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Special Session III-B
Simplifying the Complex: Demystifying Directed Trusts, Family Offices and Private Trust Companies

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Michael's practice focuses on the unique aspects of Delaware trust law, including directed trusts, dynasty trusts, asset protection trusts and all aspects of the validity, construction and administration of Delaware trusts. Michael routinely works with clients across the country to transfer the situs of trusts to Delaware and to modify trusts to take advantage of Delaware's favorable trust law. Michael drafts, reviews and comments on Delaware trust agreements for local and out of state clients and provides legal opinions on the validity of trusts under Delaware law.

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John has devoted a significant portion of his professional life to drafting and consulting on legislation to facilitate the development of trust laws and single and multi-family private trust company laws. He was the principal author of New Hampshire's 2007-2008 trust and trust company law revisions, following up as the principal draftsman of revised Nevada and Tennessee trust and trust company acts, propelling all three states into the top five trust law states. He has also written or advised on significant contributions to financial institutions and trust laws and regulations for Illinois, South Dakota, Wyoming, Texas, North Carolina, Delaware and Florida.

John has published regularly in professional journals including the Spring, 2011 ACTEC Journal, "Achieve the Promise-and Limit the Risks-of Multi-Participant [Directed] Trusts", with his wife, Anita Sarafa, and articles in Trusts and Estates Magazine, in particular "The Private Family Trust Company: The Most Customized Financial Institution Ever Devised", and the inaugural issue of The International Family Offices Journal, "The Private Trust Company Comes Back on Shore – In the United States". He has regularly presented in major forums.

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Kim is an ACTEC Regent, Past President of the Chicago Estate Planning Council, and Estate Planning & Legal Issues Domain Chair for the UHNW Institute. She also serves on the Founders' Committee for The University of Chicago Center of Law and Finance. She serves on advisory boards for multiple local philanthropic organizations.

Kim received her B.A., with distinction and departmental honors in Psychology, from Stanford University and her J.D. from The University of Chicago Law School. She is an AEP® (Distinguished) and a 21/64 Certified Advisor.

Special Session III-B

Simplifying the Complex: Demystifying Directed Trusts, Family Offices and Private Trust Companies

Section 1

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SLICING AND DICING FIDUCIARY DUTIES AND RESPONSIBILITIES THROUGH DIRECTED TRUSTS

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I. Introduction

Although directed trusts have exploded in popularity over the past decade they are not a new concept. Delaware statutorily recognized the power of the trustor of a trust to restrict a trustee's authority to dispose of or otherwise deal with specified trust assets for more than thirty-five years. 12 Del. C. § 3313 (65 Laws 1986, ch. 422, § 5). Prior to the statute, going back to the early 1900s, Delaware adopted the practice of allowing directed trusts to accommodate its wealthiest families.

In their earliest form, directed trusts tended toward the limitation of a trustee's power to sell specific trust assets without the consent or written direction of a person not serving as trustee. Today the limitations on a trustee's authority often extends to all of the trustee's discretionary powers over trust assets including voting decisions, management decisions, distribution decisions and other decisions previously solely within the realm of the trustee's discretion.

The desire of wealthy families to preserve their control over the stock of the corporation founded by their ancestors and the recognition that today's trusts often hold new kinds of unique trust investments have driven the issue of directed trusts. In fact, trustees faced with the fiduciary duty to diversify trust assets and deal impartially with income beneficiaries and remainder beneficiaries welcome the ability to limit their liability through the use of directed trusts.

The result has been the creation of a statutory framework authorizing a trustor (or the trustee and the trust beneficiaries through appropriate trust modification proceedings) to include in trust instruments a new regime for the administration of specific trust assets. In addition to the traditional trustee, the new regime often includes trust advisers or Co-Trustees with exclusive authority over specific trust powers. See, Rachel Emma Silverman, *How Many Trustees Do You Need?* Wall St. J., July 12, 2007, at B5. It is the recognition of Trustor autonomy and freedom of disposition that led to the Uniform Directed Trust Act ("UDTA").

II. What is a Directed Trust?

A. Definition

A directed trust is a trust that removes one or more powers or discretions traditionally held by the trustee and vests that power or discretion in a person who is either a special trustee or not a trustee at all. The power or discretion can relate to investment decisions, management decisions, distribution decisions and any other decision affecting the administration of the trust. The starting point for the creation of directed trusts is the statutory framework that permits them coupled with the carefully worded language of the trust instrument.

B. Statutory Recognition

1. UTC

a. Section 808(b) of the Uniform Trust Code states:

If the terms of a trust confer upon a person other than the trustee of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power **unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty** that the person holding the power owes to the beneficiaries of the trust. [emphasis added]

2. Third Restatement

a. Section 75 of the Third Restatement of Trusts states:

...[I]f the terms of a trust reserve to the settlor or confer upon another a power to direct or otherwise control certain conduct of the trustee, the trustee has a duty to act in accordance with the requirements of the trust provision reserving or conferring the power and to comply with any exercise of that power, **unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries**. [emphasis added]

3. UDTA

a. The UDTA has been adopted in 15 states.

b. Section 6 of the UDTA recognizes, that subject to Section 7, (a) the terms of a trust may grant a power of direction to a trust director, and (b) unless the terms of a trust provide otherwise: (1) a trust director may exercise any further power appropriate to the exercise or nonexercise of a power of direction granted to the director; and (2) trust directors with joint powers must act by majority decision.

c. A comment to Section 6 of the UDTA provides that, without limiting the definition of a "power of direction", the drafting committee specifically contemplated that subsection (a) would validate terms of a trust that grant a power to a trust director to:

(1) acquire, dispose of, exchange, or retain an investment;

(2) make or take loans;

(3) vote proxies for securities held in trust;

(4) adopt a particular valuation of trust property or determine the frequency or methodology of valuation;

(5) adjust between principal and income or convert to a unitrust;

(6) manage a business held in the trust;

(7) select a custodian for trust assets;

(8) modify, reform, terminate, or decant a trust;

(9) direct a trustee's or another director's delegation of the trustee's or other director's powers;

(10) change the principal place of administration, situs, or governing law of the trust;

(11) ascertain the happening of an event that affects the administration of the trust;

(12) determine the capacity of a trustee, settlor, director, or beneficiary of the trust;

(13) determine the compensation to be paid to a trustee or trust director;

(14) prosecute, defend, or join an action, claim, or judicial proceeding relating to the trust;

(15) grant permission before a trustee or another director may exercise a power of the trustee or other director; or

(16) release a trustee or another trust director from liability for an action proposed or previously taken by the trustee or other director.

4. The Delaware Model

The foregoing provisions for directed trusts should be compared with the more detailed provisions adopted by Delaware and a few other states.

a. Delaware law recognizes a broad class of advisers including direction advisers, consent advisers and trust protectors. Where one or more persons are given authority by the terms of a governing instrument to direct, consent to or disapprove a fiduciary's actual or proposed investment decisions, distribution decisions or other decisions of the fiduciary, such persons shall be considered to be advisers and fiduciaries when exercising such authority unless the governing instrument otherwise provides. 12 Del. C. § 3313(a).

b. In all cases, there may be an adviser who is a "trust protector".

... the term "adviser" shall include a "protector" who shall have all of the power and authority granted to the protector by the terms of the governing instrument, which may include but shall not be limited to:

(1) The power to remove and appoint trustees, advisers, trust committee members, and other protectors;

(2) The power to modify or amend the governing instrument to achieve favorable tax status or to facilitate the efficient administration of the trust; and

(3) The power to modify, expand, or restrict the terms of a power of appointment granted to a beneficiary by the governing instrument. 12 Del. C. § 3313(f).

