Virtual family offices – a global trend

Thomas J Handler

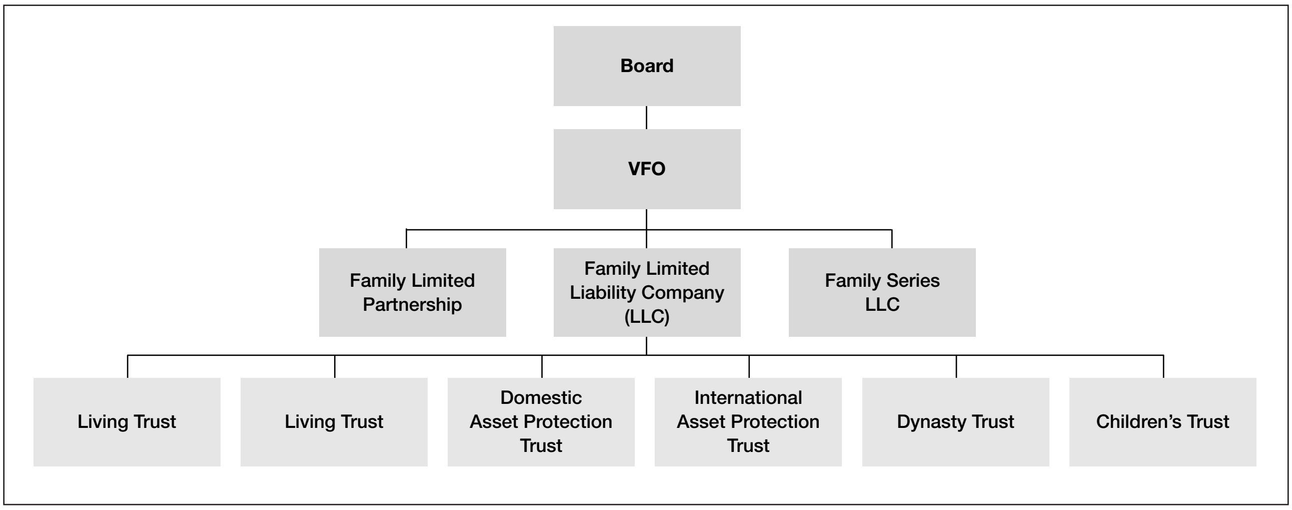
As the global proliferation and concentration of wealth continues to escalate, family offices have emerged as the best-in-class approach to achieving long-term wealth management and preservation. In recent years, virtual family offices (VFOs) have accounted for a high percentage of new family offices while some existing single family offices have been restructured into VFOs. These results reflect a clear trend within the wealth industry in the development and evolution of family offices.

VFOs are legally organised businesses designed to manage, control and facilitate both the financial and non-financial wealth of a family.[1] These enterprises are not merely in the business of investment and financial management, rather VFOs can handle tax, legal, risk management, control, family education, governance and asset protection functions. Typically, one or more family members and a small staff handle the overall management of these affairs and some services are outsourced to independent service providers with greater expertise, resources and staff professionals. VFOs are particularly attractive to newly liquid sellers of family businesses and privately held companies. Their use allows families to obtain the many wealth management benefits afforded by family offices without committing to a large payroll and a 'bricks and mortar' presence of single family offices. The consistent trend over the last 25 years has been that family office revenues have been growing slowly while family office expenses have been growing rapidly.[2] In large measure, this may be due to reliance on compensation models based on assets under management. While asset growth and corresponding yields have been slowing globally, family office operating costs have continued to grow, outpacing revenues. Consequently, cost containment has been a consistent key objective of many family office executives that has driven increased outsourcing and the proliferation of VFOs.

This trend in favour of VFOs has been driven by several key factors:

- most existing family office structures are inefficient and outdated;
- increasing global regulation and compliance requirements have made it more difficult to operate family offices; and
- many family office structures are affected by significant estate, gift, payroll and income tax leakage.

Figure 1: Integrated structures
The virtual family office (VFO) serves as the managing member, manager or general partner of family holding companies



Consequently, family office structures put in place prior to global regulatory changes such as the Patriot Act,[3] the Dodd-Frank Act,[4] the Foreign Account Tax Compliance Act (FATCA)[5] and similar international laws, should be reviewed to ensure regulatory compliance and to capture tax opportunities.

