DAY PITNEY LLP

Summer 2022

Summer is coming to an end, but before it does, please enjoy the Summer edition of Generations. In this issue, we take a look back at a hot topic from our Palm Beach Family Office Forum, which was held in May at the PGA National Resort and Spa in Palm Beach Gardens, Florida. Our first article is a recap of a very well-received panel discussion on the rising or next generation and how they can be integrated into the family office structure, moderated by Day Pitney's own NextGen Jaclyn M. D'Esposito.

In addition to that article, we have a piece discussing the tax treatment of cryptocurrency and the uncertainties surrounding those issues, as well as a piece about the Archegos scandal and how that might impact family offices. An article on art loans explains how people with valuable works of art are generating some liquidity by borrowing against their collections. We close with a timely article on steps family offices should take to protect their private information and data from breaches.

We hope you enjoy this issue. If you have any questions on the topics covered here or any related family office topics, please feel free to reach out to any of the members of our Family Office team. We welcome your feedback and suggestions on topics for future installments.

Best regards,

Stephen Ziobrowski
Editor-in-Chief
Tax Partner and Chair

# INVOLVING THE RISING GENERATION: CHALLENGES AND OPPORTUNITIES

*Written by: Jaclyn M. D'Esposito*

*On May 11, Day Pitney attorney Jaclyn M. D'Esposito led a roundtable discussion on the challenges and opportunities of the rising family office generation with single-family office executives and family members. The panel included Mercy Goddard, Vice President of Investment Resources Corp., and H. Wayne Huizenga, III, President and Founder of South Wake Capital, along with Mindy Kalinowski Earley, Chief Learning Officer at the Family Office Exchange.*

**Jaclyn M. D'Esposito (JMD):** We thought the proper way to begin our panel was with a discussion about defining the rising generation. For reference, millennials (Gen Y) are those born from 1981 to 1996, Gen X are those born between 1965 and 1980, and Gen Z are those born between 1997 and 2012. Mindy, when you begin working with a family, if they have not defined their next generation, how do you go about that process?

**Mindy Kalinowski Earley (MKE):** When we think about defining the rising generation from an industry perspective, we focus on individuals in their twenties, thirties and forties. We are covering many different life stages.

While this encompasses many different life stages, there are also commonalities between the rising gen; most notably, they are not yet in the highest family or business leadership positions.

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There are fresh-out-of-college 20-year-olds working at an operating company owned by a family with a clear governance structure. They serve on family committees and junior boards and are part of their family foundation decisions. In other families, there are individuals in their forties who have moved away from the family nucleus; they have started a career independently and a family of their own. They are now matriculating back into the family system, perhaps due to a milestone event or a new desire to serve in the family system. They look quite different from the 20-year-olds, but from a learning perspective, they are very similar. Both have a big learning curve in terms of understanding responsible ownership, the family enterprise and the milieu of the family system. They are seeking elevated seats at the table and for their voices to be heard. Age matters less; it's about the similar challenges and opportunities these individuals face.

When I work with families, I am essentially looking at how they define the next generation in terms of who has a seat at the table, who has a voice, who is allowed into family meetings. The next generation is generally comprised of those who are not there yet or who may be emerging as leaders. The big questions are, when are those opportunities available and how can the engagement begin?

**JMD:** Mercy, your family is a great example of how age is not the determinative factor in defining the next generation. Can you please tell us about your family members, their ages and the factors that you use when you look to define the next gen?

**Mercy Goddard (MG):** I am technically in the third generation in our family office. My dad and uncle were bought out of our family's operating company, on my grandmother's behalf, for our branch of the family in the early 1980s. My father then started the family office. My dad is 86 and he is part of the Silent Generation. I have four older siblings, all of whom are in their 50s. I am a millennial and am closer in age to some of my nieces and nephews than I am to my siblings. Technically, we are all "next generation" because my father remains responsible for the family office decision-making. I recognize that, partly as a result of my age, I will be a part of a lot of change in our family office along with my nieces and nephews.

**JMD:** Wayne, I understand you have a little bit more of a traditional family structure than Mercy. Tell us about your family.

**Wayne Huizenga III (HWH):** Luckily, our family is pretty straightforward and easy to understand. Wayne Sr. was the genesis of our family office. When he passed a number of years ago, my father, Wayne Jr., took over. We had an operating business at the time, which gave my siblings and me a very easy entrance. We had an understanding of where we were in the family office structure and how we were going to integrate. As we sold that operating business, there have been more opportunities in the family office. We have been able to stack up a little bit more traditionally and define the next generation. My younger siblings, who are millennials and Gen Z, are going to be involved in the next iteration of our family office.

**JMD:** My takeaway is that when we look to define the next generation, we should not be looking just at age. Rather, we should look to the roles within the family enterprise, whether that is a financial family or an operating company. We can compare that to the phases of family development and the level of involvement required for each of those phases, as well as the qualifications for various roles. In turn, we can use that to help guide and define the next generation.

Our next topic is generational characteristics. Mindy, in your research at FOX, have you identified any key characteristics that we should know about Gen X, Gen Y and Gen Z that could impact their engagement in family matters?

**MKE:** There is a lot of research, of course, on generational characteristics, and we take that data and marry it with what we see from our 500 member families, my consulting projects and working intimately with families.

Members of Gen X are individualistic and very independent. They are also somewhat of an overlooked generation. Millennials are very collaborative. We see a lot of unique family projects come about because of millennials who want to work together on shared projects, usually philanthropic or impact investing. They are really outcome- and impact-oriented. They care a lot about meaning and purpose.

Gen Z is an elusive up-and-coming group. While millennials care about meaning and purpose, members of Gen Z care about money, safety and security. They are the number one generation to have lost a job during the pandemic. They went through the recession. These major life and world events have shaped their values. There is a fantastic book, if you want to read more about Gen Z, called *iGen* by Jean Twenge. The saddest quote from that book is, "I think we care more about our phones than we care about people." This group is really slow to grow up and they have known social media their entire lives. They are driving later and spending more time at home, which means they are not going out and having experiences with peers. This lack of in-person socialization is leading to a lot of mental health issues, such as depression and anxiety. Another statistic from our industry research is that 80 percent of Gen Z plan to leave their parents' advisors when they are able to do so.

