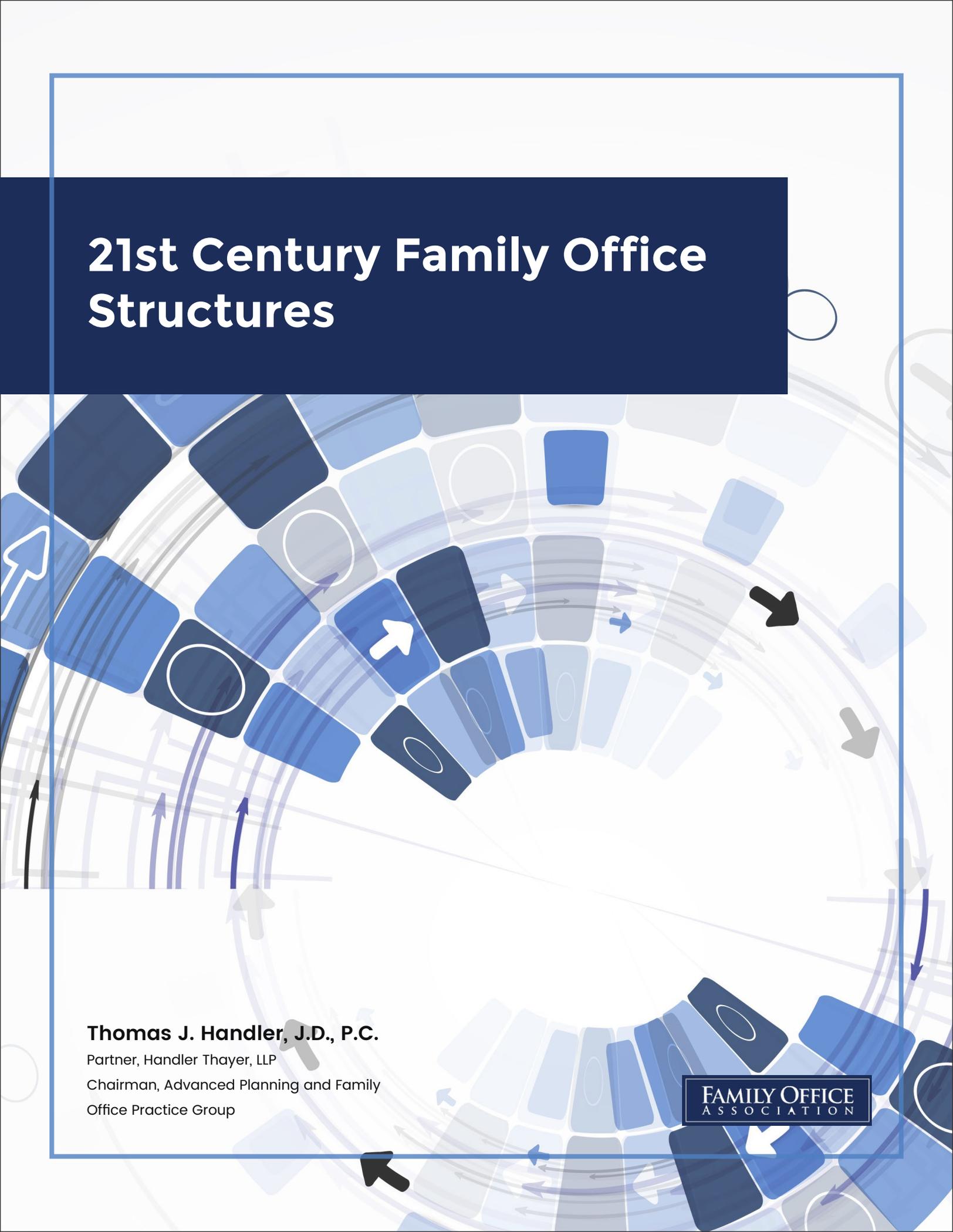


# 21st Century Family Office Structures



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**FAMILY OFFICE  
ASSOCIATION**

## 21ST CENTURY

## FAMILY OFFICE

## STRUCTURES

Family offices, largely unknown twenty-five years ago, have emerged as the twenty-first century global best-in-class solution for affluent families striving to achieve long-term wealth management and preservation. The global proliferation of ultra-high-net-worth (UHNW) families in recent years has fueled the establishment and development of these offices. Moreover, family offices of all types are expected to increase in number.<sup>1</sup>

2 A family office can generally be defined as a private family business designed to manage and preserve the wealth of the proprietary family. Using this definition, numerous entrepreneurial merchant families in the nineteenth and twentieth centuries established various businesses that could be called family offices. Moreover, these family office enterprises were used by affluent families during the Industrial Revolution to manage and invest in new business opportunities.<sup>2</sup>

Some scholars have even suggested that family offices began during the Roman Empire.<sup>3</sup>

These historical family office structures were intimately tied to the businesses that created the wealth of these highly affluent families. Family offices and family businesses are inextricably tied together; the family office is simply another business enterprise run or retained by the entrepreneurial family. In the United States, 55% of all families with single-family offices (SFOs) run one or more operating businesses.<sup>4</sup> As a result of this connection, most early family office structures, commonly organized in one of two different arrangements, were defective in important ways.

One defective structure typical of early family offices is often called the “upside-down” model. This structure resulted from the use of trusts as the primary vehicle

**Family offices have emerged as the 21st century global best-in-class solution for affluent families striving to achieve long-term wealth management and preservation.**

1 - Rosplock, K. & Hauser, B.R., “The Family Office Landscape: Today’s Trends and Five Predictions for the Family Office of Tomorrow.” *The Journal of Wealth Management*, 7.3, pg. 9. 2014.

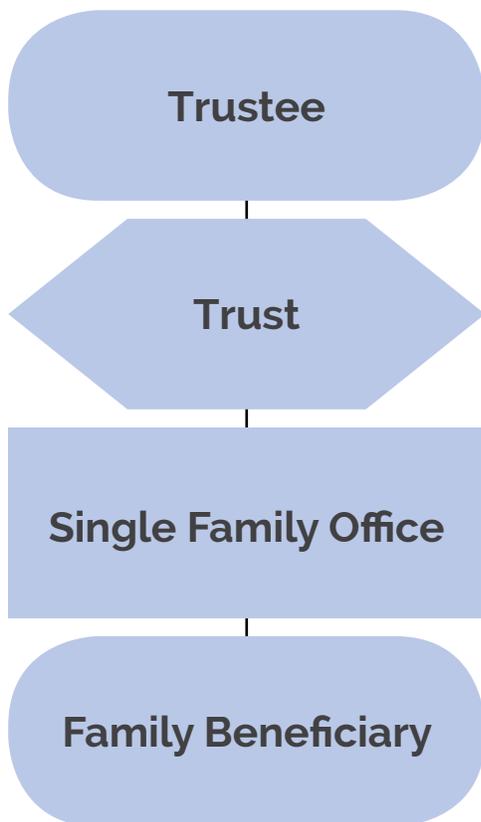
2 - Fernandez-Moya, M. & Castro-Balaguer, R., “Looking for the Perfect Structure: The Evolution of Family Office from a Long-Term Perspective.” *Universia Business Review* 82, 84. 2011.

3 - Id.

4 - “5th Annual Single Family Office Study.” Family Wealth Alliance. 2012.

for holding assets in the nineteenth and early twentieth centuries. The trustees, often together with family member beneficiaries, would determine to establish a family office. The trustees, already in complete control of the assets, established many of these early family offices. These structures then left the trustees still in complete charge of family assets as well as the newly established family offices. This left affluent families clearly in a distinct second position behind the trustees, especially given the limited options that family members had for holding trustees accountable under the trust designs common before the late twentieth century.

