

Family office

The roots of the family office extend back to the late 19th century when many family offices were founded to manage the significant fortunes of successful tycoons. While the original family offices were in many cases established for those individuals who had created large manufacturing empires, today we observe many hedge fund and private equity founders, as well as technology and real estate entrepreneurs, forming family offices following a significant liquidity event.



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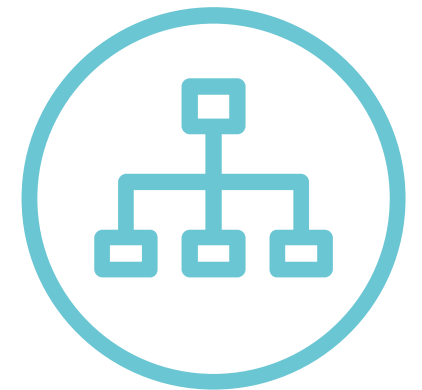
In the last decade, several factors have converged to significantly drive interest in family offices:

- A wave of new global wealth creation and accumulation, including Baby Boomers who are selling their businesses and reinvesting the resulting liquid assets to sustain, enhance, and protect the family's wealth
- Successful entrepreneurs selling their businesses and pursuing their passion to invest capital and sweat equity in philanthropic endeavors
- A growing number of families committed to "making an impact" in the world, now and in the future
- Continued market volatility leading wealthy families to take more "hands on" control over investment policy decisions
- Banking and business failures, investment fraud, and cybercrime prompting families to take an institutional approach to family risk management

Although many top-tier private banks, investment firms, and consulting practices can provide these services, a growing number of individuals and families have chosen to form a single family office that is devoted to the personal needs and desires of the family. And regardless of how long a family office has been in existence, we consistently find that individuals and families want to assess the services the family office provides to the individuals, trusts, and entities ("clients") served by the family office.

In this section of our guide, we will take a look at the services frequently provided by the family office to its clients and discuss how the family office determines whether it will insource or outsource the responsibility for such services. There are a variety of factors that will impact a family office's decision to hire talent to deliver the services internally compared to paying a third party to provide the services to the family office's clients. Those factors include the cost to

deliver the services, the complexity of the service to be delivered, and whether talent exists in the marketplace to provide the services. In many instances, the cost to acquire technology necessary to deliver the service is also a deciding factor. If the cost to acquire, implement, and maintain the technology exceeds a certain threshold, it may be more effective to hire a third party to deliver the service.



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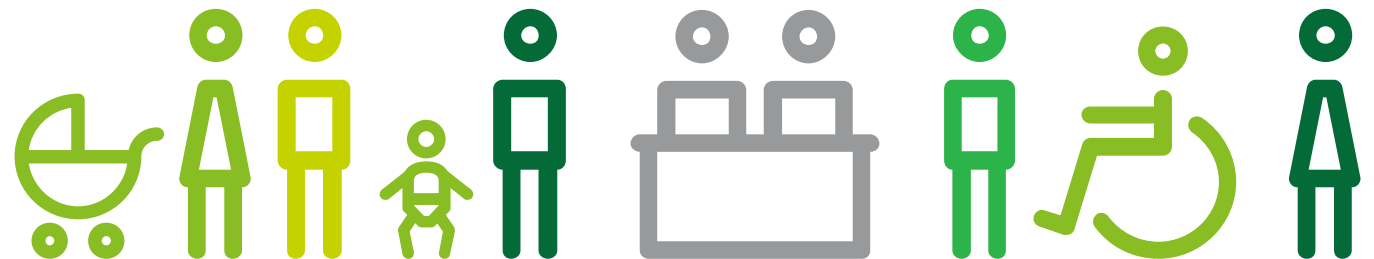
In addition to evaluating whether to insource or outsource services, many family offices are reassessing the fees charged for their services. Although a family office may be created to serve one or multiple generations, the typical goal is to create a business organization that is appropriately compensated for the customized services it delivers to its clients. Furthermore, where related party transactions occur between the family office and its clients, such as payment for the services delivered, caution

must be exercised to ensure that the amounts charged are reasonable and at market rates. We will evaluate in this section of the guide how transfer pricing guidelines could apply to assist the family office with determining reasonable compensation for the services it delivers.

