The Family Office Association Audio Series: Volume 6 with David Berek,

Legal and Tax Structures in Organizing or Restructuring a Single Family Office
FOA Audio Series Volume 6
Legal and Tax Structures in Organizing or Restructuring a Single Family Office

Copyright © Family Office Association and Angelo Robles. All rights reserved. This white paper or parts thereof may not be reproduced in any form or redistributed for commercial use. For more information about this publication, please contact angelo@familyofficeassociation.com.

Disclaimer: The Family Office Association (FOA) is an affinity group dedicated primarily to the interests of Single Family Offices. FOA is intended to provide members with educational information and a forum in which to exchange information of mutual interest. FOA does not participate in the offer, sale or distribution of any securities nor does it provide investment advice. Further, FOA does not provide tax, legal or financial advice.

Materials distributed by FOA are provided for informational purposes only and shall not be construed to be a recommendation to buy or sell securities or a recommendation to retain the services of any investment adviser or other professional adviser. The identification or listing of products, services, links or other information does not constitute or imply any warranty, endorsement, guaranty, sponsorship, affiliation or recommendation by FOA. Any investment decisions you may make on the basis of any information provided by FOA is your sole responsibility.

The FOA logo and all related product and service names, designs, and slogans are the trademarks or service marks of Family Office Association. All other product and service marks on materials provided by FOA are the trademarks of their respective owners. All of the intellectual property rights of FOA or its contributors remain the property of FOA or such contributor, as the case may be, such rights may be protected by United States and international laws and none of such rights are transferred to you as a result of such material appearing on the FOA web site.

The information presented by FOA has been obtained by FOA from sources it believes are reliable. However, FOA does not guarantee the accuracy or completeness of any such information. All of such information has been prepared and provided solely for general informational purposes and is not intended as user specific advice.

500 West Putnam Ave, Suite 400
Greenwich, CT 06830
www.familyofficeassociation.com
@familyoffice
David Berek of Horwood Marcus & Berk Chartered, where he chairs their Family Office practice. David is an attorney very well regarded in the family office community.

Contact David: dberek@hmblaw.com
FOA Audio Series Volume 6: Legal and Tax Structures in Organizing or Restructuring a Single Family Office

Angelo J. Robles

Angelo J. Robles is Founder and CEO of the Greenwich, Connecticut-based Family Office Association (FOA), a global membership organization that delivers private educational and networking opportunities, proprietary research, and access to salient thought leadership to multiple generations of wealthy families and the professionals who run their single-family offices.

A member of the Princeton Council on Family Offices and the NYU Stern Family Office Council, Mr. Robles has a long record of leadership positions at top financial-service companies, including UBS. Before launching FOA, he founded and ran several successful entrepreneurial ventures: He served as President of the New England chapter of the Hedge Fund Association, and pioneered online retirement planning for Fortune 1000 executives with two Internet startups - 401KRollover.com and IRARollovers.com.

Author of several books and articles, Mr. Robles has appeared on Bloomberg Television and Radio, and has been quoted in the Wall Street Journal, Thompson Reuters, Institutional Investor, Opalesque, Registered Rep, HFM Week, Investment News, EurekaHedge, The Luxury Institute, Private Asset Management, The Greenwich Times and many other media outlets.

Contact Angelo
angelo@familyofficeassociation.com
(203) 570.2898
Family Office Association is a global community of ultra-high net worth families and their single family offices. We are committed to creating value for each family that we serve; value that grows wealth, strengthens legacy, and unites multiple generations by speaking to shared interests and passions. FOA has the resources to solve your most difficult challenges and help you achieve your collective goals: to invest intelligently, give strategically, and learn exponentially.

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.
Angelo Robles: Hello everyone, this is Angelo Robles at Family Office Association. In today's audio podcast about single family offices, I am joined by David Berek of Horwood Marcus & Berk Chartered, where he chairs their Family Office practice. David is an attorney very well regarded in the family office community. We are very fortunate to have him on the call today. David, how are you?

David Berek: I am doing just great, Angelo, thank you for including me on this call.

Angelo: What we are going to cover in the call today a focus on effectively what we are at FOA and the main purpose of our existence, the single family office (SFO). David’s breath of experiences are practically unparalleled in the community, having practiced accounting and legal as well as active in wealth management (all at a very high level) and working within a single family office. A mystery to many is the sequence and structures that make up the single family office. After initially covering some broader topics, we’ll dive into the private world of how to create a single family office, specifically from the perspective of structuring.

Before we get started with David, it is important to note that this is a very complex topic especially when we get to the structuring side of things. Our conversation will be broad. Your own individual situation varies. There is a phrase, you know one single family office, well you know one single family office. They are all snowflakes, different. Because each family is different and has different sets of family dynamics, investing focus, tax concerns, etc. Please consult with your own advisors for advice that would be specific to you. This is meant to be conversational and broadly from the perspective of a single family office educational, a conversation starter.

David on that point, let’s get right to it. Please start by giving our audience a brief overview of your experiences over decades in the community?

David: Angelo, I think my background is unique in that I come to a client relationship with both an accounting background for 10 years and a legal background the past 17 years. I have worked within a single family office and in a multi-family office (MFO) environment. And now I focus on practicing law solely to work with family offices. What I have seen over the past number of years through talking with a lot of family offices is how different families structure their family offices.

You mentioned – if you have seen one family office, you have seen one family office. Working for the institutional MFO offered
me the ability to see a number of different organizations and how they were structured; what led the family to enter into the family office structure; and what really motivated them to design their tax and legal structure. That experience was really helpful to me. Having the tax and legal background when I sat down with a family to hear about what drove them to structure their family office a different way was really interesting for me.

