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Pivotal moments for family enterprises
Forming a family office

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EDITOR'S NOTE

Like a great work of art, family enterprises are unique, crafted over time, and highly valued. While no two family enterprises are the same, they are united by a series of pivotal moments that are part of a family business's natural evolution. This is the final article in a series exploring those moments—with actionable insights on how to create long-term value. Whether assessing capital needs or designing multigenerational succession plans, with advanced planning and thoughtful decision making, these moments can be artfully crafted to uphold the family's mission for years or generations to come.

As family businesses surpass major growth milestones, many decide they need help directing **the increasingly complex aspects of a flourishing enterprise** that may extend well beyond the core business.

Often, employees from the family enterprise and key members of the family handle these new tasks along with their day-to-day responsibilities. However, as the demands associated with overseeing new investments and wealth generated outside the family enterprise increase or in the event the enterprise is sold, it is essential that families have the appropriate structures and talent models in place to capture potential opportunities and mitigate risks.

Many family enterprises have spent a significant amount of time and energy building their enterprises and growing their wealth. The effort needed to grow and preserve that wealth outside the business requires a similar effort, and a family office can be the mechanism to formalize the future structure for the family.

Family offices are designed to assist wealthy families in a variety of areas, including assistance in managing wealth, implementing tax planning, and educating family members about their wealth in an effort to maintain the family's legacy across generations. These offices often handle investment management, gift and estate tax planning, routine administration, and charitable giving advice, as well as personalized assistance such as concierge services—with a view toward business continuity. While each family office serves the unique needs of the founders and their descendants, family offices work to seek preferential investment access, create economies of scale, manage financial and personal risks for the family, unite the family around philanthropic goals, and maintain the privacy of family affairs.[1]

Two common scenarios, both involving significant accumulation and transfer of wealth, tend to lead to the formation of a family office:

- **Asset diversification:** The profits from a family enterprise are diversified into new investments. The core family business employees cannot handle the management of those investments, so the family's nonbusiness operations migrate to a family office.
- **Liquidity event:** A family or entrepreneur sells an interest in the business, triggering the need for a family office to formalize governance and manage reinvestment of the proceeds.

When considering the creation of a family office, a common benchmark to justify the startup and ongoing operating costs is a minimum of $100 million of investable assets.[2]

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Staffing, skills, and risk management

When considering the staffing and management of a family office, one of the typical leadership profiles includes employees of the family enterprise who migrate to a newly formed family office, including C-suite executives who have close ties to the family and have earned the reputation as trusted advisors. While trust is essential when identifying individuals to employ at the family office, it is also important to consider the value that professionals with family office industry experience can bring to the organization. Individuals with industry experience should have a strong understanding of family office operations and processes, office talent requirements, service delivery models, and family communication.

In some cases, a leader with deep experience in investments might be hired to serve in the capacity of chief investment officer, managing finances and creating a team that performs regular analysis of the investment portfolio. Likewise,

[1] Deloitte, "Family office fundamentals: Modern history of family offices," *Protecting legacy: The value of the family office,* accessed January 30, 2023.

[2] Josh Baron and Rob Lachenauer, "Is your family office built for the future?," *Harvard Business Review,* September 26, 2022.

certain financial responsibilities fall to a chief financial officer, who might have a controller or accountants as direct reports. Some family offices may appoint a chief technology officer to ensure that the family office is prepared for the challenges of automation and digital transformation as well as cyber risk.

Managing the risk environment is another area of increasing responsibility for family offices: A 2022 survey from Deloitte's fourth biennial National Family Office Forum[3] shows that the vast majority of family offices surveyed have been targeted for cybercrime, with 71% of respondents reporting that malicious actors attempted to fraudulently extract funds from the family office through email or other electronic means during the prior year. Of those respondents, 13% said cybercriminals had made more than 10 attempts to defraud the family office.

