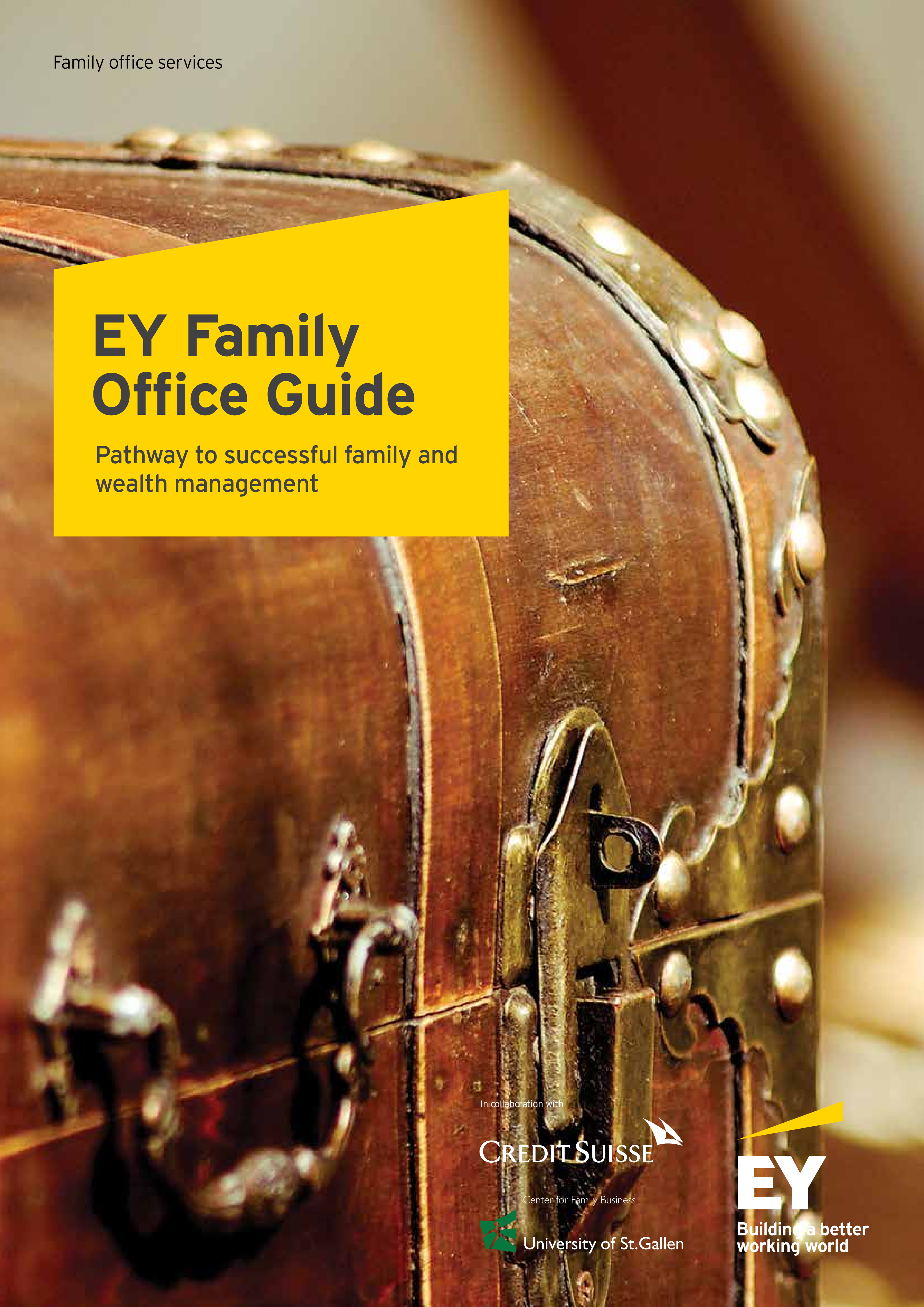
Family office services



# EY Family Office Guide

## Pathway to successful family and wealth management

In collaboration with

Credit Suisse

Center for Family Business
University of St.Gallen

EY
Building a better working world

# Contents

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

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

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

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

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

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

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

www.cfb.unisg.ch

# Foreword

Dear Reader,

It gives us great pleasure to bring to you our 2016 revised edition of the *EY Family Office Guide*.

In the last decade or so, we have seen a distinct acceleration in the establishment of family offices around the world and even more so in the emerging markets. However, irrespective of geography, there's a certain consistency to the motivations behind setting up a family office. Mitigating family conflicts, preserving family wealth and ensuring its inter-generational transfer, consolidating assets, dealing with a sudden liquidity influx, and increasing wealth management efficiency are some of them.

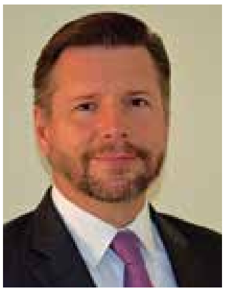
Another reason for the emergence of family offices is families' desire to have greater control over their investments and fiduciary affairs while reducing complexity. This need for a higher degree of control was partly provoked by the financial crisis, in the aftermath of which wealthy families wanted to ease their concerns about dealing with a wide range of external products and service providers.

Family offices are rather complicated structures, neither easy to understand nor simple to implement. This publication will offer a step-by-step process that aims to demystify what's involved in setting up and running family offices.

This revised edition of the guide, which was first published in 2013, is certainly one of the most comprehensive and in-depth ever published. It is designed as a learning tool to provide guidance to families considering setting up a family office. They include business families who wish to separate their family wealth and assets from the operating business, and successful entrepreneurs looking to structure the liquidity gained from a highly profitable sale in order to further grow and preserve their wealth. It is also a useful guide on the current leading practices for those who already have a family office.

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

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



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# introduction

## What is a family office?

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

Although each family office is unique to some extent and varies with the individual needs and objectives of the family it is devoted to (Daniell and Hamilton, 2010), it can be characterized as a family-owned organization that manages private wealth and other family affairs.

Over the years, various types of family offices have emerged. The most prominent ones are the single family office (SFO) and the multifamily office (MFO), but there are also embedded family offices (EFOs) linked to the family business, where there is a low level of separation between the family and its assets. The SFOs and MFOs are distinct legal entities and manage assets that are completely separated from the family or the family business.

With the progressive growth of the family tree — owing to the birth of children and grandchildren and the addition of in-laws — and an increase in the complexity of the family's asset base, families usually professionalize their private wealth management by setting up SFOs. As subsequent generations evolve, and branches of the family become more independent of each other, investment activities within the original SFO activities become separated. This is the cornerstone for the emergence of an MFO. Sometimes these offices open up their services to a few non-related families.

Since the individual services of a family office are tailored to the clients, or the family, and are correspondingly costly, the amount of family wealth under management is generally at least US$200m. It is more revealing, however, to calculate the minimum wealth under management in the light of return expectations and targets, and the resulting costs of the family office. This shows that there is no clear lower limit for a family office. The costs of the family office, plus the return target, must be achievable with the chosen asset allocation and structure.

1. For more information see rockefellerfinancial.com.

Family offices are arguably the fastest-growing investment vehicles in the world today, as families with substantial wealth are increasingly seeing the virtue of setting one up. It is difficult to estimate how many family offices there are in the world, because of the various definitions of what constitutes a family office, but there are at least 10,000 single family offices in existence globally and at least half of these were set up in the last 15 years.

The increasing concentration of wealth held by very wealthy families and rising globalization are fueling their growth. Particularly important in the years ahead will be the strong growth of family offices in emerging markets, where for the most part they have yet to take hold — despite the plethora of large family businesses in these economies.[2]

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

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

2. *Credit Suisse Wealth Report 2015*

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

Section 1

# Why set up a family office?

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

## The reasons why

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

- **Privacy and confidentiality**

  For many families, the most important aspect of handling of their private wealth is privacy and the highest possible level of confidentiality. The family office often is, and should be, the only entity that keeps all the information for all family members, covering the entire portfolio of assets and general personal information.

- **Governance and management structure**

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

- **Alignment of interest**

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

- **Potential higher returns**

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

- **Separation**
  Family offices allow for separation, or at least a distinction, between the family business and the family's wealth or surplus holdings.
- **Risk management**
  Family offices allow for operational consolidation of risk, performance management and reporting. This helps the advisor and principals to make more effective decisions to meet the family's investment objectives.
- **Centralization of other services**
  Family offices can also coordinate other professional services, including philanthropy, tax and estate planning, family governance, communications and education, to meet the family's mission and goals.
- **Focal point for the family**
  In cases where the main family business has been sold, a family office can offer a new focal point of identification for the family members, for example when the family office manages the philanthropic activities of the family.

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

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

- **Cost**
  The cost of regulatory and compliance reporting remains high, which means that the level of assets under management that a family office needs to underpin must be sufficient to offset its fixed costs.
- **Market, legal and tax infrastructures**
  Family offices function better when operating from centers where there are sophisticated markets and legal and tax structures. The absence of these in emerging markets has undermined the development of family offices there. This has often meant that there has been little connection between the huge level of wealth in some emerging markets and the number of family offices. Much of the wealth in emerging markets is still controlled by the first generation. This has also inhibited the growth of family offices, because many are launched during a wealth transition from one generation to the next.

## Main types of family offices

### Embedded Family Office (EFO)

An EFO is usually an informal structure that exists within a business owned by an individual, or family. The family considers private assets as part of their family business and therefore allocates private wealth management to trusted and loyal employees of the family business. Usually the chief finance officer (CFO) of the family business and his department's employees are entrusted with the family office duties. As not necessarily the most efficient of structures, more and more entrepreneurial families are separating their private from their business wealth and are considering taking the family office functions outside the family business, not least for reasons of privacy and tax compliance.

### Single Family Office (SFO)

An SFO is a separate legal entity serving one family only. There are a number of reasons for setting up an SFO:

- The retirement of the business-owning generation
- A greater desire to diversify and widen the asset structure beyond the focal family firm
- A rising exposure to non-investment risks, such as privacy concerns and legal risks

The family owns and controls the office that provides dedicated and tailored services in accordance with the needs of the family members. Typically, a fully functional SFO will engage in all, or part of, the investments, fiduciary trusts and estate management of a family; many will also have a concierge function.

### Multifamily office (MFO)

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

- **The MFO offering**

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

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

- **The preference for privacy**

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

- **Trust of external managers**

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

- **Expectations on returns**

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

Section 2

# Family office services

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

## Financial planning

### Investment management services

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

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

### Philanthropic management

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

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

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

### Life management and budgeting

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

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

## Strategy

### Business and financial advisory

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

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

### Estate and wealth transfer

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

- Wealth protection, transfer analysis and planning related to management of all types of assets and income sources
- Customized services for estate settlement and administration
- Professional guidance on family governance
- Professional guidance regarding wealth transfer to succeeding generations

### Training and education

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

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

## Governance

### Reporting and record keeping

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

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

### Administrative services

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

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

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

### Succession planning

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

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

## Advisory

### Tax and legal advisory

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

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

### Compliance and regulatory assistance

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

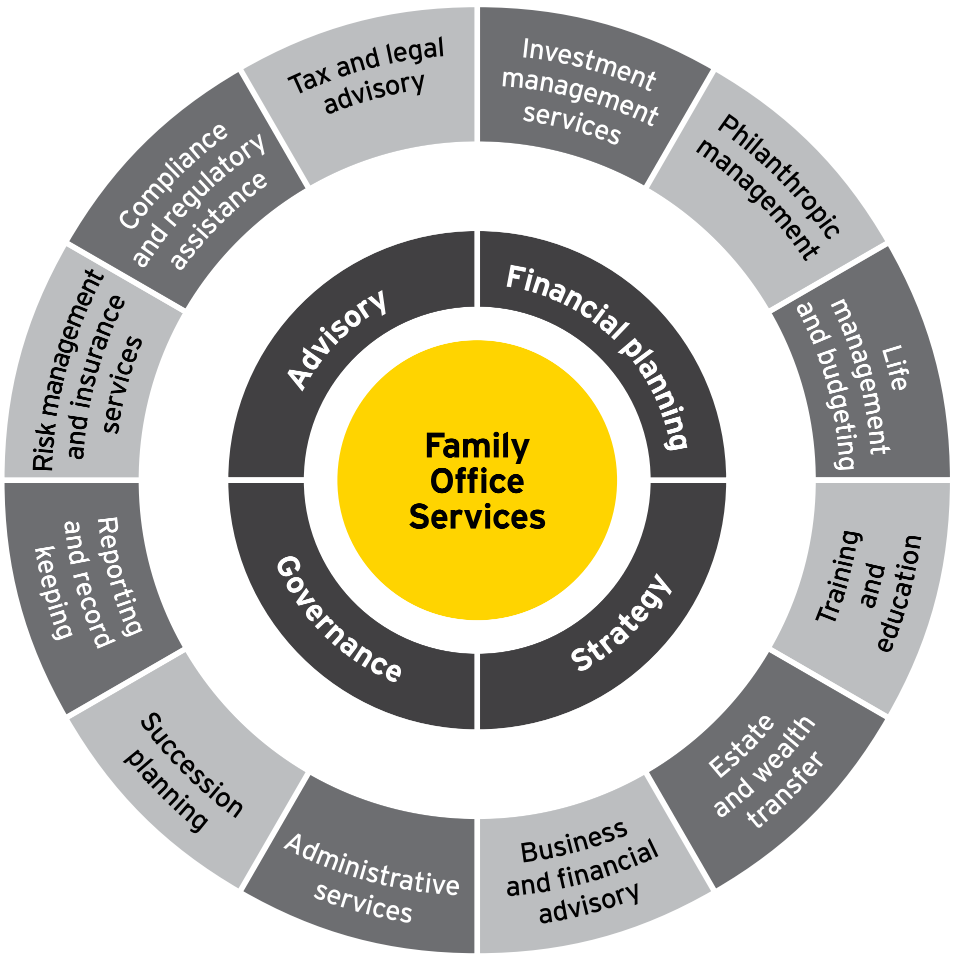
- Providing auditing services for internal issues
- Establishing a corporate governance mechanism
- Ensuring a high level of staff hiring
- Group performance monitoring and compliance
- Offering recommendations on independent and board advisory formation
- Strengthening the regulatory investment process

## Risk management and insurance services

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

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

Figure 2.1. Family office services



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

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

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

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

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

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

- The size of the family and how many family members want to use the family office
- The net worth and complexity of the family wealth
- The family's geographical spread
- The variety of assets, both liquid and illiquid, under management
- The existence of a family business and the link between this and private wealth management
- The skills and qualifications of family members
- The importance of confidentiality and privacy
- The consideration of whether the family office should be a cost or a profit center

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

- Who should be the beneficiaries of the family office and what is the overall strategy of the family to secure and expand its wealth over generations?
- Is the family's priority traditional asset management of liquid funds, with or without a portfolio of direct entrepreneurial investments? And where does philanthropy fit into the mix, if at all?
- Should the family office act as the asset manager for all family members, or should it just be an advisor for some specific services to selected family members?
- Is the family office's core task that of a financial advisor, or more that of an educational facilitator for the next generation of family members?
- What services should the family office offer from the range of asset management tasks, controlling and risk management, tax and legal advice to concierge services and educating the next generation?

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

### Table 2.1. Key determinants of the make-or-buy decision

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

## The traditional model

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

However, families should be aware that the greater the level of outsourcing, the less direct influence the family will have over the decision-making process within the family office, and the less exclusive the products and services will be. Table 2.2 provides an overview of selected family office services, which can be categorized as in-house or outsourced based on market analysis.

### Table 2.2. Family office services: in-house or outsourced

| Type of service | Service category | In-house | Outsourced |
|---|---|---|---|
| **Investment management and asset allocation** | Financial planning | Basic financial planning and asset allocation decisions should be provided in-house | The more complex, specialized and diverse assets make outsourcing a practical option |
| **Tax and legal advisory** | Advisory | Selectively done in-house | Often outsourced to a trusted advisor to ensure state-of-the-art quality of service |
| **Reporting and record keeping** | Governance | Record keeping and documentation demand confidentiality and so this should ideally be done in-house | Basic reporting tools and software may be provided externally |
| **Philanthropic management** | Financial planning | In-house expertise should serve to assist with philanthropic activities | Setting up a foundation and related activities often outsourced to a consultancy |

| Type of service | Service category | In-house | Outsourced |
|---|---|---|---|
| **Compliance and regulatory assistance** | Advisory | Size of family office might require full-time legal and accountancy expertise | Full-time legal staff will be an unnecessary and costly addition to family offices, which are not large enough to require them, so can be outsourced when needed |
| **Risk management and insurance services** | Advisory | Some risk management skills should be provided in-house, in order to ensure ultimate peace of mind | Can be outsourced, as external risk and insurance professionals can offer trusted expert advice |
| **Life management and budgeting** | Financial planning | Should be done in-house if information confidentiality is a priority | Only specialized services would tend to be brought in-house, less specialized services can be outsourced |
| **Training and education** | Strategy | Can be done in-house, as identifying suitable options for education is by its nature an internal process | Can be outsourced if expert opinion on higher education is required for training and development |
| **Business advisory** | Strategy | Often the general counsel or the finance director of the family business is involved in the setup of the family office | The services of an external expert can offer a competitive edge |
| **Estate and wealth transfer** | Strategy | In-house expertise is required as data confidentiality is vital | The family can consult external legal advisors for procedural and legal issues |
| **Administrative services** | Governance | Administrative services require daily monitoring and so can be done in-house | Outsourcing could lead to greater costs |
| **Succession planning** | Governance | Clarifying level of interest of next generation members with regard to the business and family office | Education, objective assessment of managerial skill, and definition of entry path of next generation family members |

## Benefits of in-house

- Highest level of confidentiality and privacy
- Independent and trusted advice to the family is ensured
- Total and consolidated management of family wealth
- Family office can develop distinct skills, specifically tailored to the family's needs
- Greater and more direct family control over its wealth
- Keeps investment knowledge within the family
- Ensures optimal goal agreement and avoids any conflicts of interest with external providers

## Benefits of outsourcing

- Helps a family office reduce costs and overheads, helps with staff productivity
- Helps deliver economies of scale, particularly when it comes to high-value professional services, thus enabling lower prices for related services
- Offers the benefit of objective advice from experienced professionals who possess specialized skills
- Outsourcing investment management may help a family office defend its regulatory independence by allowing investment decisions to be made by external providers
- Suggests less direct control, which implies due diligence and continuous monitoring can be carried out by the directors of the family office to ensure performance and security against risk

# Philanthropy

## Philanthropy: moving from giving to creating impact

The world, and the challenges it faces, are changing rapidly. Growing inequality, the forces of climate change, rapid urbanization and resource scarcity are increasingly putting pressure on the world's most vulnerable people, both at home and abroad.[1] We need new strategies to meet these challenges — strategies that involve a fundamental rethink of the nature of philanthropy.