To connect that back to how to work with them, we need to know that Gen Z is focused on money, and they want safety and security. They really want someone to listen to them and curate information in the way they are accustomed to receiving. Never assume lifestyle preferences, philanthropic goals or life aspirations are the same from one generation to the next.

**JMD:** Mercy, we started to get a little bit into your family dynamic with your father being the founder of your family office. He is a member of the Post-War, or Silent, Generation and was supported by his brother. He is still your family patriarch and remains responsible for managing the family office. The majority of the rising generation members in your family are in their 50s. I know that your work at FOX involved advising on generational characteristics. Even though your work focused on millennial engagement in particular, what do you think our audience here today should know about Gen X or the Silent Generation?

**MG:** In my experience, generational characteristics have the greatest impact when it comes to communication styles.

My dad had this idea of a family office about 40 years ago, and he was one of the first members of FOX. His vision was for a collaborative, inclusive family office. But one thing our family has struggled with, and I think many families struggle with, is the fact that different generations communicate differently. So, even a good faith effort by a family member to communicate and be transparent can lead to tension, because of differing communication styles and expectations based on age. These generational characteristics really can have a huge impact.

Ever the millennial, I always envision bringing everybody together and having a conversation to get everyone on the same page.

My siblings are mostly Gen X. They are typical latchkey kids who had a lot of independence growing up and are not very interested in being involved in the family office. Then my father, as a member of the Silent Generation, does not always consider the manner in which information and decisions are communicated to the family. These generational characteristics really can have a huge impact. It comes down to communication and at least acknowledging how the different generations communicate and how that can drastically impact the dynamic of your family office.

**JMD:** Thank you for sharing and being so candid with all of us. In my experience, when a family is not committed to implementing some of the core practices—family glue functions and soft skills that contribute to an inclusive family culture—lines of communication often break down despite good intent. I'm curious, Wayne, do you have anything to add to Mercy's experience? Can you relate to what Mindy said about the generational characteristics and statistics, like leaving advisors?



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**HWH:** The statistical data about Gen Z looking to leave their advisors was really interesting. I do not think there is a solution, as it is more of an ingrained difference of opinion, and they see the world entirely differently than most of us do.

As far as the family goes, I think my pop's experience was more difficult when it comes to communication with his father. They had a little bit more of a traditional family office role and there was some tension there. From the time I was really young, my father spent a lot of time with me, being very communicative and open about the legacy you want to leave behind, how he saw our siblings and me being involved in the family office, and how all that communication would play out. He has done a fantastic job of taking the time to get all this together, having those conversations and making sure no one felt blindsided by a rogue email from the big boss himself. It is completely individualistic to each family office, but the communication from a young age was what enabled my generation to be interested and involved in our family office and approach things with an open mind.

**JMD:** Communicate. One takeaway for all of us. Mindy, as we pursue this topic a little bit further here, have you identified any challenges that transcend these generational characteristics? Is there anything that you see generation after generation, no matter what environment we grow up in, that is a hallmark of the rising generation's experience?

**MKE:** We have research from hundreds of families we work with that yielded the top five challenges faced by the rising generation. In conducting this research, we took a careful and deliberate approach to ensure the soundness of the data collected.

Interestingly enough, the first one does relate to communication. The number one challenge that we hear from the rising generation is defining their future roles in their families. They are unclear of the roles they can play. Leadership and skill development is their second challenge. After that, navigating family dynamics, communicating between generations and then investment strategy/financial literacy—getting up to speed and educated. According to our research, these are the top five challenges the rising generation faces.

**JMD:** Can you elaborate on the first two challenges, defining future roles in the family and leadership/skill development?

**MKE:** The first one is this paradoxical problem of family leadership saying, "What does the rising generation want to do? What role will they take up?" And then, the rising generation is saying very similar things, such as, "What is available to me? How do I get involved? How do I get up to speed to be prepared for a role?" They are not communicating with each other, but they have the same questions.

This can be resolved in a number of different ways. It includes open, clear communication and defining pathways for engagement. If there is a governance structure, allowing opportunities for individuals to move up in it through meeting invitations and formal roles. We see this solved by creating learning programs, opportunities for the rising generation to understand the roles they can play in a family. It is important to have these clear guardrails, boundaries, expectations and understanding of where to go.

The way I talk about it in my work is to give them a map, but let them choose how they get there. Millennials and Gen Z certainly want autonomy. They want to belong in the family and the system, but they also want autonomy. Lack of pathway is a top challenge. The rising generation is not really sure how to engage and get started.

For the second one, leadership and skill development, there is a book called *Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values* by Roy Williams and Vic Preisser that has a statistic about what leads to a breakdown in generational wealth transfer. Number one is lack of communication. Number two is inadequately preparing heirs.

There is this wealth 3.0 concept, which is really moving away from this fear-based mentality. I recommend

the article "Wealth 3.0: From Fear to Engagement for Families and Advisors" by Dr. Dennis Jaffe and Dr. Jim Grubman, along with Kristin Keffeler. They talk about approaching the way we discuss the wealth 3.0 concept—from positive psychology rather than these negative "shirt sleeves to shirt sleeves" ideas.

Leadership development is huge because it gets at the action around preparing for future roles. "Once I know the path that I might take to become involved, this is what I need to do to become prepared." Some families are apprehensive to begin learning programs or next-generation inclusion because it feels like the younger family members are pushing the older generations out, but that is not the case. It is more transition and inclusion, getting someone up to speed.

Once I was in a family meeting and there was a moment when the patriarch, a man of faith, stood up and exclaimed, "I get it. This is it. John the Baptist. If he must increase, I must decrease." It was a very clear visual of the idea that if someone else is going to step in, I need to make space for them. It is not that they are pushing me out of the way; it is just a slow, intentional, methodical creation of space for them to exist. Allow them a place to step into. Provide increased responsibility with proven credibility and determination. That addresses those top two main challenges in ways that you can really think about conceptually and put into practice within a family.

**JMD:** When should this transition planning—rather than succession planning— begin? At what age is it appropriate to start having these conversations with family members?

