FAMILY OFFICE REVIEW
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To Embed Or Go Virtual With Your Family Office: That Is The Question

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Having a family office construct is essential for family businesses that are scaling up and looking for a way to manage the wealth created from it. But, a single family office can be costly. So, what are your best options? To embed or to go virtual - as Shakespeare would say - that is the question.

Embedding is a natural evolution for a family with an operating business. “When the business gets to any degree of complexity, then the ownership of that involves complexity, too,” says New Haven, Conn.-based Amy Renkert-Thomas, joint managing director at Withers Consulting Group.

Mixing Business and Personal Functions Is Dangerous

It’s common to see heads of the family business having their trusted senior staff handle the family office dealings, as well. However, this can create problems, usually unwittingly. Why? One reason is if senior staff members have been additionally tasked with personal duties, these become secondary - even tenth on the list of importance - because the operating company is compensating them, notes Renkert-Thomas. Renkert-Thomas, whose grandfather founded Fisher Price Toys, is very close to the subject matter, having worked in her own family’s operating company Ironrock, Inc., a manufacturer of ceramic tile and thin brick; she is a fifth generation family member who served as president and CEO of the business.

A big sticking point is that these staff members may not be trained in areas that the family office requires. “Just because you are a CFO that doesn’t mean you are good at running investments,” she points out. “An accountant doesn’t mean you understand personal tax - sometimes you do. There are a whole set of trade-offs being made when a family office is embedded that no one thinks about very carefully but that really can be detrimental to the family’s personal wealth.”

Moreover, with the wearing-two-or-more-hats mentality, families can find themselves deeply immersed in hot water due to tax violations on a federal state and international level. The lines get blurred very easily; the assistant starts booking personal dinners, vacations, picking up the dry cleaning; the accountant who handles the tax returns starts getting involved with investments and doing due diligence; the lawyer who worked on contracts is now doing wills and house closings, escalating further and further to the point of no return.

Chicago's Thomas Handler, partner at law firm Handler Thayer LLP, stresses that if you are a sole owner of a company and none of the employees have a bonus or qualified plan, like a 401K, all of this is fine - except you can’t deduct those expenses because they are personal expenses. If you do, you are violating the tax law and filing fraudulently.

If the lines are getting crossed, say the assistant or manager is indeed handling personal business being paid by the business and you are deducting 100% of the salary, you would have to count back and document down to the last detail that, for instance, you used 15% of the CPA for personal matters; 10% of the assistant and 10% of the lawyers. You have to cut a personal check from your personal account if you don't have a family office, Handler emphasizes.

If you have an ERISA plan [Employee Retirement Income Security Act], like a pension plan or a 401K or medical reimbursement or a cafeteria plan, (one of the many ERISA plans available), "now you have violated every one of those plans because the money that should have been available for benefits or profit sharing or bonuses, you've in effect stolen and converted it to your personal use," says Handler. On top of that, when you do the remedy for violating ERISA, that involves punitive, treble damages and attorney's fees. Onerous, to say the least.

You can have the same person in dual roles but you have to bifurcate their contracts, says Handler. That's literally one check from the family office and one from the family business. That's not unusual, he says, as long as it's properly accounted for. It's okay - but you've got to have a reasonable basis for doing that, he also says.

But, families tend not to appreciate the significance of the problems. Handler says the violations are rampant and can get wildly out of hand. Breaching duties, committing fraud, filing false tax returns is one thing. Let's say, now you want to sell the business or obtain financing. You are now obligated to make representations to the bank. Those can be false if you don't accurately report who and what is personal and what is business. "It's not a materiality issue, whether it's a $100,000 or $1 million - it doesn't matter...You can't make those representations. If you do, now you've got bank fraud," he says,

New York-based Natasha Pearl, CEO and founder of advisory firm Aston Pearl and partner and co-founder of SFO Advisor Select, raises another issue, surrounding morale around the company. "I think it's very hard - the people who are doing the personal work may feel that they are more important than the people who aren't involved in those aspects - and vice versa, because the people who are doing the personal work could take the view that they are less important and that work isn't as important as the business. Whichever one it is, it's destructive to the company morale."

