By **Thomas J. Handler**

Establishing Virtual Family Offices

VFO structures can be used to improve legal compliance, tax efficiency and risk management

In the last 25 years, family office structures have emerged as the global best-in-class solution for affluent families striving to achieve long-term wealth management and preservation. As the costs of operating single family offices (SFOs) have continued to outpace revenue growth, virtual family offices (VFOs)[1] have proliferated as the preferred platform for outsourcing, particularly as a starter for families not ready for a family office with a brick-and-mortar presence. VFOs are legally organized businesses that serve as the nerve center or quarterback for controlling a family's tax, financial, legal, investment and risk management strategies.[2] Typically, one or more family members coordinate the functions and outsource services to independent outside providers.

Another critical but typically overlooked role of VFOs is to provide a defensive shield against an entire array of common, ill-advised and problematic business practices. Often, these poor business practices are inadvertent and go unnoticed until it's too late, resulting in needless financial and reputational damage to the business and its owners. In family-owned and privately held businesses, including farms and ranches, officers often determine and develop business protocols and common practices on an ad hoc basis as the business evolves, usually starting at a time when the business enterprise is relatively simple and the employee group is small and comprised of only family members or owners.

Common Business Practices

As a business grows and evolves, it adds outside employees, qualified plans and employee benefits. It puts in place bank financing, and outside investors fund the business. Compared to its start-up phase, the business is now in a completely different position, attended by different obligations, responsibilities and duties. Often, this transition is gradual and receives insufficient attention. Let's assume that the subject business has carried over these common practices (examples derived from actual cases) from its early days:

1. The chief executive officer's (CEO) executive assistant picks up and drops off the CEO's laundry, books all personal entertainment and vacations, pays all personal bills and coordinates and pays the CEO's housekeeper and au pair.
2. The business controller is a certified public accountant who also prepares the family income tax returns.
3. The in-house general counsel prepares the family's estate plan and contracts, provides personal advice and handles the children's prenuptial agreements.
4. The family uses an office within the business premises, which includes a fire-control sprinkler system, to store closing documents, tax returns, birth certificates, titles and other personal documents.
5. The family uses one of the trucks owned by the business to move furniture and possessions from one family home to another and between home and college apartments.

Unfortunately, these common practices, albeit often unintentional, look pretty bad in the light of day. Under the scrutiny of a lawsuit or government agency proceeding, they look even worse. The dollar magnitude of a diversion or unauthorized use of business property or personnel may be largely immaterial, but materiality may be irrelevant when the allegations include fraud, Employee Retirement Income Security

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Act (ERISA) violations or breach of a shareholder agreement.

The Overlooked Problem

These unwise, overlooked practices are often actionable or provide the basis for government proceedings from the Department of Labor (DOL), Internal Revenue Service and Securities and Exchange Commission, in addition to proceedings commenced and covered by state agencies with similar subject matter jurisdictions. The use of any business employee, including executive assistants, accountants and attorneys, for a personal or investment purpose is prohibited. Courts or government agencies may consider this tantamount to theft, whereby the governing authority finds the diversion of services, capital or property from the business wholly improper, even if considered de minimus. The business pays the employee to direct his full time and attention to the business during business hours, for which the business compensates the employee. To do otherwise may violate the terms of an employment contract, union agreement or employee handbook. Moreover, an officer or director supervising this employee would be committing similar contract breaches in addition to breaches of fiduciary duties owed to the business.[3]

It's critical that advisors identify, correct and fully account for these poor practices before the business engages in additional financial transactions.

The business can't deduct for either tax or financial accounting purposes or compensation paid to the employee for performing personal services.[4] This results in potentially fraudulent or negligent state and federal income tax returns, payroll tax returns, unemployment compensation returns and workers' compensation filings.[5] To make matters worse, when the business or its agents provide these tax filings or financial statements to banks, investors or venture capital firms, such presentations may be fraudulent and serve as the basis for bank fraud,[6] shareholder derivative actions, fraudulent inducement claims[7] and even potential claims for state and federal securities fraud.[8]

Further, the supervisor might be subject to additional claims if the diversion of services or resources adversely affects third parties. In such cases, third parties may bring actions for negligent or intentional interference with contract or prospective economic advantage when the business has qualified pension plans, employee stock ownership plans, executive compensation or employees eligible for discretionary bonuses or bonuses based on profitability.[9] The improper diversion of any resources is highly problematic because the additional profit that would have otherwise inured to the business should have been available to fund these plans and bonuses. Accordingly, the business and officer could be subject to breach of contract suits from all affected parties in addition to statutory claims for attorneys' fees and damages for ERISA violations. The use of business equipment, vehicles and facilities is similarly problematic.