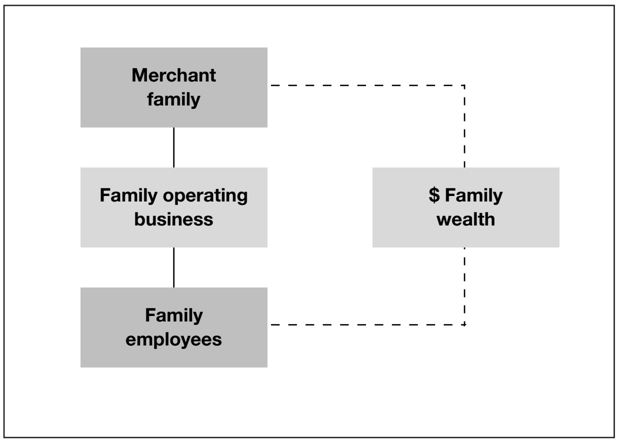
Twenty-first century family office structures

Twenty-first century family offices are attended with significantly more sophisticated structures designed to meet a larger number of primary objectives which are often elusive and competing. Current family offices should be integrated into the various advanced planning structures implemented by families to effect estate planning, business planning, succession planning, asset protection, premarital planning, risk management and tax planning objectives. Historically, the vast majority of family offices were stand-alone entities that were not tied into advanced plans. Accordingly, unlike modern structures, mid-generation family offices did not serve as general partners or managing members of family holding companies, which can be family limited partnerships, family limited liability companies, series family limited liability companies and their international counterparts. Generally, these offices did not serve as trustee or trust protector and rarely played any role in the family's estate plan.

In addition, many existing family offices play very little or no role in liability management, asset protection, premarital planning or risk management. As litigation, the scope of liability and the magnitude of judgments have grown, liability management, asset protection, premarital planning and risk management have all taken on increased importance. Further, at least two well-known global law firms have estimated that between 40% and 50% of all existing family offices in the United States are not fully compliant. Outside of the United States, it is believed that many more family offices are not compliant. The most common compliance failures relate to international tax compliance, securities compliance (including registration as a broker-dealer or as a registered investment adviser), commodities future trading commission compliance and FATCA compliance for international families.

This result occurs largely because family office structures tend to be outdated, global regulatory compliance requirements are relatively new, and embedded family offices are much more common outside of North America. That is not to say that embedded family offices are uncommon in North America; they are surprisingly common. Embedded family offices, however, are often the norm in parts of Asia and Europe. This is not surprising since family businesses and family offices are closely intertwined. Almost all family offices were formed as a result of a successful privately held or family operating business, and many family offices started inside or embedded in such businesses. An embedded family office exists when no separate legal structure has been established, and its functions are carried out by family members and others who are employees of the family operating business. It is quite common in small businesses to have family employees and non-family employees handle various personal matters for the business owners. When only family owners and family employees are involved, such work not related to the business of the family operating company is rarely problematic.

Figure 2: Embedded family office structure



As the business grows and takes on non-family employees, qualified pension plans, employee benefits and incentive-based compensation, the situation changes quickly and dramatically. Suddenly, what once were common business conveniences quickly become problematic business practices. Examples of these practices include having assistants pay personal bills, running personal errands and booking personal restaurant, hotel and travel arrangements for the business owners. Other examples include having the business accountant handling personal income tax returns and financial planning or having the in-house counsel handling apartment leases and contracts for the owners' children. Use of business premises and equipment for personal purposes is similarly problematic. An operating company should not allow family owners to use office facilities to store personal property or personal records. Similarly, company transport should not be used to move personal property between homes and college dorms or apartments.