C. Types of Advisers

The particular adviser language included in the trust instrument depends upon the purpose for which the trust is created and the reason why the adviser is appointed. There are innumerable reasons why trustors create directed trusts and it would be impossible to include in this outline all of the ways in which a trust may be directed. Most directed trusts do, however, fall into certain categories and the most common are illustrated below.

1. Investment Direction Adviser

The most common form of directed trust is one that is directed with respect to investment decisions. Often trustors find it desirable to bifurcate traditional trustee responsibility through the appointment of an Investment Direction Adviser that has the ability to direct the trustee with respect to the investment of the trust assets.

The most common reasons for the use of an Investment Direction Adviser are: (1) the trust will be funded with a concentrated position that a corporate trustee would be uncomfortable holding, or (2) the trustor would like to appoint a trustee to administer the trust and be responsible for distribution decisions while allowing the trustor's financial advisor to make all investment decisions for the trust. By designating a trustee in a jurisdiction that allows directed trusts the trustor is able to bifurcate these traditional trustee responsibilities and vest all investment authority in the third party adviser.

2. Special Holdings Direction Adviser

Another common use of the directed trust structure is the bifurcation of investment responsibilities only with respect to a certain class of assets. For example, the trust may be funded with a combination of marketable securities as well as an ownership interest in the trustor's family business. The trustor would like to appoint a corporate trustee for the trust and for the corporate trustee to manage and invest the marketable assets however neither the trustor nor the corporate trustee want the corporate trustee to participate in any decisions relating to the trustor's family business. It is possible to appoint an adviser (i.e. Special Holdings Direction Adviser) that has the ability to direct the trustee as to the special assets while at the same time allowing the trustee to be responsible for the investment and management of the marketable securities held in the trust.

Another reason to include the position of Special Holdings Direction Adviser applies when the trustor wants to retain investment control over the trust by serving as the Investment Direction Adviser of the trust. It is possible that a trust may be funded with certain assets (i.e., life insurance policies insuring the trustor's life or voting stock of a controlled corporation under IRC Section 2036(b)) where the trustor's retention of investment control over the trust assets could result in the trust assets being includible in the trustor's estate for Federal Estate Tax purposes. In this situation it is desirable to carve out the problematic assets and define them as "Special Holdings." The trustor can retain the ability to direct investments with respect to the non-Special Holdings and a third party adviser can be appointed to direct the trustee as to the investment of the Special Holdings.

3. Distribution Adviser

Another common use of the directed trust structure is to bifurcate traditional trustee responsibilities through the appointment of a Distribution Adviser who has the ability to direct the trustee when and how the beneficiaries will receive distributions from the trust based on the standards contained in the trust instrument. Often a trustor will want a corporate trustee to be responsible for the investment and administration of trust assets but will want someone who is more familiar with the beneficiaries and their particular needs to decide when distributions should be made to the beneficiaries. This may be particularly true where the beneficiaries have special needs or substance abuse issues. It is also a desirable tool in situations where the trustor has specific ideas about how and when distributions will be made to the beneficiaries. The trustor could appoint a family member or trusted adviser, who will have much more intimate knowledge of the family and their circumstances than the corporate trustee, to direct the trustee regarding trust distributions.

4. Trust Protector

One of the more powerful positions that can be created in the directed trust structure is that of Trust Protector. Often the Trust Protector is vested with key powers that will allow the trust instrument to remain flexible as circumstances change over time. Typical Trust Protector powers include the following:

a. The ability to amend the trust for certain purposes;

b. The power to change the situs and governing law of the trust;

c. The power to appoint, remove and replace the trustee and other trust advisers;

d. The ability to convert the trust from a grantor trust into a non-grantor trust for income tax purposes; and

e. The power to expand the permissible class of beneficiaries of the trust.

III. Liability and Standard of Care

A. Directed Trustees and Direction Advisers

1. UDTA

a. Liability of Trustee

(1) Section 9(a)

(a) Subject to subsection (b), a directed trustee shall take reasonable action to comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1), and the trustee is not liable for the action.

(2) Section 9(b)

(a) A directed trustee must not comply with the trust director's exercise or non-exercise of a power of direction or further power under Section 6(b)(1) to the extent that **by complying the Trustee would engage in willful misconduct.** [emphasis added]

(b) The term "willful misconduct" is not defined by the UDTA.

(3) Section 11(a)

(a) Unless the terms of a trust provide otherwise, a trustee does not have a duty to monitor a trust director; or inform or give advice to a settlor, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director.

b. Liability of Direction Adviser

(1) Section 8(a)

(a) A trust director has the same fiduciary duty and liability in the exercise or nonexercise of the power (A) if the power is held individually, as a sole trustee in a like position and under similar circumstances; or (B) if the power is held jointly with a trustee or another trust director, as a co-trustee in a like position and under similar circumstances; and (2) the terms of the trust may vary the director's duty or liability to the same extent the terms of the trust could vary the duty or liability of a trustee in a like position and under similar circumstances.

(2) Section 11(b)

(a) Unless the terms of the trust provide otherwise, a trust director does not have a duty to monitor a trustee or another trust director; or inform or give advice to a settlor, beneficiary, trustee, or another trust director concerning an instance in which the director might have acted differently than a trustee or another trust director

(3) Section 5(a)(5)

(a) One issue that often arises is whether a powerholder directing a trustee as to a particular function is serving in a fiduciary or non-fiduciary capacity. The UDTA recognizes the need to permit a trust director to serve in a non-fiduciary capacity but only for federal (not state) tax purposes. Section 5(a)(5) of the UDTA permits the terms of a Trust to provide that a power may be held in a non-fiduciary capacity but

only when the "power must be held in a non-fiduciary capacity to achieve the settlor's tax objective under the United States Internal Revenue Code of 1986".

2. The Delaware Model

a. Liability of Trustee

(1) When a trustee acts in accordance with the directions of a trust direction adviser, the trustee will only be liable for its "willful misconduct".

(2) Direction Provision:

If a governing instrument provides that a fiduciary is to follow the direction of an adviser or is not to take specified actions except at the direction of an adviser, and the fiduciary acts in accordance with such a direction, then **except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable** for any loss resulting directly or indirectly from any such act. 12 Del. C. § 3313(b). [emphasis added] The term willful misconduct means intentional wrongdoing and not mere negligence, gross negligence or recklessness. 12 Del. C. § 3301(g) and 12 Del. C. § 3301(h)(4). The term wrongdoing means malicious conduct or conduct designed to defraud or seek an unconscionable advantage. 12 Del. C. § 3301(g).

(3) The statutory standard of care required of a fiduciary acting on the consent of a Consent Adviser is only somewhat broader. When a trustee acts with the consent of a Consent Adviser, the trustee will only be liable for its "willful misconduct" or "gross negligence".

(4) Consent Provision:

If a governing instrument provides that a fiduciary is to make decisions with the consent of an adviser, then **except in cases of willful misconduct or gross negligence on the part of the fiduciary, the fiduciary shall not be liable** for any loss resulting directly or indirectly from any act taken or omitted as a result of such adviser's objection to such act or failure to provide such consent after having been requested to do so by the fiduciary. 12 Del. C. § 3313(c). [emphasis added]

(5) The statutory protection afforded trustees of directed trusts would be diminished if advisers or beneficiaries could sue the trustee on the theory that the trustee had a duty to keep them informed and to impart to them knowledge affecting their interests in the trust so they could perform their duties as advisers or otherwise protect their beneficial interests in the Trust.

