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PKF O'CONNOR DAVIES FAMILY OFFICE

Financial Services Newsletter

Taking Your Fund Private: Transitioning from Investment Fund to Family Office

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An increasing number of investment fund managers are returning outside investor capital in order to focus on managing their personal and/or family wealth. The decision to "go private" can be driven by a number of factors, including dealing with an ever more complicated regulatory environment, fee compression, increasing difficulty in finding alpha in stretched markets, the advancing age of the principal, or even as one of our clients recently told us: "You know, it's just not fun anymore." But whatever the reason, PKF O'Connor Davies can provide the roadmap, and we have the experience, personnel, and systems in place to assist in all facets of the transition.

Investment managers are certainly familiar with the layers of concurrent systems that must be in place in order to operate a successful investment fund. These systems include, but are not limited to: fund administration and accounting, investor reporting, allocations and tax filings, regulatory compliance, management company/general partner accounting and tax, etc. To varying degrees, certain of these functions will cease once the platform no longer manages outside capital — the public regulatory and compliance burden immediately coming to mind.

However, even though transitioning to a private investment structure or family office platform should eliminate a significant amount of public fund related effort, family related needs and how best to meet them should then take center stage. This becomes particularly important where the general partner/fund manager previously utilized fund related personnel to provide family related services. Transitioning to a private platform is an excellent time to reassess the overall needs of a wealthy multi-generational family, and assess how best to provide for those needs.

For example, should family related services now be provided in-house or are they better outsourced? While the decision is certainly fact and circumstance dependent, increasingly managers are turning to an outsourced solution for some or all of their family related needs. This trend appears to be driven by four underlying factors: a desire for overall simplification, access to best-in-class approaches, efficiency, and cost reduction. Services which lend themselves readily to outsourcing include cash management and bill pay, data aggregation and asset tracking, customized family reports, tax planning and compliance, management of personal planes and yachts, overall asset protection, succession planning and implementation, family concierge services, and philanthropy.

Considerations in Transitioning to a Private Platform

Below we address some of the more important considerations in transitioning your public fund to a private investment management platform or family office:

- **First, identify family *investment management* needs versus family *personal service* needs.** A properly structured comprehensive family platform should provide for both, in tandem, without creating overlapping administrative, legal, or tax issues. Ideally, these two rails should run parallel and through generations.

- **Separate investment from personal services functionality**. From a best practices perspective, family lifestyle services should be provided by staff who are independent of investment management personnel for legal, tax, and privacy reasons. Care should be taken to ensure that personal information such as documents, emails, etc. are not comingled with investment and asset information. A solid firewall between business and personal activities facilitates more accurate tax accounting and provides a solid footing in the event of a tax audit.

Transitioning the Management of the Family Assets

- **First choose how to return public capital**. Managers can choose to liquidate their legacy fund and place family investment capital into a new structure, or redeem public capital but retain the legacy structure. The decision will depend on a number of factors, including the application of tax rules governing liquidations versus redemptions, the historic tax basis of fund assets, the desire for in-kind versus cash distributions, the mix of taxable versus tax exempt public investors, etc.

- **Liquidation.** If you choose to liquidate your hedge fund and related management entities (versus returning outside investors' capital and continuing privately through the existing entities), you will need a well laid-out liquidation plan which coincides with the creation of new family entities. A family limited partnership (FLP) is similar to a fund of funds and can provide a centralized structure to accommodate co-investment by family members. An interesting alternative is a series limited liability company (Series LLC), which can provide a streamlined vehicle for co-investing, while at the same time enhance operational efficiency and reduce cost. If a proper roadmap is followed, neither the liquidation nor new formation discussed above should be taxable.

- **Single family office versus multi-family office**. A single-family investment management platform, where only one family's capital is managed, offers greater control and privacy while allowing the registered investment advisor (RIA) designation to be relinquished cleanly. A multi-family office allows members to pool their resources and buying power, creating cost savings and access to more extensive sources of expertise. However, under these circumstances the RIA designation must typically be retained, which may defeat one of the primary motivators of transitioning to a private platform.

