When to Use — and How to Choose — a Family Office

The family office industry continues to grow as there are more and more ultra-high net worth individuals. This article examines the different types of family offices, the services they provide, and the fees they charge.

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The first family offices were formed over 100 years ago by families of wealth who wanted to centralize the management of the families' financial affairs while building a purchasing power base greater than the family members could achieve on their own. Each family member benefits from a consolidated group of professionals in the family office—investment and financial managers, estate planners, tax accountants, philanthropic administrators, and compliance personnel all dedicated to, and knowledgeable about, each family's unique situation.

It is estimated that there are over 5,000 single-family offices ("SFO") in the Unites States, and approximately 100 multi-family offices ("MFO"). An SFO is an office that manages the financial affairs of one family, and an MFO manages the financial affairs of multiple families that are generally not related to each other.

A family office is usually created when: (1) the liquid assets of a family grow to such a size that professional management is required for the investible assets of the family which cannot be provided by the family business professionals, since they usually do not have the expertise to manage these assets or, if they do, it cannot be done effectively without the business suffering; (2) the family's business is sold, creating liquidity that again needs to be managed by the appropriate professionals; or (3) the family has attempted to manage their personal financial affairs, but the business has suffered due to the time they have spent doing so, or they realize that they are not equipped to manage the level and complexity of their own assets.

A single-family office must usually have assets in excess of $400 million to support the professional personnel that are needed to manage the assets. A multi-family office that manages the financial affairs of more than one family has a much smaller asset requirement per client, but the total of all assets of the MFO should be equivalent to $400 million in order for it to make economic sense for both the MFO and the clients. There are various levels of minimum asset requirements per client for MFOs that range from $1 million to $100 million in assets.

As the family office industry has grown, it has become more professional, complicated, and sophisticated. Some family offices that were formed to handle a small number of family members with a relatively simple asset base have seen both the family and the asset base grow over time as the family office executive, who is a very trusted advisor of the fami-

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ly, has struggled to keep abreast of all the demands. The family should not be afraid to bring in other professionals to assist the family office executive in areas of his weakness, and in most cases, the family office executive would welcome the help and support. While the trusted advisor is critical to the management of the family's assets and—in many families—to the civil operation of the family, it is the collective family objective that should be the highest priority with the family office executive, who is the facilitator of that objective, whether that person is a family member or a non-family member.

How are family offices different?

A family office differs from financial planners, investment managers, stockbrokers, bankers, and accountants in the services it provides and its role as a trusted family advisor. The family office sells no product to its clients except that of the service as a family office, and it collects no fee from any person or organization except the clients of the family office. The family office is not paid a broker's fee for insurance placement, securities purchase, real estate purchase, custody, commissions or transaction fees, unlike the fees paid to brokerage houses, investment management firms, investment banking firms, private banks, and product-compensated financial planners.

The real difference between a family office and many of the organizations that provide product to the family office industry is that the family office has a "*Serve*" culture and the others have a "*Sell*" culture. In the "*Sell*" culture, the client does not pay a fee for the service; the client pays a fee for the product. A family office should have "open architecture" to the universe of products that meets the client's needs and not be limited to the products of one firm, even if that firm has "the best and brightest." One of the most important values of a family office is the objective advice that it provides to its clients in all areas needed by the family. This is not to say that the "*Sell*" companies are not important and very necessary to the family and the family office. It is just to point out that the family office cannot have a "*Sell*" culture and be compensated by product sales if it is to provide the objective advice that the family is retaining it to supply.

Value of a family office

The full-service family office not only plans, but also executes and manages all the financial affairs of a family over generations. The typical full-service family office provides the following services: investment management, which includes asset allocation and investment policy development, in addition to performance reporting and monitoring; bill paying; cash flow management and accounting for investment assets in addition to all personal assets; tax projections and advice with tax return preparation; philanthropic management, including the grant-making process and all necessary filings; estate planning, execution of the plan, and trust administration; regular organized and facilitated family meetings; insurance placement and management; and personal services as needed by the family.

Some family offices offer all the services, but will allow a family to

pick and choose the services that it wishes to receive and pay for, cafeteria style. This has been done effectively by some family offices but can erode one of the most important values of a family office, the coordination of all the diverse financial aspects of the family assets. By choosing just certain services, the family can run the risk that coordination does not occur and a professional will not attend to important elements of the family's financial affairs. A full-service family office that manages all the financial affairs of the family functions much like a primary care physician who manages a person's physical well-being by coordinating all the specialists. Without the primary care physician, a person is required to manage the specialists him or herself without the medical knowledge to do so. When a full-service family office manages and coordinates all the financial affairs of the family, it is less likely that something will "slip between the cracks."

When the family office manages the entire investment process, the family office professionals have a better appreciation for what assets should be included in the family estate plan and used for charitable giving. Because all disbursements and receipts are paid and received by the family office, it can budget family cash flow more efficiently, and can better plan for taxes and prepare tax returns, than professionals outside the family office who do not have access to all aspects of the financial affairs of the family member.