These common practices seem innocent enough until you consider the impact on employees, bankers, non-family owners and related third parties. The business is often taking on unwanted risks and liabilities and suffering a diversion or unauthorised use of its assets or personnel. These legal problems are real, *An operating company should not allow family owners to use office facilities to store personal property or personal records. Similarly, company transport should not be used to move personal property between homes and college dorms or apartments.*

significant and are attended by serious unintended consequences. A wide host of issues are presented. Uses of company resources including personnel, equipment and intellectual property are impermissible diversions of company assets. This removes resources otherwise available for dividends, bonuses or pension plans. A related problem is that some of these uses or diversions of resources are non-deductible personal expenses, while others constitute tax deductions allowable elsewhere because they are tied to investments or the production or preservation of income. In any event, these deductions do not relate to the business of the operating company and should not be taken as deductions by such company. In addition, these diversions of business assets often constitute breaches of bank covenants, violations of the federal Employment Retirement Income Security Act, breaches of fiduciary duties and breaches of contract. Further, these often overlooked practices can provide the basis for government proceedings by the US Department of Labor, Internal Revenue Service, Securities and Exchange Commission and their international counterparts in addition to local jurisdictions with concurrent subject matter jurisdiction. The bottom line is that a business expense for the use of any business employee including accountants, attorneys, assistants and other staff for personal or investment purposes is prohibited.

In turn, the business owners and executives are left unable to make traditional representations and warranties which are a standard requirement for bank loans, financing transactions, mergers, acquisitions and sales. This problem is attendant with serious adverse financial consequences. In this regard, the VFO can serve a very useful defensive function, particularly for growing businesses, larger businesses and businesses with sophisticated exit strategies. The key goals in the defensive use of VFOs are to assure the integrity of accounting allocations and adherence to duties, contracts and other legal obligations. By forming a separate enterprise to coordinate the long-term wealth management and preservation objectives of a family, that family can also bring better discipline and financial integrity to the family business. The VFO can legally incur, pay for and deduct expenses incurred for the creation or preservation of income. These expenses typically include accounting fees, tax preparation fees, tax counsel, investment management and advisory fees and other related expenses. If such expenses were paid out of the family operating businesses, the VFO can simply reimburse the operating companies, which has the effect of properly transferring such expenses to the VFO as if it had originally incurred such expenses. Of course, such expenses are legally permissible in the VFO and most are deductible for its income tax purposes.

Coordination of wealth management functions and creation of income tax efficiency

The end result of the coordination of this VFO approach is that the books and records of the operating business have been 'cleaned up', thus enhancing accounting integrity and removing breaches of various covenants and fiduciary duties. For US taxpayers, another key attribute of a VFO structure is that it is also a beneficial platform that is efficient for income tax purposes. A common problem encountered by high-income taxpayers is the loss of some or all expenses for the production or preservation of income. These expenses are aggregated with unreimbursed employee business expenses reported in Schedule A to Form 1040 as a miscellaneous itemised deduction subject to a limitation of 2% of Adjusted Gross Income (AGI).[6] Pursuant to this limitation, only expenses greater than 2% of AGI are included with other itemised deductions. Consequently, these financial deductions are sometimes completely disallowed for high-income taxpayers. If this limitation can be exceeded, the Pease Amendment further limits net itemised deductions for high income taxpayers by triggering an additional limitation on itemised deductions that is the lesser of: 3% of AGI over a specified statutory level; or 80% of the itemised deductions otherwise allowable.[7] Furthermore, such expenses are also unavailable to offset state income taxes because almost all states with an income tax start with AGI or modified AGI which is not reduced by itemised deductions.

In addition to better tax efficiency, VFOs offer almost all the benefits of traditional family offices. An increasing recent trend is the proliferation of multi-family offices (MFOs). MFOs have expanded greatly in the United States[8] and are beginning to take hold in Asia, South America and the rest of the world. In turn, this has led to increased outsourcing by both VFOs and SFOs to MFOs. Increasingly, MFOs are an efficient solution for VFOs not ready for a 'bricks and mortar' presence. Progressively, start-up family offices often begin simply and build only those functions in-house that such family offices can manage efficiently.

Inevitably, some VFOs will evolve into SFOs over time while others will elect to remain structured as VFOs either because such VFOs do not have sufficient assets under management (or advisement) or the VFO provides a sufficient level of control over the family's wealth management operations. Although it is not determinative, the magnitude of assets under management or assets under advisement plays an important role in determining the appropriate structure and choice of entity. While in practice VFO assets under management range from $25 million to over $1 billion in the United States, most VFOs are managing investment assets ranging from $50 million to $500 million.