(6) Duty to Monitor, Communicate and Inform:

Whenever a governing instrument provides that a fiduciary is to follow the direction of an adviser with respect to investment decisions, distribution decisions, or other decisions of the

fiduciary or shall not take specified actions except at the direction of an adviser, then, except to the extent that the governing instrument provides otherwise, **the fiduciary shall have no duty to monitor the conduct of the adviser; provide advice to the adviser or consult with the adviser; or communicate with or warn or apprise any beneficiary or third party concerning instances in which the fiduciary would or might have exercised the fiduciary's own discretion in a manner different from the manner directed by the adviser.** 12 Del. C. § 3313(e). [emphasis added].

(7) Recognizing the multiple roles played by different fiduciaries, Delaware adopted 12 Del. C. § 3317 in 2010. The statute states that, except as provided in the governing instrument, each trust fiduciary (including trustees, advisers, protectors, and other fiduciaries) has a duty to keep the other fiduciaries reasonably informed about the administration of the trust with respect to the specific duty or function being performed by that fiduciary. The statute further provides that a fiduciary who requests and receives such information has no duty to monitor the conduct of the other fiduciary, provide advice or consult with the other fiduciary or communicate or warn any beneficiary or third party concerning instances in which the fiduciary receiving the information would or might have exercised the fiduciary's own discretion in a different manner. 12 Del. C. § 3317.

b. Liability of Direction Adviser

(1) One aspect of the directed trust structure that is often overlooked is the potential liability of the adviser appointed to direct the trustee with respect to investment decisions, distribution decisions or other decisions of the trustee. Absent express language in the governing instrument such adviser is deemed to serve in a fiduciary capacity and will be held to the prudent person standard. However, Delaware law permits a trust agreement to exculpate and indemnify a fiduciary (including an adviser) for all acts other than those committed with willful misconduct. 12 Del. C. § 3303(a).

(2) A question often arises as to whether it is permissible to allow a trust adviser directing a trustee as to a particular act to serve in a non-fiduciary capacity. As mentioned above, the presumption under Delaware law is that the trust adviser is serving in a fiduciary capacity. 12 Del. C. § 3313(a). However, it is possible to opt out of fiduciary status by expressly providing that trust adviser is serving in a non-fiduciary capacity in the trust instrument.

(3) It is typical for trust advisers, including Trust Protectors, to serve in a fiduciary capacity. However, there are certain powers that are conferred upon the Trust Protector which can only be exercised in a non-fiduciary capacity (i.e., the ability to convert the trust from a grantor trust to a non-grantor trust for income tax purposes, the power to expand the permissible class of beneficiaries of the trust or the power to substitute assets of equivalent value). Directed trusts are often drafted to provide that although the Trust Protector is serving in a fiduciary capacity there are certain powers that will be held and exercised by the Trust Protector in a non-fiduciary capacity.

c. The Excluded Co-Trustee

(1) Under Delaware law it is possible to bifurcate or trifurcate traditional trustee responsibility at the trustee level as opposed to the trust adviser level.

(2) 12 Del. C. § 3313A

(a) If the terms of a governing instrument confer upon a co-trustee, to the exclusion of another co-trustee, the power to take certain actions with respect to the trust, including the power to direct or prevent certain actions of the trustees, the excluded trustee must act in accordance with the direction of the co-trustee granted the power, and shall have no duty to act in absence of such direction and is not liable, individually or as a fiduciary, for any loss resulting directly or indirectly from compliance with the direction unless compliance with the direction constitutes willful misconduct on the part of the directed co-trustee.

(b) The excluded trustee has no duty to monitor the conduct of the co-trustee, provide advice to the co-trustee or consult with or request directions from the co-trustee. The excluded trustee is not required to give notice to any beneficiary of any action taken or not taken by the co-trustee whether or not the excluded trustee agrees with the result.

(c) The co-trustee holding the power to take certain actions with respect to the trust shall be liable to the beneficiaries with respect to the exercise of the power as if the excluded trustee were not in office and shall have the exclusive obligation to account to the beneficiaries and defend any action brought by the beneficiaries with respect to the exercise of the power.

IV. Tax Planning with Directed Trusts

A. The Springing Completed Gift Asset Protection Trust

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 (the "2017 Act"). The 2017 Act increased the exemptions for federal estate tax, gift tax and generation-skipping (GST) tax to $11,180,000 per person for 2018. The exemptions are indexed for inflation, which for 2024 means the exemptions are $13,610,000 per person. The tax rates on estates, gifts and GST transfers above the exemption is forty percent (40%).

As a result of the 2017 Act, clients are presented with an estate planning opportunity to transfer significant amounts of wealth out of their estate without the imposition of transfer taxes. However, even the wealthiest clients are often concerned with giving such large amounts of money away based on the fear that they may need to access the assets in the future.

One option that clients may have is to create a trust in a jurisdiction which allows for self-settled asset protection trusts. A client can make a transfer to a trust established in such a jurisdiction, to which the client allocates gift tax exemption, that provides that the trustee may distribute income and principal from the trust to a class of beneficiaries, that includes the client, in the sole and absolute discretion of the trustee. The client can also allocate GST exemption to the trust which would allow the trust to continue in perpetuity if established in a jurisdiction such as Delaware which has abolished the rule against perpetuities.

Provided below is the authority for why a client should be able to create a trust in a jurisdiction which allows for self-settled asset protection trusts, retain a beneficial interest in that trust, make a transfer into the trust completing the gift for federal gift tax purposes and prevent the assets from being includible in the client's gross estate for federal estate tax purposes merely because the client is a discretionary beneficiary of the trust. However, clients engaging in this strategy must have some appetite for risk as there is no guarantee that the assets of the trust will not be includible in the client's estate upon their death due to their retained discretionary beneficial interest. As a result, many clients are interested in creating a "Springing Completed Gift Asset Protection Trust" to mitigate the potential estate tax exposure.

1. <u>Grantor's Retention of Control</u>

The first issue to address is whether the transfer of assets to the trust constitutes a completed gift for federal gift tax purposes.

a. Is the Transfer to the Trust a Completed Gift?

(1) A transfer is incomplete for federal gift tax purposes if the grantor retains sufficient dominion and control over the property. Treas. Reg. § 25.2511-2(b).

(2) If an individual creates a self-settled trust in a jurisdiction where his or her creditors may attach the assets, the grantor has retained sufficient dominion and control over the assets because under local law the grantor is able to relegate his or her creditors to the assets of the trust. See Rev. Rul. 76-103; Rev. Rul. 77-378; and Paolozzi v. Commissioner, 23, T.C. 102 (1954). As such, the trust must be established in a jurisdiction that allows for self-settled asset protection trusts thereby preventing the grantor from being able to relegate his or her creditors to the assets of the trust.

(3) Revenue Ruling 76-103.

(a) In Revenue Ruling 76-103, the grantor created an irrevocable trust which provided that during the grantor's lifetime the trustee could distribute income and principal of the trust in its sole and absolute discretion to the grantor. The trust further provided that upon the death of the grantor, the remaining principal of the trust was to be distributed to the grantor's issue. The trust was determined to be a discretionary trust under the laws of the State in which the trust was created and the entire property of the trust was subject to the claims of the grantor's creditors.

(b) Revenue Ruling 76-103 concluded that as long as the trustee continues to administer the trust under the laws of the State subjecting the trust assets to the claims of creditors, the grantor retained dominion and control over the trust property. As such the grantor's transfer of the property to the trust does not constitute a completed gift for federal gift tax purposes.

(c) Revenue Ruling 76-103 also concluded that if the grantor were to die before the gift becoming complete, the date of death value of the trust property would be includible in the grantor's gross estate for federal estate tax purposes under Section 2038 of the IRC because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust.