Chart 1  
Historical Upside-Down Family Office Structure



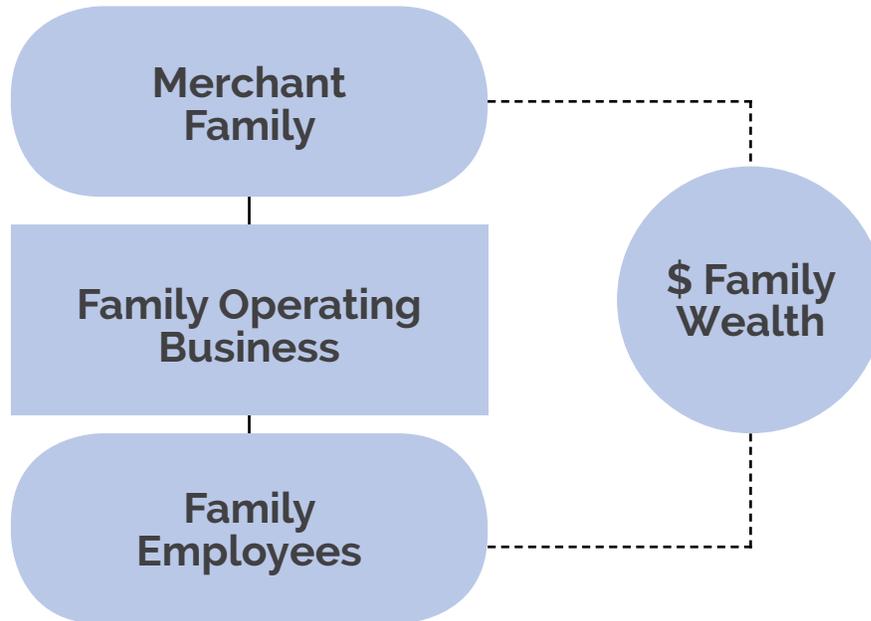
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The most common problem with this structure occurred when the family, acting through the family office, made a decision with respect to the investment or distribution of its assets, only to be vetoed by the trustee in complete frustration of family objectives. The upside-down element of the structure, then, is that decision-making authority does not rest with the private family through its family office, but with the trustees alone.

The second defective structure is commonly referred to as the “embedded” family office because no separate family office legal structure actually exists.<sup>5</sup> Instead, its functions are carried out inside one or more family business enterprises. In effect, the family office operations are embedded inside the family operating businesses.

5 - Thomas J. Handler, Establishing Virtual Family Offices, Trusts & Estates Magazine 41, 41-42 (2014).

Chart 2  
Embedded Family Office Structure



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This practice of carrying out family office operations inside a family operating business, using business employees and business resources, is often attended by numerous breaches of contract, breaches of fiduciary duty, conflicts of interest, tax reporting violations and ERISA<sup>6</sup> violations without precise cost accounting allocations and authorizing legal documents.<sup>7</sup> The simple reality is that the use of business personnel or resources for personal uses, investment or asset management is actionable self-dealing. Similarly, operating companies cannot deduct expenses incurred for investment, asset protection, personal tax planning, estate planning or similar purposes on their income tax returns.

#### 21ST CENTURY FAMILY OFFICE STRUCTURES BEGIN TO EMERGE

SFOs are dedicated to the long-term wealth management of a single family. As SFOs slowly began to take hold primarily in North America and Europe in the post-World War II environment, these modern family office enterprises were almost universally structured as stand-alone business entities, often with a single purpose. Such enterprises were primarily investment advisory businesses that were rarely integrated with a family's income tax planning,

6 - The Employee Retirement Income Security Act of 1974 is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans.

7 - Handler, *supra* note 5, at 41-42.

estate planning, asset protection planning and premarital planning objectives and structures.

Beginning in the late 1980's, these enterprises began to evolve into more sophisticated structures which continue to serve as the hub for coordinated, comprehensive and integrated long-term wealth management strategies. Concurrently, wealth management firms and SFOs began to morph into multi-family offices (MFOs), which manage the wealth of two or more unrelated families and create synergies and economies of scale among them. A subset of MFOs has been called the "affiliated multi-family office" because it is affiliated with a financial institution,

trust company or bank.<sup>8</sup> Virtual family offices (VFOs), family offices with the functions of an SFO contained within legal structures, but without separate office facilities, were created as some SFOs began outsourcing all or most traditional family office services.<sup>9</sup> This result was obtained largely due to the escalating costs and declining margins being experienced by VFOs and SFOs as the super-UHNW market began to mature.<sup>10</sup> Other compelling reasons supporting the proliferation of VFOs are to provide accounting integrity and to serve a defensive function against common non-compliant business practices.<sup>11</sup>

## CHOICE OF ENTITY CONSIDERATIONS

In the United States, almost all family offices are structured as Subchapter C corporations, Subchapter S corporations or limited liability companies (LLCs). Similarly, family offices around the world are often structured as traditional corporations and their equivalents or as LLCs and their equivalents. Of course, family offices can be structured as proprietorships or one of the many forms of partnerships; however, since these entities carry unwanted personal liability to one or more owners, such entities are generally not suitable as family offices.

**In the current marketplace, the majority of VFO and SFO structures are outdated, not well integrated and poorly structured by modern best-in-class standards.**

In the current marketplace, the majority of VFO and SFO structures are outdated, not well integrated and poorly structured by modern best-in-class standards. These structures were established many years before the development of current income tax, estate tax, benefits, executive compensation, asset protection and premarital planning laws which have effectively rendered them obsolete. Other family offices were established looking only to business law purposes

8 - Burri, M. and Reymond, O. "The family office: Fleeting trend or lasting values?," *Journal of Financial Transformation*, Vol. 15, pp 76-78. (2005)

9 - Handler, *supra* note 5, at 41-42.

10 - "The Family Office Dynamic: Pathway to Successful Family and Wealth Management." Credit Suisse Securities (USA) LLC. 1 Jan. 2016 <<https://www.credit-suisse.com/media/pb/docs/us/privatebanking/services/cs-wp-familyoffice-us-final.pdf>>

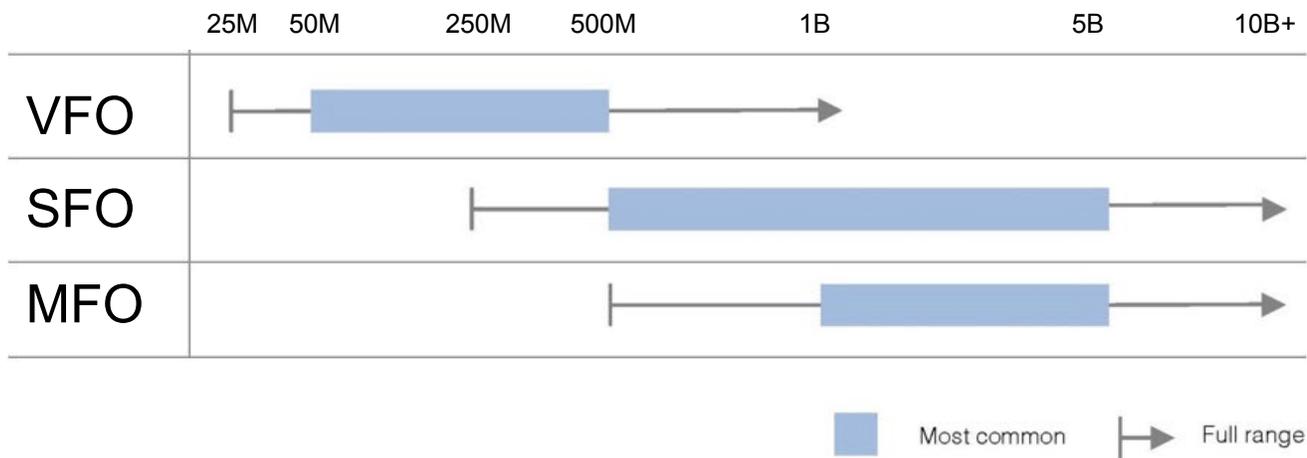
11 - Handler, *supra* note 5, at 41-42.

without considering taxation and wealth preservation principles. Most often, prior family office structures were determined without a view to comprehensive, integrated advanced planning or consideration of enlightened family governance principles.

The size of assets under management (AUM) plays an important role in determining the appropriate structure and choice of entity. In this regard, some general parameters have emerged. VFO assets range from \$25 million to over \$1 billion in AUM, with most VFOs running \$50 million to \$500 million in AUM. SFO assets range from \$250 million to billions of dollars in AUM, with most SFOs running \$500 million to \$5 billion in AUM.