Choice of entity considerations

One of the key elements of modern family office structures is that they are legally organised entities with some measure of liability protection for the acts of the principals, officers and directors. If the enterprise is properly established and maintained, liabilities of the enterprise will generally be limited to the assets of the enterprise. Accordingly, creditors and plaintiffs will be unable to reach the personal assets of the principals, officers and directors in the absence of tortious acts or criminality. In order to preserve this liability protection, each legal entity must maintain its status by filing annual registration statements and franchise tax returns, maintaining record books and accounting records and filing annual income tax returns.

Another consideration for US-based family offices or subsidiary family offices is the necessity of a profit motive. Since a family office is a business enterprise, it needs to have a profit motive as one of its goals. At any point in the life of the VFO, compliance, risk management, tax efficiency, asset protection or estate planning may be more compelling goals. Any family office, however, would be prudent to charge enough for its services to derive a profit periodically in order to validate its business status and avoid a potential 'Hobby Loss Rule' argument from the US Internal Revenue Service and other tax authorities.

VFOs are typically established as limited liability companies, S Corporations or C Corporations and their international counterparts. This choice is often ultimately dependent on income tax, executive compensation and employee benefits considerations. Often, these legal entities grew out of *de facto* family offices embedded inside family operating companies. Traditional family office structures are stand-alone enterprises that are not integrated or otherwise tied into family tax, state, asset protection, income tax or business plans. Such entities were initially established by trustees to assist families in their long-term wealth preservation and management efforts. A key problem, however, associated with these structures is that they were 'upside down' in that the family office reported to and was controlled by the trustees. By contrast, a key goal of contemporary family offices is to expect some measure of control over trustees and not to allow trustees to have absolute veto power over family office decisions, at least in most cases.

Another problem associated with stand-alone structures is that its compensation is limited to:

- cost-sharing with family foundations and supporting organisations;
- contractual compensation for providing investment management or other services, or managing such services; and
- reimbursement of professional fees and costs.

Without the ability to own equity upside in family businesses, private equity ventures and other investments, it may be difficult to attract and retain family office employees, or derive sufficient revenue to sustain the family office or to align family office compensation with performance and its tax attributes. It is for these reasons that family offices, including VFOs, are increasingly integrated into family holding

One of the key elements of modern family office structures is that they are legally organised entities with some measure of liability protection for the acts of the principals, officers and directors.

companies and comprehensive advanced plans. Without question, the most sophisticated and impactful advance plans consider estate planning, asset protection, risk management, liability management, tax planning, investment management and other financial considerations. Integration of these considerations and plans into family office structures and operations provide a potentially higher level of planning, control and customisation.

In addition to utilising management agreements and other contracts between the VFO and trusts, family holding companies, foundations and operating businesses, modern VFO structures are tied into family holding companies with equity ownership and carried interest. In turn, the interests in these family holding companies are owned by various trusts.

Coordination with family holding companies

Family holding companies tied via ownership or contract to family offices can be structured as family limited partnerships (FLPs), family limited liability partnerships (FLLPs), family limited liability companies (FLLCs), series family limited liability companies (SFLLCs) and their international counterparts. Family holding companies have emerged as the cornerstone of sophisticated estate plans for ultra-high-net-worth (UHNW) individuals. In the last 25 years, modern family offices have increasingly been structured to integrate with the subject family's advanced planning goals and structures. As a result, the inclusion of family holding companies has become a key element of modern family office structures and operations. Nineteenth-century planning was primarily effected through dynastic trusts in the United States, and, as a result, many of these advanced plans were upside down with the trustees in control of family investments, often in control of distributions and commonly in control of the family office often established by these trustees. As the first quarter of the twentieth century was ending, however, family holding companies structured as family general partnerships and FLPs began to be used both in conjunction with dynastic trusts and as an alternative to them. By the beginning of the fourth quarter of the twentieth century, FLPs were firmly established as the preferred vehicle for family holding companies in the United States. One key attribute of this vehicle was that the general partner of an FLP was personally liable and completely exposed to the liabilities, risks and lawsuits of the FLP. As a result, whenever the FLP contained assets other than publicly traded securities and bonds, the general partner was often an incorporated entity which shielded the individual general partner, now the corporate president, from personal liability. These enterprises were typically S Corporations with conduit tax treatment or C Corporations with potential double taxation. Conduit tax treatment refers to the ability of the enterprise to avoid federal taxation and have its income taxed to its owners whether or not distributions are made. A key consideration in establishing these enterprises was whether or not the state of domicile or state where operations were to be conducted imposed an income tax or franchise tax that functioned like an income tax or asset tax on the net income or total assets of the FLP.

