assets have to be permanently monitored, controlled and managed, whereas less complex structured assets may require less monitoring, but focus more on asset protection and preservation for future generations. Depending on the family's wealth structure, a family office's functions range from mere administration to high-level advice and management services.

Depending on the family's asset structure, the Austrian jurisdiction offers different suitable legal forms. Since the introduction of the Austrian Private Foundation Act in the 1990s, many family-owned fortunes were endowed in private foundations. Accordingly, many organizational and administrative services are provided by the Foundations Governing Board. Today, the governing board does not only manage and coordinate family assets, but also needs expertise in other fields and should guarantee independent, complete and comprehensive advice.

Although the Foundations Governing Board is not considered the management board of the Private Foundation by the Austrian Private Foundation Act, a family office can be installed through the Foundations Deed.

The family office's members, tasks, functions, rights and goals, as well as the governing board's instruction rights can be established in the foundations deed. Outside the legal form of the Austrian Private Foundation, a family office can be set up as the managing board of a holding company with limited liability (GmbH),

which actually holds the family’s assets, or as a service company with limited liability that offers advisory services to the family's holding companies or the family members themselves.

However, from a tax planning perspective, family offices in other legal forms, such as partnerships, can be attractive in Austria, depending on the asset and holding structure and the range and kind of services provided by the family office.

**The UK**

**Legal structures**

It is possible to set up a family office in the UK using any of the following structures:

**Limited company**

A limited company is a corporate entity limited by shares. The family may be the shareholders and possibly also act as directors, with or without non-family professionals at the family office. A company has separate legal personality.

**Partnerships**

A partnership is two or more persons carrying on a business with a view to profit. It is effectively transparent for tax purposes (i.e., the partners are taxed on their share of the income and gains of the partnership). A limited partnership has “general partners” who manage the partnership, and “limited partners” with limited liability who do not. A Limited Liability Partnership (LLP) is an entity that is taxed in the same way as a partnership, while affording limited liability to its members.

**A trust**

A trust is an arrangement whereby assets

are held by trustees for the benefit of the trust's beneficiaries. They are generally governed by a trust deed.

**Informal or contractual relationship**

Families may employ individuals directly to provide them with family office services. Alternatively, there may be an informal arrangement whereby individuals who are employed by the family company also provide family office services to the family.

**Tax structures**

UK-resident limited companies are legally distinct entities and are subject to corporation tax on their profits. Non-UK-resident companies are not subject to corporation tax unless they carry out business in the UK through a “permanent establishment.” If they receive income from a UK source otherwise than via a permanent establishment (e.g., from UK property or other UK investments), they may be subject to income tax.

Partnerships, limited partnerships and LLPs are generally transparent for tax purposes, and the partners are taxed directly on their share of the income and gains. The trustees of UK resident trusts are subject to income tax and capital gains tax on the income and gains of the trust. Non-UK resident trusts are subject to UK income tax on UK source income. Anti-avoidance provisions can apply to tax income and gains received by non-UK trusts, companies and other entities on UK residents connected with the entity. This is a complex area and advice should be taken before establishing a non-resident entity. However, offshore entities can provide tax advantages in certain situations, particularly in respect of

family members who are non-UK resident or non-UK domiciled.

Where payment is made for family office services under a contractual or informal arrangement, the recipient may be subject to tax on the income. The precise tax treatment will depend on the specific circumstances of the case.

The US

Legal structures

In the US, while partnerships and limited liability companies (LLC) are often taxed identically, the fact that all the members of a LLC can benefit from the protection of limited liability has generally decreased the use of general partnerships or limited partnerships in entity selection. This is because, in either structure, the general partners retain joint and several liability for the debts of the entity.

For either corporations or LLCs, US state law in the jurisdiction of organization will determine specific treatment of the limitations on liability and may limit the allowable legal life of the organization to a specific number of years. However, the family office need not necessarily form the legal entity in the state of the family's general residence.

Tax considerations play a significant role in the determination of the appropriate legal entity status for the family office.

US taxation of individuals and trusts

The taxable income of US citizens, tax residents and domestic trusts is subject to a graduated rate schedule. The top marginal tax rate on the ordinary income of individuals and trusts is 39.6%. Long-term

capital gains and qualified dividends are taxed at a top income tax rate of 20%. In some cases, the Alternative Minimum Tax (AMT) may apply. AMT has a top marginal rate of 28% and applies when it exceeds the regular income tax of an individual or trust.

