

Family Office Insights

2019 Mid-Year Review



Family Office Insights

Wealthy families around the globe are increasingly looking to manage and preserve their assets and relationships across multiple generations and countries through a “family office” – a formal or informal structure established to maximize the efficient transfer of wealth to future generations; preserve and consolidate family wealth; promote charitable endeavors; enhance communications; and avoid family conflicts.

For family groups with significant assets, a family office can provide greater control over their worldwide investments and can tailor investments and asset ownership structures to the family’s specific requirements. We have worked with single and multifamily offices and family investment groups around the world to help them achieve these goals.

Our global Family Office cross-practice team operates on the premise that the essentials of representing the ultra-wealthy extend beyond providing direction and oversight on tax and estate planning alone. We look to employ an integrated team approach focused on the many needs of the family office, drawing upon the skills of specialists in multiple complementary areas, including corporate, taxation and trusts, securities, employee benefits and compensation, and banking and financial services.

To support this diversified and multifaceted approach, and in an attempt to help our clients and potential clients think and act strategically, we have created the Family Office Insights series. Authored by members of our global Family Office team and distributed to our family office contacts around the world, we address key issues and trends affecting family offices, today and in the future.

With this philosophy in mind, we are pleased to present the Family Office Insights 2019 Mid-Year Review. Included in this issue are the following publications:

- Digitalisation of Tax: Effect on Family Offices
- The Family Office and Its Lawyers Part 1 – Inside or Out?
- The Family Office and Its Lawyers Part 2 – Regulations and Ethics
- Beware: Fraud Prevention in the Family Office
- Entity Transparency Comes to Luxembourg

We hope that you find these perspectives to be both informative and thought provoking, and we look forward to providing you with future installments of our Family Office Insights series.

Sincerely,



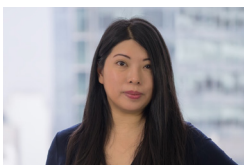
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Jeremy Cape explains why Family Offices need to be aware of the changing tax landscape towards digitalisation.

A New Era

New technology has changed and will continue to change the way businesses, including Family Offices, structure and conduct their operations. The speed, breadth and depth of change facilitated by digitalisation has been described – rightly, given the sheer breadth and depth of transformation – as the Fourth Industrial Revolution. The concept of globalisation has evolved from a world in which countries have integrated **across** borders to one in which they have integrated **without** borders.

The framework of international tax rules, designed more than a century ago, appears desperately in need of an overhaul.

Whether or not the international framework will be reinvented wholesale remains to be seen, but what is certainly happening is that individual countries are coming up with their own responses to the tax challenges presented by digitalisation.

Changes are set to impact both revenue raising (e.g. introducing new taxes for digitalised businesses), and tax procedures (e.g. reformulating the way authorities are able to assess and collect taxes through digitalisation). As with any significant change, both challenges and opportunities present themselves to those affected.

Three important considerations Family Offices are:

1. Privacy

New data-driven technology, robotics, automation, artificial intelligence and the secure capabilities of blockchain can afford new and exciting opportunities to business and tax authorities alike.

As technologies mature and the investment in adopting them expands, the day when tax authorities have real-time access to business' day-to-day transaction grows nearer. That brings real-time assessment and payment of tax much closer, too. Indeed, some aspects of these changes are already evident today. These include, for example, HMRC's Connect system and the shortening of payment windows for stamp duty land tax and capital gains tax.

This exposes the Family Office in a far more significant way than ever before. Complete transparency will be necessary, including any tax planning strategies. The opening up of digital data also throws up risks of data security.

Given the inherently private nature of Family Offices, preparation for this change towards more transparency is essential.

2. Impact on Investment Decisions

As highlighted, numerous jurisdictions around the world are taking unilateral action to implement different forms of digital taxes. In most cases, the justification is the prosperous new world of online business necessitates new methods of taxation. Global tax authorities, therefore, have good reasons to introduce digital taxes. Not only do they present a significant new stream of revenue, but they also address public pressure for the imposition of "fair" taxation on major online companies. As such, digital taxes are rooted in both political and fiscal necessity.