**MKE:** Now. Yesterday. Age 5. Not as old as Mercy's oldest brother is. I am working with a family right now doing a project with a 10- and a 12-year-old. That's really early, but if you think about investing and compound interest, we are investing in these kids. We are compounding their learning. What they are learning at 10 they will add to at 12 and 15 and 18. It is really cool to think about what they will know and how they will be educated about their family and their system. Not every family does that.

I do think about this idea of the kids' table at family dinners. At Thanksgiving dinner, the kids are sitting at the kids' table and they want to get to that big table. You can do some things at the kids' table, like learning at a young age, but they are just looking ahead to moving up and when this will happen. Of course, I evangelize learning. Start now. Start today.

**JMD:** Wayne, I take it that investment strategy was not the main challenge in your family, given your founding of South Wake Capital. But could you share with us which of these challenges best describes your experience as a rising generation member?

**HWH:** Defining roles is very difficult for a lot of family offices. It was one that I struggled with as I grew into our family office, even having all the opportunity, all the upbringing, all the conversations and getting to the adult table at Thanksgiving pretty quickly. I was presented with so many opportunities and had tremendous training when we had an operating company. Then we sold our business and I had to figure out how I was going to provide value to my family. Determining how I would add value was difficult, but the process of defining my role led to me founding South Wake Capital.

We were able to work on how we structure investments and remove tax from a lot of our investments, which is fantastic for compounding over time. The key is to work with that younger generation to figure out not only how you define a role for them, but how they will succeed in this role. Is it the role they want to inherit? Are they passionate about it? My family did a fantastic job of letting us pursue roles that we saw ourselves in long term, which has contributed to a more inclusive family office.

**JMD:** What are some of the challenges your clients face when it comes to investment strategy, the fifth most common challenge of the rising generation? Are there any solutions that you can share with our audience today?

**HWH:** Well, I wish I had a silver bullet to answer that question. We work with a lot of family offices to identify





their specialization and how they can capitalize on that in the most effective structure for them. We plan for them to have as little tax drag as possible over the next 40 years. We work to place them in the best possible position to succeed at their specialty.

**JMD:** I think that leaves only the challenge of communication among generations. Mercy, in your experience, how could poor communication impact the inclusion of the rising generation in the family enterprise?

**MG:** When families fail to communicate, it often results in them failing to define future roles, to conduct any learning or development, or to navigate family dynamics. This leaves the family left with only the investment strategy, and if the family is not communicating, they may not be in alignment on that either. I love Mindy's example: For them to come in, I have to step back. I have seen too many times when a family patriarch or matriarch resists stepping back and is focused solely on the investment strategy. This usually goes hand in hand with a perception that the soft issues like communication, family inclusion and learning are a waste of their time.

**JMD:** I take from both of your individual experiences that the attention to family communication, or lack thereof, was a clear indicator of the future of your family offices. Communication among generations is necessary to define roles and articulate what is expected of the next generation and the qualifications for these roles, but communication also fosters an inclusive environment. If there is communication and there is a place for the rising generation, they feel valued. Open communication leads to engagement.

This brings us to our final topic of engaging with members of Gen Z in particular. We millennials have talked about our experience of working with older generations, advocating for more input and more responsibility. Now, for the first time, we are starting to work with Gen Z, and everyone is terrified. Mercy and Wayne, what, if anything, have you learned from working with them?

**HWH:** It is difficult, because they are still so young. They have not fully fleshed out what their lives are going to look like or how they want to be involved with family office operations or their own businesses. The most important thing is spending the time to find common ground with them and to have those important conversations about how they are a part of this family. We meet them at a place that makes sense to them.

This younger generation grew up with a lot more information and a lot more distrust of larger organizations than the older generations did. Many of them want to leave their family's advisors or not be part of their family office because they place much of the blame for the realities of our time on the older generations. Rather than shy away from Gen Z, be armed with this information and be proactive about having the conversations around transition planning, learning and development. If they have a strong sense of distrust and value safety, security and money, then include them in the decision-making process and make them feel included and heard. If they see a place for themselves, they will want to take on a more active role in the family office.

**MG:** Everything Wayne said is right on point. I just would add, in my family especially, it is easy to get wrapped up in the intergenerational differences. We are all terrified of Gen Z and their new rules and preferences. They are dictating so much. Then I look at my nieces and nephews, who are not that much younger than I am, and I realize that we also have a lot in common. This is all to say that at the end of the day, they are individuals. They live in your home. They are part of your family. You either raised them, served as their role models or grew up with them. Don't get caught up in the stereotypes. As important as it is to remember the generational characteristics, you also have to remember these are people you know. Build those personal relationships and connect with them on a personal level. Bring them in and treat them the way you wish you had been treated when you were brought into the family office.

**JMD:** Mindy, to bring it home, you gave us some statistics and data points about Gen Z when we started out. Are there any other data points or observations you would like to share with us?

**MKE:** Make no assumptions. We have shared all these sweeping generalizations and data about different generations, but Mercy's point is spot on. There might be things that we hear of a particular generation, like they are canceling skinny jeans, but it is really important to not make assumptions about individuals. You would not want someone to paint a picture of you and your entire future based on your teens to early twenties. Think about that and give them grace. Allow them time to grow up; make space for them to be involved.

One concept we have danced around is incremental inclusion. If it is a long way to them having a vote, how do you give them a voice? Voting is years away, but how do we invite them into the room and give them a seat at the table? Incremental inclusion really matters. I see a lot of families have the younger generations do different projects, serve on junior boards and act as board observers. There are a number of things you can do to include that generation, even when you are not sure yet what their specific role will be in the family.

**JMD:** Thanks to each of our panelists for their participation, candor and insights. I am hoping that everyone is now able to define the rising generation, understand the key traits and characteristics to keep in mind when communicating with them, create an inclusive environment, and perhaps show a little grace when working with Gen Z. ■

*Written by: Mariano Robert Beecher, Seth J. Mersky*

Tax authorities are beginning to regulate cryptocurrency in the absence of meaningful Congressional legislation or monetary policy. Revenue agencies, crypto owners, and observers do not always agree on how crypto fits into existing tax laws, which lack even basic crypto terminology. Still, the IRS and state governments will examine crypto transactions for all federal and state tax purposes, applying existing legal principles that might not be a perfect fit.

Crypto owners should carefully examine their crypto holdings and potential crypto transactions to determine how the existing rules apply and to prepare for any legal challenges.

