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All in the Family

In the late-18th and 19th Centuries, Mayer Amschel Rothschild established five family banks, in Frankfurt, London, Paris, Vienna, and Naples, and assigned one to each of his five sons. His action secured the assets of Europe's wealthiest family and preserved his descendants' control of their wealth and affairs for generations. It gave the sons the tools to do business on their own and to cooperate with one another.

In the present-day U.S., as in 19th-century Europe, a family bank can preserve wealth, provide family members with independent access to capital, and more--it can substantially lessen the taxes that wealthy families pay on occasions of inter-generational wealth transfer. The U.S. has also democratized the idea of a family bank: A savvy investor can begin a family bank with as little as $1 million.

For the Rothschilds, in a day when government regulation of banking was light to nonexistent, a bank was a business that did banking. In the 21st century U.S., a bank is much more complicated and much more heavily regulated. But when established and managed properly, a family bank keeps assets within the family, brings thoughtful stewardship to the family endowment, and encourages a family's legacy to thrive. It is not a traditional brick-and-mortar lending institution, not a partnership, and not a corporation, but it does operate as an entity formally independent of the family.

How does a family bank differ from a commercial bank or a family asset-management company? There are three notable distinctions between a family bank and an outside institution. First, the family bank's primary mission is the protection and stewardship of assets as the family sees fit. It can provide loans without a traditional institution's constraints and conditions. So, for example, if an heir's credit isn't perfect, that could be irrelevant within the family bank, but would be a red flag at a traditional one. Second, commercial banks and asset-management companies are likely to offer a breadth of services and products that fall outside of the scope of traditional lending; the family bank does not. Third, under certain conditions, family banks can forgive a loan, perhaps even give the heir the loaned amount as a gift; whereas traditional institutions require repayment of loans--complete with interest and penalties when the agreement isn't honored.

How does a family bank work on a practical level? Imagine that a family patriarch (doubling as president of a family bank) is approached by his enterprising son for start-up capital. The son shows up with a solid business plan, and has loan approval from outside institutions. If the family bank green-lights his endeavor, the interest on his loan can be lower than a traditional bank would charge. Family banks typically offer preferred rates based on the IRS' Applicable Federal Rate and subject to standard regulation.

This may encourage entrepreneurship and push young heirs to strike out on their own. If they succeed, they may win big. If they lose, the blow could be softened, because a family bank can forgive the loan. If the venture fails, the son's credit rating isn't hurt. Education is another area for the power of loan forgiveness. Suppose the patriarch's daughter seeks an education loan. Her father may insist on measurable performance and provide the

incentives to help her focus. The terms of her loan might offer very low interest and easy repayment, but the debt could grow teeth if she drops out of school. On the other hand, the family bank could forgive the loan if she achieves a specified grade-point average.
Loans won't always be excused, however, because the family bank's capital must be maintained and grown for the structure to work.

Creating a Family Bank can be complicated. The patriarch often starts with a limited-liability corporation and an irrevocable trust. He becomes general partner of the corporation and grantor of the trust. The LLC will "wrap" the trust to take advantage of larger gift-tax exclusions. At present, tax-free gifts to the bank could be as high as $8 million per person, or $16 million for a couple. Over time, other people could also fund the bank's endowment, including family members, other family trusts, or a family business. Family banks can exercise more flexibility than traditional institutions, reduce borrowing costs, protect capital from personal creditors and litigators, and underscore a family's values and legacy. They also can exert financial control, such as through loan conditions, as well as provide tax advantages.

Family banks' founders set business rules that can be designed to reduce arbitrariness and calm the emotions that may surround a family's financial interactions. If the firstborn daughter requests seed capital for her start-up business, her twin brother wants money to pay for law school, and the youngest son wants to purchase a sports car, trust documents can codify family-bank policies. The potential borrowers will know the purposes and intentions for which loans will be approved, and on what terms.
The family bank can also make outright gifts. A bank founded by a family with a strong attachment to education may offer to match the earned salary of any family member who goes into teaching.

The patriarch usually forms a family bank to protect family assets. Suppose a married couple borrows from the husband's family bank on an interest-only loan to purchase a home. Instead of a typical mortgage, the loan might vest ownership of the home in the bank's name. If the couple were to divorce, the family bank would enforce its lien, take possession of the home, and leave the wife with no claim.

Governance of a family bank is open to various possibilities. The bank will have an advisory committee whose members may include professionals or just members of the immediate family. The final group may be made up of family and nonfamily members, and there may be a separate review committee serving to educate and prepare heirs for eventual decision making. Those on the review committee could have the opportunity to sit in on advisory board meetings and develop experience learning how the review process works. Depending on the family's values and altruism, heirs may be encouraged to join a helping profession that does not pay a high salary but makes a contribution to the community. The family bank might match the salary 100% (or a different percentage) tax-free.

Both a traditional bank and a family bank are obliged to ensure proper transfers of wealth and compliance with IRS rules. However, the family bank has the power to enforce stipulations on heirs and the recipients of gifts. As mentioned, loan conditions may be contingent upon personal values, such as an emphasis on achievements in education, contributions to philanthropic causes, or demonstrating business acumen through due diligence.

These same factors may apply to gifts, as well. Heirs may need to adhere to a particular code of conduct in concert with the head of the family: i.e., not abusing drugs or alcohol, completing a certain level of education, or volunteering for a political, charitable, or other organization or cause of significance to the family.

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Steven Abernathy and Brian Luster co-founded The Abernathy Group II Family Office which counsels affluent families on multi-generational asset protection, wealth management, and estate and tax planning strategies. The firm manages the personal financial and legal affairs of families as if they were a business endeavor. Abernathy and Luster are regular contributors to several publications and blogs. Contact them here.