- **Tax planning and compliance**. Since you will now be starting a new personal investment firm and/or family office, you should take the opportunity to review and optimize your overall tax posture. For example, it is advisable to collaborate with your advisors to determine how best to allocate family expenses in order to maximize tax efficiency. These allocations will typically be made between entities, as well as between the categories of personal, investment, or business expenses. To a large degree, family office expenditures may constitute either non-deductible personal or investment expenses. In the current environment, such expenditures are facing increasing scrutiny by the IRS and other taxing authorities. A knowledgeable CPA firm can assist with this overall process, especially since different generations might have different goals, risk profiles, time horizons, and tax postures.

- **New structural approaches to extracting tax efficiencies in family investment management.** IPE (internal private equity) structures can provide a means of transforming otherwise non-deductible investment expenses into ordinary and fully deductible trade or business expenses. PEP (private equity with purpose) structures can provide a corresponding slate of tax benefits in the context of philanthropy, sometimes displacing more traditional 501(c)(3) giving.

- **Other regulatory and compliance matters**. As discussed above, transitioning away from managing public capital (a single family office) will typically place the investor outside of the realm of Dodd-Frank and thereby end direct SEC regulation and related filing requirements. The manager can choose when to relinquish his or her RIA via appropriate SEC filing(s). It should be noted that in the context of a single family office, assets of key employees can often remain under management while still eliminating direct SEC regulation.

- **Investment data aggregation, accounting, and reporting**. Implement systems that are designed to aggregate and properly account for your family's investment assets. You will also want to ensure that these systems provide accurate, comprehensive, and timely reporting and analytics. Examples include tax lots, wash sale, and straddle analysis. Leading fund administration firms can provide customized service at an attractive cost.

- **Does recently enacted tax reform alter the equation?** Absolutely. There are different legal structures which can be utilized to carry out both your family investment management and family services needs. Traditionally, certain fact patterns have lent themselves to corporate structures, others to pass throughs. However, recently enacted tax reforms have upended the traditional analysis, particularly in light of the new rate structure and deduction for qualified pass through income. In addition to new structures, existing legacy family structures, should now be re-examined in light of the recent legislation.

- **The new partnership audit rules**. Consider the timing of the investment-side transition. Not only are the recently enacted tax reforms effective as of January 1, 2018, so too are the new partnership audit rules. These new rules specify that any additional taxes that become due as a result of entity level audit adjustments, must be paid by the partnership itself, not the individual partners. The partnership is now left with the task of seeking reimbursement from partners, some of whom may have already left the fund. Underlying partnership agreements may need to be amended to include hold backs or claw back provisions.

- **Succession and estate planning considerations.** No one lives forever, including investment fund principals. A self-sustaining and tax efficient investment management structure is one of the best assets that you can bequeath to your heirs, and transitioning to a private investment platform is the ideal time to put such a structure in place. If done properly, it will long survive you, and provide management, guidance, and continuity over your assets well into the future**.**

- **With respect to providing for personal family service needs.** First choose a means of delivery which best fits your needs. While an independent family office management company can be established solely to manage the family's investments, it can also house the family services personnel, providing accounting, reporting, tax, legal, asset protection, and concierge services to family members. As previously discussed, however, investment management functions should be carried out by personnel independent of the personal services staff.

- **Identify which family functions will be retained versus outsourced.** Many of our clients maintain a small family office staff, for example a CFO, bookkeeper, and administrative assistant. All other functions are outsourced. Other family office clients maintain a relatively large staff that performs a wide range of family related tasks and duties. An efficient and cost-effective approach is often an outsourced service provider who can provide an array of services under one roof. Alternatively, a hybrid approach can be used, where the family office and the outsourced provider each handle different services. If properly structured, a separate family investment management company can be formed, which can provide enhanced insurance and retirement benefits to its principals, as well as provide multi-generational continuity over family investment asset.

- **Choose family office personnel wisely.** First and foremost, family office executives should develop a thorough understanding of the family's goals, objectives, and risk profiles. In addition, a requisite set of business and management skills, depth of technical knowledge, and strong interpersonal and communication skills are a must. Over time, family office personnel should develop a keen insight into the family's mindset, or, in other words, gain invaluable "family institutional knowledge."