In March 2022, President Biden ordered executive agencies to study the risks and benefits of digital assets and their underlying technology. Soon after, the Department of Labor warned retirement plan fiduciaries that crypto investment options may not meet plan fiduciaries' standards of care, and Treasury Department Secretary Yellen called for a comprehensive policy to contain risks associated with crypto in association with the U.S. dollar.

In spite of these developments, the Treasury has not issued substantive crypto regulations other than regulations that require enhanced reporting requirements.





Without formal rules from the Treasury, taxpayers must rely on existing IRS pronouncements, including Notice 2014-21 and Revenue Ruling 2019-24. These pronouncements provide the framework for the IRS's responses to Frequently Asked Questions (FAQs) about crypto published on its website. These crypto FAQs are meant to assist taxpayers in fulfilling their tax reporting obligations but do not carry the force of law.

The FAQs generally follow these accepted tax principles: 1) taxpayers must recognize the fair market value of virtual currency received in exchange for property (including other crypto) or services in their gross income; 2) the initial cost basis of virtual currency is the fair market value paid for such currency in U.S. dollars; 3) the character of gain or loss on a sale or exchange of crypto depends on whether the crypto is a capital or ordinary asset in the taxpayer's hands; and 4) taxpayers who donate crypto or receive crypto as a gift generally should not recognize income, subject to charitable deduction limitations.

The FAQs do not, however, provide complete clarity on a range of important issues. The FAQs state that "virtual currency," including crypto, is "property" for federal income tax purposes but also observe that virtual currency that is convertible into U.S. dollars may be treated as "money." The potential treatment of crypto as both "property" and "money" is one example of how current instructions may produce conflicting tax results under different facts.

For instance, paying a service provider in crypto may generate a gain or loss to the payor, based on a deemed sale of the crypto used to pay for the service. Thus, the payor could recognize taxable gain on the difference between the crypto's fair market value on the date of payment less the payor's cost basis. This result is inconsistent with treating crypto as "money" and may create significant tax liabilities for taxpayers using crypto to pay for goods or services.

Moreover, the FAQs on the IRS website have not kept pace with the emergence of new crypto technology and assets that carry different rights and utilities. In a recent case, *Jarrett v. United States*, the IRS determined that taxpayers Joshua and Jessica Jarrett had unreported income from a "staking" transaction—a form of crypto mining on the blockchain. The IRS's determination was likely based on IRS Notice 2014-21, which states that crypto mining is a taxable event.

Mining is a form of blockchain validation that rewards miners with crypto tokens for solving a complex mathematical puzzle. Staking is a way of earning rewards for holding certain crypto—you "stake" what you own for a chance to earn more. Staking is different from mining because the "stakers" or "validators" must own the crypto tokens they seek to create before they participate.

The Jarretts, who engaged in staking, paid the amount of tax the IRS determined was due and sued for a refund. They argued that staking is like baking a cake or writing a book—the baker or author is not taxed until the work created from the effort (in this case, a crypto token) is sold. They also argued that the new tokens they received in the staking transaction were not paid to them by a "person" as currently defined by federal tax laws.

In response, the Department of Justice offered the Jarretts a full refund, probably to avoid unfavorable precedent in this new realm. The Jarretts rejected the refund and are now requesting declaratory relief to enjoin the government from making the same arguments in future tax years against the Jarretts or other taxpayers. Crypto industry *amicus curiae* have filed briefs in support of the Jarretts' request.

The *Jarrett* case highlights two important points: (1) taxpayers must maintain sufficient documents to support their crypto positions under audit and in federal court, where IRS determinations are presumed to be correct and taxpayers bear the burden of proving otherwise; and (2) the IRS's informal guidance is no substitute for congressional legislation or formal Treasury regulations subject to proper notice and comment procedures.

Without formal rules for crypto, crypto owners should presume their crypto holdings are subject to

existing tax rules, including international information return reporting. Because crypto is increasingly held through non-U.S. funds or custodians, investors must identify the applicable international information reporting requirements (i.e., Foreign Bank Account Reporting, Specified Foreign Financial Asset reporting, Passive Foreign Investment Company reporting, and Controlled Foreign Corporation reporting) for foreign crypto holdings. This reporting likely applies both to "offshore" crypto holdings (e.g., crypto custodied by an offshore broker or institution) and interests in offshore crypto funds, which are becoming increasingly popular with sophisticated U.S. crypto investors. There are extremely steep penalties for failing to report offshore financial assets and accounts (as much as 50 percent of the value of the unreported assets), and the statute of limitations for assessment (generally three years) of an investor's entire tax return does not begin to run until all foreign information reports are filed.

Therefore, U.S.-based crypto owners must regularly gauge their level of exposure for both penalties and tax.

Specifically, U.S. persons who own non-U.S.-based crypto assets or fund interests are encouraged to engage qualified U.S. tax counsel to provide advice regarding federal tax planning for these investments. For example, without proper structuring in place, crypto held through an offshore vehicle or fund that constitutes a Passive Foreign Investment Company (PFIC) could be subject to a 50 percent or greater effective U.S. tax rate (plus additional penalties if the asset is not properly reported on one or more of the required international information returns normally submitted with a U.S. federal tax return).

Further, crypto owners engaging in complex transactions using financial instruments or derivative contracts should consider tax consequences before entering into deals using crypto. Recall that the IRS views crypto as "property" and not as a security, like stock in a corporation. Therefore, an exchange of crypto in a lending or swap transaction could be characterized as a taxable sale or exchange under current IRS guidance.

Finally, crypto owners are advised to consider their crypto holdings in their estate and gift planning. This includes planning not only for access to and succession of the assets in the event of disability or death but also to lessen the impact of the federal gift and estate tax imposed on U.S. persons' worldwide assets at a rate of 40 percent of fair market value (to the extent worldwide taxable gifts plus assets owned at death are in excess of the federal lifetime applicable exclusion amount of $12,060,000 per person for 2022). This includes carefully tracking cost basis, recording passwords for digital assets in estate planning documents, and considering sophisticated strategies such as funding trusts or making lifetime gifts of crypto assets to reduce U.S. federal gift and estate taxes. Many "traditional" estate planning attorneys are unfamiliar with the intricacies of planning for crypto assets; therefore, crypto owners are encouraged to seek counsel with an understanding of tax planning for crypto ownership.