Finally, whether the family office is managing assets that the family desires to pass to future generations or to achieve family members' philanthropic goals, the

preservation and security of these assets is critical. No one wants to think that fraud could impact their family's wealth. Unfortunately, we are all susceptible to the possibility of fraud. Whether it be through identity theft, an attack on the family office technology systems, or even an employee's unanticipated fraudulent behavior, the family office should proactively implement strategies to mitigate the likelihood that one of these actions will occur.

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Evaluating services to be provided

One of the most important decisions a family office must make is identifying the services the family office will provide. These can vary widely, depending upon the family's needs and expectations, as well as the extent and complexity of assets managed. Most family offices coordinate an extensive array of services for family members (Figure 1), using both in-house and external resources.

Since wealthy families have numerous options for obtaining personal and financial services, one success factor in forming a family office is to engage the right people to do the right work. Finding an optimal balance between services performed in-house by competent family office employees and those outsourced to qualified service providers is important for long-term success. The family office should regularly reassess whether its services should be insourced or outsourced. Over time, new family members may be born and others may pass, trusts may be created, and new investments may be made. All of these life events will impact how the family office chooses to serve its clients.

Our experience with hundreds of family offices in the past decade has revealed the following insights about insource vs. outsourced services (Figure 2 on next page):

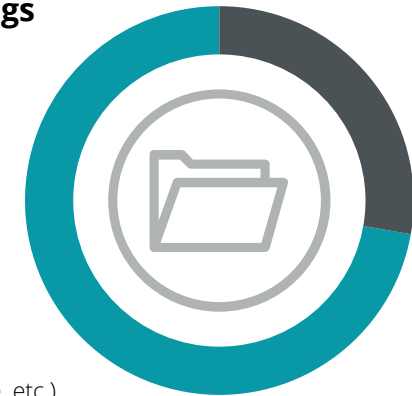
- Many in-house services (dark blue) address daily activity at a granular level.

Figure 1

How would you describe the service offerings of your SFO?

72%

Full service
(investment management, legal, accounting, concierge, etc.)



28%
Limited service

Source: Deloitte's National Family Office Forum survey

- Keeping these services in-house provides immediate access to, and control over, the information. It is also likely to be more cost efficient and expedient than outsourcing.
- Other services (light blue) may be performed by family office staff, outside providers, or some combination of the two. This can offer the best of both worlds—costs savings on work that involves lower risk or is less complicated and cutting-edge planning and quality assurance for more complicated work. For some of these services, the family office may initially rely on outside providers to establish core practices

or processes for the family office to follow. Once the set-up is complete, the family office can hire talent to maintain the processes that were established.

- The services outsourced most often (green) typically require highly specialized skills or significant infrastructure. In many instances, the services within this category require individuals to have deep technical skills and experience with current tax and regulatory matters. Few family offices have the appropriate structure, professionals or resources to provide these services in-house from a risk-return perspective.

