WRMarketplace

An AALU Washington Report

The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led ***by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone.*** **WRMarketplace #17-20** was written by Greenberg Traurig Shareholder **Jonathan M. Forster.**

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TOPIC: Private Trust Companies: The What, Who, How, & Why.

MARKET TREND: With the trust departments of many financial institutions disappearing, and those that remain declining to manage trusts with "non-traditional" assets or even life insurance policies, families with complex legacies are looking for fiduciary alternatives that can provide the requisite services for the long haul.

SYNOPSIS: Families with substantial legacies often need long-term trust structures to assist them in the management and preservation of these legacies over multiple generations. Yet, these families often encounter difficulties in finding trustees who are willing to handle complex assets and will remain committed to carrying out the family's mission over time. Private trust companies offer a customized solution for both perpetual fiduciary services and centralized family governance that can accommodate the family's needs over generations.

TAKE AWAYS: For the right family, a private trust company can provide customized fiduciary services for the long-term management of non-traditional trust assets, like operating businesses, real estate, and private equity interests. It can implement an integrated and cohesive investment approach for generations of family members, potentially increasing investment opportunities and cost-efficiencies by consolidating the family's purchasing power. Families with substantial and complex legacies who are struggling to find suitable trustees may find that private trust companies are their full-service solution.

Families with substantial legacies often need long-term trust structures to assist them in the management and preservation of their legacies over multiple generations, but may encounter difficulties in finding trustees who are willing to handle complex assets. Private trust companies may be an option not only for providing perpetual fiduciary services, but also for providing a centralized family governance system that can accommodate the family's changing needs over generations.

WHAT IS A PRIVATE TRUST COMPANY?

A private trust company ("**PTC**") is a trust company formed for the specific purpose of placing all major family assets under the ownership and control of a single entity – the PTC – as trustee.

WHO MAY WANT A PTC?

Families who may make suitable candidates for PTC generally have:

- ***Substantial (over $100 million) and complex assets***, such as private businesses, real estate, or equity interests, which they want to ensure remain in the family for generations;
- Several trusts, entities, and charitable plans in place but potentially in several different jurisdictions and with a mix of individual and corporate fiduciaries in office;
- A desire to consolidate their planning under the laws of a single jurisdiction with predictable tax consequences and robust trust, creditor protection, and business laws (such as Delaware, South Dakota, Nevada, to name a few).

Often, the family will have implemented their existing planning in a series of "one-off" transactions and selected jurisdictions and fiduciaries based on convenience, existing business relationships, etc. all of which has failed to provide a coordinated and unified succession plan for the management and investment of all family assets after the current generation passes.

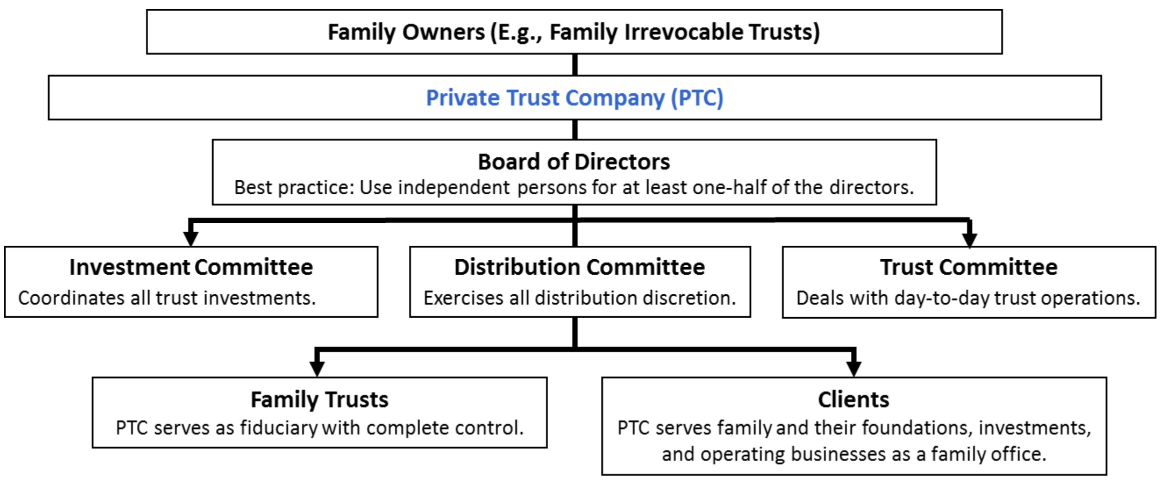
HOW DOES IT WORK?