Family Offices are, of course, sizeable investors into many such businesses. In light of the immediacy of these changes – HMRC, for instance, has announced its intention to introduce a Digital Services Tax in April 2020; Italy, Spain and France are likely to move even more quickly – Family Offices should consider the impact of these taxes when undertaking due diligence on potential investments in businesses which have a digital dimension. The impact will not be limited to "Big Tech" or the FAANGs. Shares in ASOS Plc fell over 5% when news broke of the US Supreme Court ruling that individual US states could collect digital taxes, highlighting the fact that the market places a real value on digital taxes affecting businesses.

3. Streamlining Tax Affairs

In the same way tax authorities will leverage the adoption of technology to streamline tax assessment procedures, Family Offices should be able to benefit from embracing digitalisation to streamline their own tax administrative and compliance processes.

This not only makes Family Offices more efficient and allows them to meet the ever-increasingly tight deadlines and demands set by fiscal authorities for tax payments, but also ensures that they can understand better the impact of tax law on their business models. Indeed, digitalisation could help Family Offices plan and structure their affairs more efficiently.

Streamlining tax affairs would represent, in the long term, a genuine time and cost save for Family Offices.

Future Opportunity

The digitalisation of tax is of significance to Family Offices and represents both challenge and opportunity. The change is coming, globally and domestically. Family Offices stand to benefit from the digitalisation of tax provided that they understand how the digitalisation of tax affects them, and what they might do in turn.

How We Can Help

We are a full-service global law firm. We are connected, both locally and globally, on these issues. We can provide unique insight at the point where law, business and government meet. We place our clients at the core of everything we do, giving them a voice, supporting their ambitions and achieving successful outcomes.

Tracking, understanding and adapting to these fundamental changes will be critical. With deep sector knowledge, global tax expertise and a commercial approach, we can help monitor the evolution of tax law across multiple jurisdictions and anticipate when change will affect you. We are also ready to assist with the implementation of appropriate strategies to ensure you react most efficiently when change comes. In addition, we can support engagement with government and multinational agencies and help formulate appropriate responses to proposals advanced by them.

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Family Office Insights

The Family Office and Its Lawyers

Part 1 – Inside or Out?

As is the case with any sophisticated business enterprise, a family office will have a variety of legal needs to address in the course of its operations, and will need legal advice from specialists across a wide range of specific substantive legal areas. As family offices grow in sophistication and complexity, they will increasingly face a question that has long been encountered by other business enterprises: What legal functions should be outsourced and what (if any) legal functions can be most efficiently brought in-house?

In-House Counsel vs. External Service Providers

The fundamental question as to whether, and to what extent, the legal function should be brought in-house is not, in essence, any different for a family office than it would be for any similarly sized business enterprise. A company considering bringing its legal function in-house typically will look at factors such as the projected fully loaded employment costs (meaning salary, benefits, overhead and the like) of having in-house counsel as compared with the company's current and projected legal spend on outside lawyers, and factor in an analysis of the scope and nature of the company's anticipated legal needs.

For a family office, the analysis will start with the same economic question, but the unique nature of the family office model can make the decision, in many ways, much more complex.

Lawyers and the Family Office

In looking at the legal needs of a family office, the family's decision-makers need to consider not only the cost analysis described above, but also the particular legal profile and legal needs of the family. The fundamental analysis – beyond simply whether the family office has the economic scale to make the cost proposition work – is a determination by the family's decision-makers of what core legal functions they anticipate that the family will need.

It is axiomatic that no two family offices are exactly the same. The legal needs of a family office that is overseeing the management of one or more family-owned or family-controlled operating businesses will differ widely from a family office that principally operates as a custodian and investor of family wealth. Likewise, a family office serving a one- or two-generation immediate family will have a different legal profile, and widely differing legal needs, than one serving multiple generations of a founding family.