It's critical that advisors identify, correct and fully account for these poor practices before the business engages in additional financial transactions. For example, these practices may violate financial bank covenants or notice requirements, potentially providing a basis for the bank to pull its financing commitment or fail to renew it. The same may be true for outside shareholders, venture capital firms and others.

Perhaps the most troubling problem is a business' inability to raise capital, be sold or be taken public when one or more of these poor practices is present. All significant financial transactions will require financial scrutiny or acquisition audits, in addition to traditional representations, warranties and covenants. The problem is that the executives who have engaged in these prohibited practices can't sign many commonly required covenants without committing perjury or fraud. For example, the executives can't warrant that:

1. They haven't violated ERISA, DOL rules or employment agreements.
2. They've filed timely, accurate and truthful financial statements, income tax returns and payroll tax returns.

3. They've adhered to their employment agreements and upheld their fiduciary duties.

This inability to sign such covenants is not only embarrassing and improper, but also, usually sufficient to kill a transaction or impact the transaction price adversely. Unfortunately, the detriment incurred is likely to be a multiple many times greater than the financial loss caused by the business' lack of judgment or poor practices.

A Simple Solution

Consequently, it's critical that attorneys and other professional advisors be aware of problematic practices and proactively advise their business clients. A relatively simple solution is available if the business was aware of the many common problem practices. The owner-employee can simply repay the business for his personal, investment or unrelated business uses.

There are three sides to this simple solution. First, the employee benefiting from the diversion of personnel or resources should seek permission for all such personal uses. Second, the business should be repaid by the employee benefiting from the diversion for the fair market value (FMV) of the use of personnel, equipment or premises. Third, to the extent a benefit or perquisite can't be fully reimbursed, the employer must report, and the employee must pick up, the compensation element on his Form W-2 or other appropriate reporting form, depending on the nature of the business and employment relationship. This is much like reimbursing an employer for personal use of the corporate car or jet. In turn, the benefitting employee paying for these expenses may be able to deduct such expenses if they relate to another business or are for the production or preservation of income. In the absence of statutory authorization, personal expenses are, by definition, not deductible.[10]

As a practical matter, however, owner-employees and executive employees are highly unlikely to derive any income tax benefits from legitimate business expenses incurred, because such expenses would be deducted as "unreimbursed employee business expenses."[11] Such expenses are reported on Schedule A of Form 1040, as miscellaneous itemized deductions subject to an adjusted gross income (AGI) limitation of 2 percent.[12] Only the amount over 2 percent of AGI is included with other itemized deductions.[13] Consequently, such deductions are often completely disallowed for high income taxpayers. Moreover, such expenses are "below the line" deductions for state income tax purposes because almost all state income tax calculations begin with some version of federal AGI.[14] The net result is that such expenses can't be deducted at all for state income tax purposes. Finally, effective Jan. 1, 2013, the Pease Amendment again became operative.[15] The net effect of this additional hurdle is to further limit net excess itemized deductions for high income taxpayers by triggering an itemized deduction limitation that's the lesser of: (1) 3 percent of AGI above the AGI levels specified in the statute, or (2) 80 percent of the amount of the itemized deductions otherwise allowable.[16]

Although vigilance, proper accounting, reimbursement, notification and authorization represent major strides toward appropriate compliance and responsible conduct, such steps don't solve all problems, eliminate all potential claims or result in favorable income tax treatment. To achieve these goals, a more sophisticated approach may be warranted, particularly for growing businesses, larger businesses, highly regulated businesses and businesses with a sophisticated exit strategy.

The VFO Opportunity

In this regard, affluent families and their advisors should consider the use of a VFO for defensive purposes and tax efficiency. The VFO can and should play dual roles to help secure a family's long-term wealth management and preservation goals and to add needed discipline, integrity and compliance to the family-owned or privately held business. In this role the VFO is playing offense by serving as the quarterback control entity while also serving as the linebacker defending the family's integrity, reputation and tax positions. The primary goal in the defensive use of VFOs is to assure the integrity of accounting allocations and adherence to duties, contracts and legal obligations. Accordingly, any operating business involved, including farms and ranches, should submit non-business charges to the VFO periodically. Generally, the frequency of submission varies in direct relation to the magnitude of charges/expenses incurred. This process has the impact of removing the personal, investment or unrelated business expenses from one or more operating businesses and legally transferring them to the VFO, which is in the business of managing the personal finances, business and investment activities of the family. This properly organized legal entity can deduct expenses that tend to produce or protect income.