(4) Revenue Ruling 77-378

(a) In Revenue Ruling 77-378, the grantor created an irrevocable trust which provided that the trustee was empowered to pay to the grantor such amounts of the trust's income and principal as the trustee determines in its sole and absolute discretion. Under the applicable State law, the trustee's decision whether to distribute trust assets to the grantor was entirely voluntary. Furthermore, the grantor was prohibited from requiring that any of the trust assets be distributed to the grantor nor could the creditors of the grantor reach any of the trust assets.

(b) Revenue Ruling 77-378 concluded that the grantor had parted with dominion and control over the property that the grantor transferred into the trust. Although the trustee had an unrestricted power to pay trust assets to the grantor, the grantor could not require that any of the trust assets be distributed to the grantor nor could the grantor utilize the assets by going into debt and relegating the grantor's creditors to the trust. Revenue Ruling 77-378 therefore concluded that the grantor's transfer to the trust was a completed gift for federal gift tax purposes.

b. Sections 2036(a)(2) and Section 2038

Another concern relates to whether the Trust assets will be includible in the grantor's estate under Sections 2036(a)(2) and Section 2038 of the IRC because of the grantor's retained power to terminate the Trust by relegating the grantor's creditors to the entire property of the Trust.

(1) Section 2036(a)(2) of the IRC provides that a decedent's gross estate includes property transferred in trust other than for full and adequate consideration if the decedent retained the right to designate the persons who shall possess or enjoy the property or income therefrom. IRC § 2036(a)(2).

(2) Section 2038 of the IRC provides that a decedent's gross estate includes property transferred in trust other than for full and adequate consideration if the decedent retained the right to alter, amend or revoke the trust. IRC § 2038.

(3) Both Sections 2038(a) and 2036(a)(2) of the IRC have been used to cause a self-settled trust whose assets are subject to the claims of the grantor's creditors to be included in the grantor's estate. See Rev. Rul. 76-103; Estate of Paxton, 68 TC 785 (1986).

2. Grantor's Retained Beneficial Interest.

Another issue to address is whether the grantor's mere retention of a discretionary beneficial interest in the Trust will cause the assets to be included in the grantor's gross estate under Section 2036(a)(1) of the IRC.

a. Section 2036(a)(1).

(1) Section 2036(a)(1) of the Internal Revenue Code provides that a decedent's gross estate shall include property transferred in trust other than for full and adequate consideration if the decedent retained the right to income from the property. IRC § 2036(a)(1).

(2) The use, possession, right to income or other enjoyment of the transferred property is considered as being retained by the decedent to the extent the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent. Treas. Reg. § 20.2036-1(b)(2).

(3) The right to the income need not be express but may be implied. Treas. Reg. § 20.2036-1(1)(i).

b. Revenue Ruling 2004-64 (the "2004 Ruling").

(1) The 2004 Ruling specifically states that the trustee's discretion to reimburse the grantor for the income tax liability combined with other factors including, but not limited to: (i) an understanding or preexisting arrangement between the grantor and the trustee regarding the trustee's exercise of its discretion; (ii) a power retained by the grantor to remove the trustee and name a successor trustee; or (iii) applicable local law subjecting the trust assets to the claims of the grantor's creditors may cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.

(2) The 2004 Ruling seems to address the concern raised in the completed gift asset protection trust context regarding whether the grantor's mere retention of a discretionary beneficial interest is sufficient to cause inclusion of the trust assets in the grantor's estate under Section 2036(a)(1) of the IRC. Following the rationale contained in the 2004 Ruling, the trustee's mere ability to distribute assets to the grantor should not alone cause inclusion of the assets in the grantor's gross estate for federal estate tax purposes.

3. The Private Letter Rulings

Two Private Letter Rulings have been issued addressing the transfer tax consequences associated with self-settled asset protection trusts. See PLR 9837007 and PLR 200944002. Both Private Letter Rulings involved the use of Alaska trusts established by Alaska residents.

a. PLR 9837007 (the "1998 PLR").

(1) In the 1998 PLR the grantor created a trust for the benefit of herself and her descendants. The trustee could, but was not required to, distribute income and/or principal from the trust to any of the beneficiaries.

(2) The 1998 PLR concluded that the transfer to the trust would be a completed gift for federal gift tax purposes because a creditor of the grantor would be precluded from satisfying claims out of the grantor's interest in the trust. However, it expressly did not rule on whether the assets would be included in the grantor's estate for federal estate tax purposes.

b. PLR 200944002 (the "2009 PLR").

(1) In the 2009 PLR the grantor created a trust for the benefit of himself, his spouse and descendants. Distributions of income and principal could be made to the beneficiaries of the trust in the sole and absolute discretion of the trustee.

(2) The 2009 PLR again concluded that the transfer to the trust was a completed gift for federal gift tax purposes. However, the 2009 PLR also concluded that the trustee's discretionary authority to distribute income and/or principal to the grantor does not by itself cause the trust to be includable in the grantor's estate for federal estate tax purposes under Section 2036(a)(1) of the IRC.

(3) The analysis contained in the 2009 PLR is based primarily on the 2004 Ruling. Both the 2004 Ruling and the 2009 PLR conclude that the assets will not be included in the grantor's estate under Section 2036(a)(1) under the theory that the trustee's discretionary authority to distribute assets to the grantor will not by itself result in estate tax inclusion. However, neither the 2004 Ruling nor the 2009 PLR address whether Sections 2036(a)(2) or 2038 of the IRC will cause inclusion in the grantor's estate under the theory that the grantor could terminate the trust by relegating the grantor's creditors to the entire property of the trust. Sections 2036(a)(2) and 2038 of the IRC should not cause the assets to be included in the grantor's estate as long as the trust is created in a jurisdiction allowing for self-settled asset protection trusts as the grantor will be prohibited from relegating his or her creditors to the assets of the trust.

4. The "Springing" Feature.

a. Most clients engaging in completed-gift asset protection trust planning are doing so simply based on a concern that if certain unforeseen circumstances arise they could potentially need access to the funds within the trust. If life works out the way the client anticipates it will there will never be a need for a discretionary distribution to be made from the trust to the client. However, as discussed above, the client's mere ability to receive discretionary distributions from the trust by being named as a current beneficiary of the trust creates some possibility (even if it is remote) that the trust assets would be includible in the client's estate for federal estate tax purposes upon the client's death.

b. There is an alternative structure available to clients which helps mitigate the risk of potential estate tax inclusion. The client will create the trust in a jurisdiction permitting self-settled asset protection trusts. The client will create the trust for the benefit of other beneficiaries (i.e., descendants and possibly spouse). The client will have no retained discretionary beneficial interest in the trust and instead an independent powerholder, such as a Trust Protector, will have the ability to add to the class of beneficiaries during the client's lifetime which would include the power to add the client as a discretionary beneficiary.

c. Under the "Springing" approach the client would never be added as a beneficiary of the trust if life plays out the way the client anticipates as there would never be a need to make a discretionary distribution to the client. If unforeseen circumstances arise the Trust Protector could exercise the authority conferred upon the Trust Protector pursuant to the terms of the trust to add the client as a discretionary beneficiary. For the reasons articulated above, the fact that the client becomes a discretionary beneficiary of the trust in the future should still not result in the assets of the trust being includible in the client's estate for federal estate tax purposes.

d. In order for the "Springing" concept to work the trust not only needs to be created in a jurisdiction allowing for self-settled asset protection trusts but the trust also should be created in a jurisdiction that allows for directed trusts and permits the direction adviser to serve in a non-fiduciary capacity. The power to expand the class of beneficiaries during the client's lifetime should not be held by the trustee as a trustee serves in a fiduciary capacity. It would seem impossible for the trustee to be able to exercise the power to add beneficiaries to the trust without facing potential breach of fiduciary duties to the current trust beneficiaries. It would not be in the best interest of the current trust beneficiaries, to whom the trustee owes the fiduciary duty, to expand the class of beneficiaries as doing so could potentially diminish the beneficial interests of those beneficiaries. Instead, the power should be held by an independent power holder, such as a Trust Protector, serving in a non-fiduciary capacity so as to create the possibility of the power actually being exercised in the future.