US taxation of partnerships

Partnerships are not subject to federal taxation at the entity level. Instead, the partnership allocates its items of income, deduction and credit to its partners. Allocations of items of taxable income and deduction may be in accordance with capital ownership percentages, but need not be so; partnership taxation generally offers flexibility in allocations so long as the allocations are specified in the operating agreement and reflect the partners' economic interests in the partnership.

US taxation of corporations

Corporations, other than the "S corporations" described below, are generally subject to US income tax at the entity level on their worldwide income, with a credit allowable for certain taxes paid to foreign jurisdictions. The maximum federal corporate tax rate is currently 35%. There are no preferential rates for long-term capital gains recognized by a corporation as there are for individuals. Additionally, the 3.8% net investment income tax does not apply to corporations. Corporations may deduct a portion of their dividends received, and the AMT for corporations is more punitive in its treatment of municipal bond income than it is for individuals.

S corporations

Certain corporations may elect to be taxed under subchapter S of the Internal Revenue Code as a hybrid entity, called an

S corporation, or S corp, which allows for many (but not all) of the benefits of the flow-through nature of partnerships. This may allow an entity to be a corporation in legal entity form, but avoid the double taxation of corporations.

Family offices housed within private operating companies

Many family offices begin within the structure of a private operating business, providing services to the family business owners. These family offices are not segregated into a separate legal entity, but rather exist as a division of the operating company itself. Operating a family office within a private operating company presents numerous additional tax issues to consider. Also, from a non-tax standpoint, housing a family office within a private company can create privacy and governance concerns, especially if significant management operations are handled by non-family members, or if family members have varying degrees of involvement in the operating company.

Private trust companies

Family offices often consider whether they should provide professional fiduciary (trustee) services to the family members they serve, or whether such services are best purchased from external sources. Those offices wanting to provide fiduciary services may consider setting themselves up as a private trust company in order to bundle fiduciary services with traditional family office services. The number of private trust companies remains a small percentage of the overall number of US family offices.

*Note: For a more detailed discussion of the various US legal structures and their different tax implications, please see Appendix 2.*

Setting up a family office in the Middle East: the Dubai International Financial Center

There are limited jurisdictions in the Middle East where very wealthy families can set up family offices to successfully manage their affairs. The best known and most established jurisdiction is the Dubai International Financial Center (DIFC) in the United Arab Emirates, which is an onshore financial center, offering a convenient platform for leading financial institutions and ancillary service providers. It has been established as part of the goal to position Dubai as a recognized hub for institutional finance, and as the regional gateway for capital and investment. The DIFC aims to play a pivotal role in meeting the growing financial needs and requirements of the region, while strengthening links between the financial markets of Europe, Asia and the Americas.

Benefits of setting up at the DIFC

Families who decide to set up a family office at the DIFC can take advantage of a 100% foreign ownership structure with 0% tax rate on income and profits and the freedom to repatriate capital and profits without restrictions. They can also benefit from a wide network of double taxation treaties with no restrictions on foreign exchange and a trusted legal framework.

The process

Families interested in setting up a family office can start by contacting the DIFC family office team in order to provide a better understanding of the family office's business and the proposed activities that the family office will be undertaking at the DIFC. Some of the required documentation for the submission includes:

- ▶ **Single Family Office Application Form**  
This should be submitted to the DIFC and covers areas such as the legal structure of the proposed family office, equity holders and operational requirements
- ▶ **Activity plan**  
This covers the activities undertaken, the company profile, financial projections and forecasts, family background of the principals, including biographies reflecting the origin of the funds. These documents should be pre-cleared and reviewed by DIFC staff to speed up the application process
- ▶ **Letter of intent**  
This should specify the intention to establish a family office in the DIFC, the principal's or family's background, intended activities in the DIFC, and permanent office space requirements

- ▶ **Letter from a regulated lawyer or auditor**  
This should confirm the common ancestry of the owners and that they are a single family and ultimate beneficial owner(s) of the office
- ▶ **Letter from a regulated entity such as a bank, law firm or audit firm**  
This will confirm that the family holds net assets in excess of the required minimum (US\$10m) and origin of wealth
- ▶ **Passport copy of the principal(s)**

Upon receiving the approval of the application by the DIFC Registration Review Committee (RRC), the formal provisional approval will be forwarded to the applicant in order to complete the DIFC Registrar of Companies (ROC) requirements.

