PRIVATE CLIENT & OFFSHORE SERVICES - USA

Family banks: personal commitment, accountability and multi-generational mentoring

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Introduction

Over the past decade, matriarchs and patriarchs of successful families, whether from the United States or elsewhere, have increasingly been concluding that their children are sufficiently provided for and have thus shifted the focus of their family's largess to a broader group of individuals, such as grandchildren, siblings, nieces and nephews and family by affinity. In the United States, this is the result of a wave of large gifts to children and grandchildren in 2010 and 2012 and the tremendous success of estate freezing gift strategies over the past decade, along with the passage of various tax laws increasing the US estate, gift and generation-skipping transfer tax exemptions to a current $11.4 million per person ($22.8 million per married couple). Outside the United States, this increase in scope of family largess is also attributable in part to the unexpectedly resounding success of gifts previously made to children and grandchildren over the past decade; it is also due to an increasing awareness of the material advantages in establishing trusts in the United States that use extremely powerful, substantive trust laws of various US states,(1) regardless of whether a trust's beneficiaries are US or non-US individuals (for further details, please see "Establishing 'foreign' trusts in the United States").

How are these families executing on the expansion of their family's largess? By creating so-called 'family banks' to provide capital to that broader group of individuals for business ventures, public-spirited projects and knowledge in a way that fosters personal commitment, accountability and multi-generational mentoring.

What are family banks?

Family banks are typically trusts that are funded for a customised set of purposes. They are used by or for families with the expectation that their flexible design will financially support one or more of the following types of activity:

- businesses, active investments and career opportunities of particular interest to family members (whether by blood or affinity) and others; and
- public policy advocacy and personal philanthropy that is more flexible than would be permitted for a tax-qualified charity.

Family banks make capital available for purposes that blend personal and family values and promote active family participation in both wealth building and philanthropy, without being confined to traditional models of organising family wealth or philanthropy. Those who establish family banks recognise that controlling or using capital to build businesses, improve the lives of family members and others and expand knowledge is usually more satisfying than merely funding a person's lifestyle. Family banks emphasise the tangible and intangible returns on a family's investment and active participation. Further, they provide younger generations with the opportunity to learn decision-making and financial skills from actual, hands-on practical experience and from role models and mentors.

That said, family banks are not a typical family wealth management strategy. They are not intended to fund personal consumption or living expenses *per se* and there is no sense of economic entitlement. Similarly, they are not intended to fund traditional charity, because, unlike a tax-qualified charity, there are few constraints on the family's ability to define the use of funds, whether to finance profit-making endeavours or public-spirited projects. Notably, family banks are also not so-called 'incentive trusts'; there is no 'if you do x, then you get y' formula.

Rather, a family bank is a pool of capital available to family members and others who have demonstrated that they can put that capital to productive use. Potential beneficiaries must demonstrate that they meet these requirements before receiving any assistance, similar to a grant process or a loan application process for a small business. Further, they must meet these requirements on an ongoing basis, thus creating a system of accountability from inception to completion.

Why create family banks?

Those who create family banks often do so because they believe that it is more satisfying to use capital to build businesses or careers, improve the lives of family members and others and expand knowledge. These individuals believe that, through financial support and mentoring, they can:

- foster commitment in their family members (whether by blood or affinity) and others and encourage them to actively participate in building wealth, being philanthropic and enhancing their communities; and
- provide a user-friendly process by which the individuals above can receive multi-generational mentoring from peers or qualified family members.

What do family banks look like?

Family banks can be customised to fit a family's agenda. While the family bank's design must accommodate tax costs, particularly in the United States, but also certain other jurisdictions if applicable, tax issues should not limit the use of funds, as is the case in most family wealth structures today. The following elements are commonly inherent in family banks:

- Structure – many individuals create family banks using trusts as the basic platform. As such, an administrative trustee will often be responsible for meeting certain basic requirements (eg, filing tax returns, if required, and arranging custody for assets) and an independent protector will replace fiduciaries that are not performing properly. Decisions regarding whether and to what extent to grant applications for funds, as well as ongoing monitoring of prior grants (including investments), are handled by a committee consisting of specially appointed peers, colleagues and qualified family members who possess in the aggregate the necessary investment and mentoring skills and relationships with the family.
- Funding – many individuals fund their family banks with direct gifts of liquid assets and venture capital investments that no longer have capital commitments or vesting issues. Thus, family banks are often funded without future good and services tax consequences, and for those in the United States, at little to no gift tax cost. In each case, there is no charitable deduction to reduce or avoid taxes.
- US taxation – family banks, if they are to benefit US persons, are generally established as US domestic non-grantor trusts and are subject to US federal income taxes, and distributions to applicants are taxed to the beneficiaries as income in a particular year to the extent that the family bank has distributable income for that year. Loans to individuals are subject to the usual tax rules for intra-family loans, while direct investments in new businesses are treated favourably (as expected). In all events, while taxes are sometimes the cost of flexibility, they are always manageable as a practical matter (for further details on US taxation of trusts please see the "Overview (March 2018)").
- Non-US taxation – income earned by a family bank established as a foreign grantor trust by a non-US grantor is attributed to the grantor during the grantor's lifetime and so is generally subject only to US withholding tax on US source income. Distributions to applicants are not taxable to the beneficiaries, although US beneficiaries will have a Form 3520 reporting requirement. Following the death of the non-US grantor, the family bank is already situated in the United States and can continue as a US domestic non-grantor trust if the trust benefits US persons. If the family bank is to benefit non-US persons, even more flexibility is possible.
- Reporting – family banks can be created as so-called 'quiet trusts' if the individual decides that this is appropriate. Thus, the broad groups of individuals listed as beneficiaries are not entitled under applicable law to receive reports or accounts. Instead, those reports are sent to the protector, who is responsible for:
  - receiving those reports and acting accordingly on behalf of those beneficiaries; and
  - ultimately determining when and to what extent beneficiaries should become informed about the family bank.

Required input on family bank designs

Individuals wishing to establish a family bank must answer certain fundamental questions concerning how the family bank will operate:

- Should beneficiaries be limited to family members or include non-family members (eg, close friends, community leaders, business associates and deserving individuals who nevertheless would not qualify as 'charity cases' (for a tax-qualified grant from a private foundation))?
- Should funding money-making enterprises or careers that are expected to be relatively lucrative be the only permissible use of funds, a preferred use of funds or simply one factor when considering a beneficiary's request for funds?
- If not limited to funding money-making enterprises or careers, should the purposes nonetheless be limited to careers or activities that would allow the recipient to support a modest lifestyle (albeit, if the original funds were provided on a soft-loan basis, without the ability to repay those funds out of the recipient's earnings)?
- Should funds be disbursed in order to preserve and enhance the family bank's assets with returns from successful projects or should it be expected that over time the risk and other characteristics of funded projects will tend to reduce the family bank's assets (absent extraordinary success on a given project)?

While difficult, answering these types of question is necessary for the proper design of a family bank, and more importantly, for families to have a long-term, healthy relationship with, and understanding of, available resources.

Risks inherent in family banks are manageable

There are, of course, risks in the family bank structure. If operated improperly, a family bank could become a mere incentive trust used to control conduct rather than promote commitment, personal growth and family and community values. Further, potential conflicts can arise between using funds to enhance family members' careers and funding the dreams of individuals in less fortunate circumstances, because of the powerful temptation to use family money for experimenting with business ventures and careers and conserving personal money for future personal use. Further, there is a generalised risk that beneficiaries may diverge from the intended purpose of the bank or misuse funds because there are few inherent checks and balances supplied by the law, as there are with personal trusts and tax-regulated charitable trusts and foundations. These risks, while undeniable, are readily manageable with thoughtful design and operation of the family bank and sufficient built-in flexibility and adaptability.

Comment

Now is the opportune time to consider a family bank for US and non-US individuals who want to provide well-managed and effective assistance to their family, certain family friends and others who they would be unable to help without a family bank, as these family banks make it possible to help individuals pursue entrepreneurial opportunities, venture philanthropy and knowledge in a structured and more-likely-to-succeed manner.

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Endnotes

(1) For further details on state trust laws please see "State law allows settlors to modify trustee duty to inform and report", "State law allows settlors to tailor trust investment objectives", "State law allows modifications of irrevocable trusts", and "Planning for non-US trusts using state decanting laws".