Concurrently, a significant number of international jurisdictions established laws allowing a partnership-type business entity with conduit tax treatment and no personal liability for either the owners or the individual or company running the operations. These enterprises emerged as one of the dominant choices for both operating companies and family holding companies in these international jurisdictions. Limited liability companies (LLCs) are generally attributed to the German law of 1892 which authorised the Gesellschaft mit beschränkter Haftung (GmbH).

Subsequently, the United States began adopting this concept when Wyoming passed the first law authorising true LLCs based on the German model. It was similar to the English private limited company and the limited partnership association authorised by the state of Pennsylvania in 1874. Once established in Germany, the LLC concept was quickly adopted by Portugal (1917); Brazil (1919); Chile (1923); France (1925); Turkey (1926); Cuba (1929); Argentina (1932); Uruguay (1933); Mexico (1934); Belgium (1935); Switzerland (1934); Italy (1934); Peru (1936); Colombia (1937); Costa Rica (1942); Guatemala (1942); and Honduras (1950).[9] Given the fact that the operator (manager or managing member) of these LLCs was not personally liable for the liabilities, risks and lawsuits of the enterprise, LLCs soon emerged in the United States as the preferred choice for family holding companies. Again, the state of organisation remained a key consideration as families sought to maximise flexibility, ease of operation and avoidance of state income taxes and franchise taxes.

Once again, the United States borrowed the concept of cell enterprises which were popular in a number of international jurisdictions. Under the laws of these countries, a business enterprise could be established whereby each cell was separate and distinct for ownership purposes and legal liability purposes. This cell concept was a key element in the evolution of business enterprises because it allowed separate silos of assets, owners and liabilities in one enterprise. Thus, the owners of Cell Number One could own one farm parcel operated by Company A, an agribusiness operator, while the owners of Cell Number Two could own a different farm still operated by Company A with no fear that the liabilities, risks or lawsuits of Cell Number One could adversely affect their interests.

The first state to adopt this cell structure was Delaware when it passed the first Series LLC Statute in the United States in 1996.[10] Series LLCs are currently authorised in 16 states in the United States and Puerto Rico while they are under consideration in other states. Series LLCs are sometimes called 'Master LLCs' that have separate divisions, similar to an S Corporation with Q-subs. The concept of the series LLC was first used in the United States by the fund industry and is similar to the segregated portfolio company or protected cell company. Segregated portfolio companies exist in a number of international jurisdictions including Guernsey, the British Virgin Islands, Bermuda, the Cayman Islands, Mauritius and Belize.

Although many states in the United States have not yet authorised Series LLCs and many legal questions remain unresolved, Series LLCs are quickly emerging as the preferred structure for family holding companies managed by family offices. Each series must be run as a separate, independent business (per statutory requirements).[11] Each series must have its own bank account and must maintain a separate and distinct set of records. The manager must also maintain records for the company as a whole on a consolidated basis. The commingling of any funds is forbidden by statute. Failure to abide by these requirements could result in a series being disregarded and expose the assets of the non-compliant series to additional liability.