Angelo: There are so many important areas pertaining to the family office. Again, we are going to be a little bit more concentrated today on the structuring side given your core background. I think that is an area that the audience is hungry for. But everything really revolves around the family and the single family office, and family legacy issues, and family relationships, the family business: the family office management, and the philanthropic initiatives, a sequence in structure for decision making, effectively governance, investment performance, investing in private companies, etc.

I could go on and on - legal touches everything. Now, I am not saying to the audience out there that necessarily that legal should be the driving force. You want to have a holistic picture that brings it all together. What I am saying is that very few others really have the experience of understanding the complete picture like you. Let’s take a moment, David, given the breadth of your technical training and your background. Why is it that this “all inclusive holistic approach” for understanding taxes to investing, to family governance, and dynamics is so important? Why don’t you explain to our audience who may not quite understand and say “I just want an attorney to draw up what I want them to draw up, the structure?” Why is a more holistic touch so important?

David: It is a great question. I think most clients perceive the legal structure as just kind of it is what it is – part of the family office package. Families do not always spend a lot of time understanding it. They think it is going to be a basic structure like everybody else has. Most clients perceive the legal structure as just kind of it is what it is – part of the family office package. Families do not always spend a lot of time understanding it. They think it is going to be a basic structure like everybody else has.
reviewing their current structure, making recommendations, and modify the structure.

I came away with this premise, Angelo. It is top down and bottom up analogy; so top down is the family has these particular needs. This is what we want to accomplish with our family office. I usually say those are personal needs, like family governance, or consolidated reporting or some issue that affects the family.

The family wants a family office for certain reasons. Then they turn to the lawyer and say now go put one in place. The lawyer takes those inputs, these family dynamic objectives, and puts together the structure. But as we know, over time, things change.

You have to then do what I say is the bottom up analysis, and look at the structure that the family has in place. Is it adequately meeting the needs of the family? Look at the foundational legal structures that have been put in place. Are those still what we would design today? Because it could be the case that it was a great plan when implemented, but today, we would do something completely different. We would start from a completely different perspective. There may be a mismatch in the tax and legal objectives over time.

I think it is easier to recognize this mismatch when it is a personal issue. For example, a new generation comes along and has different needs. Everybody recognizes that. But how often do families step back and say “let us do an audit of our legal structure and make sure that we are hitting it on all cylinders.” We want to know if we are accomplishing what we want to from a tax and legal perspective.

Angelo: Absolutely, and maybe a sequence to follow up on that question. What type of changes in the family, the tax picture, and legal structures? This is like changing family dynamics but not in the usual sense. We discuss the term with family offices I guess, however not the personal side, right?

David: That is exactly right. It is a different way of looking at family dynamics. I think everybody can relate to changes in the family like a new generation, a new birth, a divorce, or the sale of a business. All of the advisors are on the same page, and say, “hey, let us take a look at how this impacts what we want to do going forward.” We have now had a big change - we have sold a business and...
have gone from a concentrated closely held business assets to liquid assets. What should we do now?“ These types of family dynamics are easy to trigger a review.

Something as dramatic as that going from a closely held business to liquid assets, advisors are probably going to step back and say, okay, we likely should now take a look at the legal, tax and legal structure. But what about just adding a new generation? We now have the long-term trusts that are being invested differently, much more for the future. Does that change the tax attributes that are being distributed out of the investment pool? Have the tax attributes changed to the family’s detriment? Is the family office structure still operating efficiently or in the manner that the family intended?

Additionally, tax laws change, everyone agrees with that. Recently in the past couple of years, we have had this issue with Section 469, which addresses passive losses, especially the treatment of passive losses in a trust. If a family had a structure set up with say an S Corp as the management company – very common in the 2000’s – that S Corp running the family office is potentially throwing off losses. That is usually a good thing or okay. That means you are running close to the wire. Hopefully the family is deducting as much of those losses as they can. Single family offices, from an operational sense, should be hitting about zero net income – break even. But if the family office is throwing off losses, and those losses are being sent to potentially the owners of a family office management company, which may be long-term trusts, you might have a mismatch, because the trust may not be receiving the full deductibility benefit of the passive loss.

You might inadvertently have non-deductible losses. That might lead to a discussion with the accountant to consider if the family is getting the right tax performance on our current structure. Perhaps a change in the investment component has changed the character of the income or losses flowing through, and that may trigger a tax and legal structure change. I have found that type of issue to be a little bit of a sleeper – one of the only sure methods to find those embedded tax leakage issues is to pragmatically collaborate with the advisor team.

Whether or not the family is going to be able to take a deduction – that may still need to be worked out. But I think families need to be on call to say I am going to monitor that. I am going to determine whether the S Corp is the right structure. Maybe we should re-organize into an LLC type structure. Those are the type of high level and broad examples that we want to be as attentive to as you are with the family
governance – but family governance may be easier. Generation three may understand the family governance program. They may not understand the passive loss deduction issue.

**Angelo:** Absolutely, and maybe again kind of trying to be sequential, I am assuming easier with a family new to wealth. Not only is their culture more streamlined in the liquidity of the entrepreneur, less family members, theoretically easier governance. I am assuming starting with a clean slate, the opportunity from a legal and incorporating the structure and tax side, we are going to get to that in a second.

But, I am assuming it is more complex in a family that has had wealth through the generations, and has family office entities; but maybe has not kept abreast of certain compliance and regulation. Certainly regulation that has been enacted in the last couple of years in terms of what qualifies as a single family office. I do not want to lump it all together. But I am assuming you could go into many existing SFOs and likely find a lot of areas that could be improved.

But, I think family offices need to look at their tax and legal structure just as often as they do the other side, the personal side. That worries me about the impetus that is going to make a family office do that. Assume you have an existing family office that has been operating in business for years: have they had operational family office reviews? Is the family office achieving the goals that the family originally set out to accomplish? Or, have those original goals been adjusted and the objectives been adjusted? Therefore, does that mean that we should potentially change our structure?