Finding talent with the relevant experience as well as the temperament to engage with family members is no easy task. Also, the talent market has become increasingly competitive, while the expectations by family members for efficiency within the family office has increased. To meet these increasing demands and out of competitive necessity to attract talent, many family offices have become more open to sourcing talent from other geographies. Many have moved away from more traditional expectations—that employees work on-site full time to maintain confidentiality and a family business culture—in favor of remote or hybrid arrangements. In addition, many family offices are exploring incentive compensation linked to appreciation in the family's investment portfolio to attract senior leaders. This can be similar to incentive planning implemented for leaders within the family enterprise. (For more on this topic, please read our *Pivotal Moments* series on long-term incentive plans.[4])

Understanding the fine print

Family offices may bring wealthy families a sense of control, the ability to tap into bespoke services, and a dedicated group of people focused on the family's best interests.

There are key tax and financial considerations when establishing a family office. For example, it should be determined whether the activity of a family office rises to the level of a business for tax purposes because this will have an impact on the deductibility of the expenses incurred by the family office. Furthermore, an analysis should be performed regarding how the family office should be structured for income tax purposes.

Another consideration: Investment-oriented family offices managing holdings on behalf of a family may want to qualify for the "family office exemption" provided by the US Securities and Exchange Commission (SEC), thereby avoiding the need to register with the agency and be subjected to audits and other types of scrutiny. The SEC family office exemption emerged after the 2008 financial crisis, with the Dodd-Frank Act excluding family offices from the definition of "investment adviser" under the Investment Advisers Act of 1940.[5] SEC counsel can provide guidance on the applicability of this exemption.

Finally, attention should be given to the burn rate of payroll and other costs required to run a family office. A recent review of 187 family offices shows the average cost ratio is 0.41% of assets under management. In other words, the operating cost for a family office with $250 million in active assets could top $1 million per year.[6]

Family offices may be compensated by family members, trusts, and related entities through a fee-for-services structure. Alternatively, when family offices oversee the investment strategies for family investment partnerships, they may receive a profits interest in exchange for services provided, a compensation strategy similar to what private equity or hedge fund managers receive. In both instances, many family offices choose to have a transfer pricing study completed to demonstrate to the family that the fees charged or profits interest allocated is similar to one that an unrelated third party would charge. As with most issues related to family enterprises, communication between generations is critical. In this case, it is important that the succeeding generations understand the value—and expense—associated with maintaining a family office.

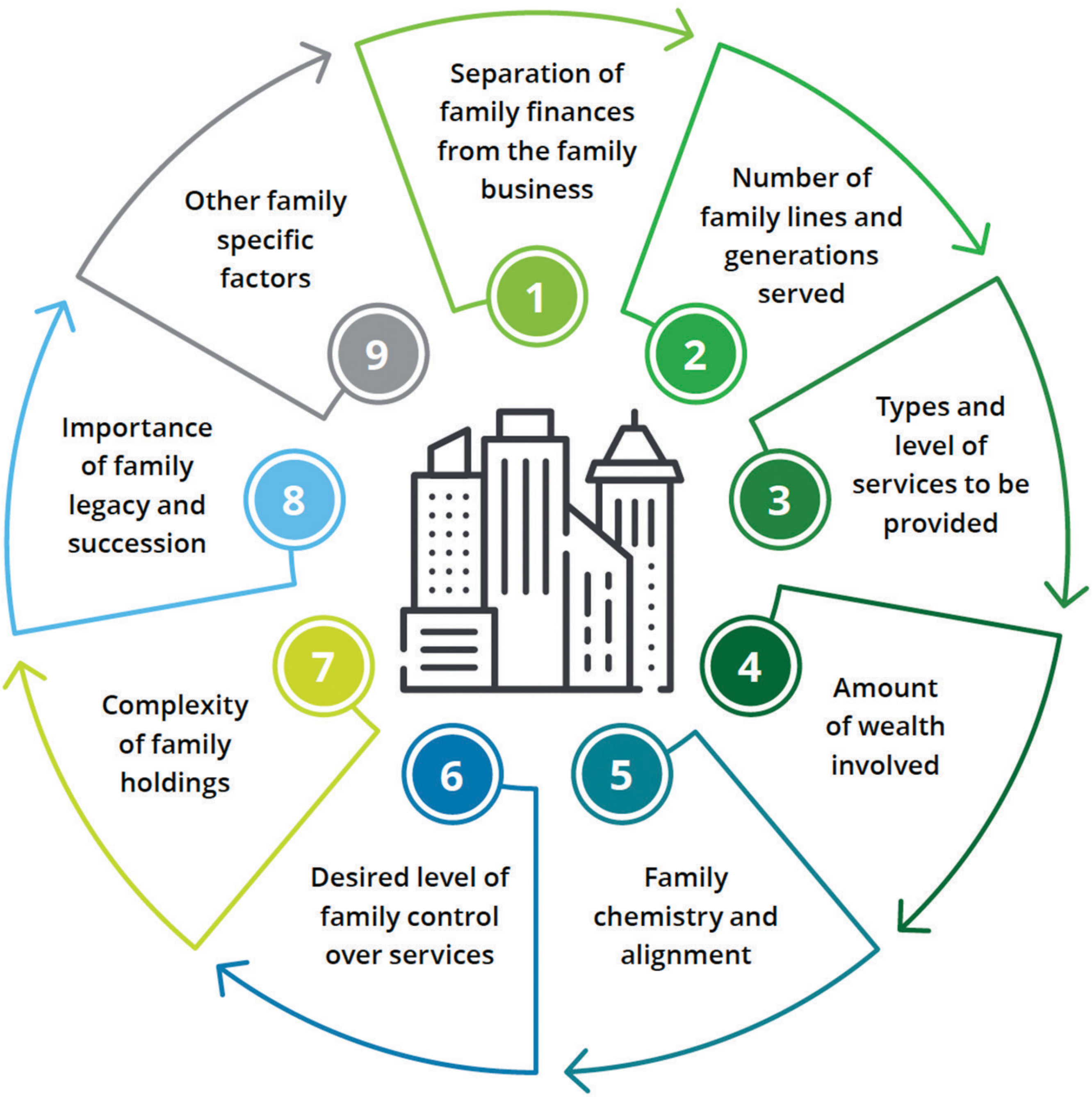
[3] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-2022-national-family-office-forum-report.pdf