Typical expenses include legal and accounting fees for tax planning and preparation, investment advisor fees, investment seminars and financial reporting software. Of course, all such expenses are required to be within FMV ranges and "ordinary and necessary" under the circumstances. As a general rule, VFOs tend to operate at the lower end of SFOs, generally under $250 million in assets under management (AUM). This number is merely a benchmark; VFOs with over $1 billion in AUM exist by design. Generally, a VFO derives its revenue from the following three sources:

1. Fees paid pursuant to contract, such as investment management oversight, financial reporting and charges for supervision of all legal, accounting and risk management functions;
2. Carried interests for serving in an integrated structure as the managing member, manager or general partner of family holding companies, which are typically family limited partnerships and family limited liability companies (LLCs) (see "Integrated Structures," this page); and,
3. Reimbursement of professional fees and related costs.

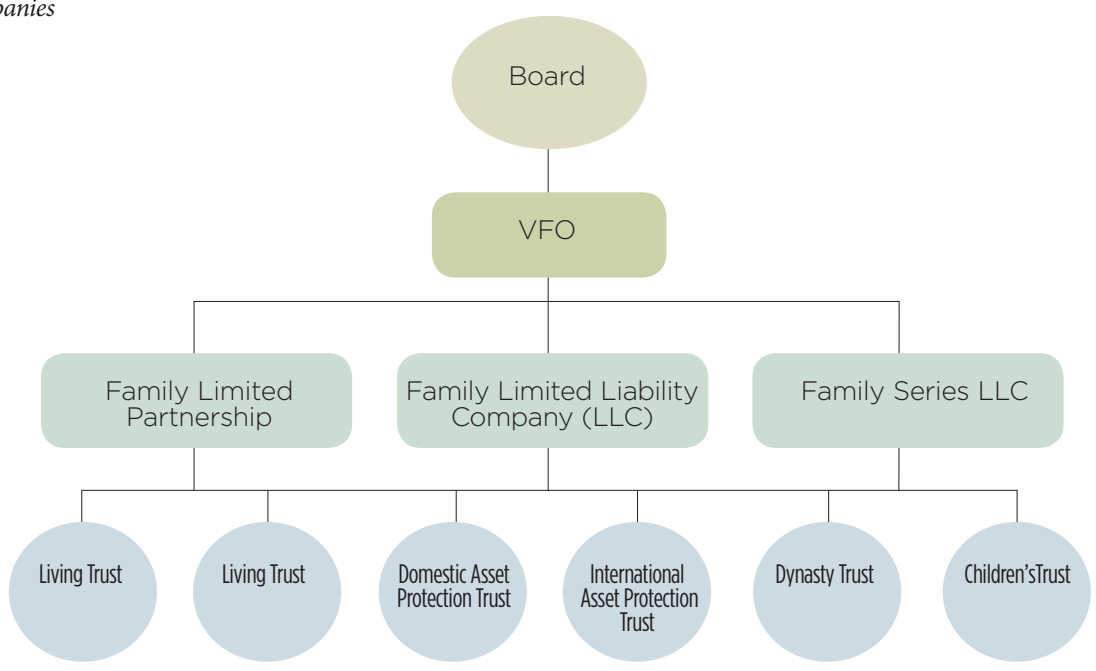
Like any business enterprise, the goal of a VFO is to derive a profit, but at any point in time, compliance, risk management, tax efficiency, asset protection or estate planning might be more compelling goals. A VFO operation would be wise to charge enough for its fees and services so that it drives a profit periodically, at least once every five years to avoid "hobby loss" arguments from the IRS.

Entity Considerations

Choice of entity considerations for VFOs start with the need to be a properly organized legal entity with limited

Integrated Structures

The virtual family office (VFO) serves as the managing member, manager or general partner of family holding companies



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liability. Accordingly, VFOs are almost always LLCs, S corporations or C corporations, depending on the family's objectives. That being said, a significant number of U.S.-based family offices, and an even larger number of international family offices don't use established legal structures; rather, the VFO or SFO is embedded and operating inside one or more family businesses. This is an ill-advised approach that represents a major departure from global best-in-class practices. It's often attended with the many problems discussed above and, theoretically, is even more susceptible to poor practices. That isn't to suggest that all embedded family offices are riddled with accounting and compliance problems, however, simply that the risk of such occurrences is magnified.