These are critical questions that need to be asked, Angelo. I have seen some longstanding historic family offices who decided to completely switch structures. They acted like a new family and just said we are going to design a new one. We are going to transfer over from one regime so to speak to another regime because now our objectives are different than when we started. We now have different goals. Our family office is bigger or it is smaller, or what have you. Being somewhat nimble and taking advantage of what the developments are I think are key.

**David:** Absolutely, and I think it should be part of a regular process to review. I think a lot of family offices are looking at the regulatory environment and saying should we do something about this?

**Angelo:** Indeed, getting perhaps to the focus of the call, and kind of the hook that I led with in the beginning. We are going to do a deep dive, well at least as much as we could in a relatively short conversation. I do understand
for those following along that it is going to get a little complicated. Without having visuals, it is probably going to be a little bit difficult.

We are going to do the best we could in effectively our audio podcast today. But you may have to put a little bit of your imagination, those listening into the recording. Maybe to streamline it a little bit as well. We are also going to probably do it from a basic or relatively basic single family office, to a somewhat more complex one.

David, for the audience listening in that is starting from scratch. They had a liquidity event. I hinted earlier that would be with an entrepreneur. They have their unique culture because it tends to be streamlined.

Let us make the assumption. They have their foundation prior to setting up the single family office, of family governance (mission, generational direction, stewardship, communication protocols etc.). Now comes a little bit of the secret sauce even for a relatively “simple SFO.” What comes next in terms of structures? Let us say they have half a billion dollars of liquid assets. How do they own the assets? How do they create whether it is an LCC, or S Corp, or other entity, the management company that is effectively the single family office?

Every family office has a similar basic structure. The family has the assets holdings in one of them. I will call that the investment holdings company, or the investment fund. The other structure is the management company. Two very distinct structures; one of them has all of the assets, the other has the management of those assets.

David: I agree, it is a little difficult without a visual. On the other hand, it causes the listener to pay more attention to the words that are being spoken! I think I can describe it adequately. I teach a family office class at DePaul University here in Chicago. What I do is I throw up three slides in a row. I say here is a really complex family office structure – lots of boxes. Then I go to the next slide and some boxes disappear. And then the simplistic version where we just have essentially two boxes. I want you to think of that concept (simplistic single family office). We have two fundamental structures. Every family office has a similar basic structure. The family has the assets holdings in one of them. I will call that the investment holdings company, or the investment fund. The other structure is the management company. Two very distinct structures; one of them has all of the assets,
the other has the management of those assets. There are a variety of ways to add more structure to that, but that is the basic single family office.

The duties that we house in the management company are not necessarily different than in a larger family office. As a family grows in wealth, you just add on more boxes around those two center piece structures. If they are a billion dollar family, you might have a lot of boxes surrounding it. But you can always break the structure down to those two basic functions: where the investments are and where the management of those investments occurs. This is where we start when we talk about the structure of a family office. What can that management company do to help the family and grow the investments?

If we can design the responsibilities of that management company to potentially replace what other outside advisors are doing, like consolidated reporting, or an activity, and some analysis. That management company begins to turn into its own operating business. What I am getting to now is business purpose. This is a critical juncture. The structure works, if you have the management company performing duties that support a business purpose. If the management company has responsibilities that are independently legitimate and that would be otherwise done by other advisors, then we will achieve income tax benefits from putting the structure in place.

To take this premise to its ultimate extreme, the management company could outsource absolutely everything, and it may then have no business purpose. That is what your average fifteen million dollar family is doing. When you start to pull activities and responsibilities in-house and you follow a prescribed responsibility list, you start to add to that business purpose. The management company is doing something, running a little business. That is your family office. You are able to pay for those activities by charging a fee to the investment fund. By doing that, you achieve income tax benefits that you would not otherwise have if you just held the investments. Because some expenses are either not deductible by the average taxpayer or severely limited by the average taxpayer.

That in a nutshell is what starts the tax conversation of why we might want in a family office. If you could break apart the family’s conversation into nice little buckets and say, we want a family office because we want good consolidated reporting, or, we want family governance, or we have multi-generational entities that need to be managed. We want to loop these responsibilities together. Another conversation is going to be where are we spending money in taxes? Where could we
develop efficiencies? That management company, if you can assign responsibilities and give it business purpose, we can achieve income tax benefits. Does that make sense, Angelo? Did I get too far in the weeds on that?

Angelo: No, actually, let's dive a little deeper into the weeds before we get to more of a mid-level or sophisticated single family office. The management company that effectively makes up the structure, the services performed, and housing the talent that is inside the family office. You bring up a critical point that again there is very little out there for the community to really understand by researching on their own. Is the single family office effectively deductible? You kind of answered broadly speaking; and again, we know each person's situation is going to be very unique and very different. Please seek your own guidance from trusted experts.

What are common mistakes that if they are doing it with an attorney or accounting firm that may not be as experienced in broadly defined single family office structures, where they could fail possibly in an audit; and have some of the deductions that were claimed now be taken away. Again, I know we are doing this a little bit blind on the phone call on an issue that is incredibly complex. What are some of the common mistakes that the average person with “less experienced advisors” in setting up a single family office are likely going to be made in the way that you described it?

David: I am going to start with what I think is the number one concern especially on an audit. That is going to be the substantiation of the business purpose; which is stepping back and saying why do we have a family office? What is the purpose of it? Here I am not talking about the personal or the wealth control side. I am talking about more the expense control side. What is it that the family office is going to do? Why do we have to create that management company? Let us get a very clear understanding as a family why we are creating it. What it is going to do? Then say, if it does those things will those be deductible?