Traditional paradigms of philanthropy are evolving. With a focus on creating impact, they are becoming more accessible, sustainable and effective. Reflective of the social and technological changes happening around the planet, this evolution reminds us that, in a globalized world, small groups of people can have profound impacts.

Philanthropy is one of the most rewarding, and distinctively different, activities that can be undertaken from a family office. As with all family office activities, philanthropy too deserves to be conducted with total professionalism and commitment. Its challenges and rewards should be acknowledged.

It has also been found that philanthropy is an integral component of many wealthy families' lives. For example, America's 50 most generous donors increased their giving by 33% last year.[2] There has also been a rise in the number of technological entrepreneurs under 40 using their wealth to engage in philanthropic work. While some of the trends in philanthropy are changing, the level of commitment to give back to society and create a positive impact remains the same.

## How can a family office help the family achieve its philanthropic goals?

One common question facing family offices and family members is how to structure philanthropic endeavors to achieve tax, economic and long-term charitable goals. Many families see philanthropy as a way to not only make a lasting impact on their communities, their countries, or the world, but also as a way to connect with and guide the principles that will impact the multiple generations that have either benefited or may benefit from the family wealth. The form of charitable giving may vary from a direct gift to a charitable organization to a donation to a charitable vehicle (discussed below) established by the family for ongoing philanthropic activities.

## Philanthropy as a way to guide future generations

Many families view philanthropy as a long-term mission that is critical to teaching future generations responsibility and the impact wealth can have on society. They believe philanthropy can teach younger family members valuable life and business skills, enabling them to develop their passions and find fulfilment in working for something they believe in. In some of these families, the future generations will even get to decide which charities should receive benefits, how much and for how long.

A family office should memorialize the family's philanthropic goals in the family mission statement or the family constitution. It should make sure the charities qualify for tax-exempt status and that charitable pledges are fulfilled in a timely manner. It is the family office that will likely be involved in deciding which assets to donate to charity. In the US, for example, the type of asset donated can impact the amount of the eligible deduction as well as the potential yearly deduction limitations.

## Philanthropy through investment choices

Wealthy families have made substantial charitable donations in recent years. There is also a trend for families to align their investment choices to their charitable motives. Families are increasingly making investments that can be categorized as impact investing or socially responsible investing. Both of these strategies seek to further philanthropic goals on the basis of how, and in which companies, the family invests.

**Impact investing** seeks to make a difference to communities by choosing to invest in companies that align profits with charitable intentions. For example, a family may decide to invest in a company that will produce methods to purify water in economically challenged regions.

1. *EY Megatrends 2015*
2. "The 2015 Philanthropy 50", The Chronicle of Philanthropy

**Socially responsible investing** seeks to maximize delivery of philanthropic goals, even at the cost of potentially higher returns. An example of socially responsible investing may be divesting your portfolio of all shares of Company X stock if they are producing goods in a manner that is not environmentally safe or if their chairperson makes a public statement on a position that the family does not agree with.

Family identification with philanthropy can be a means of honoring the family's founder. It can be a vehicle for finding new roles for family members — including those who might feel that their skills and interests may not lie in the family business. A systematic program of philanthropy can be both a shield (offering a proper process for responding to the many unsolicited and perhaps inappropriate requests for funds commonly received by high-profile families) and a sword (enabling the family to have a significant positive impact on an issue of concern to it). Most importantly, philanthropy can provide a family with at least one notable commonality — acting as "the glue that holds the family together" — especially as a family increases in size and diversity.

Philanthropy can expand a family office's networks, add skills, generate employee satisfaction, and offer new and post-career options. Family office or business involvement in philanthropy can be a tangible demonstration of corporate citizenship and can enhance the profile of the family.

## Definition and change over time

The goal of philanthropy has always remained the same, to promote the welfare of society and to increase the business's public value. However, the means of achieving this goal have undergone rapid transformation.

Traditional notions of philanthropy emphasized doing good through donations or through the establishment of charitable foundations. This approach, born of social obligation, was free from the expectations of measurable impact, accountability, transparency and direction. In this traditional approach, philanthropy was also seen as exclusive — only accessible to those with enough money to give away — or organized through religious or political institutions with specific interests and agendas.

Modern philanthropy, however, is decidedly different. Today's philanthropists use innovative solutions to solve specific problems, with approaches that are targeted and selective, and impacts and outcomes that are measurable. Philanthropy is also not seen as exclusive anymore. Now, philanthropists come from a wide range of ages and backgrounds, ranging from individuals and businesses to NGOs and not-for-profits, all of whom are brought together by one common goal, to help fellow human beings.

## Leading practices — the building blocks of an effective, family office-based philanthropy

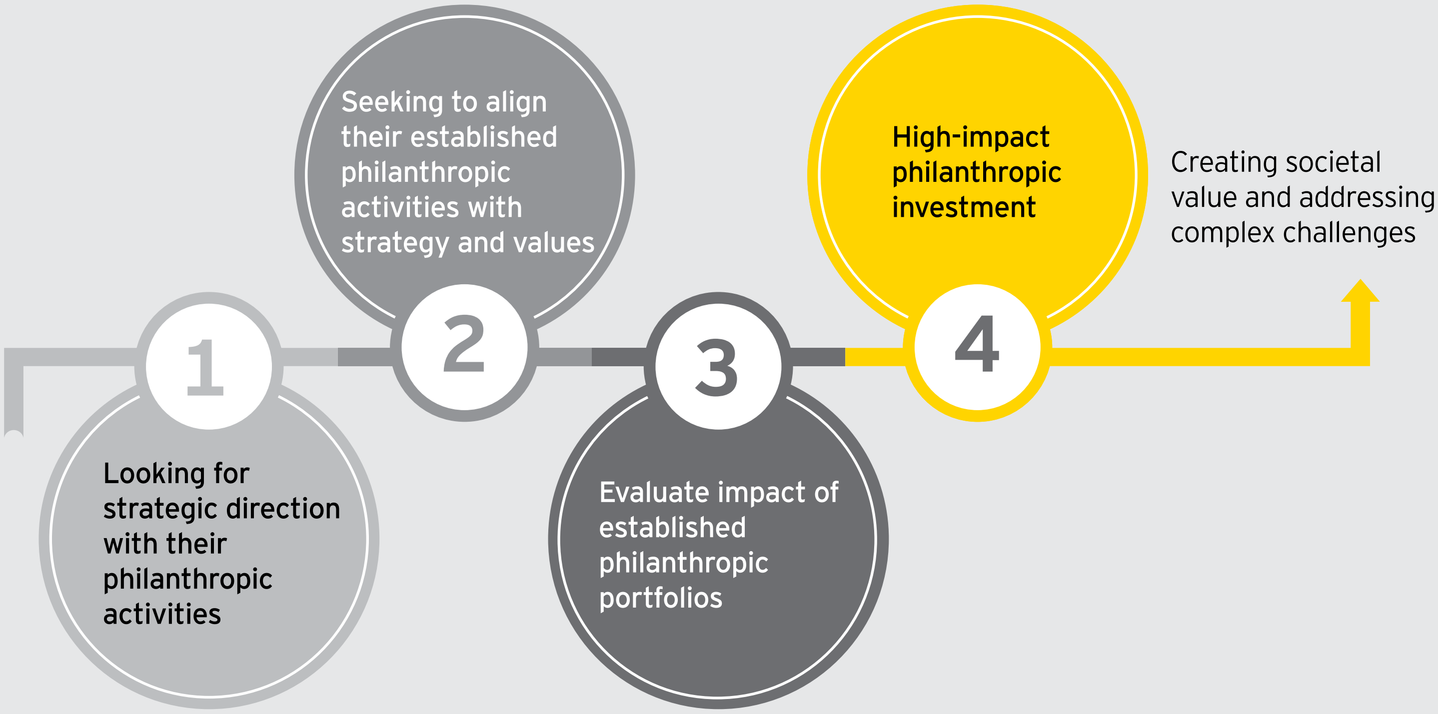
Creating an effective, office-based philanthropic program requires decisions to be made on matters such as:

- Should there be a mission statement for the philanthropic strategy?
- Should the overall program be thematic or general and, if thematic, what should the priority issues be?
- What should the geographic reach of the program be?
- Should the program be proactive (programs to be funded and initiated by the office) or reactive (inviting applications from the community)?
- Will the funding be short-term or long-term?
- Will funding be directed at projects or general organizational support?
- Should there be a few large grants or several smaller grants?
- Should there be public guidelines and an annual report?
- What should the internal decision-making process be?
- How will the directors be chosen and what succession arrangements should be made?
- What is the role of non-family members as professionals and directors?
- Are professional advisors involved and is the philanthropic strategy carried out professionally to optimize tax and legal implications?

- Will collaboration with other funders be sought in order to gain the benefits of collective impact?
- What priority should be given to impact and public value assessment, and by what means?
- Is there an investment charter to direct the length, asset type and risk of the corpus funds?

These are only some of the matters to be considered and only a few of these questions can have simple right or wrong answers. It is the nature of the philanthropic sector that much remains ambiguous and subject to different approaches. This, however, makes it all the more important that the commitment to, culture of, and processes for, reflective and systematic philanthropic practice be in place in a family office. Fortunately, the philanthropic sector is rich in accessible and helpful written resources, and personnel who are willing to advise, collaborate and share.

## Top trends



There are a number of global trends shaping the modern philanthropic landscape.

## The role of technology

Technology has impacted every aspect of modern philanthropy. The internet has given people access to a wealth of information on virtually every topic imaginable. This power not only enables light to be shined on otherwise ignored topics, but also provides access to the information needed to make contributions. While modern technology enhances the ability to form local and global partnerships more effectively, it also ensures that in some small measure, any individual can be a philanthropist.

## Socially conscious businesses

Philanthropy is increasingly seen as core to modern businesses' operations, crucial to their social license to operate and enhanced by the entrepreneurial spirit. Modern philanthropic activities take many forms, including donations, charitable projects and social ventures. However, they can also take a sustainable and profitable form, such as through impact investments that are targeted toward specific program-related social objectives. Many of the largest companies in the world have philanthropy built into their business plans, and the trend is increasingly turning toward seeing financial performance as just one of the many measures of a business's success.

## Impact investing

Impact investments are as those that set out to achieve positive social and environmental impacts, in addition to financial return, while measuring the achievement of both. Impact investing dismisses the notion that profitable investments and giving money to charitable work are separate activities, distinguishing it from other forms of philanthropy. Impact Investing Australia suggests that the market for such investments is expected to reach US$500 billion to US$1 trillion globally over the next decade.

## Collective impact

No single policy, program or organization can tackle the increasingly complex problems the world faces today. Collective impact refers to the commitment of a group of important actors from different sectors to a common agenda for solving a specific social problem. The collective impact approach was first discussed by John Kania and Mark Kramer in the 2011 *Stanford Social Innovation Review*. They identified five key elements of an effective collective impact approach, including a common agenda, the consistent measurement of results, mutually reinforcing activities and the use of a backbone organization.

## Responsible investment framework

A responsible investment framework helps organizations use their wealth to make socially ethical investment decisions, often based on environmental, social and governance (ESG) factors. Such frameworks will commonly involve thorough monitoring practices, rigid reporting policies and a great deal of accountability and transparency. For many organizations that are using part of their portfolio for ethical or impact investments, a responsible investment framework can ensure that the remainder of their portfolio is aligned to the same goals and does not deter or diminish the impact outcomes sought by part of their portfolio. An example of this is the Rockefeller family's decision to sell their investments in fossil fuels to reinvest in renewable energy.

Section

# 3 The costs of running a family office

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

Despite there being no standard definition of a family office, anecdotal evidence suggests that a full-service family office will cost a minimum of US$1m annually to run, and in many cases it will be much more. This would suggest that for a family office to be viable, a family should be worth between US$100m and US$500m. Of course, a family office can be set up with US$100m or even less, but the service range will probably be limited to administration, control of assets, consolidation and risk management. A fully integrated family office will require a great deal more wealth. Table 3.1 breaks this down in more detail.

### Figure 3.1. Family office types based on assets and costs

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

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

## Staff costs

Research from consultancy Family Office Exchange has found that a significant portion of the total costs of a family office are allocated to staff compensation and benefits.[1]

Figure 3.2 illustrates this cost breakdown in more detail.

A fully integrated family office – providing most, if not all, of the services mentioned in section three – would have a typical staff structure represented in Figure 3.3.

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

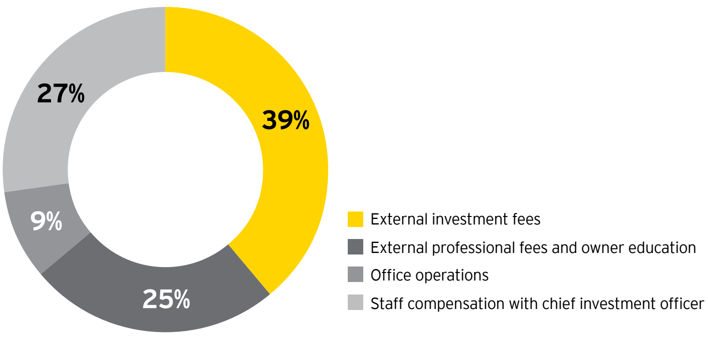
1. Family Office Primer, *Family Office Exchange, 2013*.

## Overall costs

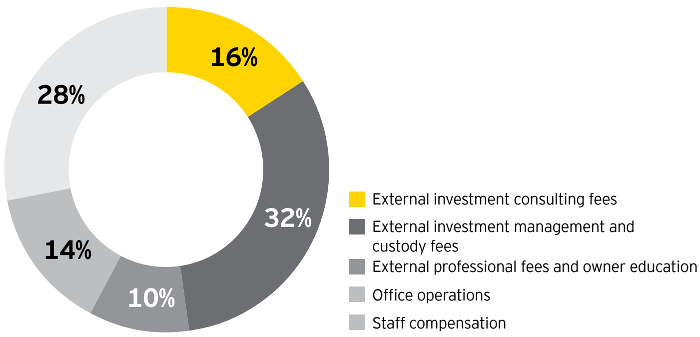
Family offices typically have operating costs of between 30 basis points and 120 basis points. A recent report by Campden Research and UBS[2] states that family office costs are on the rise globally, approaching the 1% mark as offices employ more staff. The report concludes that the costs of running family offices has increased as a percentage of Assets Under Management (AUM) over recent years and that the costs remain on an upward trend. Offices with the lowest running costs focus primarily on a limited number of wealth management services, such as handling real estate holdings. However, there is no strong correlation between the size of AUM and the operating costs.

### Figure 3.2. US family office costs

Oversight office with staff of 12 and internal Chief Investment Officer

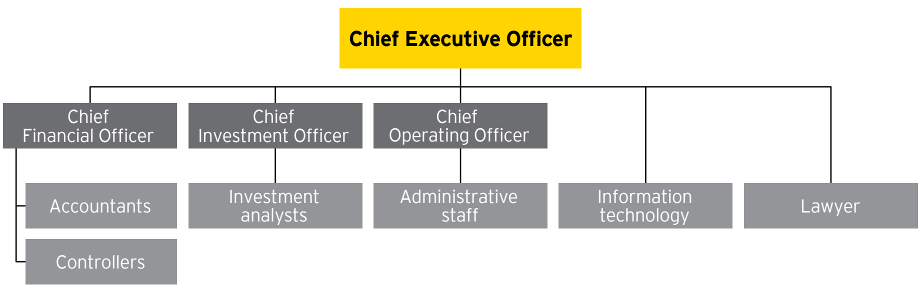



Oversight office with staff of three




Source: *The cost of complexity, understanding family office costs*, Family Office Exchange, 2011.

### Figure 3.3. Family office staff




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

2. *The Global Family Office Report,* Campden Research/UBS, 2015.

section 4

# Family office governance

## Defining governance structures

Family office governance is often ignored as a topic because families usually focus on managing their financial assets and investments and overlook the importance of implementing good governance practices in their private family office. Below is a guide to major issues regarding family office governance.

### Strategic planning

It is important to start the initial discussion with the family participating in a long-term review of their vision and strategy for the future. Such an exercise is very helpful in capturing the wishes and vision of the family as well as informing the management so they can develop a long-term strategic plan.

### Board of directors

As family offices usually stem from the desire of the founders to preserve the family wealth and protect the future of the next generation, they often tend to depend on trusted advisors whom they know well and have been working with for several years. Accordingly, the concept of a board of directors managing the strategic direction of the family office is often neglected. However, when the wealth is transferred to the next generation, managing the family office in the same manner may be a cause of conflict and dispute between family members.

There is a need to define a proper governance structure that takes into account the requirements of all family members. Electing a strong and active board that follows the direction of the family and takes into consideration the interests of all family members, not just a few, is very important. Moreover, including independent directors who add their experience and provide independent advice to the family is crucial in enhancing, strengthening and diversifying the family office investments and operations.

In many cases families are very reluctant to include independent directors and open their books to outsiders because of privacy issues. Those families may choose to appoint an interim advisory board with no voting powers to help strengthen the board and provide advice on specific topics. This step helps the family prepare and be more comfortable with including independent board members in the future, to create a fully functional board.