[4] https://www2.deloitte.com/us/en/pages/deloitte-private/articles/family-office-enterprise-planning.html

[5] Securities and Exchange Commission (SEC), "Family Offices," 17 C.F.R. Part 275, 2011.

[6] The Forge Community, Benchmarking survey report: Costs of running a family office, 2021.

Integrated factors in the decision to form a family office



Creating a long-term strategy that considers the social impact of business decisions is another vibrant discussion among family offices.

Creating an enduring legacy

Creating a long-term strategy that considers the social impact of business decisions is another vibrant discussion among family offices. For instance, a 2021 survey by UBS[7] found that sustainable investing in issues such as environmental or educational causes is firmly entrenched in family office portfolios, with 56% of family offices having such allocations. Meanwhile, a Deloitte survey of family offices[8] shows that supporting a family's charitable endeavors is another priority for family offices, with 62% of respondents indicating their single-family office operation is focused on philanthropy.

Many families are looking within, asking questions about investment holdings and the social conscience of the companies in its portfolio. One founder has moved 90% of the endowment of his investing and philanthropy platform into "mission-related" investments—part of a push common among family offices to boost the share of environmental, social, and governance or impact investments within their sustainability and equity.[9]

As these discussions occur within families, many are deciding whether the focus of their efforts is the formation of an investment-, philanthropic-, or administrative-focused family office. While these are not exclusive constructs, the increased institutionalization and sophistication of the family office is a positive step in helping high-net-worth families and other stakeholders drive significant value.

Questions to ask when considering establishing a family office

- How complex are the family's investments outside the core business?
- Do we expect growing complexity or a liquidity event that will create the need for more focus on alternative investments?
- Does the talent in our business have the capability and capacity to oversee varied investments?
- Do we need a greater level of sophistication to manage the expectations and needs of the family to ensure an ongoing legacy?
- Have we evaluated the benefits of creating a family office against the needs of our family and associated expenses?

[7] https://www.ubs.com/global/en/family-office-institutional-wealth/home/sustainable-investments.html

[8] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-2022-national-family-office-forum-report.pdf

[9] Robert Frank, "Billionaire Lukas Walton's family office accelerates impact-investing push," CNBC, September 19, 2022.

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