B. The Incomplete Gift Non-Grantor Trust.

It is possible for a grantor to establish a trust in a jurisdiction that allows for the creation of self-settled asset protection trusts, retain a beneficial interest in the trust and have the trust treated as a non-grantor trust for income tax purposes. Typically the grantor will also want the

trust to be an incomplete gift for transfer tax purposes. These trusts are typically referred to as "ING" trusts. The acronym stands for Incomplete Gift Non-Grantor trust.

ING trusts have come under fire recently both at the federal and state level. ING trusts were added to the "No Ruling List" in 2020. Rev. Proc. 2020-3. In addition, this past summer California added Section 17082 to the California State and Tax Revenue Code which treats ING trusts as grantor trusts for California State Income Tax purposes beginning January 1, 2023 thereby negating any potential State income tax benefit for Californians creating ING trusts.

Although ING trusts face headwinds they are still a viable planning opportunity for certain clients. Typically an ING trust is designed to avoid or defer the imposition of state income tax with respect to the income or capital gains accumulated within the ING trust. ING trusts are also used for Qualified Small Business Stock planning purposes for stock that qualifies under Section 1202 of the IRC.

Provided below is an explanation on how INGs are structured for income and estate tax purposes. By their nature ING trusts must be created in jurisdictions that not only allow for the establishment of self-settled asset protection trusts but also allow for the creation of directed trusts. As explained below, the ING trust must create the position of Distribution Committee, who are beneficiaries of the trust, and hold the authority to direct the trustee as to how and when distributions are made to the beneficiaries.

1. Tax Structure of Trust.

a. Section 677(a)(3) of the IRC provides that the grantor shall be treated as the owner of a trust for income tax purposes if trust income, without the approval or consent of any adverse party, may be distributed to the grantor or the grantor's spouse. IRC § 677(a)(3). Therefore, in order for the trust to be a non-grantor trust for income tax purposes, the consent of an adverse party must be obtained prior to distributing assets to the grantor or the grantor's spouse.

b. The trust also must be created in a jurisdiction which allows for self-settled asset protection trusts because if creditors of the grantor can reach the trust assets the trust will be a grantor trust. Treas. Reg. § 1.677(a)-1(d).

c. The trust is structured as an incomplete gift for federal gift tax purposes through the grantor's retention of a lifetime limited power of appointment pursuant to which the grantor can appoint trust corpus to or for beneficiaries of the trust provided that the power is limited by a reasonably definitive standard (i.e. health, education, maintenance and support), a testamentary limited power of appointment over the trust and through the grantor's retention of a veto power whereby a distribution directed by any one member of the distribution committee (as explained in more detail below) must be approved by the grantor. Treas. Reg. § 25.2511-2(b).

2. The Private Letter Rulings.

a. Several Private Letter Rulings (the "PLRs") confirm that under the laws of jurisdictions permitting the establishment of self-settled asset protection trusts, a grantor can create a non-grantor trust, fund the trust with contributions that are not considered taxable gifts for federal gift tax purposes and still retain the right to receive discretionary distributions of trust income and principal from the trust. See PLR 200715005; PLR 200647001; PLR 200637025; PLR 200612002; and PLR 200502014.

b. In the PLRs, the grantor created a discretionary trust for the benefit of the grantor and others (the "permissible beneficiaries"). A corporate trustee is appointed as sole trustee of the trust.

c. A committee (the "Distribution Committee") consisting of two to four of the permissible beneficiaries of the trust, has the power, by unanimous consent, to direct the trustee to distribute trust assets to or among the permissible beneficiaries. In addition, any one member of the Distribution Committee, with the consent of the grantor, may direct the trustee to make distributions. If a member of the Distribution Committee resigns or otherwise ceases to serve, a permissible beneficiary other than the grantor or the grantor's spouse is appointed as a successor Distribution Committee member.

d. The grantor retains a limited testamentary power of appointment over the trust assets to appoint the remaining trust assets to any person or organization other than the grantor, the grantor's estate, the grantor's creditors or the creditors of the grantor's estate.

e. The PLRs conclude that the grantor has not made a completed gift upon establishment of the trust due to the retention of the grantor's limited testamentary power of appointment over the trust assets. However, the grantor will be treated as making a taxable gift when a trust distribution is made to someone other than the grantor.

f. The PLRs also conclude that the Distribution Committee members have a substantial adverse interest to each other for purposes of Section 2514 of the IRC and therefore do not possess general powers of appointment over the trust. See IRC § 2514(c)(3)(B)

3. IR-207-127 (the "2007 Notice").

a. In 2007 the IRS issued a notice calling into question the gift tax consequences to the members of the Distribution Committee. See IR-2007-127.

b. The 2007 Notice stated that the conclusions reached in the PLRs with respect to the gift tax consequences of the Distribution Committee members may not be consistent with Revenue Ruling 76-503 and Revenue Ruling 77-158 (the "Revenue Rulings"). See Rev. Rul. 76-503 and Rev. Rul. 77-158

4. The Revenue Rulings.

a. The Revenue Rulings have facts that are identical. In the Revenue Rulings, three siblings, A, B and C owning equal one-third interests in their family business contribute their respective interests in the business to an irrevocable trust for the benefit of their descendants. The trust permits the trustees to distribute trust property to whomever they select, including themselves, in such proportions and at such times as they see fit. Each trustee has the ability to designate one of the trustee's relatives to serve as successor trustee upon the trustee's death or resignation. In the event a trustee fails to designate a successor, the oldest adult living descendant of a deceased or resigned trustee is to occupy the vacant trustee position.

b. The decedent, D, was selected by A to be one of three original trustees and D served in that position until D's death.

c. The Revenue Rulings address whether any of the trust assets are includible in D's gross estate under Section 2041 of the IRC under the view that D had a general power of appointment over the trust assets held jointly with the other two co-trustees. The Revenue Rulings conclude that one-third (1/3) of the value of the trust as of the date of D's death is includible in D's gross estate under Section 2041 of the IRC as property subject to a general power of appointment. In reaching the conclusion the Revenue Rulings focused on the language of Section 2041 of the IRC. Section 2041(b) of the IRC sets forth the definition for a general power of appointment. Section 2041(b)(1)(C)(ii) of the IRC provides that a power that is not exercisable by the decedent except in conjunction with a person having a substantial adverse interest in the property subject to the power is not a general power of appointment. IRC § 2041(b)(1)(C)(2).

d. The Revenue Rulings determined that the Section 2041(b)(1)(C)(ii) safe harbor did not apply to D because the remaining co-trustees did not have a substantial adverse interest to D. The terms of the trust provide that upon D's death a successor trustee is to be appointed in D's place. The remaining co-trustees do not receive the entire power of appointment upon D's death. Instead, the surviving co-trustees must continue to share the power with D's replacement. The Revenue Rulings determined that this does not put the surviving co-trustees in a better economic position after D's death and as such their interest is not substantially adverse to D.

e. In reaching this conclusion, the Revenue Rulings also focus on the regulations under Section 2041 of the IRC. See Treas. Reg. § 20.041-3(c)(2) and (3). The Revenue Rulings state that had the trust been drafted so that upon D's death the power of appointment would vest solely in the remaining co-trustees, the co-trustees' interests would be substantially adverse to that of D and D would not have a general power of appointment resulting in the inclusion of one-third (1/3) of the trust assets in D's estate under Section 2041 of the IRC.