It is also a DIFC requirement that all registered companies should have a physical presence in the center. Therefore, obtaining office space is one of ROC's requirements for licenses.

Duration and DIFC fees

Completion of the establishment procedure is dependent on the documentation provided and is usually completed within one month. The family office application fee is US\$8,000, payable upon application, and is renewable annually at US\$12,000.



## US regulatory and tax issues

### An important proviso

*The comments in this section are intended as a general overview of the financial and tax regulatory environment applicable to family offices operating in the US. Any US tax advice contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions. EY does not offer advice regarding non-tax related legal matters in the US. Due to the complexity of US federal and state financial laws and regulations, US legal counsel should be sought regarding the establishment and/or operation of a family office in the US.*

### Regulatory environment

Family offices in the US generally provide a broad range of services to the families they serve. Some services provided may be regulated or subject to government oversight. One important exception is legal services. While family offices may provide consulting services, they generally are unable to practice law due to statutes that prohibit the practice of law by non-licensed attorneys and rules limiting certain associations between lawyers and non-lawyers where the practice of law is involved.

As a business, a family office may be subject to general business regulations, including, for example, the Equal Employment Opportunity Commission, the Americans with Disabilities Act, and the Patient Protection and Affordable Care Act.

It is important to remember that each of the 50 states, as well as the District of Columbia and individual US territories, has its own laws and regulations that may apply to family offices. These include rules concerning business licenses, franchise taxes, and registration requirements for businesses conducted in certain forms, such as Private Trust Companies.

### SEC regulation of family offices

Pursuant to the Investment Advisers Act of 1940 (Advisers Act), the SEC generally has regulatory authority over all professionals and businesses that offer investment advice for a fee, unless specifically exempted. As noted below, family offices may be subject to registration, SEC oversight and information reporting under the Advisers Act, unless they qualify for an exemption.

### Investment adviser registration prior to 2011

In some cases, a family office was required to register pursuant to the Advisers Act. Those family offices required to register had to take into account the administrative time and professional fees required to remain compliant. More importantly, registrants had to file Form ADV with the SEC and submit annual updates. Form ADV is publicly available and includes information on the adviser's ownership structure and assets under advisement, which could represent a loss of privacy that many family offices would prefer to avoid.

Certain professionals, including lawyers and accountants who provide investment advice that is "solely incidental" to their overall client service obligations were, and continued to be, specifically excluded from

the Advisers Act. The definition of "solely incidental" as applied to the professional services exception provided only limited coverage for family offices due to the lack of a bright-line test to determine its applicability. The Advisers Act did contain a "private advisor exemption" for those persons or businesses that served fewer than 15 clients and did not hold themselves out to the general public as investment advisers. Many family offices relied on this exemption to avoid registration, but the only path to certainty in this area was an application to the SEC for a specific exempt order. In 2011, the SEC estimated that a typical family office would incur legal fees of US\$200,000 on average to engage in the exempt order application process, though they did not release support for this estimate.

### Investment adviser registration, 2011 and thereafter

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Dodd-Frank removed the private adviser exemption, effective 21 July 2011. However, Dodd-Frank also instituted several new exemptions from registration and directed the SEC to write a specific family office exclusion (the exclusion).

The initial SEC proposal for the exclusion, as submitted for public comment, was very narrow and left many family offices facing registration. However, the SEC adopted a more expansive exclusion in its final regulations. With the issuance of Rule 202(a)(11)(G)1 (Rule 202), the SEC acknowledged the "underlying rationale that recognizes that the Advisers Act is not designed to regulate families managing

their own wealth." Rule 202 provided family offices with a clearer determination of the applicability of the Advisers Act without necessitating the cost of an exempt order.

References to "services" in Rule 202 should be read only as regards investment services, or other advisory services that could be subject to the Advisers Act. The SEC published their staff position that a family office may provide non-advisory services to non-family members without losing the exclusion, but noted in a posted Q&A document on 19 January 2012, that "advisory services cover a broad range of activities and a family office should consider carefully whether any of the services it provides to non-family members are advisory services that make it subject to the Advisers Act."

