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Family office news - issue 1: An update on private trust companies

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Many family offices now use, or are considering the merits of using, a limited purpose private trust company (PTC) to act as trustee for family trusts.

This strategy involves organizing a limited purpose trust company in a user-friendly state such as Wyoming, South Dakota or (recently) New Hampshire where it is possible to create such a company at reasonable expense. Normally, the activities of these PTCs are limited to acting as trustee for a single family or a limited number of related families.

There are interesting advantages of PTCs for ultra high net worth families that include:

- Costs of incorporating and running a PTC are often significantly lower than fees charged by institutional trustees, especially where assets of significant value are held by the trust
- Keeping the commissions in the family – using trustees' commissions to pay for family office functions
- Ability to invest more aggressively than would be acceptable to a bank trustee
- Limited liability for family members making trustee decisions
- Ability to control the selection of a professional staff to manage investments and administration of family trusts
- Ability to hire and fire independent service providers
- Assuring that the trustee is dedicated exclusively to the family interest rather than to its own profitability
- Ability to retain family company stock without diversification
- Ability to provide for orderly succession
- Allowing all branches of the family to participate in the management of family assets
- Providing a training ground for younger family members to learn about investments
- Providing a vehicle for family governance
- Providing a vehicle for keeping family assets concentrated over the generations in order to achieve "economy of scale," with advantages such as negotiated service fees and investment in funds with high entry thresholds.

For these reasons, a PTC is an excellent alternative for a high net worth family to consider. But PTCs must be carefully structured in order to avoid unnecessary tax exposure. Family control, one of the very features that make PTCs appealing, can also give rise to serious tax problems.

If a family member is found to possess certain powers indirectly through control of the PTC, the trust may be treated as a grantor trust (Code §§ 671 ff.), included in the estate of the grantor as a retained interest or power (Code §§ 2036 – 2038) or included in the estate of a beneficiary as a general power of appointment (Code § 2041). In some circumstances the appointment of a PTC might also give rise to generation skipping transfer tax exposure (Code §§ 2601 ff.).

The solution is to include restrictions or "firewalls" within the PTC structure that limit the participation of a family member in his or her trust. However, there is no clear guidance as to how far these measures must go in order to be effective[1].

The easy answer in the past was to seek a private letter ruling (PLR) before naming the PTC as trustee of family trusts. However, the IRS has recently announced that it will shortly issue a revenue ruling on the tax consequences of a PTC that serves as trustee of family trusts, and in the meantime will not entertain further filings for PLRs[2].

Clearly, the safest course would be to wait for the revenue ruling before naming your PTC as trustee of your family trusts. However, if waiting is not a viable option, we would urge an ultra-conservative approach. There is no way to predict what the revenue ruling might say, and you don't want to be caught on the wrong side of it. If it turns out that your firewalls were an overkill, they can always be moderated in the future.

The by-laws or other internal rules should appoint committees to exercise tax-sensitive discretion and should prohibit any family member from attending meetings of such committees even as a non-voting member when the committee is exercising its discretion over a trust of which the family member is grantor or a beneficiary. It may even be prudent for the family member not even to be in the building when the decisions are made.

It is also important to consider a system where it cannot be argued that family members have reciprocal powers-A controls B's distributions and B controls A's distributions-so that they can arguably influence their own distributions indirectly.

In fact, the decisions that give rise to tax exposure are generally the distribution decisions, and these can easily be left in the hands of truly independent parties. PTCs are not established for the purpose of controlling distributions. Control of business decisions is the primary reason for creating a PTC, and control of business decisions by family members is not generally a tax issue.

[1]For an excellent discussion of restrictions and firewalls see “Anticipated: Ruling on PTCs” by John P.C. Duncan and Michael R. Conway Jr., Trusts & Estates, July 2006.

[2]Treasury's Office of Tax Policy and Internal Revenue Service, 2006-2007 Priority Guidance Plan, August 15, 2006.