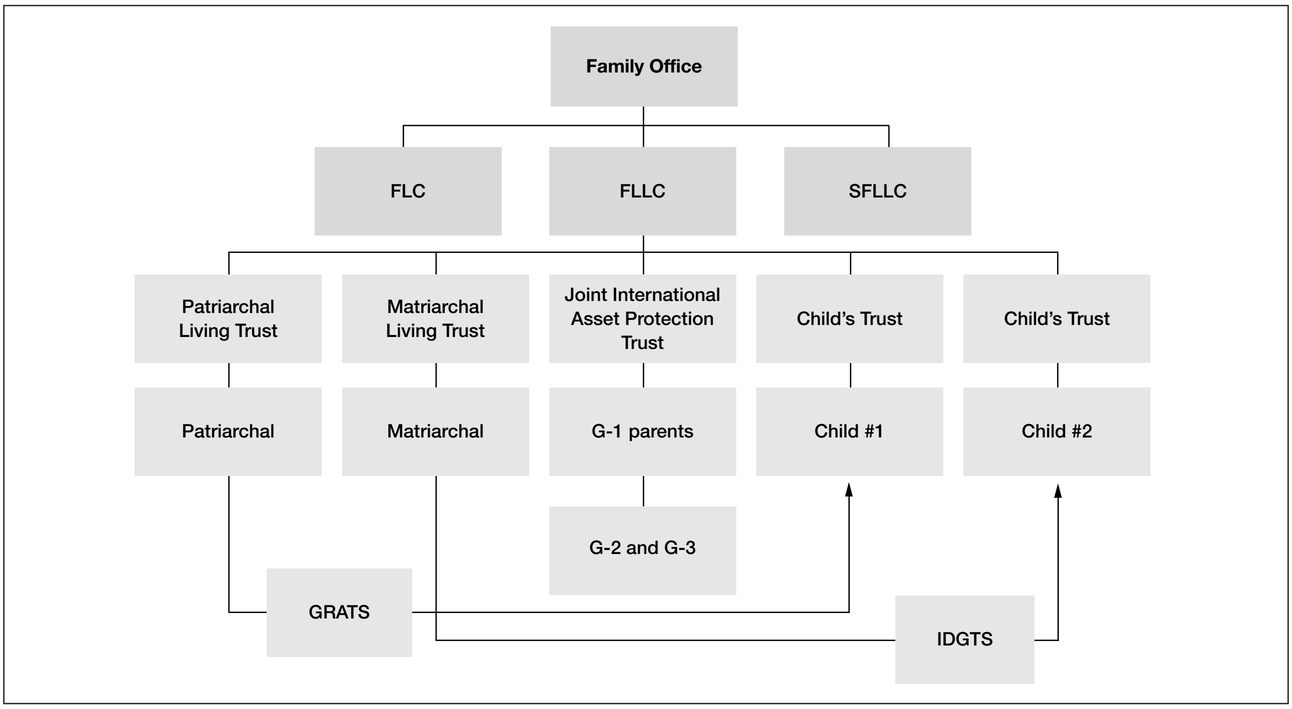
In an integrated, modern advanced planning structure, the family office serves as either the general partner of FLPs or as the managing member of FLLCs and SFLLCs. In turn, all of the interests in the holding organisations are held in various family trusts. Funding is achieved by transferring family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

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

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

Managing significant assets properly can be a business in and of itself. Family holding companies

Figure 3: Advanced FLLC/FLP structure



Using dedicated funds to facilitate governance and cover such meetings and educational events encourages family members to participate.

are a business, ideally managing a diverse group of assets, such as various business entities, mutual funds, public securities, other private securities, real property (typically not the primary residence), holiday homes, rental properties, collectibles and insurance. As the value and diversity of the assets in an FLLC increase, so too does the entity's business purpose and ultimate effectiveness. When properly administered, FLLCs protect assets from liability and are the most powerful domestic financial and tax planning vehicle available today.

Another key feature of FLLCs is the power created when multiple family members contribute their assets to an FLLC. Pooling resources allows the participating family members to obtain greater asset diversification than is available on an individual basis, provides access to investment opportunities and managers previously out of reach and increases leverage, affording the potential to negotiate lower management fees. Additionally, since participation in an FLLC is limited to family members, FLLCs' investment philosophy and policy statements can be tailored to the family's unique situation, unlike commercial investment products commonly offered to individual investors on a take-it-or-leave-it basis.

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

An FLP is often used for wealth preservation, asset protection, estate planning and tax planning. Some countries and their geographic subdivisions that have not authorised LLCs, as well as a number of countries with LLC statutes, have also authorised LLPs. A family limited liability partnership (FLLP) can be created by two or more family members who want to operate a family business. The LLP business structure is similar to a general partnership with the same taxation and management organisational structures.