Under Rule 202, a family office is excluded from the definition of "investment adviser" for purposes of the Advisers Act if it meets the following requirements:

1. It only serves clients that are considered "family clients"
2. It is wholly owned by "family clients" and is controlled exclusively by "family members" and/or "family entities"
3. It does not hold itself out to the public as an investment adviser

Therefore, to understand the potential applicability of the exclusion, it is first important to understand the definitions of the terms "family clients," "family members" and "family entities." To confirm these definitions under Rule 202, each family office must first designate a "common ancestor" that defines the family unit served. The common ancestor may be living or deceased, but may not be more than 10

generations removed from the youngest generation served by the family office. The family office may redefine the role of common ancestor in the future.

Family members are then defined as the lineal descendants of this common ancestor, as well as the spouses and spousal equivalents (and former spouses and spousal equivalents) of such descendants. To account for the realities of modern families, the phrase "lineal descendants" is expanded to include stepchildren, adopted children, foster children, and certain other children for whom a lineal descendant became legal guardian while the child was still a minor.

Family clients include:

- ▶ Current and former family members
- ▶ Certain key employees of the family office and, under certain circumstances, former employees
- ▶ Charities funded exclusively by family clients
- ▶ The estate of a current or former family member or key employee
- ▶ Trusts existing for the sole current benefit of family clients, unless funded by a family client and also for the benefit of charitable and not-for-profit organizations
- ▶ Revocable trusts funded solely by family clients
- ▶ Certain key employee trusts
- ▶ Companies wholly owned exclusively by, and operated for, the sole benefit of family clients

The term "key employees" includes:

- ▶ An executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office

- ▶ Any other employee of the family office who, in connection with his or her regular functions or duties, participates in investment activities, provided such an employee has been performing such services or substantially similar functions for at least 12 months in a family office setting, unless the employee performs solely clerical, secretarial or administrative functions

In their commentary on Rule 202, the SEC specifically prohibits key employees, their trusts and their personally controlled entities from making additional investments through the family office after their employment ends. They may, however, continue to hold their existing investments through the family office without jeopardizing the exclusion. The Rule does acknowledge that involuntary transfers to non-family clients may accidentally occur and should not cause the family office to fail the exclusion. An example referenced in Rule 202 is a bequest from the estate of a family client to a nonfamily client. Rule 202 therefore provides a transition period of up to one year to transfer those client investments to another investment adviser, or to otherwise restructure to comply with the Advisers Act.

It is important to note that the SEC specifically excludes certain other parties from the definition of family clients. Providing services under the Advisers Act to these individuals would violate the exclusion.

These exclusions include:

- ▶ Spouses or other immediate family members of key employees, except with respect to spousal joint property with the key employee

- ▶ Key employees of family entities who are not also employees of the family office, such as employees of related family-owned operating companies
- ▶ Certain key employees who do not meet the 12-month experience requirement, and other long-term employees of the family who do not meet the “knowledgeable employee standard”
- ▶ Trusts formed by key employees for the benefit of other non-spousal family members of that employee
- ▶ Irrevocable trusts who provide for a current beneficiary that is not a family client, as well as trusts where a contingent beneficiary that is not a family client becomes a current beneficiary, unless the involuntary transfer rules are followed
- ▶ Charitable or not-for-profit organizations that have accepted any funding from non-family clients, including the general public, unless restructured appropriately by 31 December 2013

These distinctions concerning which specific employees may receive investment services are very complicated and may prompt the family office to implement detailed policies preventing unintended consequences. The SEC noted that in narrowly defining the term “key employees,” they sought to allow participation only by those individuals who “could be presumed to have sufficient financial sophistication, experience, and knowledge to evaluate investment risks and to take steps to protect themselves.” In declining to include other long-term family employees, the SEC noted that “expanding the family client definition in this way would exclude from the Advisers Act’s protections individuals for whom we have no basis on which to conclude that they can protect themselves.”

As regards ownership and control of the family office, Rule 202 makes clear that in order to qualify for the exclusion, ownership must reside wholly in the hands of family clients, but control must remain either directly or indirectly in the hands of family members and family entities. The result is that control is a more exclusive test than ownership. Special care must be taken when evaluating a family office’s board of directors, to the extent that the board could exercise control and includes non-family members.