### Accountability

Founders are often reluctant to share much financial information with their children, in an effort to shelter and protect them from being accountable for their financial decisions. This is not a sustainable model; with responsibility comes accountability, and the family members need to be prepared from an early age to be responsible for their actions and understand that they will be accountable to the rest of the family. In order for them to be successful in the stewardship of wealth, they need to create the process and the opportunity for family members to grow and develop their skills and talent, as well as manage their financial affairs responsibly.

### Developing a proper structure

It is important for every family office to develop a proper management and legal structure to protect the operation of the family office and the assets of the family. Developing proper policies and procedures, and identifying key talents capable of leading the office are important factors in the successful operation of the family office. Moreover, in order to protect the family from any unnecessary tax implications and legal impact, it is also very important to select the right legal structure and jurisdiction for setting up the office.

## Block-holder and double agency costs

A crucial point for family offices to take into account when considering governance is that they are often exposed to substantial agency costs that result from managing nearly every aspect of the office.

As a result of the two main functions family offices serve, i.e., managing complex asset bases and aligning family interests, family offices encounter family block-holder as well as double agency problems that can result in additional costs (Zellweger and Kammerlander, 2015). Family block-holder costs can emerge when not all family members agree on the strategy of the family office. For example, one member of the family might be interested in short-term liquidity to finance lifestyle ambitions, whereas other members might be more interested in holding onto investments for potentially better long-term gains. This can lead to a misalignment of interest, which is a "cost" to the efficient running of the family office.

Double agency costs, similarly to family block-holder costs, can emerge when the interests of the family conflict with the interests of those non-family members hired to manage the family's wealth. An example of this is when the family is more concerned with the long-term outcomes of managing their wealth, compared with the often short-term outlook of family officers and their subordinated asset managers who look to maximize their own financial benefits to the detriment of the family's wealth. This leads to a misalignment of interests, which is a "cost" to the efficiency of the family office.

## Family block-holder costs

Families do not necessarily act in a unified way. Rather, family dynamics might counteract interest alignment and lead to conflicts involving costs that are referred to as family block-holder costs. A lack of governance of the family owners opens up the possibility of negative family dynamics.

Particularly destructive effects are expected in an EFO, which is characterized by the absence of formal and unambiguous governance instruments, such as boards, regulations and statutes. There are no clear responsibilities in controlling the EFO that shares part of its resources, staff and command structure with the operating business, which in turn could increase the possibility of family block-holder conflicts and the related costs compared with an SFO.

An increase in conflicts and struggles between family members can lead to particularly severe effects on family wealth, since conflicted family block-holders might be tempted to engage in spendthrift lifestyles. This could split the family wealth and consequently prevent the cohesion of the family and its assets across generations. Also, the absence of clear responsibilities, accountabilities and rules of engagement on the part of EFO employees who serve two masters could even aggravate the effects of family block-holder conflicts and their consequent costs.

## Double agency costs

Costs resulting anytime authority is vertically delegated down two tiers of hierarchies, are referred to as double agency costs. Double agency creates problems of control and accountability when two sequential sets of control relationships are involved, such as from the family as wealth owner to the family officer and the subordinated asset managers.

The principal's (i.e., the family's) loss of control over its agents (the family officers and the advisors) follows from incentives for opportunistic behavior. The striving for more autonomy and the behavior by agents to receive a remuneration is a major problem. The principal is increasingly exposed to biased information passed on from asset managers to the family officer and subsequently from the family officer to the family.

This phenomenon gains particular intensity in the family office environment, where the principal family usually lacks the sophisticated financial and investment knowledge that family office staff have, thereby increasing the probability of agents' empire-building at the expense of the principal. Because the family office often serves as the trusted advisor of the family for much of the family's financial affairs, and given the limited insights and know-how of the family into the complexity of these affairs, the family office is potentially well placed to act opportunistically if it is not properly monitored or incentivized.

Incentives for opportunism arise particularly in family offices since the family as principal may have difficulties in controlling the activities of a family officer and even more difficulties in supervising asset managers who are often external experts that are not part of the family office's own staff. Monitoring the family officer and his or her dealings with the asset managers is particularly difficult in SFOs. The formal setup and hierarchies often serve as barriers preventing the family from closely monitoring family office staff, accessing first-hand information on an ongoing basis, supervising asset allocation decisions, and controlling the efficiency of the family office operations.

If the family fails to provide adequate oversight, family office staff will be more prone to engage in collusive agreements with external asset managers and service providers or "self-dealings," where family officer and asset managers internally agree upon opportunistic dealings to the detriment of the family's wealth. Such conduct by family officers and asset managers undermines the preservation of wealth and generates potential reductions of the wealth and inefficiencies for the family.

## Family versus non-family members

The extent of double agency costs certainly depends on whether family office staff are composed of family or non-family members. It reflects the dilemma that families usually have to deal withemploying as family officer a non-family member who is well-versed in financial matters, or relying on a family member as family officer who might not have that competence but is trustworthy, thus diminishing double agency costs.

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

## The family office dilemma

Ultimately, family offices face a dilemma: on the one hand, the family as the ultimate asset owner wishes to appoint the most qualified people to run the family office. Sometimes, a competent person is available within the family, but this is not often the case. Then, a professional non-family family officer has to be appointed. The benefit of doing so is that family block-holder conflicts can be mitigated through the non-family member running the family office.

But a natural consequence of such delegation of control is the risk of losing control altogether. This is particularly true for wealth structures that involve trusts and foundations, but the problem is also apparent in the case of SFOs.

In light of this dilemma between professionalization and loss of control, families with a family office will have to find ways to combine the best of both worlds, achieving professional management while maintaining control.

Boards, investment advisory committees, the personal involvement of family members in selected activities, incentive systems for the managers and monitoring systems are often put in place to tackle the challenge.

Section

# 5 Constructing a business plan, staffing and strategic planning

## Planning a strategic way forward

If a family decides that it needs a family office, what are the next steps?

It is an increasingly widely held view that a family office — even an SFO — should not operate in the *long term* on a deficit basis, i.e., purely as a cost center. Most successful entrepreneurs would not start a business without a written business plan. Once the business is running, these entrepreneurs generally create and update short- and long-term strategic plans for the business. Leading family offices provide that same level of diligence for themselves. A crucial part of the strategic plan is staffing, which is discussed in the section 5.1, *Family office staff*.

## Business plan

The first step in creating a business plan is understanding the vision for the family (usually described in a family charter), and subsequently the vision for the family office. Here are some of the key components of such a plan:

### Summary

It is important to describe the vision for the family office, explain why it is being created, whom it is designed to serve and how it is expected to evolve. Is there an intention to serve other families, thus becoming an MFO, or just to serve the single family?

### Family business

Is there a business linked to the family office, or has the business been sold? Family offices often start as an EFO within the business, and become a separate entity when the family, its complexity and its risks outgrow the business staff.

## Structure

What type of entity will house the office, and who will own it? What is the plan for passing ownership across generations (assuming the office is intended to support more than the first generation)? Will the office support businesses, with the potential of having some expenses deductible against business income? It is important to discuss the intended tax impact of the structures to ensure that the family understand their potential consequences. Tax and legal advisors generally have a significant advisory role on structure and jurisdiction.

## Jurisdiction

Global families need to consider which country the office will be based in, but this decision goes much further. Within specific countries such as the US, states have vastly different tax, legal, and judicial benefits. The business plan should specify where the office and entities will be based.

## Governance

Governing boards or councils need to be defined, including how they will work. This structure often includes a family council, investment committee and even a philanthropic committee. The plan should define what boards will exist, how board members will be selected, how the boards will change over time, how decisions will be made within them, and whether they will include non-family participants.

## Services

There needs to be a description of the services the office will deliver, and for which family members or generations. In some cases, there is a list of base services available to all family members, with additional services available on an à la carte basis.

## Staffing

This section will need to discuss the types and number of staff in the office, in addition to the organization or reporting structure. Often, the family officer reports to a family council or perhaps to a particular family member. It also helps if this section discusses conditions under which family members may be permitted to work in the office.

## Operations

How will the services be delivered, and what technology is required to support them? The team should be able to delve into the key types of technology, either selecting the specific tools or narrowing them down to two or three providers. This section also describes which services are intended to be outsourced and which should be delivered directly by family office staff.

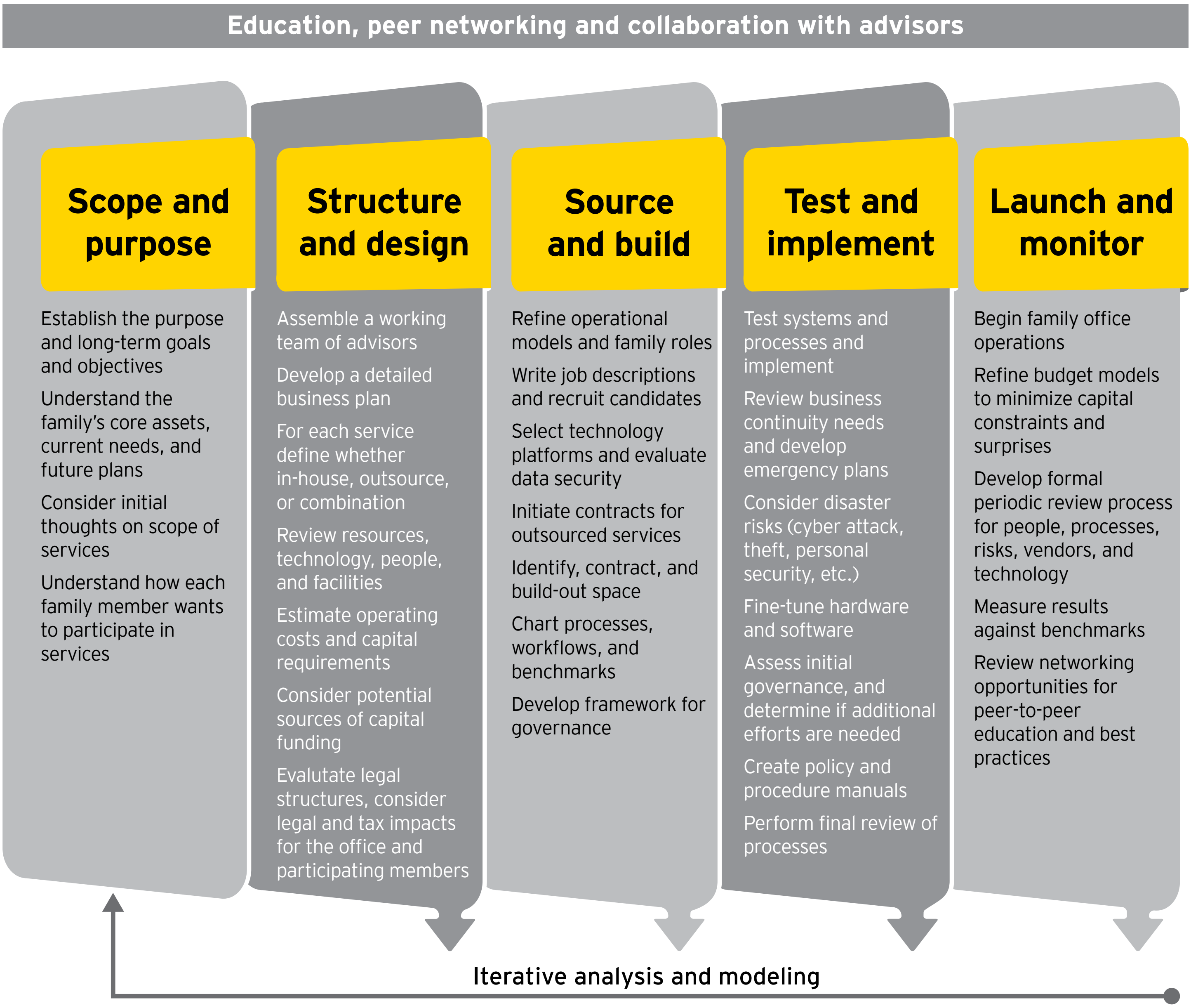
## Financials

There should be pro forma budgeting for the office, including staff, facilities, technology, and outsourced services. This section describes how the office will be funded, whether through business activities, billing family members, a charge on investments, or some other mechanism.

## Workplan

There needs to be a detailed plan of how the office will be implemented. Services may be rolled out in phases, or perhaps outsourced initially and brought in-house later (see figure 5.1).

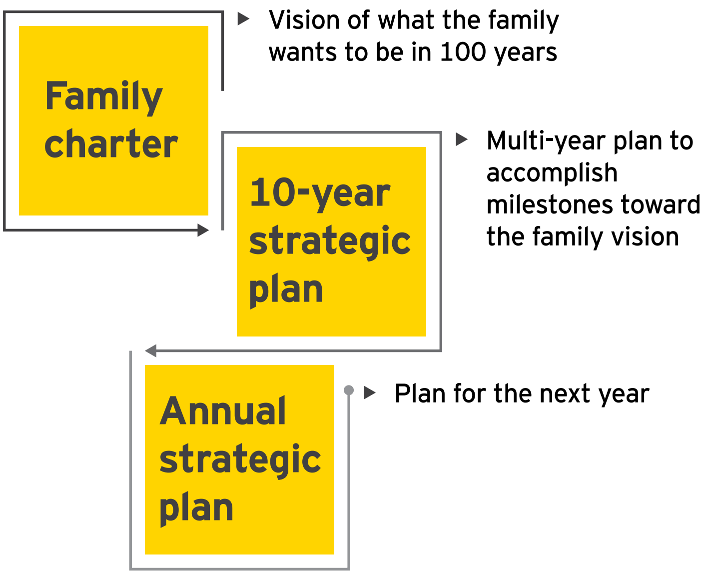
Figure 5.1. Family office implementation plan



## Strategic planning

Once a family office is operational, strategic planning remains an important exercise. Annual strategic planning is important for all family offices, but offices that have continued for generations often create additional 5- or 10-year strategic plans. Family offices respond to a wide variety of demands from many family members, and it is easy to just be reactive. Staff must take the initiative in their strategic planning (see figure 5.2).

Figure 5.2. Family office strategic planning




## The 10-year strategic plan

For family offices that have existed for a long time and are supporting multiple generations, recent years have seen an increase in 5- or 10-year strategic plans. These plans are designed to bridge the gap between the vision in the family charter (sometimes considered a 100-year plan) and the annual strategic plan.

Often, the process the family goes through is just as important as the outcome. Taking time to plan what they want to accomplish in the next 10 years causes them to think very differently than for annual planning. Here are the major elements often considered in these plans:

### Succession planning

Preparing family for leadership takes many years, whether that is for leading the business, governance committees or the family office. Families may develop programs for an entire generation, offering training, mentorship, and business internship programs to give them the experience to lead the family.

### Business or investment growth

Families may consider starting a new business, or perhaps a large real estate development plan, or a shift into private equity investing.

### Direct philanthropy

Some families set philanthropic goals of changing a particular community, providing higher education or solving health issues. These may be long-term goals, better served through a 10-year plan.

Due to the nature of these planning efforts, families often find it beneficial to engage an outside advisor to lead and facilitate the process, which can help to bring new perspectives.

## Annual strategic planning

The outcome of annual planning is an evaluation of activities in the previous year, goals for the coming year, and a plan for achieving those goals. Here are some important factors in the strategic plan:

### Reflection

How have the family and the office performed against the current year plan? What are the strengths and weaknesses of the family and the family office? What major changes have occurred since the last planning exercise? Is the family successfully moving toward its long-term vision specified in the family charter, or are there major gaps between the stated goals and what they are actually doing?

### Feedback

Actively find out what family members think of the office, its staff, and the support it provides. Quite often, the older generation are pleased with the office, while younger generations are less happy with it.

### Risks

What are the major risks the family and the family office face, and how might they be mitigated? This is an opportunity to consider succession planning, risks from staff or operations, economic, legal, or tax events, and how business risks might impact the family or how family risks might impact the business.

### Family office operations

Evaluate the current family office and its operations. Priorities often change, and some services may be better delivered by an outside provider. This is a good time to consider each outside advisor or service provider. It may be that the office needs additional staff, or needs to plan for coming retirements or other changes.

### Technology

This is a growing concern among family offices, and requires a lot of time and resources. It is beneficial to compare current offerings with the rapidly changing marketplace, including how the various tools work together to meet the family's needs. Cybersecurity must also be considered, as to how it could impact the family's finances as well as its potential effect on the family privacy and physical safety.

### Family initiatives

Consider what new initiatives the family desires and how the office will support them. Are there new businesses being formed, a real estate development activity, new philanthropic initiatives, or perhaps a major family anniversary to plan for?

### Budgeting

Bringing together the above components will help determine the budget for the coming year, including a plan for how it will be funded. When the family agrees with the planning and future initiatives, they will be much more likely to agree to the required funding.

## Recruiting, developing and incentivizing family office staff

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

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

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

Despite the lack of formal recruitment structures, families can have advantages in attracting talent — often because they are able to offer more flexibility in compensation and incentive packages for

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

senior recruits. They can also offer a working environment and culture that can appeal to the right candidate looking for a change from big-company culture.

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

- Job description. This can be flexible, but must capture the key elements and essence of the role. Family office executives are often involved in multiple projects.
- Interview committee. The responsibility of hiring for roles such as CEO and CIO should not be undertaken by one person. Sharing the process and risk of the hire is advisable.
- Checking references. The recommendation from a trusted advisor or family member is valuable, but more extensive checks should be made. The process should be rigorous in order to ensure objectivity.

## Retaining talent

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

### 1. Compensation

- Conversations

  The feedback process must be performance-based, consistent, and incorporate an element of long-term compensation.

- Incentives

  Can include things such as phantom stock (future cash payment based on market value of shares), co-investment opportunities, transaction bonuses and, in some cases, partnerships. Incentive plans often reflect the standards in the industry that created the family's wealth, so packages vary by industry.