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

The main advantages of an FLP, FLLC or an FLLP are:

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

The regulatory environment

When determining the appropriate family office structure, practitioners must consider both the planned and future services to be provided and applicable government regulation to which they may be subject. As families, family office executives and their professional advisers discuss family offices, they often refer to them as though they were a single enterprise, when, in fact, SFO structures are often comprised of several enterprises. The structure and nature of some of these entities are determined by regulatory, liability and asset preservation considerations. These structures include the family office management company (or so-called 'control entity') in addition to related and ancillary entities. The most common related family office entities include ancillary family offices, real estate property management companies, captive insurance companies, registered investment advisers (RIAs), broker/dealers and private trust companies. Since VFOs tend to be either start-up family offices or scaled down family offices these ancillary entities are rarely of concern. However, the realities of government regulation apply to all family offices including VFOs. In this regard, securities regulation and FATCA most often come into play.

Dodd-Frank compliance

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) effected sweeping global financial regulations in the family office space in the United States.[12] The Dodd-Frank Act provided for full extraterritorial application and enforcement. In this regard, it is a true global law.

Prior to the passage of the Dodd-Frank Act, any investment adviser with fewer than 15 clients was exempt from registration as a registered investment adviser under the Investment Advisers Act of 1940 (IAA).[13] The old rules (which exempted family offices with fewer than 15 clients under the Private Adviser Exemption or those with under $25 million in assets under management) were replaced with much more specific, better delineated rules with significantly more complexity. Pursuant to these rules, a family office is defined as an entity which only provides advice to 'family clients', is wholly owned by family clients and controlled by family members, and does not hold itself out to the public as an 'investment adviser'.[14]

The US Securities and Exchange Commission (SEC) has defined family clients as current and former family members, key employees, and certain charities, trusts and not-for-profit organisations funded by family members or key employees. A key employee is defined as a person who is either an officer, director, trustee, general partner or person in a similar capacity at the family office, an affiliate of the family office, or a person employed by the family office or an affiliate for at least 12 months who participates in the investment activities of the family office in the course of the employee's regular duties. If investment advice is provided to entities that are not family clients, then those officers, managers or entities need to register as investment advisers under the IAA and Dodd-Frank Act. Whether or not a person or entity is providing investment advice is a facts-and-circumstances analysis.

Registered investment advisers

A registered investment adviser (RIA) is an investment adviser registered with the SEC or a state's securities agency. An RIA is defined by the IAA as a person or firm that, for compensation, is engaged in the act of providing advice, making recommendations, issuing reports or furnishing analyses on securities, either directly or through publications.

The US SEC regulates investment advisers under the IAA and the rules adopted under that statute. If an individual or firm meets the definition of 'investment adviser' under Section 202(a)(11) of the IAA, registration with the SEC is required unless they are exempt or prohibited from registration. Under the IAA, a registered investment adviser (RIA) is a person or firm registered with the SEC that for compensation is engaged in the business of providing advice, making recommendations, issuing reports or furnishing analyses on securities, either directly or through publications. A person or firm must satisfy all three broadly construed elements of the definition to be regulated under the IAA. The receipt of any economic benefit will satisfy the compensation element. The business element is deemed to be satisfied even if an investment advisory business is not the person's or firm's principal business activity if the person or firm holds himself or itself out as an investment adviser or as providing advice, the person or firm receives separate or additional compensation for providing advice about securities or the person or firm typically provides advice about specific securities or specific categories of securities. The third element, providing advice about securities, is satisfied if the advice relates to securities (ie, advice about market trends, advice concerning the advantages of investing in securities or merely providing a list of securities to a client, even if the adviser does not make specific recommendation from the list).

Section 202(a)(l l)(A)–(E) of the IAA expressly excludes certain persons or firms from the definition of an RIA. In addition to these exclusions, the IAA gives the SEC the discretion to exclude other persons or firms not within the intent of the definition of an investment adviser who should be registered. Additionally, a person or firm that does not meet the criteria in Section 203A of the IAA or Rule 203A-2 is prohibited from registering with the SEC as an RIA. Generally, only larger investment advisers that have more than $25 million or more of assets under management or that provide advice to investment company clients are permitted to register with the SEC as an RIA. Generally, smaller investment advisers register as RIAs under state law with one or more state securities authorities. RIAs are held to a high fiduciary standard and are obligated to obtain the 'best execution' of clients' transactions.