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- **Risk management and internal controls**. The overall family office and individual family members face different risks and have differing risk profiles. It is crucial to establish a system of controls, oversight, and monitoring that are designed to preserve and protect family wealth, while managing investment, legal, fiduciary, reputational, and physical risk. Primary risks include handling cash, vendor onboarding, and bill payment. Staff members tend to have long tenures and become close with the family, which can result in a blurring of professional and personal relationships.

- **Analyze the impact of trusts and private foundations**. Given the close interrelationship between the family and the investment business, tax planning opportunities and/or issues may arise. A core function for many family offices is to support the family's efforts in charitable giving, which may include family legacy planning and philanthropic mission development. Such efforts can be enhanced using charitable trusts, donor advised funds, and/or private foundations, in addition to the PEP structures previously discussed.

- **Support younger family members and provide ongoing governance.** The family office can assist in establishing a framework for effective guidance of younger family members and their investment related activities. It can also provide a pathway for decision-making, and foster family education, communication, and legacy awareness. Depending on the size and dispersion of the family, governance structures may utilize an executive committee and/or a family council. They may also incorporate periodic family meetings, a family constitution, and the development of policy statements covering investing, risk, and controls. A "family bank" can also be established to provide funding for family endeavors deemed worthwhile. This keeps interest income within the family, in addition to fostering good business practices in succeeding generations.

- **Lifestyle and concierge support**. As previously discussed, another core function of a typical family office services wing is to support all aspects of family members' lifestyles. This will typically include the management of non-investment assets, such as multiple homes, aircraft, vessels, art, automobiles, fleets, etc. It may also include management of travel, entertainment, healthcare, personal and/or household employees, all under the heading of "concierge services".

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PKF O'Connor Davies Family Office meets the ever expanding needs of wealthy families, providing family investment administration, cash management and bill pay, tax planning and compliance, gifting, philanthropy, and lifestyle support.

Our Financial Services and Family Office practices, working in tandem, assist families in growing their wealth while controlling costs. The key is advanced planning and building a team of in-house and outside service providers to meet personal, cultural, and business objectives.

Contact Us

For more information about converting your hedge fund to a private investment company, or to establish and organize your family office, visit www.pkfod.com or contact either: Marc Rinaldi, CPA; Gemma Leddy, CPA; Thomas Riggs, JD, CPA, MAS; Alan Kufeld, CPA; or Eric Gelb, CPA. At 212.286.2600.

About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, nine offices in New York, New Jersey, Connecticut and Maryland, and more than 700 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 28th on *Accounting Today's* 2017 "Top 100 Firms" list and is recognized as one of the "Top 10 Fastest-Growing Firms." PKF O'Connor Davies is also recognized as a "Leader in Audit and Accounting" and is ranked among the "Top Firms in the Mid-Atlantic," by *Accounting Today*. In 2017, PKF O'Connor Davies was named one of the 50 best accounting employers to work for in North America, by *Vault*. The firm was recently awarded "Best Accountancy Advice" by ClearView Media and Family Wealth Report and "Best Reporting Solution" by *Private Asset Management* (PAM).

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PKF O'Connor Davies Financial Services provides performance and risk reporting, investment and consulting services, due diligence, valuation, attest (including audit, agreed-upon procedures, surprise custody examinations and SOC reports), tax planning and compliance, complete fund administration and regulatory compliance (including Dodd-Frank, AIFMD, corporate and investment mandate compliance). We are CIMA-registered. Our administration unit was ranked the 25th largest global administrator by eVestment.net.

PKF O'Connor Davies Family Office, a division of PKF O'Connor Davies, LLP, provides a full range of family office, accounting, tax and advanced planning services to high net worth individuals, family offices, closely-held businesses, executives of multi-national corporations, family trusts and entrepreneurs. With each client's needs in mind, our professionals use state-of-the art technology to develop customized and strategic solutions that meet their planning, reporting, financial and lifestyle challenges. Clients and their key advisors rely on PKF O'Connor Davies for extensive expertise in tax, accounting and reporting, wealth planning, charitable giving and investment oversight. The Firm's experienced team of dedicated family office professionals includes specialists in tax planning and compliance, estate and trust, state and local tax, and corporate and international tax.