Multi-family offices are often started by one or two large SFOs. Consequently, MFO assets typically exceed \$500 million, while most MFOs start with over \$1 billion in AUM. Industry trends show AUM ranges and averages slowly but consistently increasing over the last twenty-five years as rising family office costs outpace revenues.<sup>12</sup>

Chart 3  
Family Office AUM Ranges by Structure



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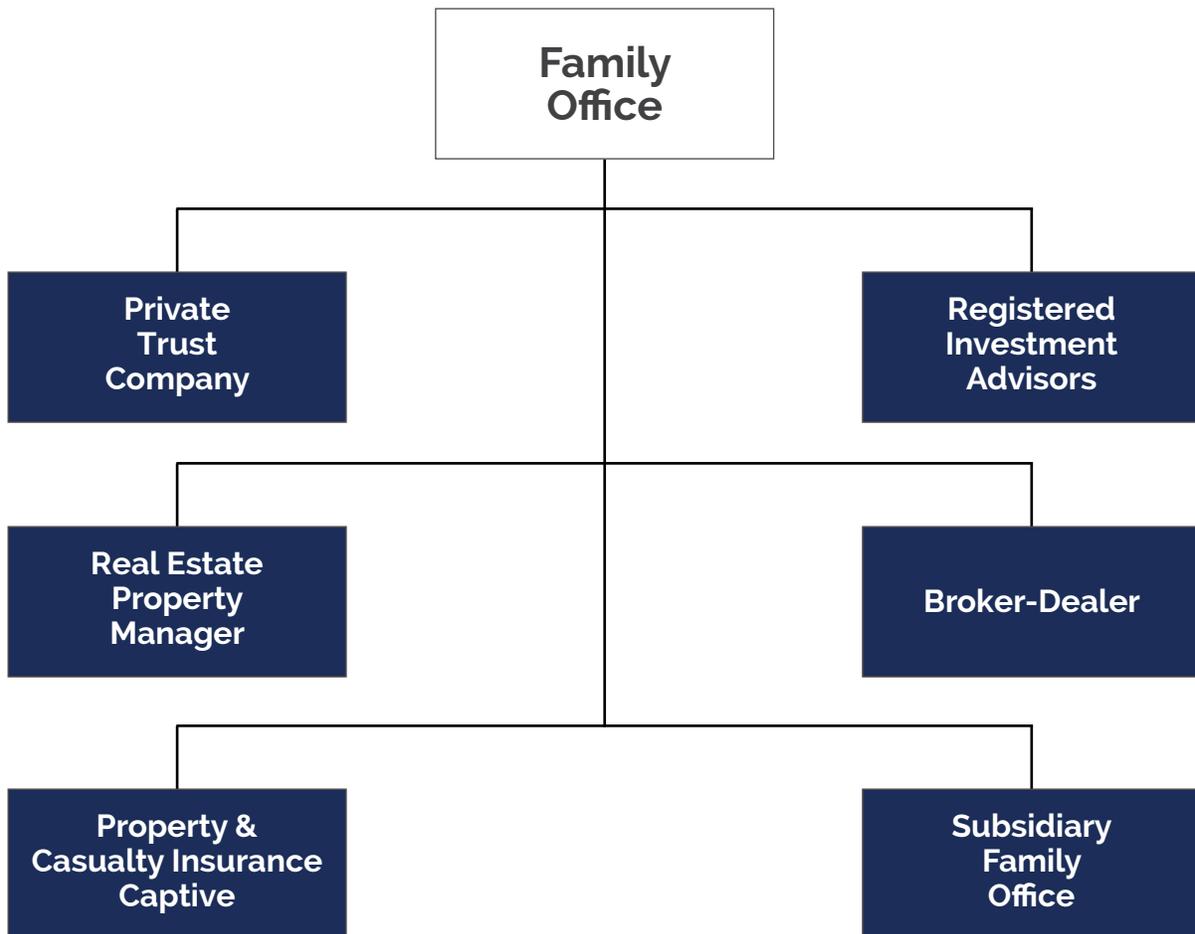
12 - Family Wealth Alliance, *supra* note 4.

**IMPACT OF GOVERNMENT REGULATION AND FUNCTION**

When determining the appropriate family office structure, one must consider both the planned and future services to be provided and applicable government regulation to which they may be subject. As families, family office executives and their professional advisers discuss family offices, they often refer to them as though they were a single enterprise, when, in fact, SFO structures are often comprised of several enterprises. The structure and nature of some of these entities are determined by regulatory, liability and asset preservation considerations. These structures include the family office management entity in addition to related and ancillary entities.

The most common related family office entities include ancillary family offices, real estate property management companies, captive insurance companies, registered investment advisors (RIAs), broker-dealers and private trust companies (PTCs).

Chart 4  
Complex Family Office Structure



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### **ANCILLARY FAMILY OFFICES**

Ancillary family offices are typically established to handle an international family's affairs in a country or continent other than that of the primary family office, centralizing the wealth management of investments, businesses and family members in these jurisdictions. A similar use of ancillary family offices is to host a portion of family office services in that enterprise, such as accounting, reporting, bill paying and tax preparation, while the primary, control-entity family office provides the majority of remaining services, outsourcing any services not provided by the family office to MFOs.

### **REAL ESTATE PROPERTY MANAGEMENT COMPANIES**

Real estate property management companies are typically established to isolate real estate management activities for business, liability and asset protection purposes. In this regard, the family office is emulating commercial and multi-unit residential real estate developers, rehabbers and operators that similarly isolate property management services from other operations and holding companies.

### **CAPTIVE INSURANCE COMPANIES**

Over the past few years, many family offices and family businesses have formed their own captive property and casualty insurance companies called "captives," providing them the ability to obtain higher levels of risk coverage, contain insurance costs and better manage business risks. A number of legacy SFOs have formed and operated their own

captive life insurance companies. In the current environment, these structures have significant capital and regulatory burdens that generally render them inappropriate for all but the very highest net worth global families. A captive entity is generally defined as an insurance company that has been organized primarily for the purpose of insuring or reinsuring the liabilities of the owners. It is usually an affiliated entity owned by the family to provide different forms of insurance for the various family entities and even some family members. Although it subcontracts some of the insurance risk through reinsurance contracts, it benefits the family by recapturing significant portions of the cost of third party insurance. As a result, the owners/insureds participate in controlling the underwriting, claims and investment decisions of the insurance company, ultimately profiting from the experience gains of the company and realizing any reduced risk management cost savings.

The many reasons to start or continue using a captive tend to change in priority as the needs of the owners evolve over time; therefore, it is essential to establish the right structure from the beginning. A properly structured captive in the correct jurisdiction will provide the flexibility required to maximize its long-term utility for the owners. Corporations and business owners use captive subsidiaries in order to retain favorable underwriting experience, maximize the benefits of self-insured retention, lower insurance costs and increase cash flow and investment income. Under Internal Revenue Code Section 831(b), captive

property and casualty insurance companies are currently allowed to annually receive \$2.2 million in revenue tax-free<sup>13</sup>, while the owners/shareholders of the captive are currently taxed at fifteen or twenty percent (depending on the taxpayers' adjusted gross income), plus possibly 3.8% for the so-called "Obamacare tax" upon any distributions out of the captive.<sup>14</sup> The captive ownership structure serves as a powerful vehicle to obtain less expensive, more controlled and customized insurance coverage with a tax-deductible reserve and transition business earnings outside of the estate to heirs as owners or shareholders of the captive on a tax-advantaged basis.