Final Thoughts

VFOs are proliferating in the United States and abroad, driven largely by wealth planning objectives and cost management considerations. Increasingly, VFO structures will be used for control, compliance and risk management goals. Such structures can be even more compelling when implemented with estate planning, governance, asset protection and income tax objectives in mind. The VFO structure will typically pay for itself with the cost savings from avoiding poor practices, coupled with tax savings, better controls and risk management, in addition to the many other long-term wealth management benefits of family offices.

Endnotes

1. *See generally Family Wealth Alliance Single Family Office Study* (2012).
2. *Ibid.*
3. Generally, directors and officers of corporations have the following two fiduciary duties: (1) the duty of care; and (2) the duty of loyalty. *See, e.g., Gantler v. Stephens,* 965 A.2d 695, 708-709 (Del. 2009) (holding that corporate officers and corporate directors owe the same fiduciary duties of care and loyalty); *Graham v. Allis-Chalmers Mfg. Co.,* 188 A.2d 125, 130 (Del. 1963) (stating that "directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances"); *Guth v. Loft, Inc.,* 5 A.2d 503, 510 (Del. 1939) (stating that corporate officers and directors owe an undivided and unselfish loyalty to the corporation and, therefore, may not have a conflict between duty and self-interest); Tamar Frankel, "Fiduciary Duties as Default Rules," *74 Ore. L. Rev.* 1209, 1210 (describing "a duty of care—to act carefully and not negligently—and a duty of loyalty—to perform their services in the interest of their entrustors and not in conflict of interest").
4. *See* 26 U.S.C. Section 162(a) (stating that "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" can be deducted, including salaries); 26 U.S.C. Section 262(a) (stating that "no deduction shall be allowed for personal, living, or family expenses").
5. *See, e.g.,* 26 U.S.C. Section 7206 (governing fraud and false statements in connection with matters related to the internal revenue laws); 26 U.S.C. Section 7207 (governing fraudulent returns, statements and other documents related to the internal revenue laws); 26 U.S.C. Section 6662 (governing the imposition of accuracy-related penalties on underpayments of tax).
6. *See, e.g.,* 18 U.S.C. Section 1344 (governing bank fraud).
7. *See, e.g., DeHart v. DeHart,* 986 N.E.2d 85, 97 (Ill. 2013). (In Illinois, fraud in the inducement is a tort claim requiring a showing that a "defendant . . . made a false representation of material fact, knowing or believing it to be false and doing it for the purpose of inducing one to act.")
8. *See, e.g.,* 18 U.S.C. Section 1348 (governing federal securities and commodities fraud); 815 Ill. Comp. Stat. Section 5/12 (governing Illinois securities fraud).
9. *See, e.g., Kempner Mobile Electronics, Inc. v. S.W. Bell Mobile Sys.,* 428 F.3d 706, 716 (7th Cir. 2005) (In Illinois, the following elements are required for a claim of tortious interference with prospective business or economic advantage: "(1) plaintiff's reasonable expectation of entering into a valid business relationship, (2) defendant's knowledge of plaintiff's expectancy, (3) purposeful or intentional interference by defendant that prevents plaintiff's legitimate expectancy from ripening into a valid business relationship, and (4) damages to plaintiff resulting from the interference."); *Fieldcrest Builders, Inc. v. Antonucci,* 724 N.E.2d 49, 61 (Ill. App. Ct. 1999) (In Illinois, the following elements are required for a claim of tortious interference with contract: "(1) the existence of a valid and enforceable contract between the plaintiff and another; (2) the defendant's awareness of the contractual relationship between the plaintiff and another; (3) the defendant's intentional and unjustifiable inducement of a breach of the contract; (4) a breach of contract by the other caused by the defendant's wrongful acts; and (5) damage to the plaintiff.")
10. 26 U.S.C. Section 262(a).
11. See 26 U.S.C. Sections 162(a), 212.
12. 26 U.S.C. Section 67.
13. *Ibid.*
14. *See, e.g.,* 35 Ill. Comp. Stat. Section 203(a) (stating that an individual's "base income" is "an amount equal to the taxpayer's adjusted gross income for the taxable year . . . "); 35 Ill. Comp. Stat. Section 5/203(e) (stating that "a taxpayer's gross income, adjusted gross income, or taxable income for the taxable year shall mean the amount of gross income, adjusted gross income, or taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code").
15. 26 U.S.C. Section 68.
16. *Ibid.*