The PTC is owned by a single family, typically through one or more family dynasty trusts, so that the PTC may continue in perpetuity. As trustee, the PTC generally provides fiduciary and wealth management services for all underlying family trusts. Typically, the PTC's operations are controlled through a board of directors (**Board**), which includes family members and trusted advisors, such as lawyers, financial advisors, and accountants, who are sufficiently close to the family to ensure that the family's intentions are understood (best practice recommends that at least half of the directors should be persons not "related or subordinate"[1] to the grantors or beneficiaries of any trust of which the PTC is a trustee). The PTC's bylaws or other governing documents should contain guidelines for the appointment of qualified directors (i.e., total number of directors, family vs. independent, years of experience, technical knowledge, term, etc.).

The Board addresses the creation and staffing of several committees, typically including:

1. A ***Distribution Committee***, which handles decisions regarding all discretionary distributions from any trust (see discussion below for structuring issues related to transfer tax considerations);
2. An ***Investment Committee***, which reviews and recommends how the PTC should invest the trust assets under its management; and
3. A ***Trust Committee***, which addresses day-to-day trust operations and oversees trust administration by trust officers and/or outside service providers.

Family members serving on the Board can participate in PTC decisions, including the creation and staffing of committees, and senior family members may appoint more junior family members who will, at a future date, become principal beneficiaries of the trust (again, see discussion below about the proper structure for such appointments). In this way, the PTC serves as a vehicle to educate junior family members about the property and business interests owned by the family trusts and to instruct them in the management of those assets. A common structure for a PTC may look like the following:



WHY USE A PTC?

Family Needs. To help illustrate why a family may need a PTC, assume John, the patriarch of the Doe family, has (1) an irrevocable life insurance trust (**ILIT**) with John's brother as trustee, which holds a life insurance policy on John's life and has a split-dollar loan arrangement with John, (2) an irrevocable grantor trust with John's business associate as trustee ("**Business Trust**"), to which John sold shares in Doe Corp., an S corporation in which John's children, Amy, Beth, and Charles, are active (but not his son Daniel), for a long-term note, (3) Trusts 3, 4, and 5, a series of short term grantor retained annuity trusts (**GRATs**) with X Bank as trustee, which pay annual annuities to John and then will pass in further trusts to John's children, and (4) Trust 6, an irrevocable grantor charitable lead annuity trust (**CLAT**) benefiting the Doe Family

Foundation, with X Bank as trustee, which John funded with various marketable investments.

Clearly John has a complicated plan with numerous moving parts. Yet, the mix of trustees, particularly the individuals who likely do not have the requisite experience or a perpetual existence, and the lack of a clear succession plan to perpetuate the family business while ensuring fair treatment of all family members, will likely lead to confusion and conflict after John is gone, possibly resulting in the sale of family assets, the dissolution of the foundation, etc. A PTC may address these issues for the Doe family as follows:

Customized & Centralized Family Governance. Corporate trustees may lack familiarity with trust beneficiaries and a family's overall goals and values, particularly over time. Using a PTC, however, allows families to select the PTC's personnel and officers, develop a family succession plan, determine the most suitable jurisdiction for managing family wealth, and continue ownership of private operating businesses in trust. A PTC also brings the benefits of a corporate hierarchical management structure to family asset management. Thus, a PTC can operate like an institution trustee but tailor services to a family's unique financial and non-financial goals. For example, in John's case, since the PTC will have a global view of all trusts and how assets will be distributed among the Doe descendants, it can help implement a succession plan for the Doe Corp. to pass to active descendants while ensuring equal treatment for passive family members.

Responsiveness. Because it serves only one client (the family), a PTC is highly responsive to family needs and offers increased flexibility compared to a traditional institutional trustee. For example, financial institutions are often reluctant to serve as fiduciaries of trusts with non-traditional assets (including life insurance), since they cannot apply their traditional compensation model (e.g., a percentage of assets under management) to such trusts. Further, financial institutions may wish to manage trust assets solely on their custodial platform, limiting options for diversification. If willing to serve as trustee of complex assets, these trustees may need to follow rigorous and time-consuming approval processes to initiate business decisions, complete major transactions, or implement other trust planning, such as decanting assets to a new trust, delaying annual GRAT annuity payments (e.g., within the allowable 105-day timeframe), or even holding concentrated stock positions, all of which may cause delays and lost profits.