The principles above also generally apply in determinations by state taxing authorities.

The taxation of crypto transactions may differ from state to state, especially in states that do not conform to federal tax laws. Although federal taxable income is generally the starting point for computing state taxable income, taxpayers must be prepared to classify crypto income as business or nonbusiness income and also address state rules for apportioning income. Without explicit federal or state laws in place, taxpayers must develop their own reporting positions and be prepared to defend them on audit.

Consequently, the taxation of crypto and crypto-like assets, such as non-fungible tokens (NFTs) and crypto derivative contracts, is largely unregulated and subject to specific fact-based determinations. The taxation of crypto largely depends on who holds the crypto, how it is held, and when. Different tax outcomes may arise depending on whether crypto is held by a creator, a dealer, a non-dealer, an investor, or a personal seller. For example, NFTs may be taxed as capital assets or as "collectibles"—although the current definition of "collectibles" does not include "intangible" assets like NFTs.



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Despite the uncertainty, the U.S. government has expressed clear interest in collecting information regarding crypto transactions. The 2021 Infrastructure Investment and Jobs Act created enhanced reporting requirements, and the Treasury's Financial Crimes Enforcement Network (FinCEN) has indicated that virtual currency may soon be subject to Foreign Bank and Financial Account (FBAR) reporting requirements. The IRS has issued John Doe summonses to crypto exchanges such as Coinbase to identify crypto owners and has expanded its Voluntary Disclosure Programs to allow taxpayers to disclose unreported transactions in virtual currency and avoid criminal prosecution.

In recent weeks, Congress has proposed granting primary regulatory authority over crypto to the Commodities Futures Trading Commission (CFTC), which considers crypto a commodity. This could potentially result in regulatory overlap between the CFTC and the IRS—adding extra compliance burdens for crypto owners.

In light of these developments, crypto owners are strongly advised to consult with a qualified tax professional to fully understand the existing rules and tax uncertainties surrounding crypto before they engage in sophisticated transactions. Also, it is clear that ignorance of the law and "burying one's head in the sand" will no longer be excusable by the IRS as reasonable cause for failure to comply with all existing U.S. federal tax and information reporting laws. ■

# MORE THAN A PRETTY PICTURE: UNLOCKING VALUE IN ARTWORK

*Written by: Melissa A. Passman*

The dramatic sale of Andy Warhol's ***Shot Sage Blue Marilyn*** (1964) at Christie's on May 9 for $195 million established this painting as the most expensive 20th-century work of art to sell at auction.

Art and money have been linked for centuries. The art market has ascended to true globalization, and given the full calendar of international art fairs coupled with the rise in infrastructure and the widespread acceptance of formalized legal agreements, greater attention is being focused on the financial aspects of artwork. There is now widespread acceptance of artwork as an alternative investment asset, to the point where a substantial number of wealth managers now address art specifically.

With the heightened attention on the financial value of artwork and the greater potential to unlock the value of an illiquid asset, art loans have gone from a niche category to a central part of business for a range of institutions, from large banks such as Bank of America and Morgan Stanley to boutique lenders, including Athena Art Finance and The Fine Art Group, and also the major auction houses (e.g., Christie's and Sotheby's). Deloitte estimates in its 2021 Art and Finance Report that outstanding art loans could reach $31.3 billion, with art-secured loans to private collectors potentially exceeding $25 billion. While art loans can provide the owners of artwork with a relatively low-cost source of

liquidity, those borrowers should be aware of other considerations for any artwork that becomes collateral.

Borrowers can range from individual collectors who hold their artwork directly or through entities to trusts, estates and charitable organizations. Borrowers will enter into art loans for a variety of reasons. In some instances, a borrower may seek to free up cash for additional investments in the financial markets. This may be particularly attractive in low-interest-rate environments, especially when a borrower is working with a large bank with which the borrower has an existing relationship. In other cases, collectors will seek to free up funds to acquire even more artwork. Regardless of the reason, there are now many different institutions that cater to the entire range of borrowers.

**How Does an Art Loan Work?**

In an art loan, the artwork serves as collateral for the loan. Loans can be either recourse or nonrecourse, meaning that the borrower's other assets may or may not be at risk in a default. Larger institutional lenders typically use nonrecourse loans, which generally allow the borrower to retain possession of the artwork. The institution will enter into a security agreement with the borrower and will file a financing statement with the appropriate U.S. jurisdiction to put other lenders on notice of its priority in the event of a default. With recourse loans, the lending institution may take possession and control of the artwork.

In the case of borrowers that are private foundations, it is essential that the board review any proposed art loan agreements for compliance with U.S. federal tax law and applicable state law governing tax-exempt organizations, particularly in connection with self-dealing transactions.

**a. General Requirements**

There are a number of requirements that attach to an art loan, depending on the lender's size and structure, but the following factors will generally apply to any art loan.

First, the lender will assess the value of the collateral. Each lending institution maintains different minimum valuations of the borrower's art collection before it will consider a loan. Some institutions will also take into consideration their current relationship with the client in terms of providing flexibility, particularly in the case of large banks. The institution will typically offer loans based on a 50% loan-to-value ratio on the collection of artwork as a whole. A bank making an art loan will likely require that the borrower maintain a minimum account balance with the bank as well. Borrowers should also be aware that new appraisals will be required during the term of the loan, with the risk that an appraised valuation could trigger a need to sell the artwork or liquidate other assets quickly to prevent a default based on the terms of the loan.

Second, the institution will consider the diversity of the collection, specifically the extent and quality of the collection, in determining the lender's ability to liquidate collateral in case of a default. Generally speaking, the art market disfavors large sales of work by one artist at one time, due to the risk of flooding the market. Therefore, excessive holdings by a single artist may prove difficult to liquidate, and a range of artworks provides better collateral. For boutique lenders, these requirements may be looser, although higher interest rates will likely apply.

Finally, the institution may consider the location of the artwork. Some institutions will only lend against works located in the United States, while others can lend against works in other countries.