#### DODD-FRANK COMPLIANCE

The Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) effected sweeping global financial regulations in the family office space.<sup>15</sup>

The Dodd Frank Act provided for full extraterritorial application and enforcement. Prior to the passage of the Dodd-Frank Act, any investment adviser with fewer than fifteen clients was exempt from registration as a registered investment adviser under the Investment Advisers Act of 1940 (IAA).<sup>16</sup> The old rules (which exempted family offices with fewer than fifteen clients under the Private Adviser Exemption or those with under \$25 million in AUM) were replaced with much

more specific, better delineated rules with significantly more complexity. Pursuant to these rules, a family office is defined as an entity which only provides advice to "family clients," is wholly owned by family clients and controlled by family members, and does not hold itself out to the public as an "investment adviser."<sup>17</sup>

The Securities and Exchange Commission (SEC) has defined family clients as current and former family members, key employees, and certain charities, trusts and not-for-profit organizations funded by family members or key employees. A key employee is defined as a person who is either an officer, director, trustee, general partner or person in a similar capacity at the family office, an affiliate of the family office, or a person employed by the family office or an affiliate for at least twelve months who participates in the investment activities of the family office in the course of the employee's regular duties. If investment advice is provided to entities that are not family clients, then those officers, managers or entities need to register as investment advisers under the IAA and the Dodd Frank Act. Whether or not a person or entity is providing investment advice is determined by a facts-and-circumstances analysis.

13 - The Protecting Americans from Tax Hikes Act of 2015 increased the maximum annual premium exclusion limitation from \$1.2 million to \$2.2 million with a provision for future inflation adjustments, effective January 1, 2017.

14 - IRC § 331 (2016).

15 - See 12 U.S.C. § 5301 – 5641 (codifying the Dodd Frank Act).

16 - See 15 U.S.C. § 80b-1 – 80b-21 (detailing the provisions of the IAA).

17 - 17 C.F.R. § 275.202(a)(11)(G)-1.

## REGISTERED INVESTMENT ADVISERS

A registered investment adviser (RIA) is an investment adviser registered with the SEC or a state's securities agency. The United States SEC regulates investment advisers under the IAA and the rules adopted under that statute. If an individual or firm meets the definition of "investment adviser" under section 202(a)(11) of the IAA, registration with the SEC is required unless they are exempt or prohibited from registration. Under the IAA, an RIA is a person or firm registered with the SEC that: (1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports or furnishing analyses on securities, either directly or through publications.

A person or firm must satisfy all three broadly construed elements of the definition to be regulated under the IAA. The receipt of any economic benefit will satisfy the compensation element. The business element is deemed to be satisfied even if an investment advisory business is not the person's or firm's principal business activity if the person or firm holds himself or itself out as an investment adviser or as providing advice, the person or firm receives separate or additional compensation for providing advice about securities or the person or firm typically provides advice about specific securities or specific categories of securities. The third element, providing advice about securities, is satisfied if the advice relates to securities (i.e. advice about market trends, advice

concerning the advantages of investing in securities or merely providing a list of securities to a client, even if the adviser does not make specific recommendations from the list).

Section 202(a)(11)(A)-(E) of the IAA expressly excludes certain persons or firms from the definition of an RIA. In addition to these exclusions, the IAA gives the SEC the discretion to exclude other persons or firms not within the intent of the definition of an investment adviser who should be registered. Additionally, a person or firm that does not meet the criteria in Section 203A of the IAA or Rule 203A-2 is prohibited from registering with the SEC as an RIA. Generally, since the Dodd-Frank Act was enacted, investment advisers with AUM in excess of \$100 million are now required to register with the SEC, subject to certain exceptions. Under the IAA and its related rules, the following three categories of advisers arise: (1) Small Advisers; (2) Mid-Size Advisers; and, (3) Large Advisers. Small Advisers with less than \$25 million in AUM are generally prohibited from registering with the SEC, and must register with state regulators, unless an exemption applies. Mid-Size Advisers with \$25 million to \$100 million in AUM are also generally prohibited from registering with the SEC, and must register with state regulators, subject to certain exceptions and the "buffer rule" for advisers with between \$100 million and \$110 million in AUM that is contained in Rule 203A-1(a). Lastly, Large Advisers with \$100 million plus in AUM are generally required to register with the SEC. RIAs are

held to a high fiduciary standard and are obligated to obtain the “best execution” of clients’ transactions.

### **BROKER-DEALERS**

Other SEC rules may require family offices to register as “broker-dealers.” The applicable provisions of the Securities Exchange Act of 1934 (Exchange Act) covering the registration of broker-dealers are contained in Section 15 of the United States Code.<sup>18</sup> Section 15(a)(1) states that it is illegal for a broker-dealer to use any means or instrumentalities of interstate commerce to “effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security,” unless registered with the SEC. Section 3(a)(4) of the Exchange Act defines a broker generally as “any person engaged in the business of effecting transactions in securities for the account of others.” Section 3(a)(5) defines a dealer generally as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.” The definition of the phrase “engaged in the business” comes from case law and SEC no-action letters. According to these sources, when determining whether a person is engaged in the business of buying and selling securities, an important element to consider is the regular participation in securities transactions.

In addition, family offices may be required to report as

the manager of hedge funds or private equity funds, as an institutional investment manager under Section 13(f), or as a control person under Section 16 of the Exchange Act. Moreover, family offices who are RIAs may have to make additional disclosures if regulatory AUM exceeds \$150 million pursuant to a recently issued joint rule by the SEC and the Commodity Futures Trading Commission (CFTC). Further, family offices may be required to file notices of exemption or register with the National Futures Association (NFA) as a commodity trading adviser (CTA) if the family office provides advice regarding certain investments or makes such investments, including commodities, derivatives, futures or options or as a commodity pool operator (CPO) operating a fund for multiple investors.

Overall, the reaction to these regulations by most SFOs has been to undertake nearly herculean steps in order to avoid registration. This often extreme reluctance to register as an RIA or broker-dealer stems primarily from concern over increased costs and unwelcome administrative work, loss of privacy and confidentiality and unwelcome government intervention into private lives. The most common approaches include wholly outsourcing the investment function, eliminating funds and qualified plans which include non-family client investors and making contributions of non-family client funds held in foundations.

18 - See 15 U.S.C. § 78o(a)(1) (discussing registration of brokers and dealers).

## PRIVATE TRUST COMPANIES

A Private Trust Company (PTC) is chartered under state law as a trust company that provides trust and fiduciary services to an affluent family or SFO. Once established, private trust companies act as the independent trustee for the family's trusts. A PTC can be structured to meet the requirements of an independent fiduciary, where the trustee must be a corporate trustee and the family desires to retain greater control over the administration of the trust. This is especially common where the trust agreement (often an older agreement) calls for a corporate fiduciary, or the trustee succession has resulted in a successor corporate trustee. Note that a PTC tends to be a captive entity because it is owned and controlled by the family. For some families, this high level of control is what they are seeking over a traditional corporate fiduciary relationship.

If a family office implements a PTC to which it delegates investment advisory functions, they can avoid the Dodd-Frank Act registration and compliance burden.<sup>19</sup> Certainly, not all families with family businesses or family offices will benefit from creating and maintaining a PTC, and the costs of establishing a PTC can be very high. Nevertheless, given the right set of circumstances, the addition of a PTC can complement the family office and family businesses. Because family needs differ, there is no

specific level of wealth that determines when the need for a PTC may arise, but there are some general industry guidelines. Industry experts believe that the investable asset threshold is approximately \$250 to \$500 million for an SFO and \$20 million for an MFO. While the MFO threshold is much lower, other factors are typically involved. Families consider the services of an MFO when they feel they no longer can manage (or no longer desire to manage) the family wealth from a complexity perspective, and the family generally believes there is enough accumulated wealth to outlast the controlling generation's lifetime. For a family in need of a PTC, many of the same attributes for a family office can be found, with the additional goal of more control over the trustee, and less concern for the cost of implementing and maintaining the PTC. The family will seek to replace an existing corporate trustee with a captive, family-friendly trustee that will cater to the family's needs while satisfying the requirements of a corporate trustee.

The family's PTC is controlled by the family, but governed by specific corporate governance provisions of the company. A common arrangement is to have a board of directors for the company comprised of a significant number of family members. That family-controlled board can then hire outside advisers to handle the day-to-day operations of the trust company. If a corporate fiduciary previously acted

19 - Handler, T., "S.E.C. Registration of Family Offices: Private Trust Companies May Provide One Avenue of Relief." *Trusts & Estates Magazine*. 2011.