Core to the legal needs of almost every family office will be tax advice – income, gift and estate tax planning. For a family office that is principally involved with stewardship of a family's investments (rather than the ownership of operating businesses), the necessary tax support will likely extend to robust expertise on partnership tax issues. Beyond tax, however, a family office implementing a sophisticated alternative investment strategy will likely need state-of-the-art legal advice regarding corporate governance and transactional matters, including structuring and negotiating private equity, venture capital, and private funds investments and co-investments, debt finance and derivatives transactions, and real estate investments. Adding to the complexity of those legal needs, all of the legal strategies involved in those transactional matters need to be not merely harmonized with, but also optimized for, the family entity and trust structures developed through the family's estate and gift tax planning process. This means that a family office's legal team – whether internal or external – needs to be structured to provide close working coordination between the tax experts and the transactional lawyers, in order to ensure that the entry by family members or family entities into complex transaction structures does not create inadvertent estate or gift tax risks.

Can these functions be efficiently and cost-effectively brought in-house at the family office, or are they best addressed by the careful selection of external lawyers – or by some combination of the two? The answer to this question will depend on a careful analysis of the particular family's economics and mix of legal needs, but, regardless of the decision, each family office will need to assess the scope and nature of its family's requirements for legal services and assemble the right team of tax, transactional, finance and other lawyers to address those needs in a fully coordinated manner.

Coordination, in this context, means both the technical coordination between transaction and investment structures and estate planning at the tactical level and the coordination of the family's legal strategy at a strategic level. This need for coordination requires family leadership to consider what arrangement of counsel (or multiple sets of counsel) will not only provide the family with the ideal mix of top-drawer subject-matter expertise, but will also most effectively and efficiently coordinate the planning of estate, gift, and income tax strategies and entity structures across multiple generations of family members.

In addition to technical coordination, any well-functioning relationship between lawyers and their clients will involve a significant element of inter-personal compatibility and “fit.” To ensure the coordination of legal strategy and planning across generations, family leadership needs to be mindful of the importance of facilitating the development of those relationships across the succeeding generations, and finding counsel who will be able to be trusted advisors to family members across multiple generations.

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The Family Office and Its Lawyers

Part 2 – Regulations and Ethics

Legal and Regulatory Considerations

As is the case with any investment vehicle, a family office may be subject to a wide range of regulatory regimes depending on the nature of the investment it makes and the industries and jurisdictions in which it invests. As to the family office itself, in the United States there are typically only a limited number of legal or regulatory issues to be considered. The principal regulatory concern is the availability of the exemption from registration under the Investment Advisers Act of 1940, as amended (the Advisers Act). For a single-family office, no matter the manner in which it is structured from a legal entity standpoint, the concern, in a nutshell, is to make certain that the family office does not provide investment advice, as defined under the Advisers Act, to specified categories of entities or individuals such that the family office would be required to undergo the burdensome (and public) process of registration with the Securities and Exchange Commission as an “investment adviser” and ongoing compliance under the Advisers Act. This analysis becomes more complex – and more critical – as the scope of the family office’s activities expand and the number of family members increases, and is of key legal importance for multi-family offices.

Apart from the regulatory issue posed by the Advisers Act, much as would be the case for the persons responsible for the legal function in any group of companies, the family office needs to ensure that the “corporate formalities” are observed and maintained for all of the legal entities established by the family group. The general term “corporate formalities” refers broadly to the formal legal steps to be taken by legal entities to substantiate their existence as separate legal entities: this suite of “corporate housekeeping” matters typically includes such things as maintaining the legal good standing of each entity through the making of all required state franchise tax or similar filings, the maintenance of separate books and records for each entity, the regular election of directors and officers for each entity, the keeping of separate records of board minutes and resolutions adopted and actions taken by each entity, the documentation of any movements of capital among intra-family entities, and the maintenance of separate bank accounts and financial records for each entity. In the corporate context, these steps are important to ensure that the legal “separateness” of each entity will be respected for purposes of liability limitation and financial responsibility. Those considerations are, of course, equally relevant for family entities – in addition, the maintenance of proper corporate formalities can help provide legal substance for intra-family transactions and help to mitigate the risk of inadvertent gift tax exposure.