Handler adds that the dilemma is that these de facto family offices that sit inside family businesses are extremely common in the marketplace.

The solution? Withers Consulting Group's Renkert-Thomas says instituting a separate advisory board is one way to begin putting the proper focus on the family office. But the choice route would be to actually create a separate staff for the family office, with people who have the right skill set and operate independently, reporting to dedicated staff.

VFO Route

Still, if you continue down de facto lane, Handler Thayer's Handler contends it's a pretty big - and defensive - reason for opting into the virtual family office.

What is a VFO? The concept is loose, but according to Handler, it's basically a legal entity or structure that does have substance, but it may have no or very few employees. For example, a VFO could house a CPA and a lawyer and everything else is outsourced. In many cases, he says, the only employees are the family members working in it on a very part time or volunteer basis.

But, there is heightened activity around this model. Handler explains:

"As costs are escalating ahead of revenues, alpha is increasingly more difficult to achieve in this post economic environment. While we are in this great depression, families just don't have the same types of options and alternatives that they had in the past. Meanwhile, the cost of running the office goes up, so there's been pressure on the SFOs because of that dilemma of increasing costs over time that are outpacing revenues. So the offices are forced to get more efficient. Also, some wealthy families are moving into 'VFO land' or looking more like VFOs because they are increasingly outsourcing. The things like the Patriotic Act and the Dodd Frank Act exacerbate and accelerate that trend. Because of the cost of registrations, needing extra staff and having a compliance officer, that's a good reason to outsource your investments if you don't have all of that built in-house."

Pearl says, not unlike the embedded model, VFOs can also be accidental in nature. She proffers an example: someone inside the embedded family office says they are spending too much time paying personal bills, so why not just outsource bill pay to the business accounting firm they already work with. “All of a sudden someone who is within the business accounting firm who had been working on your taxes and everything else - now you are saying to them, ‘we need somebody to handle bookkeeping around these bills for our five homes’,” she illustrates.

From Handler's view, VFOs have emerged as a best in class approach to wealth management. “There’s a lot of vector forces pushing the virtual family office,” he says. “You’ve got the SFOs declining, you’ve got these internal de facto family office businesses, which [beget] all kinds of problems families are not really paying attention to, you’ve got new money, people building wealth, and they are doing whatever they can to get the benefits of these best in class strategies and approaches - and VFO gets them there.”

VFOs also account for MFOs as the most resonant attractor of capital in the last 10 years, he also says, emphasizing they have outpaced trust companies, banks, RIAs and the wirehouses. “I think people realize the benefit of having an advocate looking out for you,” says Handler. “It’s huge and the protocols rounding this space are designed to be best-in-class.”

Nonetheless, there is still value in the embedded family office. “I think people are being more thoughtful,” says Renkert-Thomas. She points out that to some extent there’s a degree of the embedded family office in every family business, “so the number of families that do it is probably really small compared to the number of the families who don’t." A lot of wealth advisors are beginning to help families see this problem and provide some of the staffing and solutions on an outsourced basis, she also says.

Shifting Pieces

One key question to ask if you have an embedded family structure is who is the family risk manager if you don’t have a formal structure that caters to the family’s needs, says New York-based Linda Bourn, executive managing director of Family Enterprise Risk Services at insurance broker Crystal & Company.

There are many shifting pieces that are risks to family wealth, she says. Her advice is to make sure that there is a clear delineation between the staff who address the family’s business and personal dealings and to make sure that the family and their advisors clearly understand it.

She also advises that a very clear structure working on behalf of the family, such as a department dedicated to the family, or a family office dedicated to delivering services to the family away from the family business be considered.

It’s fair to say, according to Bourn, that families are inherently entrepreneurial, and as they grow, often is the case where they grow without being conscious of that fact. She suggests for all members to meet annually, be it a family meeting, a family council meeting; essentially a communication platform to set up a process formally. This may also include representation at the company level so that there exists a sort of advocacy and a clear understanding of what the family’s needs are.

Adds Pearl: both embedding and virtual can be good strategies, “but they have to be intentional. They can’t be accidental."