- Benchmarks for compensation

  A CEO's base salary in the UK ranges from US$240,000 to US$630,000, while in Switzerland CEOs managing multijurisdictional wealth receive between US$450,000 and US$720,000 as a base.

### 2. Feedback

- Delivery

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

- Receptiveness

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

section 6

# Risk management

## Integrating risk management

The maintenance of family wealth across generations is an extremely complex task. There are many risks, any of which can prevent a family from achieving their long-term legacy. Families should develop an integrated risk management approach between the family business assets and the private family assets, in order to protect themselves from risks.

### Categories of risk

The family office is the right entity to manage the different risks facing the family. Typically, the family wealth originates from the sale in whole or in part of the family business, or from free cash flows that are not reinvested in the existing business. This process of asset diversification goes hand-in-hand with the enterprise risk management process.

Against this background, family offices are tasked with complementing their existing standard risk measures with additional ones, particularly as direct investments in real assets gain in importance. Risk management at family offices is moving away from a mere controlling role to a time-critical, strategic advisory role.

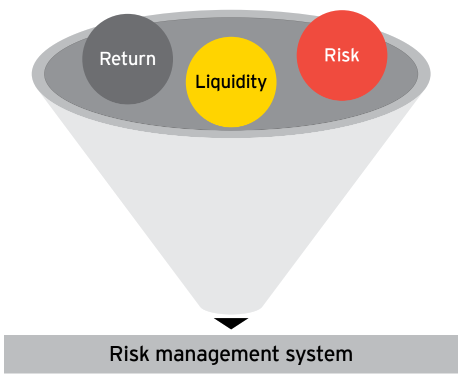
This new demand for risk transparency has led to the desire to invest more in direct investment opportunities and in real assets, rather than complex financial capital market products. A lower level of complexity of investment products, the proximity to the investment, and the possibility of having a real influence on the investment are more sought after now than ever before.

Long-term investments with lower volatility and a moderate expected return are often combined with short- to mid-term investments with a significantly higher risk profile to achieve outperformance. As part of this process, a further professionalization is taking place. Families rank investment risk, family reputation and family data and privacy among the top risks they face, according to a Campden Wealth survey on global family offices in 2014. This guide recommends that seven risk categories need to be evaluated as part of a strong and coherent approach to risk management (see figure 6.1 below).

### Figure 6.1. Risk management

| Risk category | Summary description |
|---|---|
| Vision/legacy | Stated family vision or purpose, services provided within the office, family governance, communication, education and planning |
| Operations | Transaction processing and controls |
| Estate/regulatory | Types of entities, management and oversight of those entities, compliance, reporting and office management |
| Business | Impact (or potential impact) on the family from the various businesses they own and manage, this encompasses financial, succession and reputation impacts |
| Technology | Evaluate platforms used in the office, and review the infrastructure of technology and security, particularly including cybersecurity |
| Investment | Examine the policies and processes around investment oversight, from investment policy statements to selecting managers, exclusive of evaluating the risk of specific holdings or portfolios |
| Disaster | Review plans and preparation for facing serious setbacks, which includes evaluation of existing insurance coverage |

### Figure 6.2. Risk management system




## Risk management systems

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

### Risk mitigation

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

### Cost reduction

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

### Value creation

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

Family office CEOs, CFOs and CIOs increasingly perceive enterprise risk management as adding real value to the family office operation. According to the *2014 European Family Office Survey* by Campden Wealth, families are well aware of the different risks, but often have not implemented an adequate risk management process.

In an appropriate risk management process, each of the seven categories of risk mentioned before will be assessed against the specific situation of the individual family/family office. The assessment of the inherent risks, if no controls or mitigating factors were in place, combined with the existing control environment, result in the residual risk after controls are taken into account (measured, for example, on a scale from low to medium or high risks).

Following such a diagnostic process (risk review, risk identification and risk measurement) structured recommendations can be made to report the risk objectively, improve the control environment and ultimately to mitigate the risks (see figure 6.3). Such leading practices would also include an existing disaster recovery plan for technology and data, as well as a physical protection plan (e.g., protecting against robbery or kidnapping) and an integrated human resources policy for family office staff.

Figure 6.3. Risk management process

**Risk review**

- Establish risk appetite of family and family office; what level of risk is acceptable?
- Define a common understanding of the risk level among family members, the investment committee or other relevant boards and the family office

**Risk identification**

- Establish a detailed risk identification process
- Identify and document qualitative and quantitative risks
- Define the chief drivers of volatility of the main asset classes and investments

**Risk measurement**

- Measure impact of risks on investment decisions
- Prioritize risks according to impact level and likelihood of occurance

**Risk reporting**

- Include relevant and sufficient level of information in regular reporting
- Establish family governance to deal with risk management

**Risk mitigation**

- Establish measures to mitigate at least the top priority risks
- Opportunities need to be identified in the same way as risks
- Establish regular monitoring of the family risk landscape

Section 7

# The investment process

## Background

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

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

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

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

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

## Role of the family

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

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

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

## Setting investment goals

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

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

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

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

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

## Tax considerations

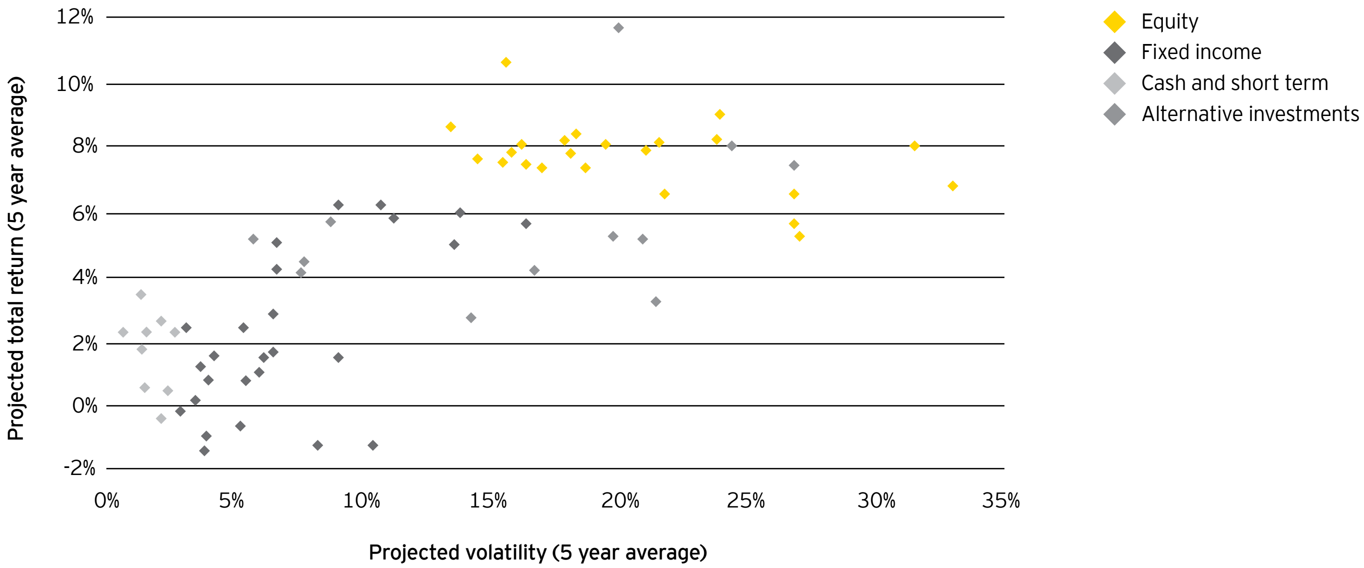
Selecting the most efficient combination of assets for the family requires an adjustment to portfolio optimization that takes into consideration the ultimate after-tax return that they would expect to receive. For each asset class, the expected return should be deconstructed to reflect the income yield from interest and dividends versus return from capital appreciation. Based on the level of turnover typical for each asset class, it is possible to estimate the percentage of asset appreciation that comes from realized versus unrealized capital gains, and also the extent to which realized capital gains would be treated as short-term as against long-term tax liabilities. Providing asset allocation analysis on an after-tax basis presents a realistic view of the return the family can expect from its portfolio investments, as well as an optimal mix of investments tailored to a family's specific tax situation.

## Stress testing and modeling

Once an initial portfolio shape is in place, several further exercises can be useful, such as stress testing the return profile of the portfolio to demonstrate to family members how the portfolio might behave during periods of volatility. In performing this type of analysis, it is sensible to examine all the family's wealth, not just their investment portfolio. Modeling the core business holding of a family as a form of private equity or direct equity holding, and then analyzing and optimizing other components of a family's wealth with respect to this, is a difficult but necessary task.

In the context of family businesses, one common outcome of this part of the process is to show that the initial investment portfolio of the family office could be better diversified, since it often has a large holding in the underlying family business or, in some cases, legacy investments that tend to be over-concentrated in certain asset classes (e.g., private equity). There are several different ways to achieve a more diversified portfolio for the family office (see Figure 7.1).

**Figure 7.1. Projected total return and volatility of various asset classes**




Source: The Captial Market Assumptions framework at Credit Suisse produces five year average return and volatility forecasts for 75 asset classes, some of which are shown in the chart.

## The importance of cash flow

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

## Implementation and governance

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

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

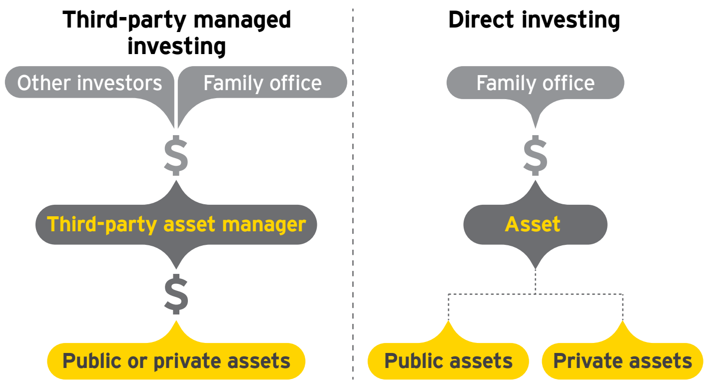
- Consideration of how legacy issues determine the starting point of the fund
- Objective setting and creation of an investment policy statement
- Mapping risk tolerances
- Building a portfolio structure across all liquid and illiquid assets
- Implementation using strategic and tactical investment tools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

## Investment strategy overview

Once investment goals have been established, family offices can begin thinking through how to deploy and manage capital. The type of investment strategy a family office pursues is a function of sourcing capabilities, desired control, liquidity needs, investing experience, and family office infrastructure. Family office investment strategies generally fall into three broad categories: (i) third-party managed, (ii) public direct and (iii) private direct. Often family offices use a mix of these strategies to diversify investment exposure and improve risk-adjusted returns.

Third-party managed investing consists of family offices using asset management funds to invest their capital. Families can make high-level decisions around how to allocate their capital between industry sectors and asset classes at the fund selection level. Below fund selection level, however, they have limited influence over investment decisions. Asset managers can focus their investments on public or private entities and on traditional or alternative asset classes (see figure 7.2).

Figure 7.2. Illustrative family office investment strategy



Direct investing involves the family office making the decision to invest capital into a specific asset or security. This requires the family office to do its own research and due diligence in the investment process. The family office is also responsible for continuing to follow asset level performance and manage its portfolio of these assets on a day-to-day basis.

- Public direct investing is centered on liquid debt, equity securities and derivatives that trade over a public exchange. These investments are made through the use of public information and are subject to regulatory requirements that both protect and constrain the investor. Unless very large positions are accumulated, public direct investing provides very limited influence over the underlying asset's management and strategic decisions.
- Private direct investing focuses on taking a more active role in the deal process and underlying investment. The family office will often be more involved in business decisions and strategy for the entity or asset. The investment can be structured as debt, equity, or as a specific asset purchase (e.g., real estate). Information can include both public and non-public items. Regulatory requirements are much looser, giving the investor greater access to information but more limited protection.

Presented below is a summary of the key benefits and considerations for family offices regarding each investment type (see figure 7.3).

### Figure 7.3. Family office investment strategy

| Strategy | Benefits | Considerations | Examples |
|---|---|---|---|
| **Third-party managed** | • Lowest infrastructure requirements<br>• Investment access is good but customization is limited<br>• Third-party expertise can be valuable | • Management fees<br>• Limited control over how capital is allocated at fund level<br>• Transparency can be limited<br>• Potential conflicts of interest<br>• Redemption features can impact liquidity | Fund investing:<br>• Mutual funds<br>• Private equity funds<br>• Infrastructure funds<br>• Hedge funds<br>• Fund of funds |
| **Public direct** | • Liquid asset class<br>• Avoids management fees<br>• Highly customizable portfolios<br>• Large investment universe<br>• Ability to use family office expertise in investment selection | • Limited to public market opportunities<br>• Information must be public<br>• Generally has limited influence over underlying entity or asset<br>• Subject to public market volatility around valuation<br>• Moderate infrastructure requirements to manage portfolio | Traditional investing:<br>• Money markets<br>• Fixed income<br>• Equities<br>• Commodities<br>• Options |
| **Private direct** | • Avoids management fees<br>• Highest potential for "alpha"<br>• Structuring flexibility<br>• Ability to use family office expertise in investment selection<br>• Highly customizable portfolios<br>• Increased access to information, including non-public<br>• Ability to influence decision-making around underlying asset | • Investment sourcing can be challenging<br>• Illiquid asset class<br>• Investment process, including due diligence and documentation, can be burdensome<br>• High infrastructure requirements | Alternative investing:<br>• Private equity<br>• Venture capital<br>• Mezzanine debt<br>• Real estate<br>• Infrastructure projects<br>• Natural resources<br>• Royalty streams |

## Private direct investing

Recently, a strong trend has emerged of family offices beginning to pursue direct investments in the private market. The primary drivers for this trend have been: (i) a search for better investment control, (ii) attractive risk-adjusted returns that have limited public market correlation, and (iii) lower price volatility. This type of investment strategy, however, requires the implementation of a formal investment committee process to identify, vet and execute new opportunities, as well as manage ongoing portfolio needs.

Some family offices have chosen to team up with other family offices to pursue this strategy as a club. This teaming-up offers attractive synergies around infrastructure, deal sourcing, and idea sharing but does create governance issues with investment selection and ongoing management. For small- to mid-sized family offices, the club approach also enhances their overall competitiveness in the marketplace by increasing the capital available to pursue new opportunities – an important criterion in winning a competitive deal.

Along the same lines, family offices can also decide to pursue individual deals on a co-investment or standalone basis. The private direct investment process can be broken into three broad phases: (i) making, (ii) managing and (iii) monetizing. Setting up a formal investment committee process around the implementation of these phases and setting up the necessary infrastructure in the family office for dealing with direct investments are critical. Family offices need to make sure that they have the right resources available and policies and procedures in place to ensure that the risks and opportunities around each investment are understood and managed (see figure 7.4).

### Figure 7.4. Private direct investing process

| Phase | Making | Managing | Monetizing |
|---|---|---|---|
| Description | The process of deciding to make the investment | The ongoing management and monitoring of the investment | The process to return capital to the investor (can be ongoing) |
| Key activities | ‣ Researching<br>‣ Sourcing<br>‣ Evaluating/due diligence<br>‣ Structuring (e.g., M&A and tax implications)<br>‣ Financing & capital markets/structure<br>‣ Closing | ‣ Strategic objectives<br>  ‣ M&A, organic, etc.<br>‣ Operations, financial results/cash flow<br>‣ Capital markets/structure<br>  ‣ Refinancing<br>  ‣ Dividend recapitalization<br>  ‣ Future capital needs<br>  ‣ Compliance<br>‣ Governance | ‣ Full sale<br>‣ Partial sale<br>‣ Capital markets/structure<br>  ‣ IPO<br>  ‣ Refinancing<br>  ‣ Dividend recapitalization<br>  ‣ Securitization |
| Ongoing support network | Financing, M&A, tax, legal, regulatory, process improvement, technology, risk management, compliance, accounting/financial reporting | | |

While family offices often possess the foundation needed to create a successful direct investment strategy, investment gaps can exist at each phase of the process. Family offices, like traditional asset managers, often rely on outside professionals to assist with specific services that are not carried out in-house (e.g., M&A advisory, capital markets advisory, legal advisory, tax advisory, accounting). This is particularly true as a family office platform initially begins pursuing the private direct investing strategy. Over time, however, as it gains experience and builds out its infrastructure, many of these professional services can be brought in-house.