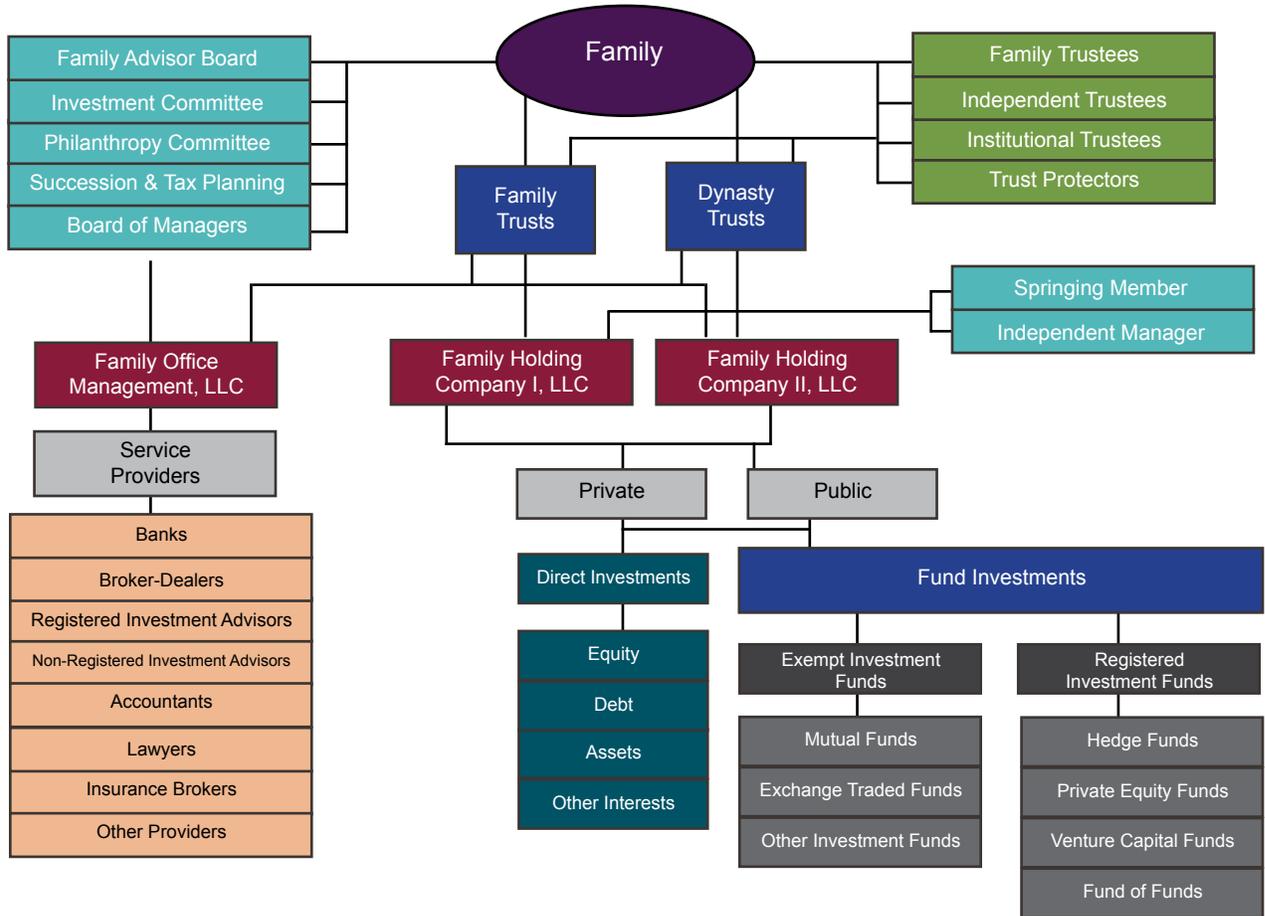
as the trustee and custodian over the family's trust assets, that corporate fiduciary may very likely be retained by the PTC to serve in a custodial or administrative capacity. Thus, the family maintains fiduciary decision-making control, a potentially uncomfortable role for the corporate fiduciary that continues to act in a custodial capacity, a routine function for the corporate fiduciary.

### **COMPREHENSIVE, INTEGRATED STRUCTURES**

While early family offices were often organized inside of dynastic trusts, providing very little or no control to the proprietary family, the succeeding generation of family offices were almost universally stand-alone entities not integrated into a family's tax, financial, premarital or asset protection planning. Accordingly, these family offices provided services required by the families but did little to further family advanced planning, education and governance objectives. In the last twenty-five years, modern family offices have increasingly been structured to integrate with the subject family's advanced planning goals and structures. The inclusion of family holding companies, the cornerstone of high-end, global advanced planning, is a key element of modern family office structures. Such companies can be structured as family limited partnerships (FLPs), family limited liability partnerships (FLLPs), family limited liability companies (FLLCs) or series family limited liability

companies (SFLLCs). The determination of which entity is best depends on the country, state or province of organization, the states or provinces of operation and the family's perception of the importance of cost efficiencies, liability, asset protection and premarital planning. State and local income tax or franchise tax treatment of specific family holding companies may be a determinative consideration. Another key consideration is that pro rata distributions from those entities will be advisable in the United States and other countries where discounting of the underlying assets is sought for estate planning purposes.

Chart 5  
Anatomy of a Modern Family Office



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## FAMILY HOLDING COMPANIES

Family limited liability companies (FLLCs) are the cornerstone of any sophisticated UHNW estate plan. FLLCs centralize asset ownership and isolate and protect various personal assets and activities. FLLCs are a fundamental piece in several financial and business planning areas, including asset and creditor protection, estate planning and tax planning. Managing significant assets properly can be a business in and of itself. Thus, FLLCs are a business, ideally managing a diverse group of assets, such as various business entities, mutual funds, public securities, other private securities, real property (typically not the primary residence), vacation homes, rental properties, collectibles, insurance, etc. As the value and diversity of the assets in an FLLC increase, so too does the entity's business purpose and ultimate effectiveness. When properly administered, FLLCs protect assets from liability and are the most powerful domestic financial and tax planning vehicle available today.

Another key feature of FLLCs is the power created when multiple family members contribute their assets to an FLLC. Pooling resources allows the participating family members to obtain greater asset diversification than is available on an individual basis, provides access to investment opportunities and managers previously out of reach and increases leverage, affording the potential to negotiate lower management fees. Additionally, since participation in

an FLLC managed by a family office is limited to family members, FLLCs' investment philosophy and policy statements can be tailored to the family's unique situation, unlike commercial investment products commonly offered to individual investors on a take-it-or-leave-it basis.

Using an FLLC to own personal assets offers a significant layer of asset protection in the event of litigation, and also protects against lawsuits involving other members. The liability protection associated with an FLLC is derived from the courts as well as protective statutory provisions, which in desirable states limit judgment creditors of the members to the exclusive remedy of a "charging order" for recovery of the judgment. Charging orders protect by only offering a creditor the right to "step into the economic shoes" of a member as a temporary assignee until the judgement is satisfied. This essentially provides that the holder of the charging order will receive payment if and only if there are distributions to members, similar to garnishment of wages.

Family limited partnerships (FLPs) are often used for wealth preservation, asset protection, estate planning and tax planning. Some countries and their geographic subdivisions that have not authorized limited liability companies (LLCs) as well as a number of countries with LLC statutes have also authorized limited liability partnerships (LLPs). A family limited liability partnership (FLLP) can be created by two

or more family members who want to operate a family business. The LLP business structure is similar to a general partnership with the same taxation and management organizational structures.

Unlike a general or limited partnership, LLPs allow all partners to enjoy limited liability depending on the jurisdiction. Some states and countries, including Canada, have provided for the formation of LLPs. LLPs tend to be a common business organization choice among professionals because of the limited liability given to all partners. Furthermore, since LLCs are not an option in Canada, LLPs are a popular tool to reduce the liability of the members while maintaining the tax benefits of a partnership. However, it should be noted that the rules regarding LLPs vary from jurisdiction to jurisdiction. Some states and Canadian provinces only allow LLPs for professional organizations such as lawyers, accountants and architects.