This is pretty cut and dry. It is yes or no. The family may start off by saying we need a management company to oversee our aviation needs. We have to have someone running that now. It may be our accountant. Or it is just too cumbersome to constantly be calling the accountant for questions about this or...
that. There are a lot of filings. We just want to pull that in-house. If the sole responsibility is just managing the family airplane, I am going to say the family office structure probably is deductible. “Probably” is not the answer you want to hear from a tax lawyer, but just that function is pretty close. If you add a couple of more responsibilities, all of a sudden it is there – substantiated business purpose.

You have to step back and say: “we need a management company to do these things.” Once you identify what the family office management company is going to do, you are headed towards deductibility. Some of those expenses may not be deductible – that’s OK. Maybe the large vacation compound generates non-deductible expenses. You still need someone to take care of things there – that’s a responsibility for the management company to make. Run those decisions through the management company. The management company is doing something that is managing the assets. Although I have given an example of something that they are doing that may be nondeductible. But it adds to their business purpose. Best practice is to step back and put together that kind of direction and document it, very similar to a family mission statement. It is your business purpose documentation. When it comes to an audit at some point in the future, hopefully you do not have to run through that. But if you do, then you stay this is what we are doing.

This is the purpose of this management company. This is why we are taking a deduction for the services that are being provided – because we have thought this out. We are not going backwards and trying to manufacture an objective after the fact. We are not rewriting history. The family is saying from a prospective nature what they want to accomplish as the family. The family is identifying those responsibilities the management company can do. Therefore, you do not have any kind of management stray where they stop doing less or more one activity or another.

With a management company business purpose document, the family is constantly on top of it. Therefore, if there is a situation where someone has to explain to the IRS what it is that the company does, you know exactly what it does. You are on top of it. I have seen it with families where again, family dynamics change. They do less of this or that. They sell the compound. All of sudden, a large majority of the work that was being done by the management company is no longer needed to be done.

The family needs to determine whether the management company is still viable. Is it doing something that qualifies as a tax deduction? If
not, should we change that? Are we better off adjusting how we have set it up? Angelo, you asked me what were the number one risks? I would say that likely is the number one risk – that the family does not have clearly defined responsibilities of the management company. Therefore your tax deduction is in jeopardy. If that happens, you potentially fall into an audit situation. Nobody wants that. That is painful.

Angelo: One more question on that aspect. Likely a common function of a family office is going to be managing the investments. Whether it is starting with an investment policy statement, asset allocation, and execution; and whether internally or potentially through third party managers.

The function of the CEO, potentially a CIO, meaning Chief Investment Officer, and possibly if they are a larger family – analysts or those working under the CIO.

Those assets are now broadly defined as the other box in the “holding company.” We are probably trying to stick a little bit more to the aspect of a simple or a more basic single family office. I am actually jumping ahead of my next question. From how I described the CIO role in managing the assets of the family from an investing perspective, is that something that is deductible to the family within the single family office? Is that another area that families can potentially get tripped up?

David: I think that is a great question. I think if you have to look at the magnitude of the fees that are being paid to have the CIO, and what they are doing. I do not have a clear cut answer for you. But I really want to say it’s absolutely deductible if the family is going to go through the process of finding a CIO, which we all know is a difficult process in and of itself. If you are going to put somebody on staff and pay them a salary to do something, then you likely have something for them to do. Therefore, someone else outside the internal family enterprise is potentially doing less of something. You are pulling it in-house. The person that is doing less of it on the outside, you otherwise would have paid and deducted. But you are having it now done in-house by your CIO. Why would that not be deductible?

Let me break that down even a little more. That function such as offering investment oversight services above and beyond mere investment advisory, similar to a consultant type role. Those expenses are going to come through to the average taxpayer from XYZ trust company on let us say a K-1, the reporting that they receive from a fund. That expense is going to be subject to limitations on the taxpayer’s income tax return. Those likely would be lumped into what we call investment
advisory fees subject to two percent of adjusted gross income.

For most families we deal with, that two percent of adjusted growth income is a big number that you have to surpass that in order to reach deductibility. Alternatively, you could take that consulting role on investments and bring that in-house, and hire that person. Let us say you go to XYZ trust company. You say: “John Smith, we want you to be our consultant on the family.” You are looking over the various funds that we choose. We would like to hire you directly. We want you to quit XYZ trust company and come work for us. You are going to be part of our payroll for our family. Mr. Smith is now part of our management company.

That is a deduction now that we hired a person who was performing a role that is for the production of income. That is business purpose. That is a deductible expense. We are going to charge. Now the management company is going to charge the investment entity a fee for that service. The management company is going to charge the investment entity for providing investment consulting. Previously, it had been done by the custodian or someone else. The profit in the investment entity was less because it covered somebody’s payroll at the XYZ trust company. But now, we are having a person in-house in our management company providing a service that is deductible. Let’s say I am paying that CIO a hundred thousand dollars, and isolate the family office management company expense to just the hundred thousand dollars. What a deal that would be, right. Let’s also assume the duties of the CIO are deductible (not purely investment advisory). I work out an agreement between the management company and the investment entity. I calculate the fee for the investment entity this year to be a hundred thousand dollars (again isolated to the CIO for this example).

We pull off a hundred thousand dollars of income from the investment entity. We pay it to the management company. Now we have income at the management company level of a hundred thousand dollars. We have an expense because we have someone on payroll: a W-2 employee in the CIO that is paid a hundred thousand dollars. Now, the management company has a net income of zero. But economically what have we just done?

Step back for a moment Angelo, and just appreciate this. We shifted that hundred thousand dollars, which otherwise flows through to the family’s 1040s, subject to limitations like the two percent of adjusted gross income limitation, that might have been
not deductible at all, over to management company. We have pulled a service in-house, and deducted the cost. We have charged a fee, a hundred thousand dollar fee to the investment fund. Then we paid a hundred thousand dollars in expenses to our new CIO. We end up with zero tax income. I have just deducted a hundred percent of that consulting fee. Does that make sense?