Broker-dealers

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

In addition, family offices may be required to report as the manager of hedge funds or private equity funds, as an institutional investment manager under Section 13(f), or as a control person under Section 16 of the Securities and Exchange Act of 1934 (Exchange Act). Moreover, family offices who are RIAs may have to make additional disclosures if regulatory assets under management (AUM) exceeds $150 million pursuant to a recently issued joint rule by the SEC and the Commodity Futures Trading Commission (CFTC). Further, family offices may be required to file notices of exemption or register with the National Futures Association (NFA) as a commodity trading adviser (CTA) if the family office provides advice regarding certain investments or makes such investments, including commodities, derivatives, futures or options or as a commodity pool operator (CPO) operating a fund for multiple investors.

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

FATCA

The Foreign Account Tax Compliance Act (FATCA)[16] was enacted to enable the US Treasury Department to discover and trace broadly defined international accounts held in all FATCA treaty countries. It imposes a 30% withholding tax on payments of interest, dividends, rents, royalties and certain other types of income sourced in the United States to foreign financial institutions (FFIs).[17] Generally, a foreign private investment entity will be classified as an FFI and must enter into an agreement with the Internal Revenue Service (IRS) to avoid the withholding tax on certain payments made to the foreign entity. Therefore, certain family offices need to pay special attention and register their FFI with the IRS to avoid the withholding tax.

Conclusion

As VFOs continue to proliferate around the world, these business entities will be increasingly integrated into family holding companies designed to carry out key wealth management, asset protection, pre-marital planning, estate and tax planning and risk management objectives. In addition, VFOs provide an excellent starting point for managing newly liquid wealth, a better platform for embedded family offices and a possible solution for outdated existing family office structures. The VFO structure also facilitates control, and minimises estate tax and income tax leakage. Accordingly, it is highly likely that the use of VFOs will continue to expand as global families seek to benefit from long-term, best-in-class strategies.

Thomas J Handler is an advanced planning attorney that chairs the global family office practice at Chicago-based Handler Thayer, LLP. He won the 2016 Excellence in Estate Planning Award and in 2015 was named International Wealth Planning Lawyer of the Year and Wealth Planning Game Changer Lawyer of the Year in addition to winning the Brink Award for Leadership and Service to the North American Family Office industry.

1 See Thomas J Handler, *Establishing Virtual Family Offices*, Trusts & Estates, March 2014, at 41.
2 See generally, Family Wealth Report Single Family Office Study (2012).
3 See generally, Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001, HR 3162, 107th Cong (2001).
4 See generally, Dodd-Frank Wall Street Reform and Consumer Protection Act, HR 4173, 111th Cong (2010).
5 See generally, 26 USC § 6038(d) (2015).
6 See Thomas J Handler, "Establishing Virtual Family Offices," Trusts & Estates, March 2014, at 45.
7 See Thomas J Handler, "Establishing Virtual Family Offices," Trusts & Estates, March 2014, at 43.
8 See Phanor James Eder, "Limited Liability Firms Abroad", 13 U Pitt L Rev 193 (1952).
9 The Wyoming Limited Liability Company: An Alternative to Sub S and Limited Partnerships, 54 J Tax'n 232 (1981).
10 See generally, Del Code tit 6, § 18-101 (1992).
11 See generally, Del Code tit 6, § 18 (1992); 805 ILCS 180 § 1 (1994).
12 See 12 USC §§ 5301–5641 (2015) (codifying the Dodd-Frank Act).
13 See 15 USC § 80(b)(1)–80(b)(21) (2015) (detailing the provisions of the IAA).
14 See 17 CFR § 275.202(a)(11)(G)-1 (2011).
15 See 15 USC § 78o(a)(1) (discussing registration of brokers and dealers).
16 See 26 USC §§ 1471–1474, § 6038(d) (2015).
17 "FATCA Information for Foreign Financial Institutions and Entities", Internal Revenue Service, 1 May 2016, available at https://www.irs.gov/Businesses/Corporations/Information-for-Foreign-Financial-Institutions.

'Virtual family offices – a global trend' by Thomas J Handler is taken from the second issue of the new *The International Family Offices Journal*, published by Globe Law and Business, http://ifoj16.globelawandbusiness.com.