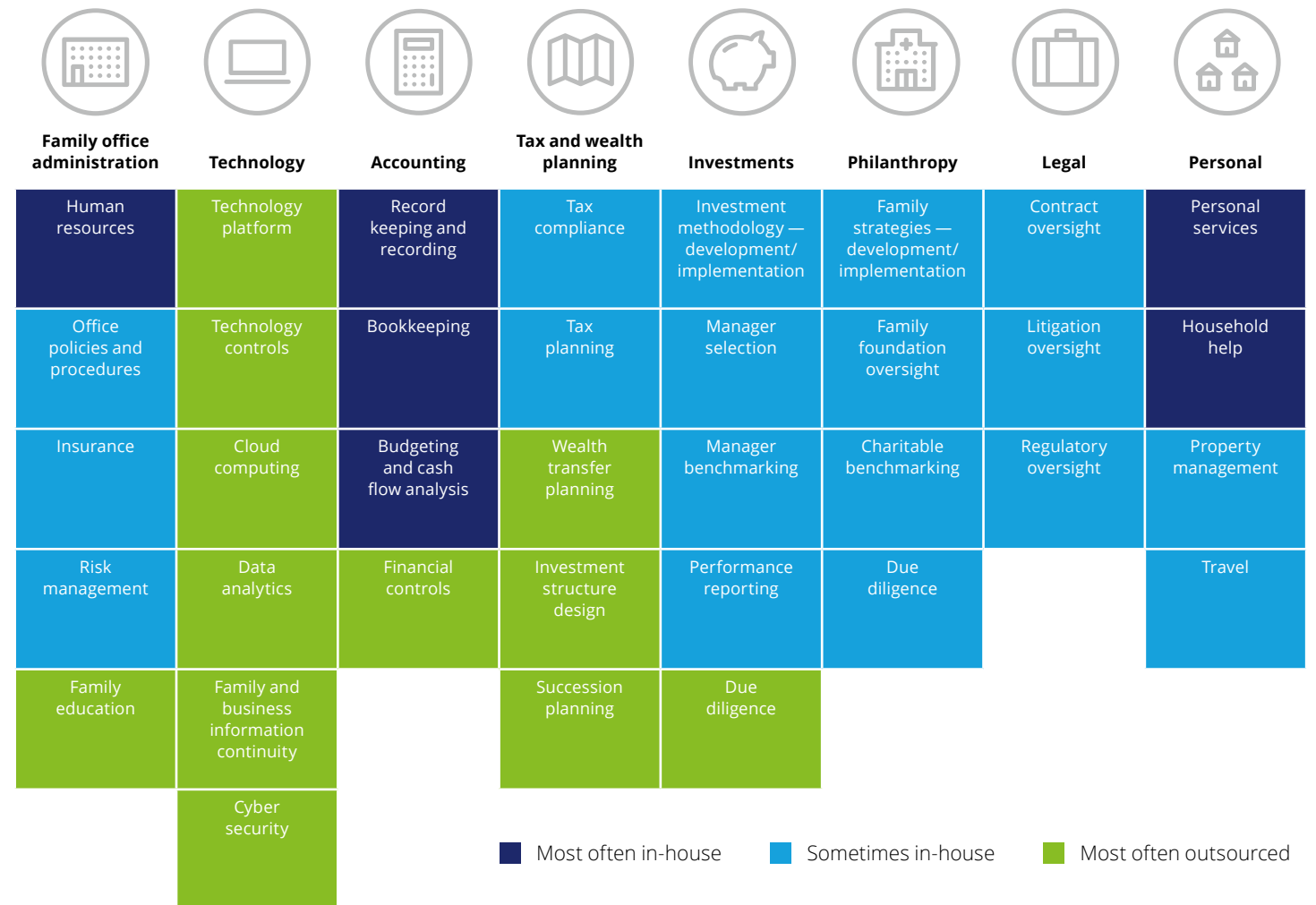
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Evaluating services to be provided

Figure 2

Insource vs. outsourced services



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Talent impacts the decision

The decision to insource or outsource specific services may also be impacted by the talent in the geographical area where the family office is located. For certain key family office roles, it may be easy to identify and attract talent to the family office. However, for more junior roles, the family office may be competing for talent with other family offices and will need to consider alternative strategies to attract and retain talent. This may include flexible work arrangements, increased opportunities to work in different areas of the family office, and training opportunities to help talent continue to develop new skills. If the decision is made to insource many functions, investing in the talents' professional and technical skills will be imperative for the family office to remain current and cutting edge.

Each family office is as unique as the family it serves. In some situations, family members will want control over the insourcing versus outsourcing decision. In other situations, transparency on this issue is not necessary and family members simply require the services to be seamlessly delivered. Regardless, in either situation, the family office will need to quantify the cost and the quality of any service that will be delivered and determine whether it

should be insourced or outsourced. This assessment should be performed regularly as significant life events occur. Furthermore, as new leaders join the family office or family members become more involved in the family office, this offers an opportunity to reevaluate the services provided and to confirm that services are executed in the most timely and cost effective manner, while considering the family's complexity and tolerance for risk.

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While a family office is created to serve one or multiple generations, the goal is to create a business organization that is appropriately compensated for the customized services it delivers to its clients. Once the family office determines the services it will provide to its clients, it must determine how much it will charge for such services. In many instances, the family office is owned by family members or trusts for the benefit of family members. Given the related party interactions between the family office and the clients it serves, there is a risk that the Internal Revenue Service (IRS) could challenge the compensation charged by the family office for the services it provides.

For example, pricing for services provided to family members that is *lower* than market rates may result in a deemed gift between family members. Alternatively, pricing for services provided to a private foundation or charitable trust that is *higher* than market rates could be interpreted to be an act of self-dealing, which may result in the imposition of an excise tax. As such, the family office and the clients it serves are both motivated to determine market-based compensation that is comparable to that charged by an unrelated third party.