**Before I can do a good job and achieve the best tax structure, I need to know what the family wants to achieve. What types of activities will the management company be doing?**

*Angelo:* Yes. That is a tremendous advantage within an SFO that is done correctly and structured properly.

*David:* Let me tell you one more thing. When I have mentioned this to families, their eyes light up. “How come no one else told me about this before?” You have to step back and say it is not every expense. Some expenses are just straight up an advisory fee and subject to the two percent floor regardless where they are paid. The commissions on selling or buying stocks may still be subject to the two percent floor. But if you have someone that is managing your real estate portfolio, those likely can be segregated.

If a family is running a fund to funds that is incurring fees, those expenses can be deducted if they are a function of the management company. Therefore, they can end up being fully deductible. That is where from a tax law perspective you want to end up.

But first I am going to let the family know that before I can do a good job and achieve the best tax structure, I need to know what the family wants to achieve. What types of activities will the management company be doing? Is there going to be a big CIO role? Do you have an airplane that you are managing? Are there a number of real estate properties that need to be looked over? I need to have an idea of what the family wants to accomplish so that I can think about what the best structure might be.

*Angelo:* Given again, the mental image of the management company being one entity and the holding company with the actual assets in another, we are going to probably somewhat transition somewhere between a more a basic SFO to more of a mid level one. I’m assuming how assets are held and even how assets are located are going to be incredibly valuable. Not just from the obvious tax and potentially asset protection standpoint, but other factors as well. But even a relatively modest sized SFO, two hundred to five hundred million. They are likely going to have a series
of various assets, some combination of irrevocable trusts, revocable trusts, family limited partnerships, GRATS, a variety of other estate planning vehicles, a dynasty trust, etc. We do not want to make this an incredibly detailed estate planning conversation, which probably in ten hours of audio, we could not fully cover, but if you had to try to – we are really going to test you now, David, if you had to try to somewhat transition giving our audience a little bit of color on the ownership and the value of asset ownership and location, transitioning from more of a basic SFO set up to somewhat of a more complex one. Give us some insight.

David: Yes, I will tell you, Angelo, I think if there is such a thing as a secret sauce in this whole process, this is it. Hopefully everyone is still listening.

Angelo: Listen up, everyone. This is the time.

David: My example with an investment advisor outside, and then the family brings the advisor inside. That probably makes sense that the advisor’s compensation is fully deductible. I would say that if you just had one expense for one function – if it was only that, it would likely be scrutinized because one activity doesn’t “sound” like a business purpose. But most complex single family offices have a number of activities that they are involved in. Even the basic single family office has a number of different tasks that are performed. It is not just one person’s salary so to speak.

There are usually a number of tasks that the single family office management company is performing for the investment holdings fund. I made the broad assumption that all of the family’s assets were in one bucket, one investment fund or holdings entity, an LLC typically. But the reality, Angelo, as you point out, the assets are spread out in irrevocable trusts, revocable trusts, offshore trusts, etc. Think of the family wealth as a pie, and consider the asset location.

We mentioned that the management company would likely be performing a variety of activities. There should be an agreement between the management company and EACH asset/entity. The irrevocable trust that owns the real estate in Montana should have an agreement between the management company and the trustee of that trust detailing what the management company will do for the trust.

The family needs to define the relationship. Put together an agreement as we would with any other third party. We will come up with a charge, a management fee specific to the entity served. Now I am going to fast forward. For the investment fund, that fee might be
structured like any other private equity type of fee, 2/20 or what have you, some percentage based formula. Because we can clearly define, for example, that we will be paid only on performance let us say. But managing the ranch in Montana, that should be structured as a completely different deal. That is going to take so many hours of our management company’s time and resources. We are going to structure that fee as such. It is going to be based on an hourly rate.

We are going to change it on a yearly basis. This year, based on a budget, it is going to be this much money. Then I am going to take all of those different fee arrangements and blend them into my management company. That is the management company revenue stream. The key is I do not want that revenue stream to be too high – because we are not really looking to reap a reward at the management company level, merely cover costs. Alternatively, I do not want revenue to be too low, I do not want to consistently produce losses, because that is not terribly helpful either. I want it to be reasonable based on the services.

If the management company is consistently generating negative returns there should be an adjustment to the way fees are calculated.

Because if the family has to answer questions under audit, you want to answer how a business would, with a business purpose. You would have an agreement with your customers on how you are going to be paid. If you do not have those agreements, that is not helpful. The type of customer it is, and whether it is an irrevocable trust or an investment fund, they are going to be charged differently. You have to be thoughtful about how you are coming up with that fee ratio. Then to take it another level, is there a way that we can have other entities participate if we achieve a greater fee? Should some of that fee go to some of the owners of the management company, which are maybe beyond the matriarch or patriarch?

Maybe a dynasty trust owns a slice of that management company. If there is a good year and we sell a business and the management company pulls in a big chunk of fee income, is it possible for other family owned entities to share in the success?

This budget is another area that I would review on a year-to-year basis, to ensure the fee is appropriate. This budgeting process should not be a disconnect between the accountants and the family and the management company. 

I am going to review really quickly. The key element to making this work is to have a clearly defined understanding of what the management company is going to do. Then, prepare the appropriate agreements with the
various clients of the management company—the irrevocable trusts, the investment fund.

Wherever the wealth is, make sure we have good appropriate agreements. Finally, Angelo, in terms of describing who is involved, you want to involve a multi-disciplinary team and process in reviewing the structure. We need strong tax counsel (attorney and CPA) thinking of the structure. We need a corporate minded attorney thinking about what type of management relationship is involved, to put those agreements together. And we probably need an attorney with litigation experience to determine what types of clauses should go into the agreements from a risk management perspective.

If it ever becomes an issue, I do not want too one sided of an agreement for example. I might have a litigator just take a look at the management agreement to identify where our risks are.

