ADDITIONAL RESOURCES ON FAMILY OFFICES AND FAMILY PHILANTHROPY

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- FOX Connects
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- Family Office Exchange
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- *Family Governance: A Primer for Philanthropic Families* by Patricia Angus (National Center for Family Philanthropy, 2004)
- *Family Governance Meets Family Dynamics: A Survey and Strategies for Successful Joint Philanthropy* by Patricia Angus and Fredda Herz Brown (National Center for Family Philanthropy, 2007)
- *The Family Office: Advising the Financial Elite* by Russ Alan Prince, Hannah Shaw Grove, Keith Bloomfield, and Richard Flynn. (Charter Financial Publishing, 2010)
- *Family Legacy and Leadership: Preserving True Family Wealth in Challenging Times* by Mark Haynes Daniell and Sara S. Hamilton (John Wiley & Sons, 2010)
- *Family Wealth—Keeping It in the Family: How Family Members and Their Advisers Preserve Human, Intellectual, and Financial Assets for Generations* by James Hughes Jr. (Bloomberg Press, 2004)
- *Generations of Giving: Leadership and Continuity in Family Foundations* by Kelin E. Gersick, Deanne Stone, Katherine Grady and Michèle Desjardins (Lexington Books, 2004)
- *Guide to Impact Investing for Family Offices and High Net Worth Individuals: Managing Wealth for Impact and Profit* by Julia Balandina Jaquier (Guidetoimpactinvesting.net, 2012)
- *The Power to Produce Wonders: The Value of Family in Philanthropy* by Virginia M. Esposito (National Center for Family Philanthropy, 2010)
- *Splendid Legacy: The Guide to Creating Your Family Foundation* by Virginia M. Esposito (National Center for Family Philanthropy, 2002)
- *Strategy for the Wealthy Family* by Mark Haynes Daniell (John Wiley & Sons, 2008)

SPECIAL APPENDIX: KEY LEGAL ISSUES TO CONSIDER WHEN A FAMILY OFFICE PROVIDES SERVICES TO A FAMILY FOUNDATION

By Ellen Kaye Fleishhacker and Andras Kosaras

When a family uses a family office to manage its wealth and a family foundation to carry out philanthropic activities, the question arises whether the family office can provide professional services to the family foundation, such as investment management, banking, and grantmaking services. Here are some key legal issues to consider when a family office provides services to a family foundation.

Self-Dealing. The private foundation self-dealing rule prohibits a family foundation from engaging in financial transactions with a "disqualified person." Disqualified persons, a term defined by the tax code, generally include substantial contributors to the foundation and its managers (e.g., directors and officers), as well as certain family members of these individuals and businesses controlled by these individuals. A family office is likely to be classified as a disqualified person.

There are some exceptions to the self-dealing rule. In general, a family office may provide services to a family foundation without charge without violating the self-dealing rule. If compensation is desired, a private foundation may pay reasonable compensation to a disqualified person for "personal services" that are reasonable and necessary to carry out the foundation's exempt purposes.

Reasonable compensation may include market rate compensation. The compensation may be structured in various ways, for example, hourly rate, fixed fee or a percentage of assets (especially in the case of investment management). The family foundation must be able to document through the use of comparables that the compensation paid is fair and reasonable in relation to the services provided.

Common examples of transactions that implicate the self-dealing rules include the following:

(a) *Banking, investment management and legal services.* A family office may provide banking, investment management and legal services to a family foundation because the tax regulations define these services to be "personal services" that fall within the exception to the self-dealing rule. These services may also include tax planning and compliance, financial reporting, accounting, and related services. The family foundation may pay reasonable compensation for these services.

(b) *Administrative and grantmaking services.* The IRS has published guidance in the form of private letter rulings that indicate that administrative and grantmaking services (e.g., grantee due diligence, strategic planning, and similar services) should qualify as "personal services" under the self-dealing rule (private letter rulings may not be relied on by taxpayers other than the taxpayer who requested the ruling, but they are helpful in providing insights into the IRS's position on a certain issue). As a result, a family foundation may pay reasonable compensation to a family office for providing these services.