The main advantages of an FLP, FLLC or an FLLP are: (1) they facilitate the transfer of large or small slivers of investment property without having to re-title the underlying property; (2) they help protect against creditors of an owner (when the entity has more than one owner); (3) they help protect the status of non-marital property (such as family businesses); and, (4) if a given interest in an FLP, FLLP or FLLC has the right conditions, it may qualify for valuation discounts reducing the amount of gift, estate, inheritance or

generation-skipping transfer tax.

### **SERIES FLLCs**

A limited number of states allow for the creation of series LLCs. The series FLLC entity contains separate protected cells or “series” within one LLC without the need to create separate entities, thus avoiding inefficiencies associated with multiple related entities. For example, the Delaware LLC Act, used most often when establishing series LLCs, allows the operating agreement to designate distinct series of members, managers or LLC interests with separate rights and duties regarding specific LLC property or obligations. Therefore, each series may be tied to specific assets and may also have different members and managers. For example, if a series LLC is comprised of Series A, B, C and D membership interests, a successful lawsuit against Series A would not adversely impact Series B, C or D, even if Series A was forced into bankruptcy. Like a cell, the separate Series is effectively treated as a separate subsidiary or affiliate that can be severed at any time.

Each series must be run as a separate, independent business (per statutory requirements).<sup>20</sup> Each series must have its own bank account and must maintain a separate and distinct set of records. The manager must also maintain records for the company as a whole on a consolidated basis. The commingling of any funds is forbidden by statute. Failure to abide

<sup>20</sup> - See generally, Del. Code tit. 6, § 18 (1992); 805 ILCS 180 § 1 (1994).

by these requirements could result in a series being disregarded and expose the assets of the non-compliant series to additional liability.

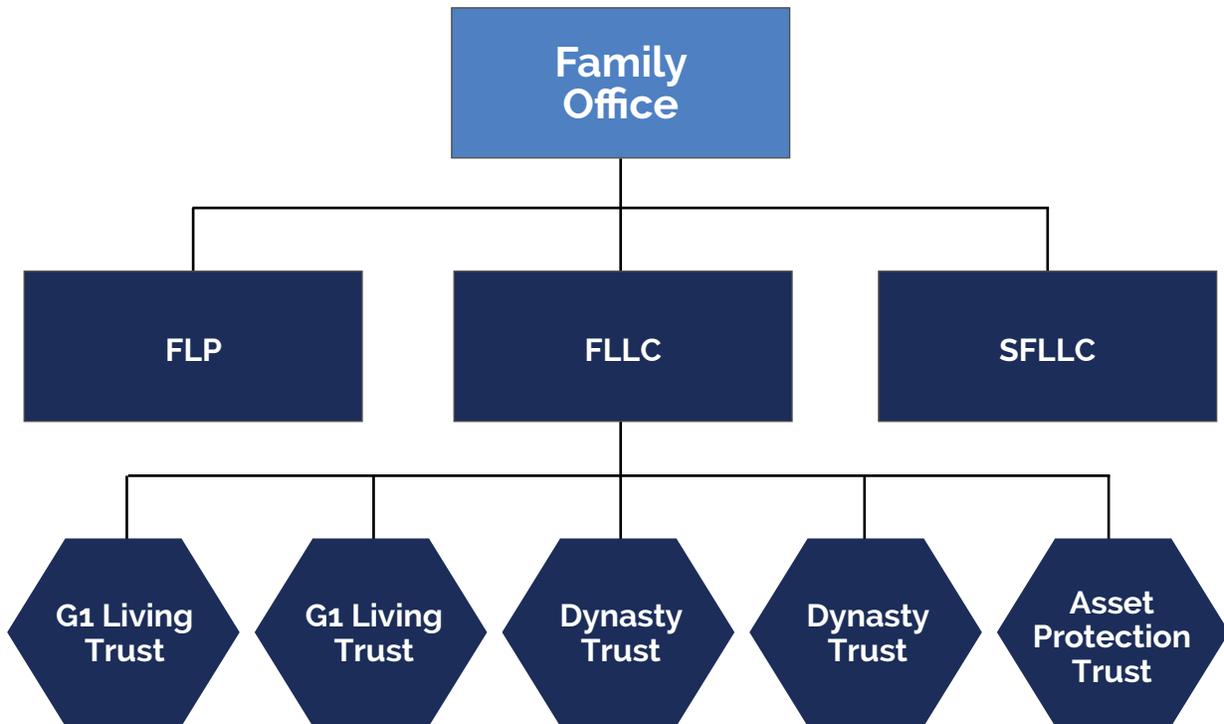
In an integrated, modern advanced planning structure, the family office typically serves as the general partner of FLPs or as the manager or managing member of LLCs and SLLCs. In turn, all of the interests in the holding organizations are held in various family trusts. Funding is achieved by transferring family holding company interests to such trusts, or by having existing trusts transfer assets in return for such interests. Generally, these are not taxable transactions for U.S. income tax purposes. In this manner, a family has the ability to achieve numerous advanced planning goals, including income tax efficiency, gift and estate tax discounting, liability protection, asset protection, premarital planning and financial efficiencies. This comprehensive, integrated strategy reflects the current global, best-in-class foundational advanced planning structure for UHNW families.

An emerging best practices concept is the establishment of a Family Support Fund to support the long-term efforts of the family, including paying for its faculty, annual meetings, educational seminars and similar ongoing expenses. Using dedicated funds to cover such meetings and educational events encourages family members to participate. These funds are traditionally being held in family holding

companies, such as in a separate series of an SLLC or in a separate, dedicated LLC or LLP.

A relatively new version of this concept is to establish a dedicated trust for this purpose, sometimes called a Family Advancement Trust. While this concept can be similarly effective, the liability protection and asset protection afforded by LLC entities set up in several states or in various countries providing for statutory exclusivity of the charging order as the sole remedy is far superior and more likely to yield long-term results.

Chart 6  
Integrated VFO/SFO Structure



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**DEFINITIVE CONSIDERATIONS**

FATCA – The Foreign Account Tax Compliance Act (FATCA)<sup>21</sup> was enacted to enable the United States Treasury Department to discover and trace broadly-defined international accounts held in all FATCA treaty countries. It imposes a thirty percent withholding tax on payments of interest, dividends, rents, royalties and certain other types of income sourced in the United States to foreign financial institutions (FFIs).<sup>22</sup> Generally, a foreign private investment entity will be classified as an FFI and must enter into an agreement with the IRS to avoid the withholding tax

on certain payments made to the foreign entity.

Therefore, certain family offices need to pay special attention and register their FFI with the IRS to avoid the withholding tax.

**COMMITTEES** – Each family office should consider implementing a number of standing committees assigned with specific tasks. For example, one of the most important committees is one that will oversee investments and distributions. Other common purposes for committees include philanthropy, family education and strategic planning. A tax committee,

21 - 26 U.S.C. §§ 1471–1474, § 6038D.

22 - "FATCA Information for Foreign Financial Institutions and Entities." Internal Revenue Service. 1 Jan. 2016. <<https://www.irs.gov/Businesses/Corporations/Information-for-Foreign-Financial-Institutions>>.