**Angelo:** Yes, that is a lot to consider. That is a fair amount of time and expenditures as well. But if we see the value in creating a single family office, you want to do it right. You also want to get the applicable tax deduction where you could. These are all of the things that need to be done right. If you are starting one, you have the chance to do it correct.

There are other areas within structuring of a single family office that in a future conversation with David and others, we will cover. But in the time today that we have, we have to make it a little more streamlined. We would have liked to have spent some time on family governance and committees, and how the legal and structure is very important for that. Make sure it qualifies as a single family office; and the guidelines of what is exempt and what is not. Compliance so to speak, but those will be subjects of future discussions.

You want to involve a multi-disciplinary team and process in reviewing the structure — strong tax counsel (attorney and CPA), a corporate-minded attorney and an attorney with litigation experience.

We cannot quite cover everything as much as we would like to cover. We would like to keep the focus on the rather deep complexities of the structuring issues in an SFO more so than some other legal aspects. Pardon my sidebar everyone. But I just wanted to make you all aware of that. Not wanting to take a step back, but kind of. The management company that likely is structured as an LLC. LLCs have managing members who are probably in a first generation family, pretty clean and simple, perhaps husband and wife.
Let us try to get a little deep without maybe going too long. For a family that may own significant assets where there is more potential of lawsuits, i.e. real estate, and private businesses. On the management side, does it make sense to have other entities but joining them as a managing member? We are entering now into a really deep subject. I know I’m asking you to cover this in probably three or four minutes before we transition into private trust companies and some other structures on the more sophisticated side. But maybe in sticking with the basic to mid level. How would you respond to my question on LLC ownership and even on some of the holding structures for the assets?

David: Sure, I think it is a great question. LLCs are likely the preferred choice that you would start with, because with an LLC there is so much flexibility. You can make allocations however you really want versus a corporate structure like an S Corp, for example, where everything is pro rata per ownership percentage. An LLC is usually where you start, then you look for a reason why it might not work.

Let us step back and recall that we have two entities that we are considering for the entity structure. We have our investment fund holdings entity where the assets are held. We have our management company. For the investment fund that is almost always a partnership for tax purposes, either an LLC treated as a partnership or a limited partnership. We do not have to think about that too much. The management company on the other hand, I also structure as an LLC. But wait a minute – I do not want it to be treated as a partnership for tax purposes. I do not want it to just flow the tax attributes down to the owners. I actually want them to be trapped at the management company level because I want to come to a calculation of net income or loss.

I do not want the character of expenses to pass right through to my owners who again are likely to be the matriarch or the patriarch, because that consulting expense, the CIO salary that we are paying, if it passes through an LLC, that may end up landing back on my family member’s Schedule A limited to the two percent of adjusted gross income.

I am going to make a blanket statement: you typically want that management company to be a corporate looking entity and not a flow through or a pass through.

Okay, but I started the conversation by saying I would use an LLC for the management company. Here is another trend that I have seen lately, which is Delaware is pretty popular in terms of LLC jurisdiction selection because
there is such a long history. We think we know exactly the courts are going to react because we have a long history of case law.

We have a good indication of what that case law is going to produce if we have to try a case in Delaware. Therefore, the Delaware LLC is preferred. For my management company, I will also pick an LLC. But I am going to actually travel across the country to Alaska. I am going to use the Alaska LLC statute. Because recently, Alaska has been on the forefront of asset protection. They have a strong LLC statute that has been tested a couple of times.

I am going to choose an Alaska LLC for my management company, but I do not want it to be a flow through, because I want to trap the income tax attributes at the management company level. I am going to elect that LLC to be treated as a C Corporation. I am getting the advantage of the LLC statute, but having the entity taxed like a C Corporation.

We plan to charge a fee to the investment holdings fund. I want to pay expenses that are legitimate to run the family wealth. I want to end up at zero taxable income. Again, I am not looking to build up wealth. Because quite frankly, if I have a C Corp, that is difficult result. If I build up wealth, I will have to pay tax on net income. Then, to get the money out of that C Corp, I am going to have to declare a dividend or pay it out of the wages, so it is double taxation. I really want that management fee at the management company level to be very precise.

So to review my entity selection, I generally look at Delaware for my investment holding fund, also because I really like the “series” legislation they have there. For the management company, prefer to use an Alaska LLC treated as a C corporation. Now some families just prefer do both in Delaware – that is fine.

You can also go to a number of different states: South Dakota, Nevada, Wyoming: they all have good statutes. One of the reasons from a legal perspective we are going through the analysis of where do we create this entity is for a litigation purpose, for creditor protection.

I like the idea that if a creditor is going to go through the machinations to sue the family, they are going to go to court in Delaware to attach the funds in my investment holding funds. And the creditor is not just going across the hall to sue my management company. They have to actually bring suit in Alaska and try to get a charging order, to force distributions out of my investment holdings fund. For some reason, I just think it sounds more difficult to say okay, if you are going
to sue this family, you need to bring suit in Delaware and Alaska. It just sounds better to me. What do you think, Angelo?

**Angelo:** No question, and again, we are going to have a limited amount of time on a very complex subject. We are probably not even really going to have the time for families that have a significant international exposure and setting up a series of entities offshore. As we transition into kind of the sophisticated family office structure. Maybe we will spend a little bit of time on that. But that is probably worthy of its own discussion. From those listening that are not American citizens, we do understand especially in many of the prior comments, that most of it is simply not as applicable for you. But the general thinking behind it still is. That is another subject about international citizens setting up effectively family office and other investment vehicles within the U.S. that is going to be worthy of its own discussion at a future time. But in the limited amount of time that we have left, and talking now about sophisticated really complex issues for families. Although you did mention a series LLC for effectively ownership of some specific holdings, I do not believe that many of our listeners are really going to understand that.

