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PKF O'CONNOR DAVIES FAMILY OFFICE

Financial Services Newsletter

Taking Your Fund Private: Is it Time to Transition your Fund to a Private Family Office?

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An increasing number of investment fund managers are deciding to return outside investor capital and turn their focus to their family wealth … as well as their personal lives. As one might expect, the roadmap to a successful transition must address a number of issues, including regulatory, accounting, legal and tax. But once completed, feedback from our clients is overwhelmingly positive.

The decision by a fund manager to “go private” can be driven by a number of factors. Based upon conversations with our clients that have made the decision, it seems that their motivation stems primarily from one of two sources: fund related or personal considerations.

From a fund perspective … managers are feeling the strain from factors such as an increasingly complicated regulatory environment, fee compression, stretched markets and succession considerations just to name a few. From a personal perspective, factors can include the advancing age or health issues of the principal, an overall desire to step back and have more free time, or even as one of our clients recently put it: ” You know, it’s just not fun anymore.” But regardless of the reason(s), at some point all of our manager clients seem to face the issue of when to move on to the next chapter of their lives.

A successful investment manager must juggle multiple and concurrent systems. Such systems include, but are not limited to, fund administration, accounting, investor reporting, investor allocations, annual tax filings, regulatory compliance, management company/general partner issues, etc. Certain of these functions will cease once the platform no longer manages outside capital. For example, in the context of a single family office, the manager should be able to shed public regulatory and compliance burdens.

However, even though transitioning to a private investment structure or family office platform should eliminate a significant amount of public fund related effort, new family related considerations will present themselves. Proper structuring of the family wealth and/or governance architecture must be planned and successfully implemented. And transitioning to a private platform is an excellent time for a high net worth and multi-generational family to reassess its overall needs and then to determine how best to provide for those needs.

Considerations in Transitioning to a Private Platform

Legal and tax structure. There are a number of different approaches to designing a family office and as one might imagine, the architecture chosen will be heavily fact dependent. There is no “one size fits all.” Regardless of the particular facts, however, all family office structures should offer tax efficiencies, avoid complexity, be scalable as well as flexible and run successfully through generations.

New tax-efficient approaches to family office design. The difference between a tax-efficient family office and one that is not is all about structuring and new approaches to family office architecture are constantly evolving. For example, in the right set of facts a portion of non-deductible investment expenses may be utilized as offsets against investment income. On the philanthropic front, charitable LLC structures can sometimes provide a slate of control, privacy and tax benefits over those afforded by more traditional 501(c)(3) giving vehicles.

Do currently proposed tax reform initiatives alter the equation? Absolutely. The Biden administration's Build Back Better package of social spending initiatives contains a myriad of proposed changes to the tax code. Although the situation remains fluid, changes affecting the taxation of trusts, corporations and partnerships, on both the income as well as the estate and gift side, are being discussed. Family offices must be knowledgeable and proactive in the current environment.

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 tax rules governing liquidations versus redemptions, the historic tax basis of fund assets, the need or desire for in-kind versus cash distributions (i.e., the liquidity of the underlying portfolio), the legacy mix of taxable versus tax-exempt investors, etc.

Liquidation. If liquidation of the fund and related management entities is the chosen path, the liquidation plan must synch with the creation of the 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. It can also offer estate and gift tax efficiencies. Another 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. In any event, the proper roadmap will ensure that neither the liquidation nor the new entity formations will generate adverse tax consequences.

Redeem out public capital, then set up a single family office. If instead the manager chooses to retain the original fund structure and redeem outside investors, the registered investment advisor (RIA) designation can be relinquished cleanly. This can coincide with the addition of a side-by-side family office structure to address the familial needs outside of the investment sphere.

Redeem out public capital, then set up a multi-family office. The legacy fund structure can be retained and the portfolios of other outside families can be added to the mix. A multi-family office allows members to pool their resources and buying power, creating cost savings and access to more extensive sources of expertise. And more importantly it can, under the right circumstances, enhance tax efficiencies. 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.

Annual tax compliance. Since you will now be starting a new personal investment firm and/or family office, you should take the opportunity to review, streamline and otherwise optimize your overall tax posture and filing requirements. New legislation currently pending in Congress, if enacted, is expected to substantially increase tax audit rates, especially for high earning individuals and families. Tax-related best practices should be implemented now in anticipation of the more robust tax enforcement environment potentially on the horizon.

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 sales and straddle analysis. Leading fund administration firms can provide customized service at an attractive cost.

Outsourcing or an in-house model. While the decision is both situation and desire 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.

Separate investment from personal services functionality. From a best practices perspective, a family's *investment management* needs must first be identified and separated from the family's *personal service* needs. 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 reporting and provides a solid footing in the event of a tax audit.

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 assets.

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."

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, depending on the facts and circumstances.

Succession and estate planning considerations. No one lives forever, including investment funds. 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 provide management, guidance and continuity over your assets well into the future**.**

Different approaches to providing for personal family needs. This entails first choosing 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.

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."

In Conclusion

As alluded to above, at some point every fund manager comes to a point where they decide it's time to move on to the next chapter of their lives. And although that next chapter will look different for every manager, a myriad of issues will certainly present themselves for resolution before, during and after the transition. But with proper planning and implementation, the process should be painless and the result well worth the effort.

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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, contact any of the following:

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The Firm is a top-ranked firm, according to *Accounting Today's* 2021 "Top 100 Firms" list and was recently recognized as one of "America's Best Tax Firms" by *Forbes*. PKF O'Connor Davies was named one of *Vault's* 2022 Accounting 50, a ranking of the 50 best accounting employers to work for in North America and ranked among the top 50 most prestigious accounting firms in America in a complementary *Vault* survey.

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