The Treasury Regulations under section 482 and section 6662 govern how to establish and document pricing between taxpayers under common control (controlled service transactions). During an examination, the IRS may request the support and documentation for payments made between related parties. A transfer pricing analysis and related documentation can support the pricing of services and mitigate penalties if the IRS successfully challenges the amounts charged. Risk mitigation is the primary benefit of a transfer pricing study based on section 482 and section 6662 guidance.

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Transfer pricing in the family office

What triggers transfer pricing considerations?

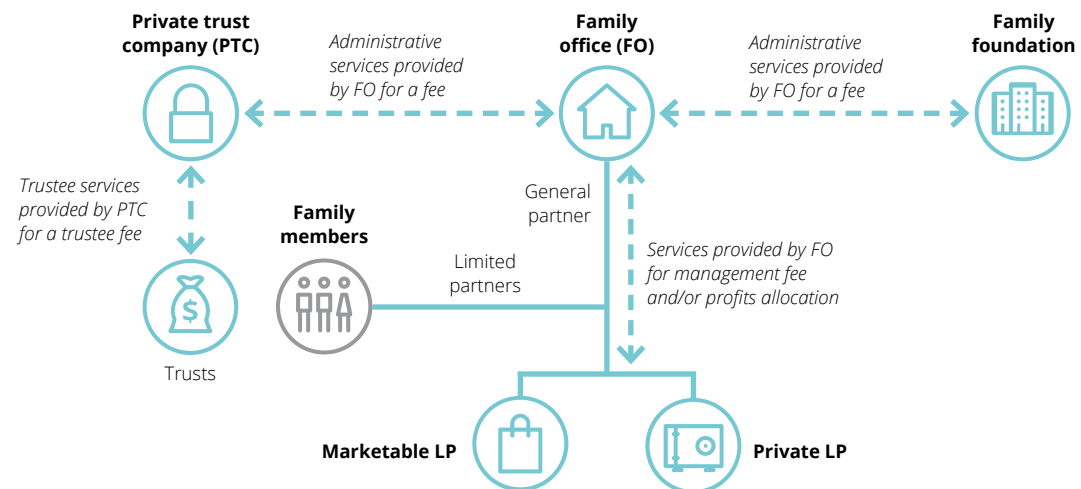
Services provided by a family office

Many of the services a family office provides can be analyzed and documented using methods provided in Internal Revenue Code (IRC) section 482, including:



Common family office structures and arrangements

The diagram below is representative of many family office structures whereby the family office provides accounting, administrative and investment management services to individuals, trusts, entities, and foundations related to the family.



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Which method fits your family?

Section 482 provides six alternative methods that can be used to benchmark and document transfer pricing for various controlled services transactions. Once the right method for a service is determined by the family office, the method should be applied in a consistent and reliable manner.

When completing a transfer pricing analysis, the first step involves interviews with family office executives who provide services to family members or to entities controlled by family members. The purpose of this fact-gathering step is to understand the services currently offered by the family office and to whom those services are provided, as well as how the family office is currently compensated for its services. For new family offices that are just being created, this discussion will relate to the services the family office plans to deliver to clients. Through these discussions, the family office is able to identify the controlled services transactions that will be evaluated through the transfer pricing analysis.

Once the controlled service transactions are identified, the next step is to use various public sources to identify and analyze industries that provide similar services to the ones offered by the family office. This process helps to identify relevant market benchmarks for the services provided.

All of this information is then used by the family office to select the best method to determine the appropriate price for the service(s) offered. After this analysis and identification of the applicable method occurs, a transfer pricing report is prepared to summarize the controlled services transactions analysis, the industry analysis, the benchmarks selected and applied, and the methods ultimately used to determine the pricing for services.

While a transfer pricing analysis and related documentation can support pricing of services and mitigate penalties if the IRS successfully challenges the amounts charged, it can also be a beneficial exercise to demonstrate to family members and fiduciaries that the amounts they are paying for services are consistent with those that would be charged by an unrelated third party. In addition, it provides an opportunity to re-educate family members on the services offered, as well as engage with the family on how the talent employed by the family office and third-party service providers serve the family.

Maintaining a family office may require significant costs to rise to the level of the customization that the family office desires. A transfer pricing analysis may provide comfort to family members that the family office is carefully managing these costs, while delivering valuable services to its clients.