This same concern applies equally to all intra-family transactions – whether they are investments or loans between entities owned by different members of the family, employment arrangements between family-owned entities and family members, or loans directly from family entities to individual family members. Part of the legal function of the family office should be to ensure that each such intra-family transaction is properly documented and, unless the transaction is intended to be a gift, reflects reasonable arm’s-length market terms, to mitigate the risk of a transaction being re-characterized, in whole or in part, as a gift for tax purposes.

Ethics and Conflicts

As to the lawyers themselves, whether in-house counsel or external, the family office, with its constellation of entities and individual family members all requiring legal advice, can present a special challenge – the ethical issue of conflicts of interest and the recurring question of “Who is the client?” Providing legal advice to multiple generations of family members can present unique challenges to the “family lawyer,” and the family decision makers – whether senior family members or family office professionals – and the lawyers themselves need to be alert to potential conflicts of interest under the lawyers’ applicable rules of professional conduct. External counsel for a family office should carefully consider the terms of their engagement letter, and consider addressing issues such as whether (or the extent to which) they may represent individual members of the family, as well as the family’s entity or entities and, if so, for what purposes. For internal family office counsel, these can be even more difficult waters to navigate, and a written policy as to the scope of the professional services the in-house lawyer will perform on behalf of the various family office stakeholders can be a useful tool for establishing ethical guideposts. Although those agreements and policies, and written conflict waivers, joint representation agreements and other structural approaches can be valuable tools for mitigating the potential for ethical conflicts of interest and for avoiding intra-family disputes, it is almost inevitable that circumstances will arise in which the differing interests of family members will make it advisable to retain separate counsel, and identifying those circumstances and managing that process, when it arises, poses a unique challenge to the “family lawyer.”

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Beware: Fraud Prevention in the Family Office

The transition from a family business to a family office can be treacherous. In a family business, the family is still involved in the day-to-day operations of the business and is literally “watching the store.” In a family office, the day-to-day operation of the family business and other financial investments and endeavors of the family may be delegated to experts outside of the family. This should create an enhanced level of professionalism and provide institutional safeguards and protections for the family, but can backfire.

I will tell you an apocryphal story that is based on real events. A family engaged in the energy business hired a professional CEO/CFO to help run the business for a decade. The third generation of family members still worked and had titles in the business, but devoted more and more time to personal interests. The family business appeared to be steadily prospering and money was plentiful. Gross sales exceeded US\$1 billion, with a healthy margin. The family had acquired real estate and synergistic businesses to help expand and diversify the pie. The most prominent local bank in the area provided over US\$100,000,000 in revolving and fixed financing for many years.

The family enjoyed benefits of wealth such as estates, yachts and high-end travel. While the family still held a puritan ethic, particularly in the retired second generation, it was generally understood that there was plenty of money for all of the family members to be able to enjoy themselves. There was also a focus on giving back to the community, and the family had a high profile as a major local employer and sponsor of charitable events.

Then it all came tumbling down. The hiring of new management consultants to help modernize/streamline the business led to a more careful examination of the financial status of the operations. On their face, the reported numbers were solid, but there had been no formal audits and the back-up supporting materials were not well maintained. Upon closer examination of the books, there were questions, but answers were not readily available. Soon, a major fraud that had gone on for several years involving the CEO/CFO and the accounting department was discovered. The numbers did not reconcile and false sales had been booked. The biggest customer of the business was not purchasing products, but was, in fact, merely having them delivered. The lock box accounts at the bank had only been receiving a few hundred million dollars a year, not the billion dollars of revenue that had been reported.

As a result, there was an US\$80 million hole owed to the bank, which opted for a liquidation instead of a restructuring. There were massive lay-offs. The CEO/CFO fled. The FBI became involved. The business was lost and the bank started to pursue the proceeds that had been used to fund the family and try to seize assets.