Section 8

# IT, trading tools and platforms

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

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

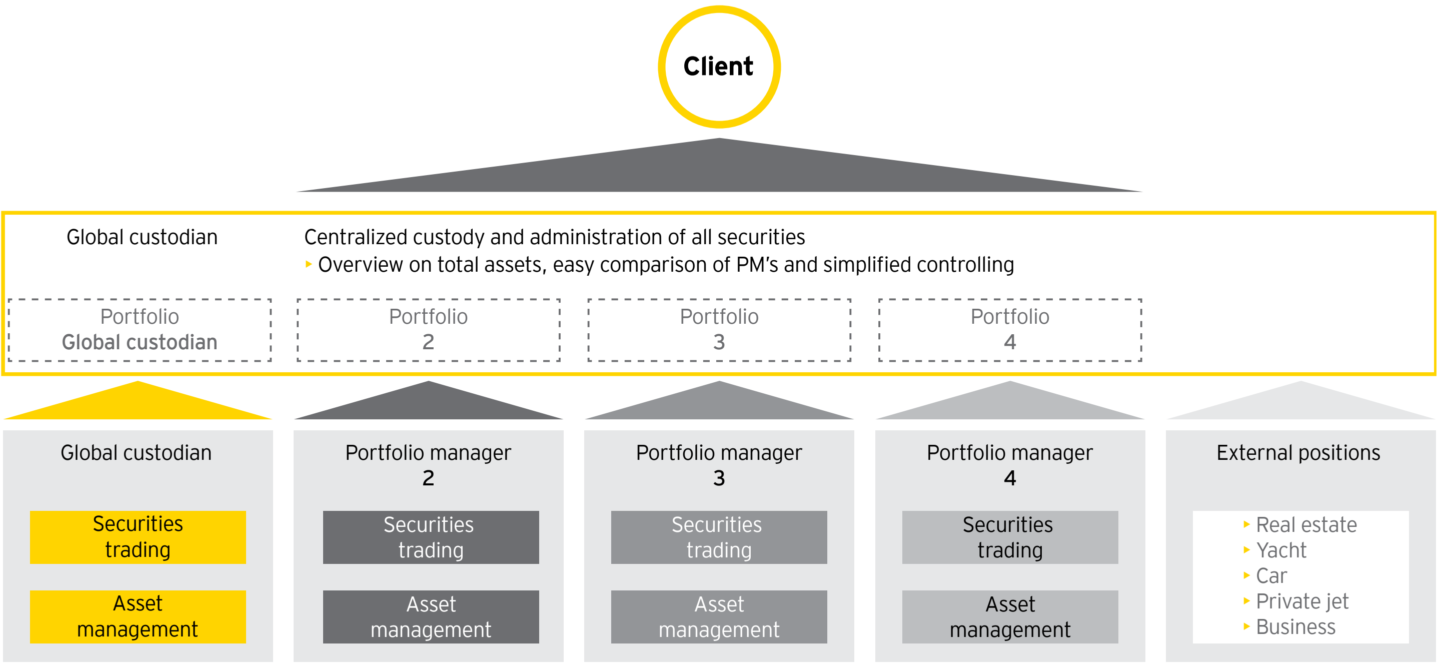
The selection of IT should be well thought out and designed in order to provide efficient reporting, trading, portfolio management and accounting. The technology can range from off-the-shelf products to highly sophisticated, customized solutions. Much of this can be outsourced or provided at low cost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

## Custody platform

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

The custody of bankable assets is the safekeeping and servicing of assets, either with one or multiple custodians or banks (see figure 8.1).

## Figure 8.1. Structure with global custody




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

Global custody refers to the custody and administration of assets with one custodian, which offers many advantages such as:

- The consolidation of all bankable securities, financial instruments, and liquid assets, so that the time-consuming work of consolidation resides with the global custodian and not the family office[1]
- The provision of a comprehensive, transparent overview of the performance of all the assets at all times via a consolidated investment report (providing a uniform format and standards for all assets)
- The assets can be managed either by the custodian bank, an external asset manager, or the client himself (i.e., the client selects their preferred asset manager with no restrictions, and the asset manager is free to select the brokers for securities trading)
- The opportunity to include some non-bankable assets, such as direct real estate investments, mortgages, third-party derivatives, art collections and yachts

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

## Consolidated reporting

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

## Trading and portfolio management tools

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

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

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

## CRM tool

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

## Human capital and technology

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

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

## Implementing technology

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

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

# Appendix 1

# The legal setup (excluding the US)

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

Given that the family is at the center of the family office, choosing a location close to the family, or at least to the central members, would appear to be much more important than a tax-optimized choice of location. Also the proximity to already existing, substantial family assets can be a decisive aspect. Nevertheless, legal, tax and regulatory aspects relevant to the setup, as well as to the operations of a family office, have to be checked carefully.

## Structure and jurisdiction

Considering the often global nature of families and investments today, the location and structure of the family office needs to be flexible enough to manage the changing landscape of the family, while still maintaining the benefits of a traditional, centralized family office. The family should gather the following information about its global concerns:

- Location of each family member – presence in multiple jurisdictions
- Future migration and travel plans
- Location of substantial family wealth
- Future investment plans and goals in other jurisdictions
- Locations where family members are subject to various taxes

## Criteria catalog

After reviewing various global interests of the family, the next step is to investigate the relevant jurisdictions by weighing the particular benefits and disadvantages of various structures and jurisdictions. This analysis is unique to each family. Pertinent items for consideration in each jurisdiction include:

- Legal structures available
- Tax implications of structure
- Ease of maintaining employees
- Cost of operation versus value received
- Ability to invest and manage assets of a global family
- Risks, reputation, and volatility – economic and political climates
- Regulatory and information filing requirements – immigration and visa requirements for family members
- Ability to coordinate efficiently with advisors in other jurisdictions
- Quality of communication and relationships with tax and regulatory authorities
- Streamlined exchange of information
- Flexibility to restructure in the future – including migration
- Opportunities for succession

Which aspects are actually relevant in each individual case depends in particular on whether the family office will:

- Actually own the family wealth

  Or
- Administer the family wealth by acting for the family members

  Or
- Only advise family members on their joint investments, and in selected fields of activity

Depending on the framework provided by the jurisdiction, there are normally many aspects that must be considered in order to optimize the individual situation within the given set of legal, tax and regulatory frameworks. This section examines these considerations in more detail.

### Asking the right questions about location

The most crucial aspect of choosing a location for a family office may not be the legal and tax environment. Nevertheless, there are obviously a few jurisdictions that stand out as centers of family office excellence.

The following jurisdiction summaries provide you with information on the regulatory environment for the provision of family office services in the most relevant jurisdictions and with an overview on the company law and tax issues regarding the family office itself. This basic information is intended to illustrate those aspects that have to be considered when defining the scope and the location of the family office. It is important to establish which questions have to be asked – and answered – in the process of setting up a family office.

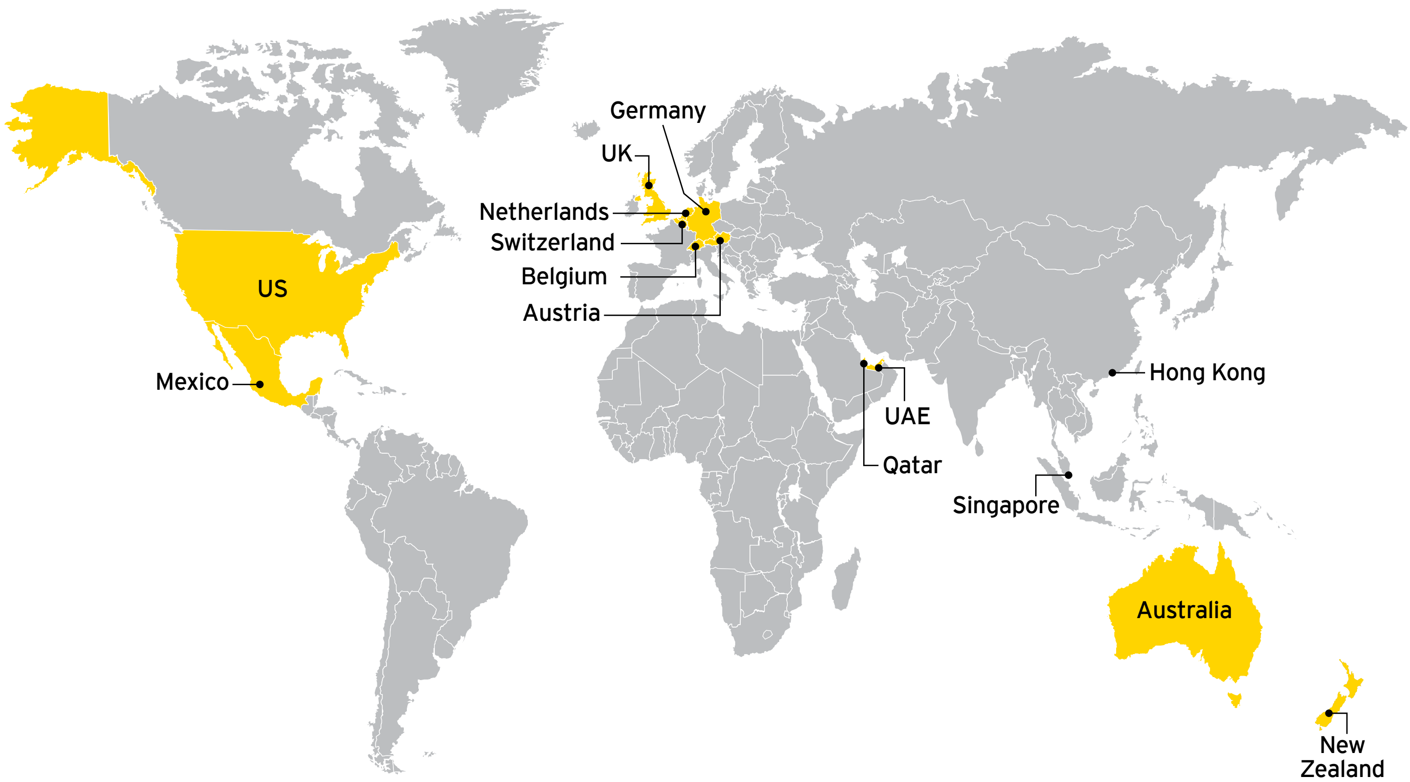
## Germany

### Limitation regarding financial activities

The most important law regarding the regulatory environment for family offices in Germany is the German Banking Act (Kreditwesengesetz – KWG). This sets out the regulatory terms and conditions for giving investment advice and similar services. To what extent regulatory restrictions have to be respected depends on the structure and the specific tasks of the family office. Nevertheless, the following aspects have to be considered:

- If the family office is structured as a company (corporation or partnership) that actually owns the family wealth (with the family members as shareholders or partners) its investments qualify as "own account transactions" (Eigengeschäften), which do not require a special permit and are not subject to further regulatory requirements. Consequently, the family office's personnel do not require special permits.
- If, on the other hand, the family office acts as an advisor to the family or family members on how to invest their assets, or if the family office performs the investments on behalf of the respective owner of the funds, such activities may require special permission from the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin).

On 22 July 2013, the European Alternative Investment Fund Managers Directive (AIFMD) and the domestic law based upon this guideline (KAGB – Kapitalanlagegesetzbuch) became effective with a huge impact on the whole industry. Investment undertakings, such as family office vehicles which invest the private wealth of investors without raising external capital, should not be considered to be AIFs in accordance with this Directive. Any impact on the activities of MFOs have to be closely monitored and need to be addressed individually.



## Limitation regarding legal and tax advice

Under German law, legal and tax services may only be administered by lawyers and by certified tax advisors respectively. If a company performs these professional services, such a company has to be registered as a law firm or a tax consultancy practice, which requires that the company is at least partly owned and managed by persons who are personally authorized to render such services. Thus, the provision of such professional services by a family office is only possible if the company meets the aforementioned requirements or if it only arranges for the provision of such services through trusted advisors.

## Limitation of liability

The extent of possible liability for professional mistakes is dependent on the structure of the family office and on the legal nature of its services. If the family office actually holds the family assets (as the legal owner) its management is only accountable within the limits of directors' and officers' liability. Financial losses are losses of the family office itself and cannot be claimed as damages by the family directly.

However, if the family office acts as an advisor to the family (still owning the assets according to legal definition) any shortcomings in the quality of the advice resulting in financial losses may be claimed as damages. A total exclusion of liability, even for gross negligence, is not permissible under German law. Furthermore, it is advisable to cover such risks by using financial-loss insurance.

## Company law issues

Family offices may be structured in various ways in Germany. Normally, it would be advisable to establish an independent legal entity using a corporation (stock corporation — AG, limited liability company — GmbH) or a limited liability partnership (KG). The use of a partnership (without built-in limitation of liability) does not seem appropriate (but is also possible). From the point of view of corporate law, corporations (especially stock corporations) do not offer the same degree of flexibility as limited liability partnerships.

But this effect is, more or less, limited to corporate matters, such as the notarization of the articles of association and their amendments and (in the case of stock corporations) notarization of other shareholder meetings. As far as day-to-day business is concerned, there are no real differences between the relevant structures. German law does not have structures comparable to common law trusts; it has not ratified the Hague Convention on the Recognition of Trusts. For instance, a foreign trust with German-situated property set up by a will is invalid from a German civil law perspective.

## Limited liability company

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

## Stock corporation

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

## Limited liability partnership

The limited liability partnership is normally composed of a GmbH acting as a general partner, and one or more limited partners whose liability can be limited to any amount (but must be registered with the commercial register of the company). The partnership is managed by the general partner which is a GmbH. One or more limited partners may be managing directors of the GmbH (general partner).

## Family foundation

According to German civil law, a foundation is an organization that, by using its capital, promotes a special purpose set by the founder. Usually, the capital of the foundation needs to be preserved and only the income is spent for defined purposes. A foundation has its own constitution regulating its organizational structure and codifying the purposes set by the founder. A foundation has no members or shareholders and can be formed as a legal entity.

## Tax issues

From an income tax point of view, the treatment of corporations and partnerships is different. Corporations are subject to corporate tax (Körperschaftsteuer, 15%) and solidarity surcharge (Solidaritätszuschlag, 5.5% on the corporate tax). Furthermore, trade tax (Gewerbesteuer, approximately 15% depending on the municipality where the business is located) is imposed on the company.

If a family office is set up as a corporation and actually holds the family assets, certain parts of the income (dividends and capital gains from the sale of shares in corporations) are tax-exempt (except for 5% of such income which is deemed to be nondeductible business expenses). This can lead to material economic benefits if the income is accumulated at the corporate level. The 95% tax exemption is not granted for portfolio dividends (less than 10% shareholding at the beginning of the calendar year) received from 1 March 2013 onward. There are plans to extend this restriction to portfolio capital gains as well.

If, however, the profits of the family office in the legal form of a corporation are distributed to its shareholders (individuals), this income (dividends) may again be subject to German income tax (and solidarity surcharge and church tax, if applicable), if such shareholders are taxable in Germany. Generally, a flat tax of 25% and solidarity surcharge (5.5% on the income tax) and church tax (if applicable) are applied on the dividends.

If the shareholding belongs to the private assets of the shareholder and amounts at least to 25% respective to 1% in the case of the shareholder being employed by the corporation, the shareholder can opt for the taxation on the basis of the partial income procedure (60% of the dividend is taxable and 40% is tax-free), which — in contrast to the flat tax — allows the shareholder to consider negative income resulting from the shareholding.

Partnerships are not subject to taxation (except for trade tax). Their income is split among the partners (without regard to whether or not a profit distribution is actually made) and taxed as their personal income. Such income of the partners is subject to income tax (Einkommensteuer, current marginal rate of 45%), if the partner is an individual, or corporate tax, if the partner is a corporation. Dividend income and capital gains from shares held at partnership level may be partially tax-exempt; in this regard, special rulings may apply (depending partly on the shareholder structure).

## Switzerland

### Limitation regarding financial activities

Given that family offices do not normally accept deposits from the public on a professional basis, family offices do not require a banking license. Asset management is a standard activity of many family offices. Asset management as such — i.e., acting in the name and for the account of the family — is currently not subject to licensing in Switzerland.

However, asset managers are subject to the Anti-Money Laundering Act, and must become members of a recognized anti-money laundering self-regulatory organization or directly subordinated to the Swiss Financial Market Supervisory Authority (FINMA). If the family office acts as an asset manager of a collective investment scheme (either Swiss or foreign), a FINMA authorization is required for the asset management activity. Further, if a family office intends to distribute units or shares of a collective investment scheme, this is also a regulated activity and subject to a FINMA authorization.

### Limitation of liability

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

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

### Company law issues

The legal form of a Swiss family office is neither driven by the complexity of its functions nor the family's wealth structure. Given the unlimited personal liability of at least one partner, Swiss partnerships are not a common legal form for a family office. Swiss foundations are also seldom used, given their rigid rules in the Swiss Civil Code. In addition, Swiss law does not provide for legal forms comparable to common law trusts, although Switzerland has signed the Hague Convention of 1 July 1985 on the law applicable to trusts and on their recognition, which has been in force in Switzerland since 2007. Finally, limited liability companies are often avoided, given the need to register company members with the register of commerce. Therefore, the usual legal form would be a share corporation.

More important than the legal form is the fundamental question of whether the family office holds the family assets, i.e., whether the family office is part of the family-run concern or whether the family office is separated from the family business. In practice, both setups exist. A separation is more often seen in large-scale, multinational family businesses with fully operational entities, whereas integration occurs where the business is smaller or the assets only consist of financial investments.

### Tax issues

Due to Switzerland's federal system, taxes are levied at three different levels, the federal, cantonal and communal level. Therefore, the taxation of similar legal structures varies from canton to canton as some of the applicable regulations, and in particular tax rates, are not harmonized. In general, corporate taxation for family offices in Switzerland consists of the following aspects:

- Corporate income tax is levied at the federal, cantonal and communal level. Whereas the federal statutory tax rate is 8.5% of the net profit after tax, the cantonal and communal rates vary depending on the location of the entity and the tax privileges available, if any. In the case of ordinary taxation, the total effective maximum tax burden, consisting of federal, cantonal and communal taxes, ranges from approximately 12% to 24%.
- Provided that a tax privilege is applicable, the total effective maximum tax burden starts at approximately 8%.
- Capital tax on net equity is also due once a year and varies, as it is levied on the cantonal and communal level only, between 0.001% and 0.525% depending on the location of the entity and the tax privileges available, if any. Approximately half of the cantons allow corporate income tax to be credited against the net equity tax.

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

A one-off capital duty of 1% is generally levied on capital increases or contributions to Swiss-incorporated companies. However, tax planning is available around exemptions for (i) qualifying mergers, reorganizations and financial restructurings and (ii) other contributions within incorporations and capital increases of up to the first CHF1m. In addition, a securities turnover tax on the sale or exchange of taxable securities may apply if the family office (i) qualifies as a securities dealer in the capacity of a broker or dealer or (ii) trades on the family office's own account, provided it holds more than CHF10m of taxable securities. The tax rate is 0.15% for Swiss securities and 0.3% for foreign securities.