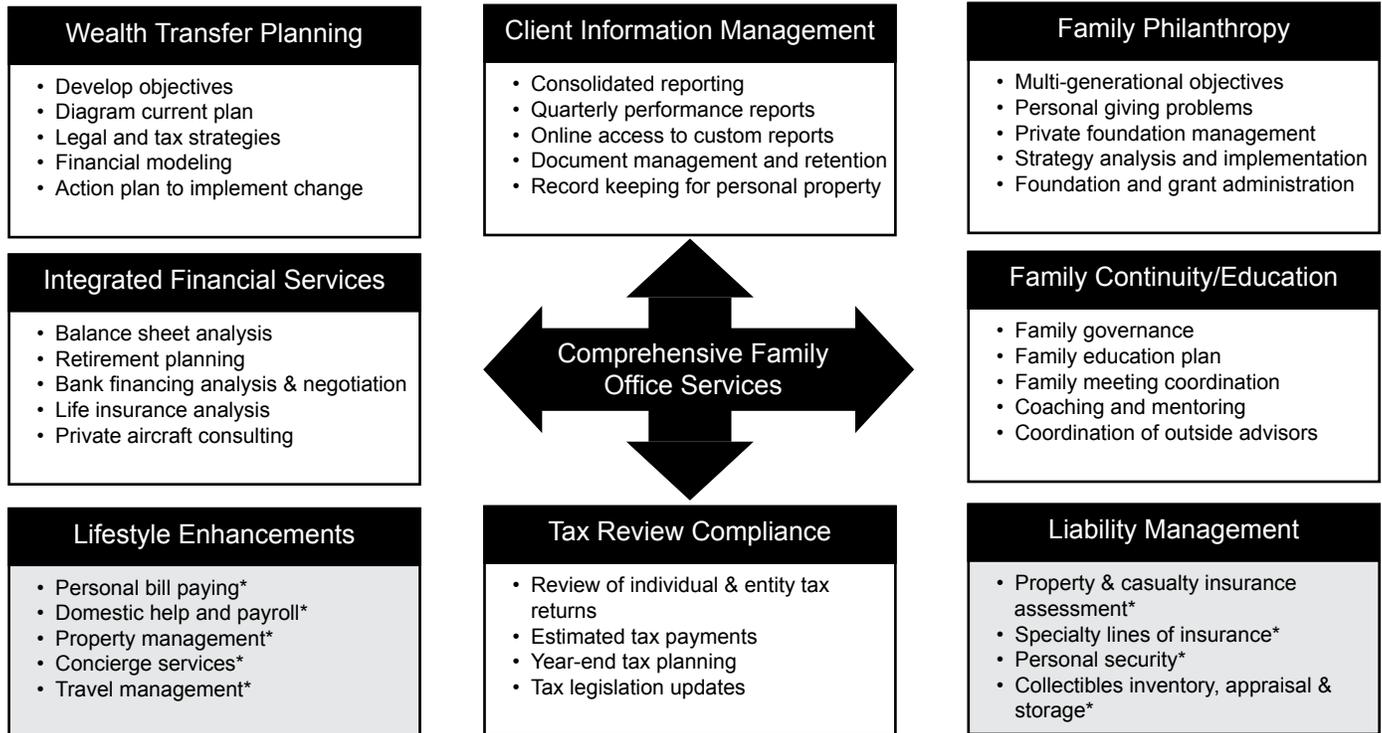
although not common, can be very effective in focusing the family office on net investment results, tax planning, estate planning and tax strategies and goals.

If family members have the skills and qualifications to run the family office without the use of external management or advisers, the use of family office committees should be implemented as part of the envisaged governance structure. Such committees could also include social responsibility, succession planning, philanthropic giving, distribution, family constitution, family council, community giving, faculty compensation or any other committees that a family office wishes to establish as they move forward. These committees may be classified as advisory committees or empowered with full voting authority. The addition of committees helps establish the business purpose necessary to support the deductibility of expenses incurred by the family office related to each of these initiatives.

**POTENTIAL FAMILY OFFICE SERVICES** – Generally, a family office provides services to the family which are more personal in nature as services are customized to address a wide spectrum of long-term financial needs. Further, which comprehensive services the family office provides determines, in part, what structure should be implemented for the family. For example, one service family offices can provide is

wealth transfer planning. Inside this service, the family office develops objectives, diagrams current plans for legal and tax strategies and develops action plans to implement necessary changes. Family offices can also provide integrated financial services, where the family office focuses on retirement planning, bank financing analysis and negotiation, private aircraft consulting and life insurance analysis. Tax review and compliance is another service platform the family office can provide, in which a review of individual and entity tax returns is conducted, estimated tax payments are made and tax legislation updates are provided to the family. The family office should also provide information management services in order to produce quarterly performance reports and record keeping for personal property. Liability management, lifestyle enhancements, family continuity/education and family philanthropy are other service platforms that can be used by the family office in order to meet long-term needs.

Chart 7  
Family Office Services



\*Outsourced to third-party providers

**GOVERNANCE, STRUCTURE & DOCUMENTS** – It is recommended that each family office implement a Compliance, Policies and Procedures Manual<sup>SM</sup> where the governance and structure of the family office is documented. This set of policies and procedures sets rules, guidelines and long-term goals that all persons must follow in the family office structure. It also provides some protection should the structure of the family office be called into question.

A Compliance, Policies and Procedures Manual typically includes the mission, vision, values and objectives of the family office, in addition to the code of ethics, family constitution, trading practices, accounting procedures, privacy policy, conflict of interest policy, annual review, business plan, employee handbook and transaction log, as well as the family tree. This manual also provides guidance for the committees of the family office and describes any established rules and protocols.

Chart 8  
Family Governance Components

<b>Constitution</b>	<b>Preservation of Family Values</b>	What is it that matters most to your family and its business? A mission statement and/or family constitution can articulate your family's core values and keep you moving forward.
<b>Council</b>	<b>Responsible Governing Body and Use of Outside Board Members</b>	The family enhances the strategic effectiveness of the governing body by using the expertise and experience of non-family professionals as board members to broaden insights and avoid insular thinking.
<b>Assembly</b>	<b>Leadership Training for the Next Generation</b>	What steps does your family take to encourage stewardship instead of a sense of entitlement? Avoid the "shirtsleeves to shirtsleeves" phenomenon with structure and guidance.
<b>Process</b>	<b>Efficient Decision-Making Conflict Resolution Process</b>	Create a process for solving conflicts and presenting new ideas; it can minimize discord within the family and create an outlet so that each member is heard.

**TAX AND LIABILITY ISSUES**

Some of the most important considerations in determining choice of domicile for a family office are income taxes, liability protection, asset protection, executive compensation and benefits. Since some countries and their geographic subdivisions do not impose income tax or franchise tax on certain structures, such jurisdictions should be analyzed and considered. For example, some jurisdictions impose franchise tax based on an entity's balance sheets

rather than as a fixed fee per entity. Such jurisdictions are generally avoided while low, fixed-fee franchise taxes are preferred. This is so even though most family offices do not themselves hold significant assets.

Income tax benefits can be derived from the nature of compensation paid to family office structures. Family offices typically derive revenue from three sources: (1) management and service agreements; (2) reimbursement of professional fees, costs and

expenses; and, (3) carried interests in the profits and losses of integrated family holding companies. The carried interest is often used to align economic incentives of family office investment professionals with family investment objectives and benchmarks. In addition, because carried interest profits come out of income, such payments are not subject to various Internal Revenue Code (IRC) limitations. Moreover, such payments are efficient because they also offset state and local taxable income.

Because the family office is a control entity, the asset protection issues are inordinately important. If it controls FLPs, FLLCs or other holding companies in an integrated structure, it becomes an attractive alternative target for litigants and creditors. Consequently, selecting a jurisdiction where control of the family office cannot be successfully attacked and secured is a critical step. If a plaintiff were able to seize control, that plaintiff would also have full control of the family holding company for which it serves as general partner, manager or managing member. If significant executive compensation, benefits and resources are needed to recruit and retain personnel including family members, these forms of compensation and benefits are more efficient in C corporations where the individual employees are less heavily taxed on such compensation. Similarly, where the family office generates a modest profit, corporations are taxed at lower brackets

than individuals receiving pass-through income from conduit entities. Accordingly, a tax arbitrage advantage can be gained. Further, deferral of such income can be effected for one year in perpetuity by using a fiscal year if the necessary election and contract terms are appropriately structured.

A family office is typically established as a separate legal entity to serve as a single-function or multi-function shared services center to support the investment and wealth preservation strategies of family holding companies. By centralizing certain back office and personnel functions, companies can simplify and standardize processes, achieve economies of scale, consider outsourcing options, and provide services to third parties. Although it is possible to achieve these benefits without one, a separate legal entity can help isolate service-related costs and liability.

Along with the efficiencies a service platform can provide, if structured appropriately, the service entity can take advantage of the many tax-favored executive employee compensation, benefits and perks available under the IRC.