It is important for any borrower considering an art loan to know that documentation of his or her ownership will be required (i.e., invoices, bills of sale and other evidence of ownership that demonstrates clear title). Borrowers should keep this information handy; ideally these documents are included as part of a larger collection management process. Given recent high-profile cases highlighting the dangers of opacity of ownership in certain art transactions, together with expanding sanctions in connection with Russia, lending institutions are paying even greater attention to due diligence concerning proof of ownership of artwork.



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**b. Ongoing Considerations During the Course of the Loan**

Even though the borrower may retain possession of the artwork, restrictions will apply as to what the borrower may do with that artwork. In the case of tangible artwork, such as a painting, sculpture or photograph, the institution will note the location of the artwork. In the due diligence process, the institution may approve of multiple locations that the collector may use to house the artwork, and the artwork may be stored in any of these locations with only prior notice.

A borrower should be aware that any change in ownership structure, such as moving artworks into a limited liability company or other legal entity, or in location, such as movement to a new residence, will require prior notification and potentially an amendment to the agreements governing the art loan and new legal filings to protect the lender's security interest.

Borrowers, especially collectors who are active in the marketplace, should be aware that pledged artwork cannot be placed for sale without prior consultation with the lender. In some cases, this can be addressed by substituting artwork of equal or greater value.

A borrower will need to maintain adequate insurance throughout the course of the loan, with the institution imposing certain requirements for coverage. The institution will also need to be named as an additional insured.

**Estate Planning Considerations**

Borrowers should also take note of any artwork that is pledged when thinking about the impact on their estate planning. For example, if artwork is functioning as collateral at the time of the owner's death, additional restrictions may apply before that artwork may be distributed from the estate. For artwork that is owned through a business entity, the valuation of the entity may be impacted by the valuation of the artwork. In the case of a boutique lender, the lender may have possession of the artwork in its storage facilities. For artwork that is subject to a pledge agreement with a charitable institution, borrowers need to ensure that the pledge agreement is consistent with the terms of the documents governing their art loan.

**Conclusion**

Art loans are a viable option for unlocking the value of an otherwise illiquid asset. When contemplating an art loan, owners of artwork should be prepared to work with an art advisor or otherwise consider their plans for artwork prior to entering into any formal agreement with a lender in order to make sure they understand the details of the arrangement and that their rights are adequately protected. ■

## THE ARCHEGOS SCANDAL: THE SEC RESPONDS

*Written by: Peter J. Bilfield, Alexis C. Coudert*

In late March 2021, Archegos Capital Management LP, the family office of Bill Hwang, a former New York-based hedge fund manager, defaulted on margin loans used to acquire total return swaps, a form of derivative contract. As a result, several prominent banks were forced to sell approximately $20 billion in securities to cover Archegos' obligations. This exposed a major regulatory blind spot related to the trading of swaps and other derivatives by institutional investors, including family offices.

Swaps are financial instruments that exchange one stream of income for another. They are a key way activist investors build up positions in companies

before other investors or the companies themselves become aware of their interest. There is currently no required reporting of swap positions. The public may access information on publicly traded stock holdings of institutional investors (such as hedge funds, mutual funds or family offices) by reviewing reports filed on forms 13F and 13D or 13G filed with the Securities and Exchange Commission (SEC). These forms serve to identify significant stock holdings of large institutional investors. Under current SEC regulations, investment firms that own shares designated as 13F securities with an aggregate fair market value of $100 million or greater must file a Form 13F detailing their portfolios every quarter. Investors whose beneficial ownership in a single corporation exceeds 5 percent in any class of equity securities must file a Form 13D or 13G. Family offices have historically avoided public disclosure by seeking confidential treatment from the SEC for reports filed on Form 13F. Investors, including family offices, however, are not currently required to report any purchase or sale of swaps.

Following the 2008 financial crisis, the Dodd-Frank Act implemented a rule known as the family office rule, which provides that a family office will not be considered an investment adviser under the Investment Advisers Act of 1940 (the Advisers Act). The rule provided that any company that (1) provides investment advice only to "family clients"; (2) is wholly owned by "family clients"; (3) is exclusively controlled by "family members" and/or "family entities"; and (4) does not hold itself out to the public as an investment adviser is excluded from the definition of "investment adviser" under the Advisers Act. The thought behind exempting family offices from SEC registration was that no third-party investor capital would be managed by a family office, subject to limited exceptions. As a result, Archegos was neither registered as an investment adviser with the SEC nor subject to any reporting obligations with respect to the financial instruments it was trading.

Archegos managed the personal assets of Hwang. Prior to founding Archegos in 2013, he ran the New York-based hedge fund Tiger Asia Management. In 2012, Hwang pled guilty to criminal fraud charges and paid $44 million to settle a civil insider trading case with the SEC. The SEC alleged that he used confidential information received in private placement offerings to short sell three Chinese bank stocks. The settlement also prohibited Hwang from associating with brokers, dealers, municipal securities dealers, municipal advisers, transfer agents or credit agencies. He was effectively banned from managing hedge funds. After the settlement, Hwang wound down Tiger Asia Management and opened Archegos. In April 2020, the SEC voted to vacate the ban outlined in the settlement.

As of 2020, Archegos managed assets in an amount estimated to be in the range of $10 billion. Archegos used total return swaps to build up massive positions in stocks including ViacomCBS Inc. and Discovery Inc. without triggering public disclosure requirements. This allowed Archegos to mislead some of the largest and most sophisticated financial institutions in the U.S. into continually extending credit. Archegos entered into swaps with Credit Suisse, Deutsche Bank, Goldman Sachs, Morgan Stanley, MUFG, Nomura, UBS and Wells Fargo, among others. To avoid market risk, many of the banks bought the securities underlying the swap and paid the gains on the shares to Archegos. As Archegos bought more swaps, the banks bought more shares, artificially inflating the stock prices of the securities underlying the swaps. The use of swaps allowed Archegos to maintain anonymity despite having exposure to the underlying securities that was well in excess of the normal disclosure thresholds. In its 2022 civil complaint against Hwang, the SEC stated that when combining its equity and derivative stakes, Archegos accumulated direct and indirect positions in stocks equal to more than 70 percent of the outstanding shares of GSX Techedu Inc., 60 percent of Discovery Communications and 50 percent of IQIYY Inc. These large, undisclosed positions enabled Archegos to manipulate the price of the securities.