Insurance can be placed and managed more effectively because the family office is constantly aware of what needs to be insured and the level of protection the family requires. If legal or other professional assistance is needed in a transaction, the family office is better prepared to ask for the right assistance and monitor the process since they know the family members' complete financial situation. In addition, the family members need only interact with the family office and not a multitude of professionals. In many cases, family offices will also help family members with the purchase of homes or businesses, manage and be involved in lawsuits, assist in the operation of the family business, and mentor the next generation with advice on career, education, and pre-marriage contracts.

Family meetings

The family office assists families with multi-generational education by conducting family meetings with each generation separately (sometimes including spouses and sometimes not), or with multiple generations. The purpose of such meetings is to inform family members about the financial affairs of the family and their responsibility, if any, in the ongoing process of managing the family's assets, as well as to learn about the current activities of the family. In today's complex world, the coordinated efforts of a family office can help to maintain the asset base of the family, perpetuate the goals and objectives of the family, and maximize the effectiveness of the professionals required to manage the family's financial lives.

At the family meeting, the family office manager gets an opportunity to hear from the family about what is happening in the lives of the family members to obtain a better understanding of their planning needs and be more constructive in achieving the family's goals. As family members grow, marry, have children, and age, their needs change and the family office should be prepared to handle all stages and generations of the family. Often, reports of investment performance, cash flow and net worth are presented to the family in addition to a review of the tax return annually, a review of insurance coverage annually, or an update on real estate or other specialized businesses or assets. In addition, there are usually some "non-agenda" items that the family wants to discuss with the family office manager that results in a good exchange of information between the family office executive and the family members.

Structure of ownership

The legal structure of the family office differs based on the needs and objective of the family and the goals established for the family office. As an operating and/or investment entity, some SFOs use one or more limited partnerships or limited liability companies ("LLCs") in which the family members hold a limited partnership interest or an LLC membership, with a corporate entity acting as the general partner or managing LLC member. This entity provides liability protection for the family members, as does an S corporation.

In determining the right structure for the family, it is important to consider whether there is a need for distributions and the methods of distributions from the entity, because frequently these distributions must be prorated, and that requires that all family members take the same amount of distribution at the same time. This may often create a problem if family members do not want equal distributions. If all family members do not share equally in the fees for services, an operating entity that is not owned directly by all the family members may be a good choice, and it should be designed to "break even." The family members may then simply be clients of the family office, which will manage their assets separately, possibly in a separate investment structure, for a fee reflecting the amount of assets and services to be provided.

The legal structure of an MFO is not subject to the same concern regarding unequal fees or distribu-

tions to family members. An MFO is often not owned by a family member, although it may be if it began as an SFO that later accepted nonfamily member clients. In either case, the legal entity may be a C corporation, an S corporation, an LLC, or a limited partnership, and the choice is not restricted because of a need to provide for equal family member distributions or fees. The selection of entity type depends on the needs and preferences of the nonfamily member professionals who own and operate the MFO.

Fees and costs

Family offices charge for their services in a variety of ways, but most bill a fee based on assets under advisement ("AUA"), or assets under management ("AUM"). The difference between the two is that many family offices are managing nonliquid assets or noninvestment assets on which they are paid, and the AUA fee allows that to occur. AUM is a fee usually applied to liquid investment assets. Some firms bill on a retainer basis or a combination retainer plus AUM basis to allow them to be paid for the management of noninvestment assets, and some—but not many—bill on a hourly basis.

The rule of thumb seems to be that the all-inclusive fee to manage the family's financial affairs should be about 1%-2% of assets, but that depends a great deal on the level of assets under management, the size of the family, the complexity of the assets, the services provided, the type and frequency of reporting and communication, and many other factors. An SFO and an MFO usually have different fee structures, as the SFO will charge a fee to the family based on all the costs to serve that one family, which usually results in a breakeven. It could be more or less than the fee the family would pay if they were part of an MFO. In addition, in an SFO, the allocation of that fee to each family member may or may not be based on the level or cost of the service to each family member. In some cases, family members may share the cost unequally, with the older generation paying a larger percentage of the fee.

An MFO will bill each family member based on the cost of the service that family member requires. The challenge for the MFO is to account for and understand the cost of the service for each family member and still be competitive in the marketplace. Some family offices do so by recording the office's time so it has a better understanding of the costs associated with a particular task or client, but this still seems to be more the exception than the rule in the family office industry.

If a family office provides services in a cafeteria style, which lets family members choose what services they want and do not want, rather than full services, the family will probably be charged on an unbundled fee basis for each of the services they request. For example, a family may want bill paying for which they pay a fee and investment management for which they pay another fee, but they may not want tax or accounting work, so that service is not calculated in the fee structure. But ultimately, the fee paid to the family office must cover the cost of that service to allow the family office to sustain itself.