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

Also, it is worth mentioning that due to the Hague Convention of 1 July 1985 on the law applicable to trusts and their recognition, which has been in force in Switzerland since 2007, Swiss-based family offices acting as trustee or protector should generally not trigger negative tax implications in Switzerland. This is because in neither capacity is the family office the beneficial owner of the trust assets, although the trustee holds the legal title. Trust assets have to be permanently monitored, controlled and managed, whereas less complex structured assets may require less monitoring, but focus more on asset protection and preservation for future generations.

## Austria

### Limitation regarding financial activities

Under Austrian law, legal and tax services may only be offered by lawyers and by certified tax advisors. If a company performs such professional services, it has to be registered as a law firm or a tax consultancy practice. Thus, the provision of such professional services by a family office is only possible if the company meets the aforementioned requirements or if it arranges for the provision of such services through trusted advisors only.

### Limitation of liability

The extent of possible liability for professional mistakes depends on the structure of the legal form of the family office and on the nature of its services. If the family office manages a company that actually holds the family assets (as the legal owner), the family office is only accountable within the limits of its directors' and officers' liability. Financial losses of the holding company itself are losses of the family office itself and cannot be claimed as damages by the family directly.

If the family office acts as an advisor to the family's companies or the family members themselves, any shortcomings in the quality of the advice resulting in financial losses may be claimed as damages. Normally the liability is (and should be) limited by contractual agreement to gross negligence and/or capped at a certain amount.

### Company law issues

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

More important than the legal form is the fundamental question of whether the family office holds the family assets, i.e., whether the family office is part of the family wealth or is separated from the family or business. Depending on the family's asset structure, the Austrian jurisdiction offers different suitable legal forms. Since the introduction of the Austrian Private Foundation Act in the 1990s, many family-owned fortunes were endowed in private foundations. Accordingly, many organizational and administrative services are provided by the foundation's governing board.

Today, the governing board not only manages and coordinates family assets, but also needs expertise in other fields and should guarantee independent, complete and comprehensive advice. Although the foundation's governing board is not considered the management board of the private foundation by the Austrian Private Foundation Act, a family office can be installed through the foundation deed.

The family office's members, tasks, functions, rights and goals, as well as the governing board's instruction rights can be established in the foundation's deed. Outside the legal form of the Austrian private foundation, a family office can be set up as the managing board of a holding company with limited liability (GmbH), which actually holds the family's assets, or as a service company with limited liability that offers advisory services to the family's holding companies or the family members themselves.

### Tax issues

From a tax planning perspective, family offices can be set up in a variety of legal forms, such as corporations, partnerships or private foundations. Which form fits the requirement best will depend on the individual asset and holding structure as well as on the range of services provided through the family office.

From an income tax perspective, corporations and partnerships are treated differently. Corporations are subject to tax, while partnerships are "look through" vehicles and taxed at the partner's level. If a family office is set up as a corporation and actually holds the family assets, then dividends (including hidden profit distributions) received by an Austrian company from other Austrian companies are exempt from corporate income tax (no minimum holding is required). Capital gains derived from the sale of shares in Austrian companies are treated as ordinary income and are subject to tax at the regular corporate tax rate.

An Austrian company is entitled to the international participation exemption, if it holds at least 10% of the share capital of a foreign corporation that is comparable with an Austrian corporation for more than one year. Dividends from participations that do not meet the criteria for international participations are subject to the general corporate income tax rate of 25%. However, shareholdings in EU corporations, certain European Economic Area (EEA) corporations and corporations that are resident in other countries with which Austria agreed to exchange tax information qualify as international portfolio participations. Dividends from such international portfolio participations are exempt from tax, irrespective of the ownership level.

Distributions from corporations are subject to a withholding tax of 25% (from 1 January 2016, the rate will increase to 27.5%), if not qualifying as repayment of capital. Partnerships themselves are not subject to taxation. Their income is allocated to the partners (irrespective of any distribution) and taxed as the partner's income. Currently, the top marginal rate for individuals is 50%; from 2016 this will increase to 55%.

A private foundation is subject to the standard corporate tax rate of 25%. Dividends (including hidden profit distributions) received by an Austrian private foundation from Austrian and foreign companies are exempt from taxation. Capital gains derived from the sale of shares are subject to a special intermediary tax of 25% which can be set against the withholding tax on grants of the private foundation to its beneficiaries. Grants are subject to a withholding tax of 25% (from 2016 the rate will increase to 27.5%).

## The Netherlands

### Limitation regarding financial activities

The most important law regarding the regulatory environment for family offices in the Netherlands is the Financial Supervision Act (Wet Financieel Toezicht — Wft). The Wft sets out the regulatory terms and conditions for giving investment advice and similar services. This law is monitored by the Authority for the Financial Markets (AFM). Any company or person wishing to provide financial services will need a permit from the AFM. The costs of these permits range from €2,000 to €5,500. Neither the law nor the AFM distinguishes between the legal forms of a financial services company. Besides a permit for the company itself, all employees providing the actual financial services will require a Wft certificate (i.e., they must have completed a professional training).

### Limitation of liability

The extent of possible liability for professional mistakes is dependent on the structure of the family office. If the family office holds the family assets (as the legal owner), its management is only accountable within the limits of directors' and officers' liability.

If, on the other hand, the family office acts as an advisor to the family (still owning the assets according to legal definition), any shortcomings in the quality of the advice resulting in financial losses may be claimed as damages. Normally, the liability is — and should be — limited by contractual agreement to gross negligence and capped at a certain amount. It is advisable and common to cover such risks by using financial-loss insurance.

### Company law issues

Family offices may be structured in various ways in the Netherlands. Normally, it would be advisable to establish an independent legal entity using a corporation (stock corporation — NV, limited liability company — BV). The use of a partnership (without built-in limitation of liability) does not seem appropriate (but is also possible). From the point of view of corporate law, corporations (especially the BV) offer a large degree of flexibility.

Dutch law does have structures comparable with common law trusts (foundations). The Netherlands has ratified the Hague Convention on the Recognition of Trusts (dated 1 July 1985). For tax purposes, assets owned by a trust-like entity (separated private assets or APV) are generally attributed to the settlor or his or her heirs.

### Limited liability company (GmbH)

A limited liability company (BV) requires a minimum share capital of €0.01. The BV is represented by a board consisting of at least one director (bestuur). The members of the board are elected by the shareholders. The board is (only) internally bound by shareholder decisions, but can act independently, against explicit shareholder instructions, with legally binding effect.

### Stock corporation (NV)

A stock corporation requires a minimum share capital of €45,000. It is represented by a board consisting of at least one director. The members of the board can act independently. The board members are chosen by the shareholders or, in the case of larger corporations, a supervisory board (Raad Van Commissarissen). A supervisory board is compulsory if the company either has capital exceeding €16 million, more than 50 employees on a stand-alone basis or more than 100 employees on a group basis. The supervisory board is elected by the shareholders.

### Dutch foundation

A foundation (Stichting) is a legal entity that, by using its capital, promotes a special purpose set by the founder. A foundation has no members or shareholders. The foundation is represented by a board consisting of at least one director. The way the board is appointed is not prescribed by civil law. A procedure to appoint the board can be chosen to fit the appropriate needs of the foundation, but the choice has to be included in the articles of association.

It is prohibited for a Dutch foundation to make distributions to its founder(s), director(s) or any other persons unless, in the latter case, the distribution has a social or charitable purpose.

### Tax issues

From a tax point of view, the treatment of corporations and foundations is different.

### Corporations

Corporations are subject to corporate income tax (Vennootschapsbelasting, 20% on the first €200,000 of profit, 25% on the profit over that threshold). If a family office is set up as a corporation and holds the family assets, certain parts of the income (dividends and capital gains from the sale of shares in corporations) are tax-exempt. The tax exemption is not granted for portfolio dividends (less than 5% shareholding) or dividends received from corporations resident in tax havens. Distributions by the family office or corporation to the shareholders are generally liable to dividend withholding tax (15%).

### Foundations

The Dutch foundation is only liable to corporate income tax to the extent that it performs commercial activities. If a foundation engages in commercial activities, but the profit does not exceed an amount of €15,000 in a year (or €75,000 in the last five years), the exemption will also apply. Distributions by the family office or foundation are generally liable to Dutch gift tax (10%-40%).

## Belgium

### Limitation regarding financial activities

Family offices in Belgium may be subject to several laws and royal decrees regarding the supervision of the financial sector and of financial services. This legislation sets out the regulatory terms and conditions for giving investment advice and similar services.

This legislation is monitored by the Financial Services and Markets Authority (FSMA). Any company or person wishing to provide financial services will need a permit from the FSMA. The cost of these permits depends on the kind of services offered by the family office. The law limits financial services to certain legal forms.

Besides a permit for the company itself, employees providing the actual financial services may require certain certifications, depending on the services offered.

### Limitation of liability

The extent of possible liability for professional mistakes is dependent on the structure of the family office. If the family office holds the family assets (as the legal owner), the liability of its management will be covered by the directors' liability as described in the Belgian Companies Code or, if the management is not a director of the family office, by the contract between the family office and the management.

If, on the other hand, the family office acts as an advisor to the family (still owning the assets according to legal definition), the liability for shortcomings in the quality of the advice resulting in financial losses will be a contractual liability. Normally this liability is — and should be — limited by contractual agreement to gross negligence and capped at a certain amount. It is advisable and common to cover such risks by using financial-loss insurance.

### Company law issues

Family offices may be structured in various ways in Belgium. Normally, it would be advisable to establish an independent legal entity using a corporation (a public limited company — NV, or a private limited liability company — BVBA).

### Private limited liability company (BVBA)

A private limited liability company (BVBA) requires a minimum share capital of €18,550. The BVBA is represented by one or more directors (zaakvoerder/gérant). A distinction is made between a statutory director (appointed in the articles of association) and a non-statutory director (appointed by the general meeting of shareholders). The board is (only) internally bound to shareholder decisions, but can act independently, against explicit shareholder instructions, with legally binding effect.

### Public limited company (NV)

A public limited company (NV) requires a minimum share capital of €61,500. It is represented by a board consisting of a minimum of three directors (bestuurders or administrateurs). However where the company is incorporated by two founders or has no more than two shareholders, the board of directors may be limited to two members. The members of the board can act independently. The board members are chosen by the shareholders.

### Tax issues

Corporations are subject to corporate income tax (Vennootschapsbelasting, of in principle 33.99%). The highest rate for small and medium enterprises (SMEs) is, however, 35.54%. An SME for the application of the so-called reduced progressive tax rates is defined as a company with a taxable profit not exceeding €322,500. Income below €322,500 is taxed at progressive rates ranging from 24.25% to 34.50%, to be increased with 3% crisis surtax (subject to conditions, and not applicable to holding companies).

If a family office is set up as a corporation and holds the family assets, certain parts of the income (dividends and capital gains from the sale of shares in corporations) are (partly) tax-exempt. Capital gains on shares which are held for an uninterrupted holding period of one year are subject to a 0.412% tax. This rule is, however, only applicable to large companies (and not to SMEs). If the one-year holding period is not reached, the capital gain will be taxed at the rate of 25.75%. Dividends received are taxed at the normal tax rates. However, according to the EU Parent-Subsidiary Directive, the participation exemption provides for a deduction of 95% of qualifying dividends from the taxable basis in certain circumstances.

Distributions by the family office or corporation to the shareholders are generally liable to a dividend withholding tax (25%). A reduced rate applies to dividends paid by small companies on nominative shares issued as of 1 July 2013 provided these shares are received in exchange for a contribution of cash into the company and that an ownership requirement and holding period requirement are met. The rate amounts to 20% for dividends distributed during the third year following the contribution, and to 15% for dividends paid as from the fourth year following the contribution.

## The UK

### Regulatory environment

A family office can work at different levels — from being run by a small group of trusted individuals or family members to being managed by a professional service provider. The laws governing a family office can vary depending on its structure. In the UK, investment advice is given either by a financial advisor or a stockbroker. Both have to be registered with the Financial Conduct Authority (FCA), and certain larger institutions have to be registered with the Prudential Regulatory Authority. The FCA is the independent body that regulates the financial services industry in the UK. With statutory powers invested in it by the Financial Services Act 2012, the FCA has a wide range of rule-making, investigatory and enforcement powers.

### Limitation of liability

Family offices can act as an unincorporated entity and thereby there is no limitation of liability. All investments remain owned by the principal, and employment laws and other public liabilities (and other litigation) will attach to the individual. For those who wish to limit liability, there are three entities normally considered: limited liability companies (Ltd), limited partnerships (LPs), and limited liability partnerships (LLPs). All, in general, protect the owner from financial penalty up to the level of equity invested in the family office entity.

An LP is used primarily as an investment vehicle where the aim is purely asset-holding, growth, and income generation. An LP is normally distinguishable from an LLP because its owners are generally not active within an LP business. Therefore, an LLP is most frequently seen where the entity is a trading concern or where the owner is active in the business. LPs are more frequently used for UK-based families as a vehicle which can be used to transfer wealth through the generations in a well-governed and tax-efficient manner over time.

Many international investors want to use UK law as the governing law of operation because of the independence and enduring stability of the UK judicial system. An often perceived disadvantage of obtaining limitation of liability is the corresponding requirement to lodge financial information with the UK authorities, which then becomes available to the public. Those wishing to keep their financial affairs private can, however, often take advantage of various opportunities to keep their profile private, with appropriate structuring. Many family offices are established in the UK as an advisory function but with ownership of assets held abroad. This is to take advantage of the financial expertise in London, but also because certain families, who are not citizens of the UK (although they may be tax residents), can take advantage of the UK tax system, which allows income earned outside the UK to not be taxed in the UK unless brought into the country.

### Legal structures

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

### Limited company

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

### Partnerships

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

### A trust

A trust is an arrangement whereby assets are held by trustees for the benefit of the trust's beneficiaries. They are generally governed by a trust deed.

### Informal or contractual relationship

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

### Tax structures

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

Partnerships (LPs and LLPs) are generally transparent for tax purposes, and the partners are taxed directly on their share of the income and gains. The trustees of UK resident trusts are subject to income tax and capital gains tax on the income and gains of the trust. Non-UK resident trusts are subject to UK income tax on UK source income. Anti-avoidance provisions can apply to tax income and gains received by non-UK trusts, companies and other entities for UK residents connected with the entity.

This is a complex issue and advice should be taken before establishing a non-resident entity. However, offshore entities can provide tax advantages in certain situations, particularly in respect of family members who are non-UK resident or non-UK domiciled. Where payment is made for family office services under a contractual or informal arrangement, the recipient may be subject to tax on the income. The precise tax treatment will depend on the specific circumstances of the case.

## The United Arab Emirates (UAE)

There are limited jurisdictions in the Middle East where family offices can be set up to successfully manage the affairs of a family. The Dubai International Financial Center and the Dubai Multi Commodities Center are two free zones within the UAE that offer various benefits, and cater to the family office structure.

### The Dubai International Financial Center (DIFC)

The DIFC was established in 2004 as a free zone financial center offering a convenient platform for leading financial institutions and ancillary service providers. The DIFC is a well-known and established jurisdiction; it aims to play a pivotal role in meeting the growing financial needs and requirements of the region, while strengthening links with the financial markets of Europe, Asia and the Americas.

### SFO Regime

In order to provide a platform for families to manage their own wealth, the DIFC has introduced the SFO Regulation, which applies to families comprising one individual or a group of individuals all of whom are the bloodline descendants of a common ancestor or their spouses (further defined within the SFO Regulation). One of the main criteria for establishing a DIFC SFO is that the family's wealth exceeds the required minimum of US$10 million.

MFOs are also possible in the DIFC. If providing wealth and asset management services to multiple families, this will fall under the financial regulations of the Dubai Financial Services Authority (DFSA), which regulates all financial services conducted in the DIFC (purely consulting or advisory services would not fall under DFSA regulation).

### Legal structures

SFOs may be structured in various ways within the DIFC; several vehicles are permitted, which include (but are not limited to) the following:

- Company limited by shares (LTD)
- Limited liability company (LLC)
- Limited liability partnership (LLP)
- General partnership (GP)

### Benefits of the DIFC

The DIFC offers companies a 100% foreign ownership structure, no exchange controls, and a US dollar-denominated environment. The DIFC also follows an international legal system based on the common law of England and Wales, an independent common law judicial system consisting of the DIFC Judicial Authority (the DIFC courts), and a regional international arbitration center launched by the DIFC and the London Court of International Arbitration (LCIA).

### Dubai Multi Commodities Center

The Dubai Multi Commodities Center (DMCC) was originally established in 2002 as a commodity market place. However, today it caters to a broad range of activities and is currently one of the largest and fastest-growing free zones in the UAE. The DMCC offers 100% foreign ownership and recently expanded its offering to include an SFO license to manage the private wealth of family members, where all individuals are bloodline descendants of a common ancestor or their spouses.

One of the main criteria for establishing a DMCC SFO is that the family's wealth has a minimum of US$1 million of investible or liquid assets.

### Legal structure

DMCC SFOs are permitted as free zone LLC structures with a specific license to allow the wealth, asset, and legal and administrative affairs management of a single family. These can be provided to a family member, family business, family entity (corporate structure), family trust or foundation. The DMCC SFO must be wholly owned by the same family, or by a registered trust owned by the same family members.

### Criteria for setting up an SFO

The main criteria for both the DIFC and DMCC are:

- 100% of the ultimate beneficial ownership of the SFO belongs to members of a single family
- If the ultimate beneficial owner is a trust or similar entity, 100% of the principal beneficiaries/controlling individuals are members of the same family
- The SFO does not provide services to third parties; it manages a single family's proprietary assets only
- The SFO has a physical presence within the applicable free zone

### UAE tax structure

There is currently no federal UAE taxation. Each of the individual emirates (Dubai, Sharjah, Abu Dhabi, Ajman, Umm Al Quain, Ras Al Khaimah and Fujairah) has issued corporate tax decrees that, theoretically, apply to all businesses established in the UAE. However, in practice, these laws have not been enforced.