In March 2021, the value of the securities underlying the swaps held by Archegos fell sharply, causing its lenders to make margin calls against the swap positions to cover the interest payments owed on



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the swaps. Archegos failed to meet the margin calls, which prompted a $20 billion stock sale, as each lender rushed to sell off its positions to satisfy Archegos' defaulting swaps. Nomura reported a $2.87 billion loss related to the winding down of these positions and changes in market prices. Credit Suisse reported a $5.5 billion total loss (which forced it to raise $1.9 billion in capital from investors to support its balance sheet). Though Goldman Sachs, Morgan Stanley, UBS and Deutsche Bank also extended credit to Archegos in the swap transactions, they liquidated their positions quickly and managed to avoid significant losses relative to the other lenders. In total, banks linked to Archegos suffered combined losses of around $10 billion.

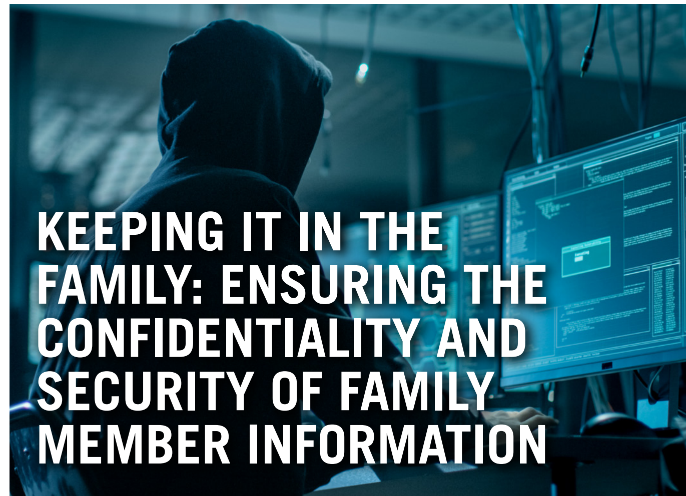
Following the Archegos collapse, there was concern that the SEC would regulate family offices directly and possibly eliminate the exclusion of family offices from the definition of "investment adviser" under the Advisers Act. Others worried that family offices and other market participants would be made subject to enhanced disclosure requirements under the Securities Exchange Act of 1934.

The SEC responded to the Archegos scandal in December 2021 with proposed new rules that directly addressed derivatives and security-based swaps. The new rules were aimed at all market participants, not just family offices. One proposed rule would prohibit fraudulent, deceptive or manipulative conduct in connection with all transactions in security-based swaps, including misconduct in connection with the exercise of any right or performance of any obligation under a security-based swap. A second proposed rule would prohibit any officer, director, supervised person or employee of a security-based swap entity, or any person acting under such person's direction, to take any action to coerce, manipulate, mislead or fraudulently influence the entity's chief compliance officer in the performance of their duties under the federal securities laws. A third proposed rule would require any person with a security-based swap position that exceeds a specified reporting threshold to promptly file a report disclosing its position and to amend those reports promptly in the event of any material change to a previously filed report. These proposed rules would require investors to disclose swap positions within one day if they exceed $300 million ($150 million in some cases) or 5 percent of a company. The large swap positions reported would also be made public. The goal would be to prohibit persons involved in securities-based swaps from manipulating prices or trading on insider information. Family offices involved in security-based swaps would fall within these proposed rules.

In addition to these rules, the SEC proposed that holders of certain cash-settled derivative securities will be deemed beneficial owners of the underlying equity securities if the derivative is held with the purpose or effect of changing or influencing the control of the issuers of the securities.

The SEC also proposed replacing year-end filing obligations to require that investors file within five business days of the end of the month in which their percentage ownership of any issuer exceeds 5 percent or within one business day of exceeding 10 percent. Holders of security-based swaps that exceed these thresholds will have to file a report detailing their position as well as any positions in a security or loan underlying a swap and any other instrument relating to the security or loan. There are, of course, concerns that accelerating the filing deadline for certain reports from 10 days to five days and requiring amendments be filed within one business day after a material change will cause significant compliance burdens on investors.

It is likely the SEC will in the future propose rules that attempt to balance the unique nature of a family office against the SEC's desire to reduce volatility in the market. It is possible that the SEC will seek to require registration of family offices as investment advisers, or, in light of Hwang's prior bad acts and insider trading violations, the SEC may want to consider requiring family office members to certify that they have not committed any securities law violations in the past in order to qualify for the family office exemption. ■




*Written by: William J. Roberts*

Data privacy and cybersecurity are on everyone's mind these days. Ransomware, hacks, and data breaches are rampant, affecting all economic sectors and hundreds of millions of individuals each year. Many readers of this newsletter likely know this all too well after having a cybersecurity incident at their business or receiving a breach notification letter in the mail. The implications of these incidents can be significant and costly, ranging from the loss of highly sensitive personal information to extortion, cyber fraud, wire fraud, reputational risks, lawsuits, fines, penalties, and more.

Family offices are not immune to this reality and in fact are often seen as soft targets for attack, given the information the family office holds on family members, the assets being managed, the frequency of fund transfers, and the relatively small size of many family offices. This combination puts them at particular risk. Why try to steal information from a Fortune 100 global bank when a smaller target with perhaps fewer defenses is available?

**Cybersecurity Risks**

Cybersecurity risks come in many forms, though a few are more pertinent to family offices. The cybersecurity risks discussed below are those most likely to affect a family office and the ones most likely to result in meaningful harm to family office members.

- *Ransomware:* A ransomware attack is one in which a cybercriminal infiltrates an organization's computer network, often as the result of a user clicking on an attachment or a link in a fraudulent email or the failure to secure the network properly against external parties. Once network access is obtained, the cybercriminal may lock the organization's files (preventing anyone other than the cybercriminal from accessing them) or steal copies of the organization's files and then threaten to publish them. In either instance, the cybercriminal may offer a sum of money (typically in cryptocurrency) that the organization could pay to regain access to its locked files or to prevent the files from being published. This extortion can be particularly dangerous for families of wealth, given the financial and reputational risks involved.