In addition, a family should be mindful of the tax deductibility of family office fees, as well as trust and investment expenses. Frequently, these fees are subject to the 2% of adjusted gross income ("AGI") floor.[1] In particular, the *Knight*[2] case requires the imposition of the 2% floor unless the costs would not have been incurred if the trust property were not held by a trust—in which case they may be deducted without regard to the floor.

Regulation

If a family office is going to accept outside clients (i.e., nonfamily members), there may be a need to register with the SEC. The federal government and many states require that family offices register as investment advisors. Such registration is triggered if "investment advisory services" are provided. Investment advisory services would include not only selection or recommendation of security purchases and sales, but also selection of investment managers, reporting on investment performance, recommendations about asset allocation, and similar services.

In addition, if the family office has possession of client funds or securities, its financial statements must be audited. Possession includes having signature authority on a client account in order to pay the client's bills, no matter how much money is maintained in that account. Consequently, most MFOs will need audited financial statements. Registration as an investment advisor involves additional costs, systems, and controls.

If a family is considering operating as private trust company or using a private trust company as a trustee, they should pay attention to recent IRS Notice 2008-63,[3] which contains a proposed Revenue Ruling on private trust companies. The IRS is currently soliciting comments on the conditions under which the assets of a family member, which are in a private trust company, would be subject to estate tax at his or her death. If the grantor or beneficiary of a trust has any control over trust distributions through the private trust company, there may be concern that the assets are not really owned by the private trust company and therefore would be included in the estate of the grantor.

1 See Sections 67(a) and 67(e).

2 128 S. Ct. 782, 101 AFTR2d 2008-544 (2008).

3 2008-31 IRB 261.

Choosing a family office

There are many issues to think about before selecting a family office. The first is whether to join a family office or to form a family office. If the family has sufficient assets to form a family office, they should understand that it is a business, just like any other business, and it will take time and resources to operate. Some SFOs have closed their offices and joined MFOs because of this very issue. Next, consider the services to be provided to the family. Should the office be a full-service family office, an office that offers only investment management to the family, or an office in which the family members can pick and choose what services they want to use. When making a choice, families should not forget the value of the full-service family office and the coordination of all the various functions that many family offices perform.

The family needs to consider the culture of the organization that they are going to join, or the family office they are going to form, and how it will be compensated for its services. Does the family want objectivity in the management of their assets and complete open architecture to all the products available in the marketplace, or is being captive to one firm's platform of products acceptable? How will the family pay for the services of the family office? Do they wish to pay through product sales or a fee based on all the services to be performed? If they set up their own family office, how will each family member be charged, and if they pay a fee to a multi-family office, are the assets of each family member capable of paying for that individual's own services or will the other family members assist in paying the total family cost?

In setting up a single-family office, the family should think about the long-term objective of the family office. If the family office is going to be designed to operate for many generations, a governance structure for its operation should be developed, especially if the family is going to participate in the operation of the family office. This should include the requirements of who and how family members can be part of the operations of the family office. Does the size of the family office matter? Would the family prefer to form or join a small family office to maintain a high level of personal service, or is a bigger office with more personnel and resources their preference?

The family should also consider the reporting needs of the family. How often would they like reports, and is it necessary to have customized reporting or are the standard reports produced by a specific firm acceptable? How will this be communicated—by web access updated each day or in person at family meetings, or some combination of both? Does geography make a difference? Some families like to have their family office close by so they can visit on a regular basis, but others believe that with e-mail, phones, and the Internet, it is not necessary to have an office in their backyard. There are many considerations that families should think about before they form or join a family office; these are just some of them.

Conclusion: The future of family offices

Based on the media fascination with ultra-high net worth families, and the amount of attention that is focused on them by financial institutions, it would seem that the universe of high net worth families is very large. While it is a larger universe than it was 20 years ago, it is small by comparison to the institutional investment industry. In addition, while many families of modest means could really use and appreciate the services of a family office, it is still difficult to provide all the services they would want, and could use, for a fee that makes economic sense for both the family and the family office. As family offices grow as an industry, the threshold of assets necessary to provide family office services will also grow.

The family office industry will continue to grow, as there are more and more ultra-high net worth individuals, but it will never achieve the size of the institutional investment market and will continue to be a cottage industry. As more people learn about family offices, and as family offices receive more attention from more providers of financial products, many firms are considering providing family office services in addition to selling investment products in an effort to gather more assets under management. This could result in too many firms chasing too few families, and the outcome could be that the noninvestment family office services, which are so important to the family, become lost to the investment of the assets. So firms that intend to enter the family office industry should understand and plan for all the needs of the family and not just offer noninvestment services as a "loss leader" to gather assets. In addition, the family office industry should strive hard to develop and implement best practices and policies with more standardized pricing and fee structures, similar to those of investment management firms or realtors, so that existing and prospective clients understand the value and services of a family office and how they will be charged for those services. ■