(c) *Sharing employees.* A family foundation may reimburse a family office for the employees who provide "personal services" to the foundation. The foundation may reimburse the family office for the allocable share of such employees' salaries and benefits. The family office and the foundation should keep precise records of time spent on foundation activities.

(d) *Sharing office space.* A family office may provide office space to a family foundation, but it must do so without charge to comply with the self-dealing rule. The family office may not charge any rent to the foundation, even if the proposed rent is below market rate. However, the foundation may pay its allocable share of utilities or maintenance costs incurred for the use of the property, as long as the foundation makes those payments directly to the third-party and not to the family office.

(e) *Side-by-side investments.* A private foundation that has an opportunity to invest in a fund managed by a family office or in which disqualified persons are significant investors should consider any restrictions on such investments under the self-dealing rule. A side-by-side investment may be beneficial to the foundation because it may reduce administrative costs of investing, diversify assets, and gain access to additional investment opportunities. However, if the foundation's investments provide a benefit to disqualified persons, such as, for example, increasing the ability of disqualified persons to participate in a fund, then the foundation's investment may be prohibited under the self-dealing rule.

Investments. Under the private foundation rules, a private foundation is prohibited from making investments that jeopardize the carrying out of the foundation's exempt purposes (with certain exceptions, a private foundation, together with its disqualified persons, is also prohibited from owning more than 20% interest in a business enterprise). No type of investment is strictly prohibited, but careful scrutiny is applied to trading in securities on margin, trading in commodities futures, buying or selling puts, calls or straddles, buying warrants, and selling short.

A private foundation must also comply with any state law requirements regarding its investments. For example, the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"), enacted in almost every state, provides requirements and investment standards that fiduciaries must follow when making investment decisions (these standards are generally consistent with modern portfolio theory). UPMIFA requires foundation managers to make decisions regarding investment management "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstance." UPMIFA also requires foundation managers to incur only "costs that are appropriate and reasonable" in connection with investment management.

Investment Adviser Registration. A family office that provides investment management services to a family foundation should be aware of any registration requirements pursuant to applicable state laws and recent federal laws enacted and new rules adopted by the Securities and Exchange Commission ("SEC"). Before the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was enacted in 2010 in the wake of financial regulatory reforms, most family offices fell within the definition of an "investment adviser" under the Investment Advisers Act of 1940 (the "Advisers Act") because they provided advice about securities for compensation. However, many were nonetheless exempt from investment adviser registration with the SEC in reliance on the Advisers Act's "private adviser exemption."

Under Dodd-Frank, Congress repealed the private adviser exemption. Nonetheless, following Dodd-Frank, the SEC adopted the "family office rule," which excludes certain single family offices from the definition of "investment adviser" and therefore provides some relief to certain family offices from the investment adviser registration requirements. The family office rule provides that a "family office" that is excluded from the definition of "investment adviser" must (i) provide advice about securities only to "family clients"; (ii) be wholly owned by "family clients"; (iii) be controlled by "family members"; and (iv) not hold itself out to the public as an investment adviser. "Family clients" include, among others, current and former family members, private foundations and other charities funded exclusively by family clients, estates of family members, and companies that are wholly and exclusively owned by and operated for family clients. "Family members" include all lineal descendants (including by adoption, stepchildren and foster children) of a common ancestor no more than ten generations removed from the youngest generation.

A private foundation is only a "family client" if all of the funding it *currently* holds came *exclusively* from one or more family clients. This reliance on funding from "family clients" instead of the more restrictive "family members" is seen by many as the SEC's attempt to strike a middle ground for family foundations under the family office rule. (In addition, the SEC provided a special transition rule that gives a family office the ability, under certain limited circumstances, to continue advising family foundations that do not meet that criteria without the obligation to be registered until December 31, 2013.) As a result of these definitions, family offices need to apply the criteria above to determine whether any family foundations or related entities they advise are "family clients."

To the extent that a family office advises a family foundation that does not meet the criteria above, if it wishes to rely on the family office rule to avoid the need to register as an investment adviser (and otherwise complies with that rule), its primary options are to (i) stop advising the family foundation or (ii) have the family foundation dispose of the non-family funding. In addition, a family office needs to consider potential state registration requirements that may apply under state law.

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