The SEC confirmed their position that family members retaining the right to appoint, terminate, or replace the directors does not cure this issue if the board is controlled by nonfamily members. By 20 March 2012, family offices were required to register with the SEC under the Advisers Act, meet the terms of the exclusion, or receive a formal exempt order.

The SEC decided against rescinding previously issued exempt orders, such that family offices in receipt of existing exempt orders would continue to be exempt from registering as an investment adviser even if they did not meet the terms of the exclusion. Family offices qualifying for the exclusion are not required to notify the SEC of their status. Advisers subject to the Advisers Act must register with the SEC and file annual informational forms and operating reports.

Rule 202 and the exclusion have provided greater clarity on the registration requirements for family offices. But uncertainty still exists in certain key areas, especially when the family office is a division of an operating business entity rather than a separate legal entity. Such a structure makes distinctions between

ownership, control, employees, and clients even more challenging to apply. Some published reports indicate that certain family offices have transferred their investment adviser function to a non-employee, “outsourced chief investment officer” model to avoid registration. Such family offices appear to be taking the position that residual family office investment services (cash flow modeling, etc.) either do not constitute “investment advice” under the Advisers Act or are “solely incidental” to their general obligations.

Forming a private trust company may similarly render the investment services as solely incidental to the trustee function. If this is the case, the family office may not be subject to the Advisers Act. However, these approaches are not specifically sanctioned, and the only certain way for a new family office to avoid registration at this time is to either meet the terms of the exclusion or apply for an exempt order.

### IRS oversight

The IRS has no direct oversight of family offices. However, the US Treasury Department publishes Circular 230, which presents the regulations applicable to those professionals who practice before the IRS. Circular 230 also contains rules of professional conduct and lists requirements for providing tax advice. Tax advisers who violate Circular 230 may be sanctioned, fined, or suspended from practicing before the IRS. Therefore, while the family office itself might not be subject to oversight by the IRS or the Treasury, employees involved in the tax function may be subject to Circular 230.

Generally, the ability to practice before the IRS has been limited to specific classes of professionals, including certified public accountants, attorneys, and enrolled agents. Prior to 2011, however, the IRS did not attempt to regulate preparers of tax returns. In that year, the IRS began a program to regulate all tax return preparers who are compensated for their services, requiring annual registration and payment of an annual fee, as well as ongoing continuing education and testing requirements. The IRS registration process resulted in registered preparers being assigned a Preparer Tax Identification Number (PTIN), to be reported on all returns signed by the preparer.

In January 2013, the US District Court for the District of Columbia invalidated these paid preparer regulations and enjoined the IRS from enforcing them.

The District Court has clarified that the injunction applies only to the education and testing requirements and annual fees. At this time, the IRS registration process to obtain a PTIN remains in effect. The concept of “paid preparers” is also important in the family office when considering the potential for IRS penalties that may be applicable to tax return positions that are not ultimately sustained. IRC Section 7701(a)(36) defines a return preparer as any person who prepares a tax return for compensation, with limited exceptions. IRC Section 6694 outlines the monetary penalties that may apply to return preparers who prepare tax returns containing unsustained positions.

The rules are complex and beyond the scope of this report, but generally a paid preparer may be subject to significant

monetary penalties for an unsustained tax return position, unless the position:

- ▶ Meets at least the “reasonable basis” test and is disclosed appropriately on the tax return
- ▶ Or has “substantial authority”
- ▶ However, a tax shelter or reportable transaction must at least meet a “more likely than not” standard and may also be subject to other disclosure requirements

It is important to note that these rules apply not only to the person who signs the tax return as preparer, but also to any other person who prepares a substantial portion of the return and any person who provides advice on a substantial portion of a return entry. A tax return may have multiple preparers for these purposes, and the penalty standards are applied on a position-by-position basis.

One of the limited exceptions to Section 7701(a)(36) is a person who “prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed.” It is unclear whether this exception is sufficient to except family office employees from paid preparer status with respect to all tax returns that they might prepare. It is also unclear whether the requirement of compensation applies in situations where family offices who prepare tax returns may not bill their family clients directly for such services. Therefore, it is unclear how these preparer penalty rules will be interpreted by the IRS in a family office setting where employees sign returns, prepare portions of returns signed by others, or provide advice on tax return positions.