The DIFC applies a 0% tax rate guaranteed until 2054, while the DMCC offers a specific tax exemption for 50 years from the date of incorporation. Thus, families who decide to set up an SFO in the DIFC or DMCC can take advantage of a 0% tax rate on income and profits, as well as the freedom to repatriate capital and profits without restrictions.

They may also benefit from the wide UAE network of double taxation treaties with no restrictions on foreign exchange.

While there is currently no applicable value added tax or corporate income tax enforced in the UAE, the introduction of both are under consideration. All families and businesses considering establishment in the UAE should be mindful of the potential introduction of both direct and indirect taxes, and of future developments.

## Qatar

The Qatar Financial Centre (QFC), which was established in 2005, is another place in the Middle East where it is possible to set up a family office. The QFC stands alone from the Qatar state regime and has separate legal, regulatory and tax laws, which are of international standard. The QFC is not a free zone or an offshore center.

After the enactment of the SFO Regulations (SFOR) in 2012, the QFC Authority (QFCA) now aims to inform families and advisors to families to consider the QFC as the preferred jurisdiction for SFOs and for other investment purposes.

### Benefits of setting up in the QFC

Families who decide to set up an SFO at the QFC can take advantage of a 100% foreign ownership structure with extensive tax exemptions available, a low effective tax rate (currently 10%), and the freedom to repatriate capital and profits without commercial and tax restrictions. They can also benefit from a wide network of double taxation treaties, a world-class regulatory and legal environment, and a swift and a streamlined licensing process.

### Setup and activity requirements

An SFO is a corporate body, established within the QFC as an unregulated entity that manages the business, investments and wealth of a single family with a minimum of US$5 million in investible or liquid assets.

Families interested in setting up an SFO in the QFC are encouraged, in the first instance, to set up a meeting with the QFCA strategic team, who will provide them with deep understanding of the setup process and the documentation required. A single application pack should be submitted to the QFCA which covers both the licensing and the registration of the SFO. The application must be accompanied by:

### Letter from an eligible firm

The letter should confirm that the Articles of Association of the SFO satisfies the requirements of the SFOR, confirmation that the applicant family constitutes a single family and is ultimately owned by one or more family members of the single family/ family fiduciary structures/family entities.

### Statement signed by the applicant or its designated representative

This should state the name of the common ancestor and sufficient information to prove that the applicant qualifies as a single family. This also includes, but is not limited to, a description of the sources of assets of the single family, full details of who controls the single family, the legal and beneficial owners, the total number of family members, the SFO's activities, and details of the designated representative.

The SFO must at all times have a registered office situated in the QFC or any other QFC-approved business building.

### Duration and QFC fees

Upon submission of the complete application pack, the establishment procedure is generally completed within one month. The SFO application and annual fee amount to US$500.

## Australia

### Regulatory environment

#### Structures

The laws governing a family office will be affected by its legal structure. A family office may be set up in Australia using any of the following structures (or any combination of the structures):

#### Proprietary company

A proprietary company is a corporate entity that is typically limited by shares. The family members may be the shareholders or directors of the company, with or without the involvement of non-family professionals. The directors have certain common law, statutory and fiduciary obligations owed to the shareholders and may be subject to civil and criminal penalties. A company is a legal person and has a legal identity separate to its shareholders and directors.

Depending on the size and status of the company, there will be various financial reporting and auditing obligations imposed on the company. The Australian Securities & Investments Commission is the corporate regulator that administers corporate legislation and rules.

### Trust

A trust is a legal arrangement under which a trustee (which may be a company and/ or family member) holds property for the benefit of the trust's beneficiaries. The terms on which the trustee may deal with the property it holds for the beneficiaries are generally determined by the trust deed, trust law and legislation.

Specific tax and regulatory rules apply for certain types of trusts, including in particular:

- Superannuation funds (i.e., a type of pension fund)
- Private ancillary funds (i.e., a type of private charitable foundation)

### Partnership

A partnership consists of two or more legal persons carrying on a business with a view to profit. A partnership may be registered as a limited partnership, where the liability of one or more partners (other than the general partner) for the debts and obligations of the business is limited. Compliance with statutory requirements under Partnership Acts of each state in Australia may also be required.

#### Contractual relationship

Families may engage individuals directly to provide them with family office services. Individuals employed by a family company (or other entity) may also provide family office services to the family. Employment of individuals will also be subject to statutory requirements, including the payment of salary and superannuation entitlements.

### Regulation of services

The provision of the following types of services is subject to Australian federal or state regulation:

- Investment advice
- Legal services
- Tax services
- Employment services

Accordingly, care should be taken to ensure that the professional services to be provided by a family office comply with the relevant legislative and common law requirements.

These requirements will include adherence to rules and legislation that have reporting and compliance obligations with the Australian Taxation Office, and will vary according to the entities, size and status of the family office.

Any family office that operates internationally should also be aware of its obligations with regard to foreign investment policies in Australia. Most notably, this will require liaising and applying for certain investments with the Australian Foreign Investments Review Board.

### Tax issues

The family office structures described above (i.e., a private company, trust or partnership) are all recognized as taxpayers for Australian income tax purposes. Consequently, they are generally required to register with the Australian Taxation Office to obtain a tax file number and file annual income tax returns.

Australian resident taxpayers (e.g., a company incorporated in Australia) are subject to Australian income tax on their worldwide income and capital gains.

For the year ending 30 June 2016, the Australian corporate tax rate is 30% (or 28.5% for companies with an aggregated turnover under AU$2m). Dividends paid out of profits that have been subject to Australian tax may be franked (i.e., a franking credit broadly provides the dividend recipient with a tax credit for the underlying company tax paid).

Generally, trusts and partnerships are treated as "flow-through" entities for Australian income tax purposes. That is, subject to certain exceptions, the taxable net income of a trust or partnership is taxed in the hands of the beneficiaries or partners, respectively, according to their interests in the trust or partnership. For the year ending 30 June 2016, the tax rate for an Australian resident individual beneficiary or partner with taxable income of more than AU$180,000 is 49%.

Another important tax consideration is that capital gains on trust or partnership assets owned for more than 12 months may be eligible for the 50% CGT discount (subject to the circumstances of the beneficiary or partner).

Some exceptions to that flow-through tax treatment exist in respect of:

- Complying superannuation funds (which are subject to concessional tax rates)
- Private ancillary funds (which may be exempt from income tax)
- Limited partnerships (which are generally taxed as companies)

## New Zealand

### Regulatory environment

A family office can work at different levels depending on the family's needs and preferences. The family office can be run by a small group of trusted individuals and/or family members, or be managed by a professional services firm. The laws governing the family office depend on its structure.

Financial advice should be obtained from an authorized financial advisor registered under the Financial Advisers Act, the Code of Professional Conduct, and other relevant financial market legislation. Stockbrokers are also required to be licensed with the Financial Markets Authority (FMA). The powers given to the FMA under the Financial Markets Conduct Act 2013 are wide-ranging and include monitoring, supervision, investigation and enforcement. They are also responsible for education, information, policy-making and guidance.

Under New Zealand law, legal advice may only be offered by lawyers holding a practicing certificate.

### Limitation of liability

Family offices can act as an unincorporated entity (e.g., trust or partnership) and consequently enjoy no limitation in liability. In these cases, all investments remain owned by the principal, and employment laws and public liability will attach to the individual.

For those families that wish to limit liability, the family office can be incorporated and registered with the New Zealand Companies Office. A company is a separate legal entity from both a legal perspective and a tax perspective. This affords the owner protection from financial penalty up to the level of equity invested in the incorporated family office entity. A company is required, as a minimum, to have one or more shares, one or more shareholders, and one or more directors. At least one director must either be resident in New Zealand, or be resident in an enforcement country and be a director in that enforcement country. The list of enforcement countries only includes Australia at present. All directors must be natural persons.

A company must file an annual return confirming that information held by New Zealand Companies Office is complete and correct. Non-compliance with filing may result in the company being removed from the Companies Register.

Limited partnerships also afford a level of protection from liability for the limited partner while the general partners are liable for all the debts and liabilities of the partnership, and are generally used purely as an asset-holding entity. Limited partnerships are registered with the Companies Office.

## Tax issues

From a tax planning perspective, family offices can be set up in a variety of legal forms, such as companies, partnerships or trusts. Which form best fits the required needs depends on the individual asset and holding structure as well as on the range of services provided through the family office.

As tax obligations are dependent on the nature and activities of the investment entity, advice should be taken before establishing a family office investment vehicle.

## Income tax

From an income tax perspective, companies, partnerships and trusts are treated differently. Companies and trusts are subject to tax, while partnerships are transparent and taxed at the partners' marginal tax rate.

### Corporate tax

Companies are required to lodge an annual tax return with New Zealand Inland Revenue. The current company tax rate is 28% and the standard tax income year ends on 31 March, unless prior approval is received from Inland Revenue.

A New Zealand company is subject to tax on its worldwide income. Relief may be available under applicable double tax treaty agreements. Companies that are 100% commonly owned have the option to consolidate for tax purposes.

Special rules apply to life insurance, nonresident insurers, ship-owning, petroleum and mining, and forestry companies, as well as group investment funds, overseas investments in controlled foreign companies and foreign investment funds.

The dividend imputation system applies to New Zealand resident companies. Dividends derived by a New Zealand resident company are exempt from tax where the companies are 100% commonly owned.

Foreign tax credits can be claimed by a New Zealand resident. This credit is limited to the lower of the amount of tax paid or the New Zealand tax payable on income.

There is no capital tax regime; however, certain transactions are specifically taxable, including property acquired for resale, or part of business dealings. Recently, legislation was enacted to ensure that all residential property bought and sold within a two-year period is taxable, with limited exclusions.

## Trustee tax

Trustee income is taxed at 33% and beneficiary income is taxed at the beneficiary's marginal tax rate. There is an exception to this rule called the minor beneficiary rule, whereby distributions made to beneficiaries under 16 years old are taxed at 33%.

The tax treatment of distributions from trusts depends on the classification of the trust and the nature of the distribution.

## Partnerships

Partnerships are, themselves, not taxed. Their income is allocated to the partners in accordance with the partnership interest held, and is taxed at the partner's marginal tax rate. Marginal tax rates for individuals range from 10.5% to 33%.

# Hong Kong

## Regulatory environment

A family office in Hong Kong normally exists to provide comprehensive services to the high net worth individuals (HNWIs) and their family members — be it purely owning family assets and businesses, providing administrative support or conducting investment management activity. Such functions or activities are normally run by the family members or their trusted employees, with the support of professional service providers, namely, independent trustees and legal and tax advisors.

The laws governing the setup and operation of a family office can vary vastly, depending on its structure and business model. A family office usually takes the form of a private company, managed by trusted individuals or another company providing professional services.

In Hong Kong, advising on securities and asset management are regulated activities governed by the Securities and Futures Ordinance. If the family office is operating as a business, it has to be a corporation licensed for "asset management" (type 9 license). Depending on the exact scope of service to be provided to clients, the family office may need additional licenses for "dealing in securities" (type 1 license), "advising on securities" (type 4 license) or other licenses issued by the Securities and Futures Commission, a statutory commission vested with policy-making, investigatory and enforcement powers. Furthermore, if the family office is an MFO and is taking deposits from multiple high net worth families, such an office will be regarded as a "restricted license bank" or a "deposit taking company" under the Banking Ordinance and subject to the regulations of the Hong Kong Monetary Authority. Hong Kong offers a well-developed common law system providing a stable legal environment for the prolonged settlement of a family office.

## Limitation of liability

The popular types of corporate registration vehicle for setting up a family office in Hong Kong are:

- Private company limited by shares (a subsidiary company)
- A branch office of a corporation incorporated outside Hong Kong

Also possible, but less common, are sole proprietorships, partnerships and limited partnerships, because they are not a separate legal entity whereby all debts and liabilities would be the personal responsibility of the sole proprietor or partner, no legal firewall between them and the business exists. Further, they do not have continual existence.

Many HNWIs, especially those from China, would want to use Hong Kong as an investment platform for their private investments overseas, and set up a family office in Hong Kong to manage their assets and businesses centrally. Such an arrangement takes advantage of Hong Kong's close proximity to Chinese markets, its ease of business formation, its sound legal and banking system without foreign exchange controls, as well as its low and simple tax regime, under which profits earned outside of Hong Kong, dividends and capital gains are not taxable.

### Company law and tax issues

Given the general limited restrictions on setting up family offices in Hong Kong, coupled with the low rate of taxation and "offshore profits tax exemption regime," Hong Kong is felt to be a favorable place for HNWIs to consolidate and manage their own assets and businesses.

In Hong Kong, there are no special legal provisions relating to the setting up of family offices and the following structures are normally used:

### Private company limited by shares (a subsidiary company)

A subsidiary company is a common type of vehicle for setting up a family office in Hong Kong. The minimum number of directors and members is one. There is no limitation on the nationality of directors and members. Both corporates and individuals can act as members. That said, at least one natural person must be appointed as a director. Accordingly, overseas corporates and individuals are free to set up their own family office in Hong Kong with few legal requirements.

### A branch office

If the HNWI is uncertain about the Hong Kong market, or the family office's operation in Hong Kong is relatively small at the initial stage, they can choose to set up a Hong Kong branch office of their foreign corporations. Under Hong Kong law, there is no distinction between the foreign corporation itself and its Hong Kong branch, and the branch is only an address at which the corporation carries on a business.

Maintaining a branch office can be simpler (e.g., a separate audit is not required). Also, the business operation of a branch office can be terminated relatively easily by notifying the Companies Registry that it ceases to have a place of business in Hong Kong, whereas a subsidiary company can only be terminated by liquidation or deregistration, either of which can be a lengthy and cumbersome process.

### Limited company

A limited company is an entity incorporated under the Company Ordinance of Hong Kong limited by shares. Family members can act as the only shareholders in an LLC, owning the family assets through owning the LLC, and appoint non-family professional individuals or corporate bodies as directors to manage the LLC as a family office.

### Limited partnerships

A partnership is defined under the Company Ordinance as two or more persons carrying on a business with a view to profit. There are two kinds of partnerships, regular partnership and limited partnership. Partners in a regular partnership do not enjoy limited liability. In a limited partnership, there are two kinds of partners, limited partner and general partner. While both types of partner are entitled to the profit generated by the partnership, only a general partner has the right and power to manage the partnership. The trade-off of such power is that a general partner does not enjoy limited liability. While limited partners cannot take part directly or indirectly in the management of the partnership, they enjoy limited liability. Therefore, limited partnership can be used as a family office vehicle to pass down a family's wealth through the generations by having family members appointed as limited partners, while non-family professional individuals or corporate bodies can be appointed as general partners in charge of the partnership, being remunerated instead of having a significant share of the profits generated by the partnership.

### Trust

Other than owning the family office in Hong Kong, directly or through their overseas corporates, HNWIs can also consider using a trust structure. A trust is an arrangement under which trust assets, which may include businesses, are held and managed by trustees for the benefit of the trust's beneficiaries. The trustee can be a non-family professional individual or company managing the family assets for the beneficiaries, presumably the family members. Trustees will manage the trust according to a trust deed, detailing what can and cannot be done by the trustees, the distribution of interest and profit, and the purpose of the trust.

Without setting up a new entity or engaging a trust, families may employ individuals or a professional service provider directly to provide them with family office services.

### Hong Kong tax structure

Hong Kong's simple tax system and low tax rates are always welcomed by the many HNWIs who set up their family offices in Hong Kong.

Regardless of whether a subsidiary company or a branch office is used to operate the family business, they are subject to the same tax consequences in Hong Kong.

### Profits tax

Hong Kong adopts a territorial concept of taxation whereby only persons that carry on a business in Hong Kong and derive Hong Kong sourced profits from that business would be chargeable to Hong Kong profits tax. The current corporate profits tax rate is 16.5%.

A person (defined to include a limited company, a partnership or a trustee) carrying on a trade, profession or business in Hong Kong is subject to profits tax on profits arising in or derived from Hong Kong. Gains of a capital nature are specifically exempt from profits tax.

Partnerships in Hong Kong are not treated as transparent for tax purposes. Except in certain circumstances, profits derived by a partnership are generally subject to tax in the name of the partnership. While the definition of a person does not include a trust, in practice, besides its own profits, a trustee is also subject to tax on behalf of the trust in respect of the latter's profits.

Dividends and distributions paid by companies, partnerships and trusts from after-tax profits in Hong Kong are not subject to any further tax in Hong Kong, either by way of withholding or otherwise.

Further to the above, under the "source of profits" rule, an entity will not be subject to Hong Kong profits tax even if it carries on a business in Hong Kong but derives profits that are arising or derived outside of Hong Kong.

That said, the question of locality or source of profits is a hard, practical matter of fact. Case law indicates that, as a broad guiding principle, "one looks to see what the taxpayer has done to earn the profits in question and where he has done it." It is necessary to appreciate the reality of each case, focusing on effective courses for earning the profits without being distracted by antecedent or incidental matters.

Pursuant to the Departmental Interpretation and Practice Notes (DIPN) No. 21 (revised), the Hong Kong tax authorities' view on certain major types of income that family business could generate is as follows:

- Trading profits: the place where "the contracts of purchase and sale are effected"
- Service income: the place where the services are rendered
- Profits from listed shares: location of the stock exchange where the shares or securities in question are traded
- Profits from unlisted shares: the place where the contracts of purchase and sale are effected

For each kind of profit, if the aforementioned activities are performed outside Hong Kong, the profits derived therefrom will be offshore sourced and not subject to Hong Kong profits tax. On the contrary, if any of such activities are conducted in Hong Kong, the profits derived therefrom will be onshore sourced and subject to Hong Kong profits tax. Also note that apportionment of onshore and offshore profits is possible for service income derived from activities carried out partially in and outside of Hong Kong.

Other merits of the Hong Kong tax system include the following, Hong Kong does not tax on capital gains earned by companies and individuals, and does not impose withholding tax on dividends and interest received by a foreign entity from a Hong Kong taxpayer.

Lastly, Hong Kong profits tax compliance procedures are relatively simple and straightforward, an entity is only required to file its profits tax return once a year together with the audited financial statements.