- *Cyber espionage:* Not every cybercriminal is after money—at least directly—from a family office. Some cybercriminals are more interested in learning about the family office's business plans, financial interests, strategies, and members. Other cybercriminals may be interested to learn where the children of family members attend boarding school or the flight schedule of a family member. As with ransomware, a cybercriminal will obtain access to the family office's computer network, but once access is obtained, the criminal will quietly go about collecting information for months (or even years). This information can then be sold to third parties seeking to block the family office's business dealings, media outlets looking to capitalize on an embarrassing or unfortunate incident, or financial criminals looking to siphon funds from the family office.

- *Masquerading:* A masquerading scheme is a type of cyber fraud in which the cybercriminal impersonates a family member or family office leader in order to trick a family office staff person into divulging confidential information or initiating a wire transfer to a fraudulent bank account. These frauds may be very



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sophisticated and often occur after months of studying both the target and the family member or other person being impersonated. The fraud often takes advantage of a change in operations or life events, such as parental leave or vacations. A successful masquerading scam can be devastating to a family office, resulting in the quick loss of significant funds or exposure of confidential information.

**Best Practices**

While cyber threats are prevalent and potentially very harmful to the family office and family members alike, there is quite a lot family office leaders can do to reduce the risk of an incident occurring and mitigate potential harms arising from an incident. The following best practices provide a road map for family office leaders looking to examine and improve their cybersecurity preparedness.

- *Understand applicable law:* Between federal and state laws, there are hundreds of data privacy and security laws on the books. Some of these laws apply to businesses and organizations generally, some to only specific sectors of the economy, and others in only certain limited contexts. These laws often govern how a business or organization may collect personal information and, once the business or organization possesses it, how the business or organization may use, retain, or re-disclose it. In light of this, it is vital for family offices to understand which laws they need to comply with, which laws they can safely ignore, and how to develop a compliance program to ensure the family office is satisfying applicable legal requirements. Examples of laws that may apply to family offices include laws protecting Social Security numbers, setting forth minimum cybersecurity protection standards, and outlining data breach response requirements. Family offices with members living abroad may also need to comply with the laws of those jurisdictions and other laws regarding the cross-border transfer of personal information. Compliance with these laws is the foundation of any cybersecurity and data protection program.

- *Information security review:* In collaboration with outside advisors, family offices should work to evaluate the sufficiency of the family office's current information security infrastructure (e.g., virus detection, firewalls, passwords). Based on the results of this review, a risk management plan should be created to identify opportunities for improvement, rank the opportunities by risk, and outline a process and timeline for implementing such improvements.

- *Incident response plan:* A family office should have in place a comprehensive incident response plan. This plan should outline how the family office intends to comply with applicable law, investigate an incident, bring in outside experts, notify affected family members, and take steps to protect family members from financial or reputational harm.

- *Have a team:* Complying with data privacy laws and ensuring data security are difficult for any organization, regardless of size or resources. To comply with the laws, protect family member data, and respond to a data security incident in a timely and appropriate manner, family offices should have a team of qualified advisors in place.

The laws and best practices described above are designed to safeguard family member information and reduce the likelihood of a data breach. Importantly, legal compliance and the adoption of best practices demonstrate that if a breach someday occurs, a well-prepared family office can act promptly and effectively in a manner consistent with the expectations of government regulators. Otherwise, a family office may be at much greater risk of government investigations, fines and penalties, and legal claims from family members. Since no family office can be absolutely breach-proof, all family offices should be breach-ready. ■

*Written by: Stephen Ziobrowski*

Like so many around the world, you may be looking for ways to support Ukraine and its people. Russia's ongoing invasion of Ukraine continues to be a frightening and devastating situation for so many people.

We have put together a list of organizations that are providing medical and humanitarian aid to the people of Ukraine affected by the ongoing violence of the Russian invasion. We are sharing this information in the case that you are looking for worthy causes to help during this time of critical need.

- Mercy Corps is in Ukraine, meeting urgent humanitarian needs. From Lebanon and Yemen to the Horn of Africa and beyond, they are responding in communities reliant on imported food and fuel as war in Ukraine and climate impacts exacerbate food shortages and extreme prices.
- Sunflower of Peace is a non-profit organization providing humanitarian and medical aid to Ukraine.
- Bstrong is a disaster relief fund that is providing supplies and housing to Ukrainian refugees at the borders of Poland, Romania, and Hungary.
- Unite With Ukraine is providing medical supplies, protective equipment, fuel, and communication systems to those fighting in the war to defend Ukraine.
- UNICEF is providing aid to the children and families affected by the violence in Ukraine.
- World Central Kitchen is partnering with chef José Andrés to provide meals to Ukrainian refugees in Poland and Romania, as well as the people in Ukraine.
- Razom for Ukraine is providing much needed medical supplies to Ukraine.
- International Medical Corps is providing primary healthcare and mental health services in Ukraine.

**Lex Mundi Develops Resource Center to Provide Guidance in Ukraine Crisis**

In light of the humanitarian crisis unfolding in Ukraine, Lex Mundi has mobilized to provide the Lex Mundi Ukraine Crisis Resource Center. It draws upon the knowledge of its member firms globally to produce guidance on the rapidly developing situation. They share country-specific guidance for Ukrainian citizens on relocation and access to social services.

The resource center also includes information on the legal requirements to establish non-profits and NGOs for those that plan to create new entities or otherwise expand operations. The goal is to provide a single point of reference that accounts for ongoing developments across countries and supplements individualized pro bono services. Visit the Lex Mundi Ukraine Crisis Resource Center regularly for updated information. ■



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Named "Law Firm of the Year - Trusts & Estates Law" by *Best Lawyers*, 2021

Named "Best Law Firm – Estates and Trusts" category (2020) and "Highly Commended" in categories for "Best Private Client Law Firm" (2017 and 2019) by *Private Asset Management* (PAM)

Named "Law Firm of the Year" by *Family Wealth Report*, 2017

Named a Family Office "Industry Awards" Finalist in the "Client Initiative" category by *Wealth Management*, 2017 & 2019

Finalist in "Accounting, CPA or Law Firms Serving Family Offices" category for Family Wealth Alliance Best in the Industry Awards, 2018

Shortlisted as USA Private Client Team of the Year – East Coast, 2020 and ranked Nationwide, and Band 1 in CT and MA, in Private Wealth Law by *Chambers HNW*, 2016-2020

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