Any person engaged in the business of preparing US tax returns, or providing services in connection with the preparation of US tax returns, is subject to financial and/or criminal penalties if that person knowingly, or recklessly, discloses any information furnished to him or her in the tax return preparation process to another person or uses such information for any purposes other than preparing or assisting in the preparation of such a return.

**US legal structures**

In general, a key consideration for most family office organizers is selecting an entity structure that provides some degree of liability protection to the owners. This includes forming the legal entity as a corporation, a general or limited partnership, or a limited liability company (LLC). The tax treatment of each of these types of entities is discussed below.

While partnerships and LLCs are often taxed identically, the fact that all the members of an LLC can benefit from the protection of limited liability has generally decreased the use of general partnerships or limited partnerships in entity selection, as in either structure the general partners retain joint and several liability for the debts of the entity.

As used below, the term “partnership” generally refers to income tax classification and not legal entity status as an actual general partnership or limited partnership.

For either corporations or LLCs, state law in the jurisdiction of organization will determine specific treatment of the limitations on liability and may limit the allowable legal life of the organization to a specific number of years. However, the

family office need not necessarily form the legal entity in the state of the family’s general residence.

Tax considerations play a significant role in the determination of the appropriate legal entity status for the family office. Because of the numerous differences between the taxation of corporations and partners in a partnership, it is difficult to compare the net tax effect of both structures without a thorough understanding, among other factors, of:

- ▶ The nature of the family office operations
- ▶ The capital funding structure and expense funding mechanism
- ▶ The specific underlying investments and operating businesses
- ▶ The use of partnership structures for underlying investment pooling
- ▶ The designs for succession and future ownership

The points below highlight some of the key tax considerations that need to be taken into account when selecting the legal structure.

**Cost allocations and treatment of expenses**

Regardless of the type of entity selected for structuring a family office, the entity may incur expenses related to a number of different activities, including managing and accounting for family-owned business entities, portfolio investments, real estate, and personal activities of family members. The costs of operating the family office must be allocated to the family’s business ventures, investment activities, and philanthropic affairs, as well as the personal

services provided, based on a reasonable allocation methodology.

Some items may be specifically allocated if they represent the direct costs of a particular area of operation; others may be allocated based on usage of family office resources on a time and materials basis. A family office must take care in classifying and reporting its expenditures due to the differing tax treatment afforded to each. Making matters more complicated, the extent of the deductibility of these items will differ based on the entity classification of the family office (discussed in greater detail below).

Expenses related to trade or business and real estate rental activity are generally treated more favorably under US tax law – they are currently deductible or deferred and deductible in later years – than are expenses related to the management of investment assets, for which deductions are limited. Personal expenses of the family members incurred by the family office are generally not deductible under any entity classification, though costs that are partially personal and partially related to a trade or business or to investment management may be allocated appropriately.

The active management of a family investment portfolio, and the management of family enterprises conducted through the corporate format, may not be viewed as a trade or business, despite the time and expense typically incurred in such an operation, unless the family office charges for its services and operates as more than a mere cost center for the family members. Thus, as noted below, the deductibility of these expenses may be substantially limited.

Many family offices assist in coordinating philanthropic activities for family members. IRS rules on “self dealing” prohibit certain relationships between charities and their related parties, though exceptions may apply for certain expense reimbursements for professional services rendered. The self-dealing rules are highly complicated and warrant specific attention from family offices who handle charitable affairs for their family members.

**US taxation of individuals and trusts**

The taxable income of US citizens, tax residents and domestic trusts is subject to a graduated rate schedule. The top marginal tax rate on the ordinary income of individuals and trusts is 39.6%. Long-term capital gains and qualified dividends are taxed at a top income tax rate of 20%. In some cases, the Alternative Minimum Tax (AMT) may apply. The AMT has a top marginal rate of 28% and applies when it exceeds the regular income tax of an individual or trust.

Many tax benefits (e.g., accelerated depreciation) and certain deductions (e.g., state and local income taxes and investment expenses) that are allowed under the regular tax do not apply for AMT purposes. For that reason the AMT, with its 28% rate, may exceed the regular income tax, even at its top rate of 39.6%. An additional 3.8% tax generally applies to net investment income recognized by an individual or trust with overall income above certain thresholds. This additional tax applies to net income from interest, dividends, rents, royalties and passive business income, and non-business capital gains received or recognized by an individual or trust.