#### **TAX FAVORED FRINGE BENEFITS**

From a tax savings perspective, fringe benefit planning can achieve considerable results. The family office would be able to deduct the cost of these qualified

benefits to save on its taxes so long as they were reasonable and necessary to perform the family office's services; yet (if the family office made a C-corporation election) the recipient would not have to pay current taxes on the value of the benefits received. The following is a brief synopsis of the most common fringe benefits used by family offices. It should be noted that there are limitations, compliance issues and non-discrimination rules for each particular fringe benefit, which are beyond the scope of this white paper.

**HEALTH & ACCIDENT INSURANCE** – The cost of health and accident insurance to benefit employees, their spouses and dependents may be deducted by the family office. Further, benefits received under an insured plan are generally not taxable to an employee according to IRC Section 105(e). Similarly, long-term care insurance is treated as health insurance. Therefore, the value of employer-paid coverage is excludable from an employee's income as are contributions to a health plan.

**MEDICAL EXPENSE REIMBURSEMENT PLAN** – A medical expense reimbursement plan (MERP) is a plan or arrangement under which an employer reimburses an employee for uninsured health or accident expenses incurred by the employee and his or her dependents. Health or accident expenses in this context are defined in IRC Section 213(e). The most common type of MERP

for a family office or small business is a self-funded health plan, whereby the employer purchases health insurance coverage (discussed above) which is then supplemented by the MERP which pays all health care costs not covered by insurance. Typically, this includes co-pay amounts, deductibles, second opinions, etc.

Alternatively, an employer can establish a MERP as a self-funded plan whereby it chooses not to insure health care benefits, but rather to self-fund these benefits on a tax-deductible basis.

Some of the services which may be reimbursed under a MERP include any reasonable, necessary and customary charges incurred for medical services including amounts paid for:

- services of licensed practitioners of the healing arts acting within the scope of the license, including specialists such as psychiatrists;
- hospital room and board charges up to an amount equal to the hospital's semi-private room rate; charges for private room and board will be considered covered medical expenses to the extent of the hospital's most common semi-private room rate;
- other hospital services required for medical, surgical care or treatment; oxygen, anesthetics and their administration; X-rays and other diagnostic laboratory procedures; nursing services

(where paid by the member); annual physical examinations conducted by the individual's physician; medical, laboratory, surgical, and dental services; oral surgery and other healing services;

- medicine and drugs which are legally procured and which are generally accepted as falling within the categories of medicine and drugs; eyeglasses and hearing aids and examinations for their prescription or fitting; and,
- transportation primarily for and essential to medical services.

MERPs are also frequently found inside cafeteria plans in the form of Medical Flexible Spending Accounts. It is permissible, however, to implement a medical reimbursement plan alongside a conventional health insurance plan (to reimburse amounts not covered by insurance) and outside of a cafeteria plan. This may be appropriate in situations where significant uncovered health costs are expected.

MERPs offer advantages to both the employer and the employees. The medical expense reimbursements are tax deductible by the employer and the employer has flexibility in the design of the plan's provisions, such as establishing maximum amounts for reimbursement and setting eligibility requirements for participation. The biggest advantage to employees is that the plan's reimbursement payments are not considered to be taxable income to the employees, provided that they have not taken a medical expense deduction for these

amounts on their personal income tax return.

The insurance industry is currently shifting more of the costs related to medical care onto their customers.

Unfortunately, the current trend appears that it will not subside anytime soon and is likely to be exacerbated pursuant to the national health care program.

Undoubtedly, as employees begin to age, these costs could quickly skyrocket, forcing such employees to liquidate assets. Use of the MERP allows an individual to pay for out-of-pocket medical expenses with pre-tax dollars. Further, if an employee paid for the same medical expenses personally, he or she would have to meet a certain minimum threshold for claiming a deduction, and even after meeting this threshold the employee could end up only getting to deduct twenty percent of the amount paid above the threshold. With a MERP, however, the employee would be entitled to a dollar-for-dollar offset.

**LIFE INSURANCE** – Group-term life insurance up to \$50,000 in coverage for employees, and up to \$2,000 coverage for employee spouses or dependents is a tax free benefit. Beyond that limit, a portion of premium cost may be taxable, but usually at far lower rates than if privately obtained. Certain other types of life insurance arrangements (such as split dollar or generational split dollar) may be set up with some limited tax-free or tax-deferred benefits.

**DISABILITY INSURANCE** – The premiums paid by the

family office for a disability insurance policy are a tax-free benefit to employees. A disability income plan is a plan that provides income replacement benefits to employees who are unable to work because of illness or an accident. The IRC provides an income exclusion for the cost of disability insurance coverage received from an employer.

**CONDITIONAL MEALS & LODGING** – Meals provided to employees on business premises, and lodging provided as a condition of employment—both for the employer’s convenience—are tax-free to the employee. The family office deducts the full cost of lodging, and 50% of the cost of meals.

**DEPENDENT CARE ASSISTANCE PROGRAM** – A dependent care assistance plan is a program sponsored by an employer to provide care for employees’ dependents. Benefits may take the form of employer-provided cash, cash reimbursement for dependent care expenses incurred by the employee, or both. If the dependent care assistance program satisfies certain requirements, dependent care is excludable from an employee’s income up to specified limits. The maximum annual exclusion is \$5,000 if the employee is single or is married and files a joint tax return, or \$2,500 if the employee is married and files a separate tax return.

**QUALIFIED RETIREMENT PLANS** – Contributions to a qualified retirement plan made by employers and

employees may be deducted. Various limitations restrict the amount of allowable contributions depending on the type of plan and participation percentages. Examples of such plans include: SEP, Sar-SEP, SIMPLE, Keogh, 401(k), customized Defined Benefit and Defined Contribution plans.

**EDUCATION ASSISTANCE** – A tax-qualified education assistance plan can provide employees with up to \$5,450 per year of tax-free educational assistance under IRC Section 127.

**DEFERRED COMPENSATION** – Deferred Compensation Plans allow businesses to defer paying an employee for current work until a future date. Such plans can be a good tax saving tool in situations where the expectation exists that the tax bracket for the recipient may be lower in future dates versus the current date. This is primarily a tax-deferring benefit, and the family office takes the deduction for the paid compensation at the future date as well.

# CONCLUSION

As family offices continue to proliferate and evolve in the twenty-first century, increasingly their structures will become more sophisticated, taking into account numerous and often competing wealth management objectives. This development will occur around the globe and new family office structures will be better integrated with the tax, estate, risk management, premarital planning and asset preservation planning strategies adopted by proprietary families. In order to develop, implement and operate these increasingly efficient and sophisticated structures, a developing network of high-end global advisers<sup>23</sup> will be required. Increasing globalization will drive the development of global best-in-class structures, strategies, practices

and protocols delivered by multi-jurisdictional family offices and their affiliates. This dynamic area of family enterprise wealth management will provide leading strategies to UHNW families exiting or diversifying out of family business enterprises as collaboration and cooperation increase. Accordingly, the future of the family office industry is bright and almost assured.

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23 - Rosplock, K. *The Complete Family Office Handbook*, Wiley/Bloomberg (2014).

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## ABOUT the AUTHOR

# Thomas J. Handler



Thomas J. Handler is an advanced planning attorney that represents primarily family offices and family businesses. He has been named to the list of Top 15 Wealth Planners in the United States, the City Wealth Global Leaders List of Top 100 U.S. Attorneys, Who's Who in American Law, Who's Who in America, Lawyers of Distinction and Leading Lawyers. In 2015, he was named International Wealth Planner of the Year and Wealth Planning Gamechanger Lawyer of the Year in addition to receiving the Michael J. Brink Award for Leadership and Service to the North American Family Office Industry.

Handler Thayer, LLP was named Best Private Client Law Firm in North America in 2012 and 2013, Best Private Client Law Firm in the United States in 2013, 2014 and 2017, Most Effective Private Client Legal Team in North America in 2015 and 2016, and Best Overall Law Firm in the United States in 2012 and 2015.



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FOA is the community leader in serving all the key imperatives for ultra-high net worth families, respecting your privacy but enabling an intimate community of global families like yours. Our organization delivers private education and networking opportunities, proprietary research, and access to salient thought leadership that will interest all generations of your family.