Maybe starting on that in a brief definition of what a series LLC does. Then we will transition a little bit into a direct investing family office. How they may want to set up a separate vehicle and even totally different compensation structure for that. But why do we not have a little deeper understanding of series LLC, David?

**David:** Sure. There are a number of states that have series legislation. Essentially what that means is one LLC that has a number of subsidiaries: all under one LLC umbrella. There is one filing in the state of Delaware with a number of sub-LLCs underneath that umbrella. The investments can be allocated according to the different series. Early in my career as an attorney, I worked on one client that had a hundred different series in their one Delaware LLC. When they made a new investment or type of investment, say emerging markets, they created a new series, and made the investment in that particular series. Think of it as your personal asset allocation.

I might choose to have my investment holding fund, which is an LLC, as a Delaware series LLC. I would create series underneath that LLC. Then the owners of the family wealth might have different asset allocations: GST dynasty trustor generation three solely invested in the private equity, generation two solely invested in domestic equities, and generation one solely invested in fixed income.
As I mentioned, you can have as many series as you want, or different owners of different series. I could have the grandchildren 20 percent invested in fixed income and 80 percent in private equity. You can slice and dice the owners however you want. You could have some owners only in one and not others. You can charge different fees to each of those separate series depending upon services offered by the management company. For example, the management company might be doing a lot of work for the private equity series, and not much at all on say fixed income.

Angelo: I do not want to get too far off the track on estate planning issues, which again is another subject that we could spend literally hours on. But one that probably does have some level of importance for complex and very large families would have and you noted it a couple of times. Something like a dynasty trust that could be incredibly tax beneficial over the generations of families.

As you are describing the various holding companies, and custody, explain to our audience a brief foundation on the value, especially in a multi-generational family, where the trustee may not even be a family member who is active in the benefits of the trust. Also, explain the value in having a trust protector: what that means, how that incorporates effectively into very sophisticated estate. What I will call, making my own definition, "single family office planning."

David: This "single family office planning" is interesting how it has developed. Because I would say today, if you have a sophisticated estate, you are going to have a provision for a trust protector. It is a new trendy component of the estate plan. The trust protector role is to essentially make changes to the document because of changes in tax laws. Or oversee the trustee to make sure the trustee is doing what the trustee should be doing.

The most common example is that it allows someone else outside of the family, usually a third party, that acts only when they need to, to ensure that the trust is being administered the way the trust should be administered. I would say it is a clever new addition. But it has really been around for years when we did offshore planning. We always had a trust protector. You had to have a trust protector with an offshore trust. Today it is much more just part of the sophisticated estate plan. I credit that to the development of family office principles.

I would go as far to say that the family governance concept is the ultimate motivator when you considering trust protectors. Because the family governance is really how I want the family to achieve certain values and ambitions. The trust protector is one of those
resources that can enable the family to get back on track if they are not on track. An entry level family governance discussion is likely starting with that trust protector.

The dynasty trust is another single family office planning stalwart that is going to be around forever because we created it in Delaware or one of the states that allows long-term trusts in perpetuity. Who knows who the trustee is going to be? I want to make sure that we are looking out after the beneficiaries; or that the family is benefiting from their advice and not giving the advice that we don’t want the trustee to give. That is why we want a trust protector. But if I do not want to have to wait until something bad happens with the trustee to have to call on the trust protector come in and fix it, I may consider a private trust company solution—something functioning from the get go. A private trust company is similar to a super trust protector role so to speak.

The private trust company operates, in my opinion, as your family governance vehicle. It is the entity looking after the family wealth, offering guidance. A private trust company offers a built in board structure. But that is an easy one to solve for, because that is a clearly defined role and we know what to expect from a private trust company. Did that answer your question Angelo?

Angelo: It answered the question and somewhat into my next question. I effectively have two final questions as we begin to conclude. Part of it you already answered. Certainly getting a lot of play, not just in America but internationally is what is broadly defined as a private trust company, Understandably so, as an amazing vehicle for
governance as a trustee including of some unique assets, not always traditional or classic, which corporate trustees avoid. I know we are butting up against the clock a little bit. I am going to ask you to do the impossible but still leave a little bit of room for effectively my final question. Tell us why in two minutes other than what you told us already. Why? I am not saying for every family but potentially for many big families to look at, why a private trust company, could be so valuable?

David: In my opinion, and this just may be a person by person opinion, but in my opinion, families set up private trust companies because they get instant governance. I met with one particular family that was interested in setting up a private trust company. I said well, wait a minute - We don't have any legacy trusts that require a corporate fiduciary, so why a private trust company (I was talking to generation one, and generation two was like two years old) – we usually recommend private trust companies for long, well established families that are required to have a corporate fiduciary. Therefore the private trust that facilitated that requirement. The answer I heard from this particular family was no, even before we set up the family office, we want a private trust because that is where the governance, the proper boards, supervision, and oversight – all centralized in one place.

Angelo you mentioned overseas, we are seeing more and more interest especially within the private trust company field from overseas families. I would almost go as far to say there are twice as many private trust companies being created outside of the U.S. as there are inside the U.S. I think that is because of the immediate governance component that the U.S. environment offers.

Angelo: Why do international families have any interest in American style family governance?

David: Because in the U.S. we have the experience of transferring wealth over numbers of generations due to our tax and property laws. We created a need for a governance vehicle like a private trust company. I think outside of the U.S., it is becoming more and more prevalent that they want to continue to build those dynasties. They see other outside family member influences...
coming in. They want to adopt some of the best practices that we have had in the U.S., one of which is the private trust company concept.

The other influence non-US families are interested in is the family office structure for the same reason. They have seen it work here in the U.S. I do not think it has been as popular or as utilized as much outside of the U.S. We are seeing a number of families coming into the U.S. and investing here, setting up a family office even though they have very few if any members here in the United States. They want to take advantage of that structure and the certainty of how they expect that entity to be treated – because we have been doing it for a long time.