5. Comparing the PLRs to the Revenue Rulings.

a. The PLRs are similar to the Revenue Rulings in that upon the resignation of any Distribution Committee member, a permissible beneficiary is to be appointed

as a successor Distribution Committee member in place of the resigning Distribution Committee member. Therefore, the distribution power does not vest in the remaining Distribution Committee members but instead must be shared with a successor Distribution Committee member. This does not put the remaining Distribution Committee members in a better economic position after the resignation of a Distribution Committee member.

b. However, there is an important fact which distinguishes the PLRs from the Revenue Rulings. The PLRs conclude that the transfer to the trust by the grantor is an incomplete gift and that a distribution from the trust to any person other than the grantor would be a completed gift. In the Revenue Rulings, A, B and C irrevocably transferred their interests in the family business to the trust upon its creation at which time they made a taxable gift to the trust. Distributions from the trust to the beneficiaries would not be considered taxable gifts by A, B or C.

c. If the rationale of the Revenue Rulings were applied to the PLRs, distributions from the trust would constitute completed gifts by the Distribution Committee members. This would produce unprecedented gift tax results. For instance, a distribution from the trust to the grantor would constitute a taxable gift to the grantor of property which the grantor is already treated for federal transfer tax purposes as owning. Furthermore, a distribution to any other person besides the grantor would constitute a taxable gift of the same property to the same person at the same time by both the grantor and the Distribution Committee members.

6. Additional Rulings Affecting the Use of ING Trusts.

a. CCA 20120826 (the "CCA")

(1) In 2012 the IRS issued an opinion relating to the gift tax ramifications associated with a transfer of property into a trust where the grantor retains a testamentary limited power of appointment.

(2) In the trust at issue in the CCA, parents transferred property in trust with Child A as trustee. The trust beneficiaries were Child A, Child B, spouses and other lineal descendants. The parents reserved a testamentary limited power of appointment. The trust provided that if the limited power of appointment was not exercised, the trust would terminate at the death of the survivor of the parents and the remaining trust assets would be distributed to Child A and Child B. The trust provided that the trustee had the discretion to distribute trust assets to the beneficiaries for broad purposes.

(3) The IRS determined that the gift into the trust should be severed into two components, the term interest and the remainder interest. The IRS further determined that the term interest was not subject to change by the exercise of the parents' retained testamentary power of appointment and therefore the gift of the term interest constituted a completed gift.

(4) The IRS did rule that the gift of the remainder interest was an incomplete gift due to the retention of the testamentary limited power of appointment, but that

the gift was valued at zero (0) under Chapter 14 of the IRC meaning that the value of the gift was the full fair market value of the property transferred into the trust.

b. PLR 201310002 (the "2013 PLR")

(1) In the 2013 PLR the grantor created a trust for the benefit of himself and his issue. During the grantor's lifetime, the trustee is required to distribute such amounts of the net income and principal to the grantor and his issue as directed by the Distribution Committee and/or the grantor, as follows:

(a) At any time, the trustee, pursuant to a direction of a majority of the Distribution Committee members, with the written consent of the grantor, is required to distribute to the beneficiaries such amount of the net income or principal as directed by the Distribution Committee ("Grantor's Consent Power");

(b) At any time, the trustee, pursuant to the direction of all of the Distribution Committee members, is required to distribute to the beneficiaries such amount of the net income or principal of the trust as directed by the Distribution Committee; and

(c) At any time, the grantor, in a non-fiduciary capacity, may, but shall not be required to, distribute to any one or more of the grantor's issue, such amounts of the principal (including the whole thereof) as the grantor deems advisable to provide for the health, maintenance, support and education of the Grantor's issue ("Grantor's Sole Power").

(2) Upon the grantor's death, the remaining trust assets are to be distributed to or for the benefit of any person or persons or entity or entities, other than the grantor's estate, his creditors, or the creditors of his estate, as the grantor may appoint by his Last Will and Testament. In default of the grantor's exercise of his limited power of appointment ("Grantor's Testamentary Power"), the balance of the trust will be distributed, per stirpes, to the grantor's then living issue in further trust.

(3) The 2013 PLR concluded as follows:

(a) The grantor's retention of the Grantor's Consent Power caused the transfer of property into the trust to be wholly incomplete for federal gift tax purposes;

(b) The grantor's retention of the Grantor's Sole Power also caused the transfer of the property into the trust to be wholly incomplete for federal gift tax purposes; and

(c) The grantor's retention of the Grantor's Testamentary Power caused the transfer of property into the trust to be incomplete with respect to the remainder interest in the trust for federal gift tax purposes.

c. PLR 201550005 (the "2015 PLR")

(1) The 2015 PLR has similar facts to the 2013 PLR with a few important distinctions:

(a) In the 2015 PLR, the grantors (husband and wife) as co-grantors created a trust for the benefit of themselves, their issue, the spouses of their issue and a separate California irrevocable trust (the "Investment Trust") created for the benefit of their issue;

(b) The grantors resided in a community property State (California) and all property contributed to the trust was community property;

(c) The trust created a Power of Appointment Committee (the "Committee") initially consisting of the grantors' four minor children, the Investment Trust and the grantors;

(d) The voting power of the minor children on the Committee is exercised during their minority by a "Guardian" appointed by the grantors, acting together, or by the survivor of them;

(e) As long as the Committee consists of two or more members, other than the grantors, the Committee by unanimous consent, including the grantors, can add a trust beneficiary who is not on the Committee to the Committee;

(f) The Committee ceases to exist upon the death of the surviving grantor, the membership of the Committee falling to one member other than the grantors or the resignation of all of the Committee members whereupon the trustee has the power to make distributions to the grantors and the beneficiaries in its discretion;

(g) At any time, the Trustee, pursuant to the direction of a majority of the Committee members, other than the grantors, with the written consent of either grantor, is required to distribute to the beneficiaries such amounts of the net income or principal as directed by the Committee ("Grantor's Consent Power");

(h) At any time, the Trustee, pursuant to the direction of all of the Committee members, other than the grantors, is required to distribute to the beneficiaries, such amount of the net income or principal of the trust as directed by the Committee ("Unanimous Member Power");

(i) At any time, either grantor, in a non-fiduciary capacity, may, but shall not be required to, distribute to any one or more of the grantors' issue, such amounts of the principal (including the whole thereof) as the grantor deems advisable to provide for the health, maintenance, support and education of the grantors' issue ("Grantor's Sole Power"); and

(j) Upon the death of each grantor, such grantor's half of the community property is to be distributed to or for the benefit of any person or persons or entity or entities other than the grantor's estate, the grantor's creditors or the creditors of the grantor's estate as the grantor may appoint by his or her last will and testament and in the event the grantor fails to exercise the testamentary limited power of appointment such grantor's share is distributed 10% to the Investment Trust and the balance to the issue of the grantors, per stirpes.

(2) The 2015 PLR reached the same conclusions as the 2013 PLR relating to the gift tax consequences to the grantors in contributing property to the trust. As such, the 2015 PLR concluded that the grantors' retention of the Grantor's Consent Power and the Grantor's Sole Power caused the transfer of property into the trust to be wholly incomplete for federal gift tax purposes. The 2015 PLR also concluded that upon the deaths of the grantors their respective interests in the trust would be includable in their gross estates for federal estate tax purposes.