Litigation ensued and the family was forced, in effect, to start over with a tarnished reputation. Generations of hard work and contributions to the community were undone.

What could have been done to prevent this catastrophe? Would best practices have uncovered or mitigated the fraud? What lessons can be learned?

Well, of course, closer involvement in and scrutiny of the business would have helped. Audits can be expensive and viewed as a waste of money in a successful privately owned business, but they are invaluable in uncovering fraud. In hindsight, the CEO/CFO clearly had too much authority. Perhaps the positions should have been split or a group of family members could have functioned as an audit committee, similar to those in a public company.

The protections of having a bank credit committee review, periodic reporting and lock box did not help either. The bank became too comfortable and did not adequately ask for or review the necessary information. Since the bank was out US\$80 million, the fact that the bank was negligent did not help the family.

Sufficient insurance against fraud or malfeasance would have helped, too. Although there are costs involved, the discipline of obtaining and maintaining insurance can both protect the beneficiaries and help uncover fraud.

Best practices might have uncovered the fraud much earlier as well. If the CEO/CFO had been forced to observe all corporate formalities with respect to contracts and transactions, and provide regular detailed reports to the family, then questions would have likely arisen. The formalities of corporate governance (e.g., double signature authority, maintaining complete and accurate records, frequent reports to and board of directors and shareholders meetings) provide a useful discipline and interaction between professional management and the family members. But in this case, because the news was all good, this was not viewed as a priority.

Further diversification would have prevented the loss from being so devastating. There is a tendency for a family to seek to invest in what it knows best and make it successful, but a series of interrelated businesses and real estate become more vulnerable. A nice cache of publicly traded securities, private equity investments or other non-correlated assets might have given the family sufficient liquidity to weather the loss.

In summary, it is best not to cut corners in establishing and implementing the structure of a family office. Without proper attention, the risks can be high and the transition process hazardous.

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Entity Transparency Comes to Luxembourg

As we have noted in prior Insights¹, in accordance with the regulations of the European Union, EU member states are taking regulatory action to require greater entity transparency.

Luxembourg has joined in, with a law that establishes a public register of beneficial owners of entities (the REBECO Act). The REBECO Act went into force on March 1, 2019, and entities that fall within its scope will have until September 1, 2019 to comply with its provisions.

The REBECO Act applies to entities registered with the Luxembourg Trade and Companies Register (*Registre de Commerce et des Sociétés* or *RCSL*), including civil and commercial companies, branches of foreign companies, Luxembourg common investment funds and certain other types of investment funds, but excludes companies whose securities are listed on a qualifying regulated securities market. Under the REBECO Act, entities must maintain at their offices, and provide to the Luxembourg Business Register (LBR), regularly updated information on their ultimate beneficial owner(s). This information includes the ultimate beneficial owner's first and last name, nationality, date and place of birth, country of residence and national identification/registration number, and the nature and scope of the interest held in the entity. Luxembourg's national tax, law enforcement, customs and similar authorities will have unlimited access to the information stored in the LBR. The REBECO Act also provides that "any person" will be entitled to access certain of the information (including the scope of the beneficial interest), although the Act provides the ability for beneficial owners, in exceptional circumstances and on a case-by-case basis, to request that the LBR limit access to the information on file to the national authorities and banking and financial institutions.

Family offices should be aware that direct or indirect ownership in Luxembourg entities will no longer be "opaque". While Luxembourg will likely remain a favored jurisdiction for sophisticated cross-border corporate and investment fund entity structuring, this new requirement of entity transparency should be taken into consideration by family offices and their advisers when considering potential investment structures.

Please contact your principal Squire Patton Boggs lawyer or the lawyers listed in this publication for additional information, or for help on these matters from our global Family Office team.

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¹ "Beneficial Owners of German Subsidiaries" (January 2018) and "UK Register of Beneficial Owners – The Details" (August 2018).

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