**Angelo:** I may open up a can of worms with a complex question. Would an international family be able to do that with an entity of the U.S. without a family member needing to have a green card or be a U.S. citizen and subject to our complex tax laws?

**David:** It is a great question. It is a bit of a can of worms. I was referring to utilizing the U.S. knowledge base that we have here and investable assets, but probably not attain U.S. taxable presence. Just like a family overseas can invest wherever, they can invest here. If they do invest here, might that be in a structure like a family office as opposed to just having accounts? Would they achieve a benefit for their broader family that is not in the US by having a structure here? Those are the type of questions I am receiving lately.

I have to say, it is an emerging trend in my opinion of the past couple years. I have received a number of requests from families not in the U.S. curious about setting up a family office structure here just to run a diversification of their investment. They want to part with let us say 25 percent of the family net worth in the United States and draw access to these investments. Why not have it in such a structure?

**Angelo:** PTCs and international PTCs are worthy of its own podcast session. I know we are only touching the surface of something that needs a lot to talk about.

There is a growing trend. We all know being a direct investor. Effectively wealthy families or SFOs investing in privately held companies. Would you recommend, I do not want to put words in your mouth, I am just phrasing it from my own perspective, but would you recommend that a family that is a serious, active, significant direct investor that has attracted top talent, that probably needs to be compensated, not too differently than an investment banker or a private equity investor
as opposed to simply salary and bonus. Is the family better off setting up a separate entity and to a degree that chief person on investing – on direct investing is kind of a co-investor? Whether the family is loaning them money to be a co-investor. Or whether there are golden hand-cuffs to motivate them to be long-term with the family. Now here I go again. A subject that is worth an hour or two, on its own that we are going to need to cover in two minutes. I’m sorry about that, David.

David: I think you identified another trend. I have recently had a number of inquiries about building out a family office within a family that has already been doing direct investments. They have been operating the XYZ capital group, formed to make a few investments. They might have had their money at an institution or what have you. Now the family wants to enter into a separate and isolated function, which is direct investments. We would set up our own little company that does that. And yes, we could use this new enterprise to compensate the internal staff. This could be done with a series LLC to isolate the non-family members from the family members. The funding could occur through performance based allocations or a note secured against the interest. Then your question is how does the family office work into that?

Now, we were straight down the middle of the fairway management company for a family office. That is one of the lead-ins to creating a family office - direct investments, which has been very popular the past number of years. We do not have to have the discussion of whether we are doing the right things to get a tax deduction. Those are the right things. Why not make it the most tax efficient that we can and potentially provide some other services to the broader family and have a full-fledged management company.

Angelo: Indeed, could you give me one minute on another complex area for a sophisticated families? Likely what amounts to – although sometimes onshore – often a BVI, i.e. British Virgin Island set up as a captive insurance company? Why they are valuable for some families especially those that are still active in the business or a series of businesses. Kind of how they incorporate, or managed,
or governed, or how a family would get the resources through a family office in overseeing a captive insurer?

David: Sure. This is one of those areas that is not for everybody. But for the right family, it is the complete home run. I mean, it just makes a complete financial sense. You need two attributes: (1) You need an operating business as you had mentioned, and (2) you need an insurable risk that you are facilitating. If you have those two attributes, then essentially why not create your own insurance company to provide the coverage for that identifiable risk that you have. If things go well and there are no claims, then there is wealth built up in that entity.

The entity is usually offshore. Who might be the owner? Who is the good owner for something like that? Most commonly the answer is why not have a dynasty trust own the captive? Whether it is an offshore version of the dynasty trust or onshore. There is nothing wrong with having your U.S. dynasty trust be the owner of that offshore interest. The money sitting offshore in the captive insurance company, but assuming you do not have any claims, you are building up wealth offshore. Now you have got a really clever income tax driven wealth transfer.

Angelo: My last comment, slash question, and I know it is a question I get asked. One that again each family is going to be different. We broadly went over a relatively more straightforward SFO. One that went into more of a mid level. One that was kind of sophisticated and not really having enough time for any of us to potentially do the justice that we wanted to do. But, this is worthy of something – of further follow up of one or multiple day programs under subject alone trying to cover it all in an hour and ten minutes is effectively impossible. But a question that I do get is what are the costs?

I am going to put some words in your mouth. Correct me, a more basic SFO in terms of legal documents, and structure; fifty to a hundred thousand, probably about hundred to two hundred thousand for a mid level. But for a family that is going the route of a very complex family office with a series of – a lot of complexities, including a private trust company and/or a captive insurer, very possibly, half a million to a million. Am I right? Am I wrong? A little bit of color for my audience, please?

David: Yes, I think that is about right.

Angelo: This was incredibly insightful for me, and I am sure my audience. We look forward to doing more and even deeper dives on some of these topics in the future. Thank you very much for your time, David. For those that
are listening in, that may be do not get the transcript or other correspondence and that maybe want to reach out to you. If you could provide and be very clear given it is an audio podcast, your contact info. I am sure they would appreciate that.

David: Sure. First of all thank you very much for inviting me. It is something that I am passionate about. I really enjoy it. I have been doing it for a while. This was a great afternoon for me. I am based in Chicago, but work with families across the country. I can be reached at Horwood Marcus & Berk: my e-mail is dberek@hmblaw.com and my telephone number is 312-606-3239.

Angelo: Fantastic, and thank you so much, David. I greatly enjoyed it. It probably says something about each of us that we love nothing more on an afternoon than talking about the structures for hours on end in a single family office! But we are both dedicated. On that note, I would like to thank David and everyone listening in both now and in the future to this FOA audio podcast. I’m Angelo Robles at Family Office Association. We hope that you find this valuable. I look forward to the next one. Thank you everyone and have a good day. Good bye David.

David: Angelo, thank you for this wonderful opportunity!