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Family office fraud is not often in the news due to the private nature of the industry, but fraud does occur. Many family offices serve as investment managers, giving employees proximity to cash and other assets. In addition, they are often small organizations, where a single employee can have significant control over finances and be the sole person handling all communications to family members. These factors, among others, make family offices prime targets for fraud.

The overarching goal for fraud prevention is for the family to establish a culture that values integrity and transparency and encourages employees to report any suspicious activity. There are several steps that family offices can take to limit fraud, the first of which is to accept and acknowledge that fraud is a real threat. Then family offices and family members should become educated on fraud, perform periodic risk assessments within the family office, and structure and train the staff to prevent fraud.

Get educated

Employees engaged in fraud have a clear pattern of behavior that family members and other employees can be trained to detect. For example, hallmarks of embezzlers include a tendency to work very long hours, often arriving before and leaving after other employees. Embezzlers also tend to work weekends and generally do not take long vacations. These are all signs of employees working hard to “cover their tracks.” The challenge is that these traits can also be characteristics of dedicated employees and are not in any way proof of a fraud. They are merely red flags and can be a prompt for additional research.

One simple technique is to require at least two weeks of consecutive vacation for all employees above a certain level or with access to the cash ledger. It is very challenging for an employee to keep a fraud hidden during a two-week absence from the office when another employee assumes their duties. Another technique that can limit fraud is periodic unannounced job rotations that require employees to switch job responsibilities.

Perform a periodic fraud risk assessment

Another good practice is to perform a periodic test, not just of the controls, but also of the entire operating environment. As mentioned, there are likely areas of fraud, such as payroll, expense accounts, and accounts payable, which are most often abused. These can be examined using data analytics that will flag suspicious activity or unanticipated patterns, such as an abundance of checks being written just under a control level or invoices to a single vendor that have been split to avoid the additional oversight of higher check amounts. The risk assessment does not have to happen every year or even on a regular basis; however, it is considered a prudent use of a family's resources to perform one periodically. Even if no fraud is uncovered, the clean bill of health gives the family a level of comfort and peace of mind.



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Solve for the staffing problem

One common trait of family offices is that many have long-term employees. This is often a sign of loyalty and a productive work environment, but it can also lead to an overreliance on the trust and goodness of human beings. For example, a family office with trusted employees might not have the proper checks and balances in place for financial transactions. It can be challenging for a family to impose proper checks and balances when most employees are honest. However, one individual with too much control and access can cause an enormous amount of financial or reputational damage.

The small staff at most family offices makes establishing checks and balances very difficult. However, the segregation of duties is one of the simplest ways a family office can prevent fraud. For example, a family office should consider separating the individuals who handle cash from those who record cash on the ledger, which should then be reconciled by another party. At first glance, this may seem like a tedious and unnecessary process, especially for a smaller family office that is trying to run in a lean and efficient manner. However, such a system is a proven and effective way to combat fraud and more likely will pay for itself many times over. Placing a family office employee in a situation where he or she has access to cash, without the proper controls,

can encourage fraudulent behavior. Even the most honest and trustworthy employee may at times be under financial pressure and can find it challenging to resist taking advantage of such a situation. These controls may feel inefficient to some and that is because they are not meant to be efficient—they are meant to be effective. If they are working well, fraud will have much less opportunity to take root.

The bottom line

The best way to prevent fraud is to accept that it occurs and to make a decision to prevent it. While it is often hard for a family to accept that they are being taken advantage of, experience shows that fraud is often perpetrated by trusted individuals. Once the fraud issue is a focus of the family, it is very possible to promote the culture and controls designed to thwart it. Doing so does not have to be overly intrusive or expensive; the solution is finding the right balance between trusting employees and verifying that they are being trustworthy. Family offices that do not make this a focus risk serious financial and reputational harm to the family. In addition, family offices may ultimately spend more time and effort on damage control than they would have in prevention.

Looking into 2017

While each family office is unique, they are businesses that are offering tailored services to satisfy their clients' needs while being compensated for the high-touch delivery that they provide. Reevaluating the services that are offered, how the family office is compensated for such services, and who should provide such services is one of the leading practices family offices can employ. In addition, family offices may consider performing a fraud assessment to mitigate risk within the operating environment. Family office leaders must be able to understand the challenges faced, determine priorities and develop and execute an action plan to address these matters.

Once the fraud issue is a focus of the family, it is very possible to promote the culture and controls designed to thwart it.

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