(3) The 2015 PLR also analyzed whether the distribution of trust property by the Committee to any beneficiary of the trust, other than the grantors, would be treated as a completed gift subject to federal gift tax, by any member of the Committee and whether upon the death of any Committee member any portion of the trust property would be included in his or her estate because such Committee member is deemed to have a general power of appointment within the meaning of Section 2041 of the IRC. The 2015 PLR reached the following conclusions on these issue:

(a) The powers held by the Committee under the Grantor's Consent Power are powers that are exercisable only in conjunction with the creators of the trust (i.e. the grantors) and accordingly under Sections 2514(b) and 2041(a)(2), the Committee members do not possess general powers of appointment by virtue of holding the power. The powers held by the Committee members under the Unanimous Member Power are not general powers of appointment for purposes of Sections 2514(b) and 2041(a)(2) based on the examples in Sections 25.2514-3(b)(2) and 20.2041-3(c)(2) of the Treasury Regulations as the Committee members have substantial adverse interests in the property subject to the power. As such, any distribution made from the trust to a beneficiary, other than the grantors, pursuant to the exercise of the powers held by the Committee members are not gifts by the Committee members and instead are gifts by the grantors; and

(b) The powers held by the Committee members are not general powers of appointment for purposes of Section 2041(a)(2) and accordingly the possession of these powers by the Committee members will not cause the trust property to be includable in any Committee member's gross estate under Section 2041(a)(2) of the IRC.

(4) Finally, the 2015 PLR reached an important conclusion relating to the income tax basis of the community property held in the trust. The 2015 PLR concluded that the basis of all community property (i.e., 100% of the property) in the trust on the date of death of the first grantor to die will receive an adjustment in basis to the fair market value

of such property at the death of the first grantor assuming that the Committee is in existence at the time of the death of the first grantor, such that the trust is not treated as a grantor trust as to either grantor.

C. Avoiding the Net Investment Income Tax Through Directed Trusts

1. Overview of the Net Investment Income Tax

a. 26 U.S.C. § 1411(c)

(1) 26 U.S.C. § 1411(c) provides that Net Investment Income ("NII") is income received from, among other things, assets (before taxes) including bonds, stocks, mutual funds, loans and other investment (less related expenses).

b. 26 U.S.C. § 1411(a)(1)

(1) NII is subject to a 3.8 percent tax for individuals with NII and modified adjusted gross income above certain thresholds.

c. 26 U.S.C. § 1411(a)(2)

(1) Trusts and estates are subject to the NII tax if they have undistributed NII and their annual adjusted gross income exceeds the dollar amount at which the highest tax bracket begins.

2. The Material Participation Rules

a. Individuals, trusts and estates can avoid the imposition of the NII tax if the taxpayer "materially participates" in the activity, or the income is not earned as a result of passive activity.

b. Section 469(h)

(1) Section 469(h) of the Internal Revenue Code provides that a taxpayer materially participates in the activity only if the taxpayer is involved in the operation of the activity on a regular, continuous, and substantial basis.

c. 26 C.F.R. § 1.469-5T

(1) In Treasury Regulation § 1.469-5T, the IRS has created a quantitative regulative test to determine whether individuals have materially participated in the activity. Treasury Regulation § 1.469-5T has not been applied to trusts and estates.

(2) An individual shall be treated, for purposes of Section 469 of the Internal Revenue Code and the Treasury Regulations thereunder, as materially participating in an activity for the taxable year if and only if:

(a) The individual participates in the activity for more than 500 hours during such year;

(b) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(c) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(d) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(e) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(f) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(g) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

3. Frank Aragona Trust v. Commissioner of Internal Revenue, 142 T.C. 165 (2014).

a. In the *Aragona* case, a trust consisted of six trustees, five of whom had delegated their powers to an executive trustee, though all trustees acted as a management board and made all major decisions regarding the trust. Three of the trustees were also fulltime employees of an LLC wholly owned by the trust.

b. The trust had income from the LLC which the taxpayer argued should not be subject to the NII based on the fact that the trustees were materially participating in the activity of the LLC. The IRS argued that the court must disregard the activities of the trustees in their capacity as employees of the LLC, and the activities of any non-trustee employees and therefore the trustees did not materially participate in the LLC thereby subjecting the trust to the NII.

c. While the court declined to address whether the activities of non-trustee employees should be considered when determining material participation, the court found that the activities of the trustees, including while in their capacities as employees of the LLC, should be considered in determining material participation. In making this determination, the court noted that the trustees were required to administer the trust solely in the interest of the beneficiaries, and they were not relived of the duty of loyalty when "conducting activities through a corporation wholly owned by the trust."

d. Because the activities of the trustees, in their roles as trustees and employees of the LLC, can be considered "personal services" performed by the trust, and the trustees had performed the requisite number of hours, the trust qualified for an exception to the NII tax under Section 469(c)(7) of the IRC.

4. Application to Directed Trusts

a. A question arises as to whether the holding in the Aragona case would apply in the context of a directed trust. A client may want to appoint a corporate trustee to administer a trust for the benefit of the client's family and have that trust funded with a closely-held business interest. Both the client and the corporate trustee want an Investment Direction Adviser to be appointed to direct corporate trustee with respect to the investment and management of the closely-held business interests. The client would also like to avoid the imposition of the NII on the income earned within the trust associated with that closely held business interest by naming an Investment Direction Adviser for the Trust that works for the company or otherwise materially participates in the company so as to satisfy the requirements of Section 469(h) of the IRC.

b. Under this framework it is the Investment Direction Adviser, and not the trustee, that is materially participating in the company. Therefore there is a question as to whether the NII applies.

c. TAM 200733023 (the "2007 TAM")

(1) In the 2007 TAM, Trustees of a Trust contracted with Special Trustees to perform tasks related to a business owned by the Trust. The contract with the Special Trustees stated that the Special Trustees did not possess the capacity to legally bind or commit the Trust to any transaction or activity. The Trustee retained all decision making responsibilities related to the Trust's financial, tax, or business matters.

(2) The IRS stated that because the Special Trustees were not granted decision making powers, they were not fiduciaries of the Trust. Furthermore, because the fiduciaries were not involved in the operation of the business on a regular, continuous, and substantial basis, the Trust had not materially participated.

d. PLR 201029014 (the "2010 PLR")

(1) In the 2010 PLR, the IRS states that Congressional intent for the passive loss rule to apply to trusts, and that "[a]n estate or trust is treated as materially participating in an activity. . .if an executor or *fiduciary*, in his capacity as such, is so participating." Using this language, the IRS determined that the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement because such employees are not executors or fiduciaries.

e. Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex, 2003).

(1) In *Carter*, the IRS argued that only the activities of the trustee should be considered when determining whether a trust materially participated.

(2) The United States District Court for the Northern District of Texas found that the statutory language of Section 469 is unambiguous, and therefore there was no need to turn to legislative history to decipher the text. The court concluded that material participation of the Trust included not only the Trustee, but also any person who conducted business on behalf of the Trust.

D. <u>Avoiding the Reciprocal Trust Doctrine Through Directed Trusts</u>

1. <u>Overview of Reciprocal Trust Doctrine</u>

a. The reciprocal trust doctrine is a judicially created doctrine developed in response to perceived tax-avoidance strategies where two parties, commonly spouses, create trusts for each other which, practically speaking, allows each lifetime enjoyment over their property while avoiding it being in their gross estate. Under the reciprocal trust doctrine the beneficiary of the trust at issue is deemed to be the transferor of funds into the trust thereby typically negating any tax benefit. For example, if husband and wife were each to create and fund an identical trust for one another the reciprocal trust doctrine could apply so as to treat husband as being both the grantor and beneficiary of the trust he established and wife as being both the grantor and beneficiary of the trust she established.