### Indirect tax

There is no goods and services tax or value-added tax in Hong Kong.

### Estate duty and gift tax

There is no estate duty and gift tax in Hong Kong.

### Taxation on trust

The Hong Kong tax law does not contain a code, or a set of provisions that deal with the taxation of trusts. In other words, a trust would in practice be taxed in the same manner as a subsidiary company or branch office whereby it would be chargeable to Hong Kong profits tax if it carries on a business in Hong Kong and derives Hong Kong sourced profits. The general practice is that if a trust is chargeable to tax in Hong Kong, it would be charged in the name of the trustee.

## Singapore

### Limitation regarding financial activities

Activities pertaining to securities, futures and funds management are governed under the Securities and Futures Act, Chapter 289 (SFA). The SFA puts in place the rules and regulations concerning markets, market operators, clearing facilities, intermediaries and representatives. Regulated activities include dealing in securities, advising on corporate finance, fund management, and securities financing, among others. To what extent the regulatory requirements and restrictions apply depends on the structure and the specific tasks of the family office.

If the family office is structured as a company that holds the family's wealth (with the family members as shareholders and directors) and the family office enters into investments on its own account, such a company could be viewed as an investment-holding company and therefore will not be regulated under the SFA. Such a company will be subject to Singapore's normal tax rules, and an applicable income tax rate of 17% applies on income that it derives.

On the other hand, if the family office acts as an investment advisor or manager to the family's asset-owning vehicle(s), such investment management activities may be regulated under the SFA. Under the SFA, among other requirements, the family office will have to register as a Registered Fund Management Company (RFMC) or apply for a Capital Markets Services (CMS) license for fund management with the Monetary Authority of Singapore if there are third-party assets under management (AUM). If the AUM belongs solely to the family, there may be an exemption from registering as an RFMC or holding a CMS license for fund management. Where the asset-owning vehicle(s) are managed by such a family office (i.e., exempt, registered as an RFMC or licensed under the SFA), the asset-owning vehicle(s) may be able to enjoy tax exemption on prescribed qualifying income.

### Limitations regarding legal and tax advice

Under Singapore law, legal advice may only be offered by lawyers. If a company performs such professional services, it has to be registered as a law firm, with Singapore registered practicing lawyers.

There are currently no regulations specifying that tax advice can only be rendered by certified tax advisors in Singapore. However, there is a tax accreditation body in Singapore — the Singapore Institute of Accredited Tax Professionals (SIATP) — to which tax professionals can apply to become accredited tax advisors or practitioners.

Thus, the provision of such professional services by a family office is possible if the company meets the aforementioned requirements, hires personnel with the relevant tax expertise and accreditation, or arranges for the provision of such services through trusted advisors only.

### Limitation of liability

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

If the family office actually holds the family wealth (as the legal owner), it is only accountable within the limits of its directors' and officers' liability. Financial losses are losses of the family office itself and cannot be claimed as damages by the family directly.

If the family office acts as an investment advisor or manager to the family's companies or the family members themselves, any shortcomings in the quality of the advice that results in financial losses may be claimed as damages. Normally, the liability is limited by contractual agreement to gross negligence and capped at a certain amount.

### Legal structures

Family offices in Singapore are typically structured as a limited company. The use of partnerships is not commonly seen (although it is possible) in view of the unlimited personal liability of at least one partner. There are also structures involving the use of a trust.

### Limited company

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

### Partnerships

A partnership is two or more persons carrying on a business with a view to profit. It is effectively transparent for tax purposes (i.e., the partners are taxed on their share of the income and gains of the partnership). A limited partnership must consist of at least one general partner who has unlimited liability and one limited partner who enjoys limited liability. An LLP is taxed in the same way as a partnership, while affording limited liability to its members in view of its separate legal status.

### Trusts

A trust is an arrangement whereby assets are held by trustees for the benefit of the trust's beneficiaries. The trust is generally governed by a trust deed.

### Tax structures

Singapore has adopted a territorial and remittance-based tax system. Tax is only imposed on income accruing in or derived from Singapore, or received in Singapore from outside, unless otherwise exempt.

Companies are subject to corporate income tax on their profits (at a prevailing rate of 17%), with certain partial tax exemptions on chargeable income.

If a family office is set up as a company in Singapore and holds the family assets, certain parts of the family office's income (e.g., Singapore one-tier exempt dividends and capital gains from the sale of shares in corporations or other capital assets) will be tax-exempt.

If the family office is a Singapore tax resident company, certain foreign-sourced income earned (e.g., foreign dividends) may qualify for tax exemption, subject to conditions being met. The tax resident family office would also have access to Singapore's network of over 70 comprehensive double taxation agreements with other countries, which may offer certain double taxation reliefs and reduced withholding tax rates.

The profits of the family office (in the legal form of a Singapore tax resident company), when distributed to its shareholders as one-tier exempt dividend income, will be tax-exempt in the hands of the shareholders. Withholding tax is not applicable on dividends made by the family office.

Partnerships, limited partnerships and LLPs are generally transparent for tax purposes, and the partners are taxed directly on their share of the income and gains — at the prevailing progressive tax rates (currently up to 20% or up to 22% for the basis period from 2016 onward) if the partner is an individual, or corporate tax rate if the partner is a company.

The taxable income of a trust may be assessed to tax on the trustee (in general, a limited company) or the beneficiaries (or both) depending on the circumstances. Where tax is assessed on the beneficiaries, this is commonly referred to as the "tax transparency treatment."

Where the taxable income of a trust (or part thereof) is to be assessed to tax on the trustee, such income will be subject to tax at the prevailing corporate income tax rate (currently 17%). The tax at the trustee level will be a final tax.

If tax transparency treatment is accorded, no tax will be imposed at the trustee level on that beneficiary's share of taxable income and that beneficiary will be subject to tax on the income distributions received at his or her own individual tax rates. That beneficiary will also be entitled to the same concessions, exemptions and foreign tax credits as if he or she had received the income directly.

## Mexico

### Legal setup and regulatory environment

Family offices are not specifically regulated by law in Mexico. However, it is not uncommon for wealthy families to set up a family office to manage their estates. Some families have an SFO to ensure the value of their assets, while others rely on the services of an MFO or choose to outsource the services needed through a virtual family office.

Family offices offer a wide range of services, primarily classified into three categories: (i) legal and bookkeeping; (ii) tax compliance; and (iii) investment advice. Legal services vary, depending on the specific asset and family structure, but typically involve legal advice with respect to contracted obligations and succession planning, as well as bookkeeping and the maintenance of legal documentation. Tax services are also determined by the specific needs of the family, but normally consist of the preparation and filing of tax returns and notices, and the compliance of other tax obligations arising from the transactions carried out by the family members directly or through their investment structures. In general terms, legal and tax services do not have restrictions under Mexican law.

However, some relevant regulations for investment advice services were introduced recently through the Mexican Stock Exchange Law (Ley del Mercado de Valores — LMV) and the newly enacted Mexican Anti-Money Laundering Law (Ley Federal para la Prevención e Identificación de Operaciones con Recursos de Procedencia Ilícita — LFPIORPI).

In terms of the LMV, individuals and entities that provide services for stock portfolio management or personal investment advice, will be considered investment advisors and will be subject to the supervision of the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores — CNBV). Their obligations include registering with the CNBV, and periodically filing information with the CNBV about their clients and operations.

In order to be registered by the CNBV, individual investment advisors must, among other requirements, be properly certified, and have a sound reputation and credit history. Entities operating as investment advisors also have to be properly certified and have a good financial reputation and credit history, among other things. They should also have a physical office where the services will be provided, file information about their shareholders, and provide a manual that sets out standards and policies to resolve conflicts of interest.

It is important to consider that investment advisors may not be required registration before the CNBV if, among others, (i) services are provided exclusively for the benefit of a family group (i.e., SFO) and the services are not promoted in Mexico; (ii) the investment advisor is non-resident in Mexico, the services are not promoted in Mexico, there is no physical office available in Mexico, and there are no agents, commissioners, or any other type of representatives of the investment advisor in Mexico.

In terms of the LFPIORPI, family offices qualifying as investment advisor also have obligations relating to anti-money laundering, including the proper identification of their clients through "know your customer" procedures, maintenance of documentation related to the operations carried out on behalf of their clients, and the appointment of a compliance representative before the CNBV.

### Limitation of liability

In general terms, investment advisors will be liable for damages from their clients if they do not comply with the restrictions established by the LMV in rendering their services. The LMV does not allow them to accept any kind of remuneration for the promotion of certain securities or intermediaries; accept funds or securities from their clients (unless as a remuneration for their services); offer guaranteed yields or act against their client's interest; or act as co-owner of their client's securities intermediary contracts, among other restrictions.

Investment advisors are also bound by the terms of the service contract with the client.

## Legal structures

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

### Legal vehicles

The two main types of commercial entities are the limited liability company (SRL) and the stock corporation (SA); civil entities may be used, principally the civil law corporation (SC).

A limited liability company is established by partners who are only obligated to pay their contributions. There must always be a minimum of two partners and a maximum of 50 partners. The administration of limited liability companies will be held by one or more managers who may be partners or third parties to the company, appointed temporarily or indefinitely.

A stock corporation is established by shareholders who are liable only for a payment of the value of their subscribed shares. There must be a minimum of two shareholders and each one must subscribe to at least one share; there is no maximum number of shareholders. The social contract must set up the minimum amount of capital stock, which must be fully subscribed. The administration will be held by one or several directors.

A civil law company is established by the partners for a common purpose that is primarily economic, but must not constitute commercial speculation. The partners are only liable for the payment of their contributions. There must be a minimum of two partners; there is no maximum number of partners. The social contract must set up the minimum amount of capital and the share of each partner. The administration of the partnership may be held by one or more partners.

### Tax issues

Corporations (either commercial or civil) that are resident in Mexico for taxable purposes will be taxable on their worldwide income. Corporations are considered to be resident in Mexico if they have established their principal place of management, or their effective management center, in Mexico.

Corporations are subject to federal corporate income tax at a rate of 30% on their taxable profit. When a corporation makes a distribution of dividends to its shareholders, it will be subject to an additional 10% withholding tax. However, in some cases, when a civil law corporation makes a distribution of yields to its partners there will be no additional withholding tax.

Appendix

2

# US regulatory and tax considerations

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

## Regulatory environment

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

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

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

## SEC regulation of family offices

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

### Investment advisor registration, 2011 and thereafter

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

Under this direction, the SEC issued Rule 202(a)(11)(G)1 (Rule 202). Under Rule 202, a family office is excluded from the definition of "investment advisor" for the purposes of Dodd-Frank if it meets the following requirements:

- It only serves clients that are considered "family clients".
- It does not hold itself out to the public as an investment advisor.

To understand how the exclusion may be applicable, it is important, first of all, to understand the definitions of the terms "family clients," "family members" and "family entities." To confirm these definitions under Rule 202, each family office must first of all designate a "common ancestor" that defines the family unit served. The common ancestor may be living or deceased, but may not be more than 10 generations removed from the youngest generation served by the family office. The family office may redefine the role of common ancestor in the future.

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

Family clients include:

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

Recently, the SEC has granted exemptive orders for advisors seeking to include in-laws and in-laws' relatives in the definition of "family member." The term "in-laws" does not refer to a spouse of a family member (which is considered a family member), but is more accurately reflected by an individual who is a member of the extended family, such as the sister of a family member's spouse.

On 20 January 2015, the SEC granted an exemptive order for a family office that advised a former sister-in-law (sister of family member's spouse) for 26 years under the prior family office rules. The SEC accepted the assertion that the former sister-in-law was an important part of the family, her assets had been managed by the family office for more than 20 years, and the familial, non-commercial relationship should allow the family office to continue to advise her while relying on the family office exemption. Similar relief has been granted to other family offices; however, it should be noted that the requests granted have been submitted by advisors that filed applications with the SEC after the rules relating to in-laws changed in 2011.

The term "key employees" includes:

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

In their commentary on Rule 202, the SEC specifically prohibits key employees, their trusts and their personally controlled entities from making additional investments through the family office after their employment ends. They may, however, continue to hold their existing investments through the family office without jeopardizing the exclusion.

The rule does acknowledge that involuntary transfers to non-family clients may accidentally occur and should not cause the family office to fail the exclusion. An example referenced in Rule 202 is a bequest from the estate of a family client to a non-family client. Rule 202 therefore provides a transition period of up to one year to transfer those client investments to another investment advisor, or to otherwise restructure to comply with Dodd-Frank.

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

These exclusions include:

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

These distinctions concerning which specific employees may receive investment services are very complicated and may prompt the family office to implement detailed policies preventing unintended consequences. The SEC noted that in narrowly defining the term "key employees," they sought to allow participation only by those individuals who "could be presumed to have sufficient financial sophistication, experience, and knowledge to evaluate investment risks and to take steps to protect themselves."

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

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

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

Rule 202 and the exclusion have provided greater clarity on the registration requirements for family offices. But uncertainty still exists on certain key issues, especially when the family office is a division of an operating business entity rather than a separate legal entity. Such a structure makes distinctions between ownership, control, employees, and clients even more challenging to apply. Some published reports indicate that certain family offices have transferred their investment advisor function to a non-employee, "outsourced chief investment officer" model to avoid registration. Such family offices appear to be taking the position that residual family office investment services (cash flow modeling, etc.) either do not constitute "investment advice" under the Advisers Act or are "solely incidental" to their general obligations.

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

## Internal Revenue Service (IRS) oversight

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

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

The concept of "paid preparers" is also important in the family office when considering the potential for IRS penalties that may be applicable to tax return positions that are not ultimately sustained. IRC Section 7701(a)(36) defines a return preparer as any person who prepares a tax return for compensation, with limited exceptions. IRC Section 6694 outlines the monetary penalties that may apply to return preparers who prepare tax returns containing unsustained positions.

The rules are complex and beyond the scope of this report, but generally a paid preparer may be subject to significant monetary penalties for an unsustained tax return position, unless the position: (1) meets at least the "reasonable basis" test and is disclosed appropriately on the tax return; or (2) has "substantial authority." However, a tax shelter or reportable transaction must at least meet a "more likely than not" standard and may also be subject to other disclosure requirements. These terms are defined in Treasury Regulations to the Internal Revenue Code.

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

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

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

## US legal structures

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

While partnerships and LLCs are often taxed identically, the fact that all the members of an LLC can benefit from the protection of limited liability has generally decreased the use of general partnerships or limited partnerships in entity selection. This is because, in either partnership structure, the general partners retain joint and several liability for the debts of the entity. As with LLCs, corporations provide limited liability to their owners.

The creation and operation of these structures are governed by US state law. US state law will also determine the limitations on liability and legal life of these structures. When creating a family office, the legal entity is not required to be formed in the state of the family's general residence.

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

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

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

## Cost allocations and treatment of expenses

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

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

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

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

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

## US taxation of individuals and trusts

The taxable income of US citizens, tax residents and domestic trusts is subject to a graduated rate schedule. The top marginal tax rate on the ordinary income of individuals and trusts is 39.6%. Long-term capital gains and qualified dividends are taxed at a top income tax rate of 20%. An additional 3.8% tax generally applies to net investment income recognized by an individual or trust with overall income above certain thresholds. This additional tax applies to net income from interest, dividends, rents, royalties and passive business income, and non-business capital gains received or recognized by an individual or trust.

In some cases, the Alternative Minimum Tax (AMT) may apply. The AMT has a top marginal rate of 28% and applies when it exceeds the regular income tax of an individual or trust. Many tax benefits (e.g., accelerated depreciation) and certain deductions (e.g., state and local income taxes and investment expenses) that are allowed under the regular tax do not apply for AMT purposes. For that reason the AMT, with its 28% rate, may exceed the regular income tax, even at its top rate of 39.6%.

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

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

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

## US taxation of partnerships

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

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

A partnership must file an annual tax return with the IRS to report its total income, deductions and credits. Additionally, the partnership must provide its owners with Schedule K-1, partner's share of income, deductions, credits, etc., which reports each partner's share of these items. These items are then reported on the partners' own income tax returns to compute their income tax accordingly. This may allow partners to offset income from the partnership with items of deduction or loss from other sources. Such specific treatment may differ, depending on whether the partner is an individual, trust, or other type of taxpayer and the character of the partner's income and deductions.

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

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

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

## US taxation of corporations

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

Dividends of cash or property paid by the domestic US corporation (and certain non-US corporations) to the shareholders are generally taxed to the shareholder at a maximum individual income tax rate of 20%, though additional complexities may apply on distributions of appreciated property. At higher income levels, individuals and trusts are also subject to the 3.8% net investment income tax applicable to dividends.

The corporation receives no deduction for its dividend distributions. For this reason, shareholders in US corporations are often said to be subject to "two levels of taxation" — earnings are taxed annually at the entity level and accumulated profits are taxable to the shareholders when distributed. However, at lower income levels the overall rate of corporate income may be less, depending on the mix of income received and tax paid by the corporation, compared to such income in the hands of a partner in a partnership.

When analyzing the deductibility of expenses, corporations are generally not subject to the same restrictions as individuals on expenses related to producing portfolio income (i.e., investment expenses). If the family office itself represents a profit-making activity, then expenses will generally be fully deductible to the corporation unless they represent personal expenses of the shareholders. Thus, the lack of preferential tax rates for certain income at the corporate level may be offset by more favorable treatment of deductions, especially when considering AMT.

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

### S corporations

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

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

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

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

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

### Family offices housed within private operating companies

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

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

Also, as noted earlier, the SEC registration requirements for family offices may be more difficult to navigate and manage within the confines of a private company structure, especially if the company has any degree of employee or non-family ownership. For these and other reasons, many families have chosen to relocate their family office from within their private operating company to a separate legal entity.

### Private trust companies

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

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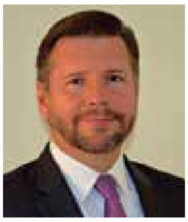

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