PTCs, however, allow the selection of multiple outside investment managers and access to independent advice, because the PTC has no interest in selling its own financial products. Further, for trusts invested in privately-held companies, a PTC can react more promptly to major transactions than a traditional institutional trustee. In the Doe Family case, if a sale of the Doe Corp. becomes desirable, the PTC can act more flexibly in the sale negotiations on behalf of the Business Trust, since it does not need approval from an outside risk management department. Also, the PTC can more easily coordinate, track, and pay all interest, annuity, and other payments when due, ensuring proper administration of these plans which is crucial to their success.

<u>Continuity & Multi-Generation Planning</u>. Because PTCs can be unlimited in duration, they can provide multi-generational asset management, fiduciary services, and general family governance. Further, the PTC can provide administrative and other services to family members and entities, such as tax compliance, financial recordkeeping and bill paying, investment services, etc., effectively doubling as a family office. In this manner, a PTC can pool the purchasing power across a family group, resulting in better services for a better price than family members could obtain individually. These features offer continuity for the orderly transfer of wealth, governance, core family values, and other goals from one generation to the next.

<u>Risk & Asset Management</u>. PTCs can be ideal vehicles for managing risk. By consolidating all major family assets under the management and control of one entity, the PTC is able to identify, assess, and analyze risk holistically rather than in a piecemeal fashion. Further, each investment decision is made based on its merits in relation to the family's entire portfolio of assets, rather than in isolation, ensuring cohesive asset management. For example, with the Doe Family, the PTC can assess diversification across all trusts, allowing certain trusts (like the ILIT, Business Trust, or the GRATs) to hold concentrated positions in a family business, private equity, or similar investments while the other trusts are diversified. Further, the PTC can collectively monitor and assess the performance of all planning transactions (split-dollar arrangements, GRATs, CLATs, installment sales) to ensure that hurdle rates are being achieved and to make investment adjustments as needed.

<u>Personal Development of Younger Generations</u>. A PTC can enhance the personal development of younger family members by introducing them to financial management and investment principles. It also offers younger family members the opportunity to work together with senior family members on PTC matters. Senior family members can serve as mentors to educate and train younger family members. Specific roles can be tailored for younger family members to involve them in PTC operations. For example, younger family members may participate in and observe board meetings or may even be given specific tasks to accomplish. Over time, junior family members will become well-versed in the PTC's operations and the family's goals so that they may succeed senior family members.

WHAT ARE THE CONSIDERATIONS?

<u>Governing Jurisdiction</u>. Selecting the jurisdiction in which to form and operate a PTC is an important and complex consideration, as compliance with applicable jurisdictional requirements is crucial. Jurisdictions with PTC statutes include Delaware, Nevada, New Hampshire, South Dakota, and Texas, just to name a few, and requirements can vary significantly from state to state. Although some states do not regulate PTCs, they may limit the services the PTC can provide and PTCs generally will not qualify for an exemption from SEC registration. Other questions to consider when selecting a PTC jurisdiction will include:

- *Minimum Capital Requirement:* How much is required to capitalize the PTC (e.g., Delaware requires $1 million; South Dakota requires $200,000);

- *Application Time & Fee:* How long does it take to process the PTC application and what is the cost?
- *Annual Reporting & Fees:* What are the annual reporting requirements and is there a corresponding fee?
- *Interstate Trust Activities:* Can the PTC engage in trust activities in other states (e.g., serve as trustee of a trust located in another jurisdiction)?
- *Perpetual Existence:* Does the jurisdiction allow perpetual/dynasty trusts? And are there limits on the duration of the PTC itself?
- *Office/Residency Requirements:* Must the PTC have an office in the jurisdiction where established?
- *Tax/Trust/Creditor Protection Laws:* Does the state provide suitable tax treatment for the PTC and the trusts and does it have robust trust, business, and creditor protection laws?

In sum, choosing the most appropriate jurisdiction to establish a PTC depends on a variety of factors and will vary depending on each family's personal circumstances.