US tax law applies numerous limits to the deductibility of expenses that are not related to the conduct of a trade or business, such as investment expenses, interest, charitable contributions, medical expenses and certain types of taxes. Net losses from business activities reported by an individual or trust in which the individual or trust is not a material participant in the management of the enterprise on a regular, continuous and substantial basis (commonly referred to as “passive activities”) are generally deductible only against income from other passive business activities.

The practical effect of the limitation on the deductibility of “passive losses” is that these losses are only allowed when the individual (or trust) has positive net income from other passive business activities or the passive activity is completely disposed of in a taxable transaction. Note that portfolio-type income (interest, dividends and gains from the sale of investments) is not income from a passive business activity for these purposes. A detailed discussion of the limits on the deductibility of losses and expenses is beyond the scope of this report.

Deductions incurred in the course of a trade or business are generally deductible to individuals and trusts without limit, unless from a passive activity. However, expenses incurred in the production of portfolio income are subject to substantial limitations on their deductibility. Investment expenses are generally only deductible to the extent that they exceed 2% of an individual or trust’s adjusted gross income, and are not deductible for purposes of computing AMT. As noted below, these limitations on investment expenses generally do not apply to activities engaged in by corporations.

**US taxation of partnerships**

Partnerships are not subject to federal taxation at the entity level. Instead, the partnership allocates its items of income, deduction and credit to its partners. Allocations of items of taxable income and deduction may be in accordance with capital ownership percentages but need not be so; partnership taxation generally offers flexibility in allocations so long as the allocations are specified in the operating agreement and reflect the partners’ economic interests in the partnership.

LLCs with more than one member are generally treated as partnerships for income tax purposes, unless the organizers file an election to treat the LLC as a corporation. LLCs with only one member, or Single Member LLCs, are generally disregarded for income tax purposes (i.e., they are fiscally transparent for US tax purposes and the owner of the LLC is treated as the owner of the underlying assets). For purposes of the discussion below, the term “partnership” refers to any entity taxed as a partnership under US tax law, and the term “partner” includes any owner of such an entity.

Annually, a partnership must file a tax return with the IRS to report its total income, deductions and credits. Additionally, the partnership must provide its owners with Schedule K-1, Partner’s Share of Income, Deductions, Credits, etc., which report each partner’s share of these items. These items are then reported on the partners’ own income tax returns to compute their income tax accordingly. This may allow partners to offset income from the partnership with items of deduction or loss from other sources. Such specific

treatment may differ, depending on whether the partner is an individual, trust, or other type of taxpayer and the character of the partner’s income and deductions.

Individuals and trusts pay a top federal income tax rate of 39.6% on ordinary income, including the income from family office operations. Income from a partnership retains its “character” as it is reported to the owners. Therefore, preferential tax rates on qualified dividends or long-term capital gains applies to such items allocated to a partner from a partnership. Consequently, items of income or loss flowing through from a family office taxed as a partnership will retain their character when allocated to the partners.

Deductions incurred in the course of a trade or business are reported separately from deductions incurred in the production of portfolio income. It is important to recall that limitations may exist on the ability of individuals and trusts to deduct their investment expenses and that these limitations on investment expenses generally do not apply to corporations.

The distribution of cash (or property) from a partnership to the partners generally does not result in the recognition of income (although there are many exceptions to this general rule), so long as the partner has sufficient “basis” in the investment. The basis rules are complex, but usually seek to ensure that previously taxed income can be distributed without incurring an additional layer of tax.

**US taxation of corporations**

Corporations, other than S corporations (described below), are generally subject

to US income tax at the entity level on their worldwide income, with a credit allowable for certain taxes paid to foreign jurisdictions. The maximum federal corporate tax rate is currently 35%. There are no preferential rates for long-term capital gains recognized by a corporation as there are for individuals. Additionally, the 3.8% net investment income tax does not apply to corporations. Corporations may deduct a portion of their dividends received, and the corporate AMT is more punitive in its treatment of municipal bond income than for individuals.

Dividends of cash or property paid by the domestic US corporation (and certain non-US corporations) to the shareholders are generally taxed to the shareholder at a maximum individual income tax rate of 20%, though additional complexities may apply on distributions of appreciated property. At higher income levels, individuals and trusts are also subject to the 3.8% net investment income tax applicable to dividends. The corporation receives no deduction for its dividend distributions. For this reason, shareholders in US corporations are often said to be subject to “two levels of taxation” – earnings are taxed annually at the entity level and accumulated profits are taxable to the shareholders when distributed. However, at lower income levels the overall rate of corporate income may be less, depending on the mix of income received and tax paid by the corporation, compared to such income in the hands of a partner in a partnership. When analyzing the deductibility of expenses, corporations are generally not subject to the same restrictions as individuals on expenses related to producing portfolio income

(i.e., investment expenses). If the family office itself represents a profit-making activity, then expenses will generally be fully deductible to the corporation unless they represent personal expenses of the shareholders. Thus, the lack of preferential tax rates for certain income at the corporate level may be offset by more favorable treatment of deductions, especially when considering AMT.

Additional complications may apply if the corporation is treated as a personal holding company (a corporation whose gross income consists principally of portfolio income or rents and royalties) or a personal service corporation. Proper consideration should be given at formation to addressing these issues.

**S corporations**

Certain corporations may elect to be taxed under subchapter S of the Internal Revenue Code as a hybrid entity, called an S corporation, or S corp, which allows for many (but not all) of the benefits of the flow-through nature of partnerships. This may allow an entity to be a corporation in legal entity form, but avoid the double taxation of corporations.

However, the eligibility requirements are very restrictive, especially if the entity is owned by trusts. The complicated rules concerning trust ownership must be analyzed before formation in a family office structure, due to the high likelihood that a trust will ultimately be an owner of the family office. Further, the eligibility requirements prohibit any foreign ownership of the corporate stock, which may limit the applicability of S corp status in a global family office context.

With the exception of certain distributions of appreciated property, S corporations are generally not subject to federal tax at the entity level, unless the legal entity existed as a non-electing S corporation prior to electing S corp status. S corporations may also be subject to entity-level tax on the disposition of certain appreciated property that was held by the entity upon conversion from traditional corporation status.

Like a partnership, an S corporation passes through all items of income and deduction to its owners, and such items retain their character when reported by the shareholder. Distributions of previously taxed income are generally not taxed as income to the shareholder if the shareholder has basis in their stock. However, if an S corporation was previously a traditional corporation and had undistributed accumulated earnings and profits at the election date, the distributions could be taxable. Because the income and deductions of an S corporation retain their character, the treatment of investment expenses is similar to that of a partnership, and thus less advantageous than the treatment of a traditional corporation.

Unlike partnerships, S corporations do not allow for flexibility in allocations among shareholders. All income and deductions must be allocated pro rata to the shareholders on a per-share, per-day basis. S corporations may only have one class of stock, unless the only difference is with respect to voting rights. This prohibits S corporations from allowing any action that could be viewed as creating a second class of stock, including disproportionate distributions.

**Family offices housed within private operating companies**

Many family offices begin their life cycle within the structure of a private operating business, providing services to the family business owners. These family offices are not segregated into a separate legal entity, but rather exist as a division of the operating company itself. Operating a family office within a private operating company presents numerous additional tax issues for consideration. Also, from a non-tax standpoint, housing a family office within a private company can create additional privacy and governance concerns, especially if significant management operations are handled by non-family members, or if family members have varying degrees of involvement in the operating company.

A family office that is not adequately compensated for its services by the family members it serves may be thought to have made a distribution to its shareholders, to the extent that the value of services rendered is deemed to exceed the value paid for such services. This consideration may not be material in a stand-alone family office structure (especially those taxed as partnerships) but may be very material within a private operating company. The issue is heightened for S corporations, where a deemed distribution could terminate the entity’s S election if not proportionate to all shareholders.

Also, as noted earlier, the SEC registration requirements for family offices may be more difficult to navigate and manage within the confines of a private company structure, especially if the company has

any degree of employee or non-family ownership. For these and other reasons, many families have chosen to relocate their family office from within their private operating company to a separate legal entity.

**Private trust companies**

Family offices often consider whether they should provide professional fiduciary (trustee) services to the family members they serve, or whether such services are best purchased from external sources. Those offices wanting to provide fiduciary services may consider setting themselves up as private trust companies in order to bundle fiduciary services with traditional family office services. The number of private trust companies remains a small percentage of the overall number of US family offices.

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