Structure. Some of the common structural requirements for operating a PTC, such as the minimum number of directors, will be set forth in the applicable law of the chosen jurisdiction. However, the structure of the PTC is also affected by transfer tax laws. In structuring the PTC and the trusts for which it will serve as trustee, it is critical to ensure that the PTC qualifies as an independent trustee which is not "related or subordinate" to the trust's grantor, as defined in the Internal Revenue Code ("**Code**") and the relevant Treasury Regulations.[2]

Notice 2008-63. Following a series of private letter rulings,[3] in 2008, the IRS issued Notice 2008-63, requesting comment on a proposed Revenue Ruling on the transfer tax results for family members that create PTCs to serve as trustee of trusts in which such family members are grantors and/or beneficiaries. The Notice outlined two factual situations: (1) one where the PTC is created in a state with specific statutory requirements, and (2) one where the PTC is created in an unregulated state, but the PTC's governing documents (a) contain the same requirements as the state statutes in Situation 1 and (b) create an Amendment Committee, which has the sole authority to amend the PTC's governing documents and which must have a majority of committee members who are neither family members nor related or subordinate to any PTC shareholder. In both situations:

- The PTC must create and delegate to a discretionary distribution committee (**DDC**) the sole authority to make all decisions regarding discretionary distributions from trusts for which it serves as trustee; **and**
- No DDC member may participate in the DDC's activities with regard to any trust of which that member or the member's spouse is a: (i) grantor, (ii) beneficiary, or (iii) owes a legal obligation of support to a beneficiary of that trust.

Assuming the above restrictions are met for a PTC, either by the governing law or the governing documents, the proposed Revenue Ruling holds that the PTC's appointment or service as the trustee of a family trust alone will ***not cause***:

- The inclusion of the trust assets in a grantor's gross estate under Code §§2036(a) or 2038(a) (dealing with retained interests of the grantor);
- The inclusion of the trust assets in a beneficiary's estate under Code §2041 (regarding general powers of appointment);
- The grantor's transfer to that trust to be an incomplete gift under Code §2511, or any distribution from the trust to be a gift by any DDC member; or
- Any effect to the GST tax exempt status of that trust or change the trust's inclusion ratio.

Note that this proposed Revenue Ruling has not yet been finalized, and the IRS is no longer issuing private letter rulings with regard to the transfer tax consequence of a PTC.[4] However, best practice would recommend structuring the Distribution Committee of a PTC to comply with the above until final guidance is issued.

Compliance, Formalities, & Costs. PTCs not only must comply with state requirements but also must implement governing and operational documentation, including a business plan, a policies and procedures manual, committee guidelines, etc. Initial expenses for set-up as well as on-going costs for accounting, audits, outside investment advice, administration services, and operational expenses will be incurred and should be compared to the costs of continuing to rely on outside trustees.

TAKE AWAYS

For the right family, a private trust company can provide customized fiduciary services for the long-term management of non-traditional trust assets, like operating businesses, real estate, and private equity interests. It can implement an integrated and cohesive investment approach for generations of family members, potentially increasing investment opportunities and cost-efficiencies by consolidating the family's purchasing power. Families with substantial and complex legacies who are struggling to find suitable trustees may find that private trust companies are their full-service solution.

DISCLAIMER

NOTES

[1] Under Code §672(c), the term “related or subordinate party” means any nonadverse party who is (1) the trust grantor's spouse if living with the grantor; (2) any one of the following: the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

[2] See Note 1 for the definition of “related and subordinate” under the Internal Revenue Code.

[3] E.g., in PLR 200523003, PLR 20531004, and PLR 200548035, the IRS privately ruled that even though a grantor was a shareholder in a PTC, the use of that PTC would not result in estate tax inclusion of the trust assets which the PTC owned as trustee, since the grantor had no control over those assets due to certain “firewall” provisions that precluded his control). However, note that PLRs apply solely to the taxpayer to whom they were issued and cannot be relied upon by other taxpayers.

[4] See Rev. Proc. 2017-3, §§5.01(11)-(13).

(11) Section 2036.—Transfers with Retained Life Estate.—Whether the corpus of a trust will be included in a grantor's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the grantor's family.

(12) Section 2038.—Revocable Transfers.— Whether the corpus of a trust will be included in a grantor's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the grantor's family.

(13) Section 2041.—Powers of Appointment.— Whether the corpus of a trust will be included in an individual's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the individual's family.