2. <u>Reciprocal Trust Doctrine Cases</u>

a. U.S. v. Estate of Grace, 395 U.S. 316 (1940)

(1) In *Grace*, the United States Supreme Court held that application of the reciprocal trust doctrine is not dependent upon a finding that each trust was created as a quid pro quo, nor on a finding that the settlor's had tax avoidance motives. The Court found that application required the trust to be (1) interrelated and (2) the arrangement leaves the settlors in approximately the same economic position as if they had created trusts naming themselves as life beneficiaries. Also important to the Court's finding that reciprocal trusts had been created, resulting in an "uncrossing" of the trusts, was the fact that the trusts contained nearly identical terms, were created within 15 days of each other, and were part of a single transaction.

b. Estate of Bischoff v. Commissioner of Internal Revenue, 69 T.C. 32 (1977).

(1) *Bischoff* involved a husband and wife who created trusts in which each named the other as trustee and named with grandchildren as the trust beneficiaries.

(2) The Tax Court found that the reciprocal trust doctrine is applicable even in situations where the decedent did not possess an economic interest in the property transferred at the time of their death. Relying on the fact that husband and wife each held the discretionary power to make income and principal distributions of the other's trust, the Tax Court found that the two trusts were interrelated and need to be uncrossed.

(3) It is important to note that the Tax Court did not discuss whether the settlors were in the same economic position as if they had created the trust, as required by the second prong of the *Grace* test.

c. Estate of Levy v. Commissioner of Internal Revenue, T.C. Memo 1983-453 (1983).

(1) In *Levy*, husband and wife created trusts which contained similar terms (each contained the same number of shares, named the other spouse as Trustee, and named their son as residuary beneficiary) and were created on the same date within the same transaction.

(2) Relying on a stipulation by the IRS regarding interrelatedness of the trust, the Tax Court found that the trusts were not interrelated because the terms of the trusts were not identical, specifically, wife was granted a special power of appointment over husband's trust that was not granted to husband in wife's trust.

3. Establishing Differences with Directed Trusts

a. Avoiding the reciprocal trust doctrine has become incredibly important for clients in today's tax planning environment. Many clients are interested in transferring large amounts of wealth out of their estate for federal gift and estate tax purposes while still retaining some access to the gifted funds. A common technique that is utilized to accomplish this goal is gifting the assets into a spousal lifetime access trust ("SLAT") for the benefit of the grantor's spouse and descendants. By including the spouse as a discretionary beneficiary of the SLAT it creates the possibility of distributions being made from the SLAT to the beneficiary spouse which can in turn be used by the marital unit.

b. Often clients are interested in establishing a dual SLAT structure whereby wife creates a SLAT for the benefit of husband and descendants and husband creates a SLAT for the benefit of wife and descendants. Such planning can run afoul of the reciprocal trust doctrine. A common way to avoid the reciprocal trust doctrine when engaging in dual SLAT planning is to create substantial differences between the SLATs.

c. There are several ways that practitioners design SLATs to include different provisions and thereby avoid the reciprocal trust doctrine. However, directed trusts can present a unique opportunity to establish substantial differences.

d. For example, husband could create a SLAT for the benefit of wife in a directed trust jurisdiction creating the positions of Investment Direction Adviser to direct the trustee as to all investment decisions; Distribution Adviser to direct the trustee as to all distribution decisions; and Trust Protector to hold certain other powers over the trust. Husband would then name certain individuals to occupy such positions. Wife in turn could create a SLAT for the benefit of husband in a directed trust jurisdiction creating the positions of Special Holdings Direction Adviser to direct the trustee as to the investment of the closely-held business interests owned by the trust or special assets contained within the trust while allowing the trustee to invest the marketable assets in the trust; Distribution Adviser to direct the trustee with respect to distributions to the trust beneficiaries pursuant to an ascertainable standard such as health, education, maintenance and support; Independent Distribution Adviser to direct the trustee as to distributions to the beneficiaries for any purpose; and Trust Protector to hold certain other powers over the trust. Wife would name different individuals than those named by husband to occupy the various positions. Creating different fiduciary positions to hold different powers and naming different individuals to occupy those positions should help create substantial differences between the SLATs to avoid the reciprocal trust doctrine.

e. Another way to help avoid the potential application of the reciprocal trust doctrine in SLAT planning is through a springing feature contained in one of the trusts. For example, wife could create a SLAT for the benefit of husband and descendants. Husband could create a trust solely for the benefit of descendants without any spousal beneficiary feature. However, in husband's trust an independent powerholder, such as a Trust Protector, will be granted the power to add to the class of beneficiaries during wife's lifetime. This power would be held in a non-fiduciary capacity.

f. Under this springing approach the reciprocal trust doctrine should be clearly avoided as wife is not a beneficiary of husband's trust. However, the couple is still afforded the flexibility they are looking to achieve as wife could be added as a discretionary beneficiary of husband's trust, thereby converting it into a SLAT, at some point in the future in the event the Trust Protector deems it advisable to do so.

EXHIBIT A – SAMPLE INVESTMENT DIRECTION ADVISER LANGUAGE

TENTH Investment Direction Adviser. Notwithstanding any other provision of this Agreement, there may at any time be one or more Investment Direction Advisers (the "Investment Direction Adviser" or "Investment Direction Advisers") to serve in accordance with this Article TENTH. The role and function of the Investment Direction Adviser is set forth in this Article TENTH. The Investment Direction Adviser shall serve in a fiduciary capacity and conform to the purposes of this Agreement.

(a) Initial Appointment of Investment Direction Adviser. The initial Investment Direction Adviser shall be ___________________. All additional and subsequent Investment Direction Advisers shall be appointed in the manner provided in section (k) of this Article TENTH0. To the extent that more than two persons are serving as Investment Direction Adviser at any time, an affirmative vote of a majority of such Investment Direction Advisers must be reached with respect to any decisions, actions taken or direction given. Otherwise, the Investment Direction Advisers must act unanimously. Notwithstanding the foregoing, to the extent that more than one Investment Direction Adviser is serving, the Investment Direction Advisers may designate one such Investment Direction Adviser to communicate all directions to the Trustee.

(b) Role and Function. The Investment Direction Adviser shall hold and exercise the full power to direct the Trustee as to the investments of the Trust. Notwithstanding the foregoing, if the Grantor is serving as Investment Direction Adviser, the Grantor shall not participate in any investment decision regarding the Special Holdings. The Investment Direction Adviser's power to manage the investments of the Trust estate (other than the Special Holdings as to the Grantor) shall include, but not be limited to, the power to direct the Trustee to purchase, sell and retain all of the Trust assets, and the power to direct the Trustee to exercise voting, subscription,

conversion, option and similar rights with respect to such property and to participate in and consent to any voting trust, reorganization, merger, dissolution or other action affecting any such property. The Trustee shall follow the direction of the Investment Direction Adviser with respect to all matters relating to the management and investment of Trust assets (other than the Special Holdings as to the Grantor). The Investment Direction Adviser (other than the Grantor) shall hold and exercise the full power to manage and invest the Special Holdings. In the event no Investment Direction Adviser other than the Grantor is then serving, the Trust Protector shall hold and exercise the full power to manage and invest the Special Holdings. In the event no Investment Direction Adviser is then serving, the Trustee shall hold and exercise the full power to manage and invest the Trust assets, including the Special Holdings.

(c) Loans, Guarantees and Creation of Entities. Without in any way limiting the broad powers conferred upon the Investment Direction Adviser pursuant to this Article TENTH, the Investment Direction Adviser shall have the specific authority to direct the Trustee to borrow and lend money and to guarantee the repayment of any indebtedness, for such periods of time and upon such terms and conditions as to rates, maturities, renewals and securities as the Investment Direction Adviser deems advisable, including the power to borrow from the Trustee itself and any of its affiliates and to mortgage, pledge or encumber such portion of the Trust property as may be required to secure any loans or indebtedness and as makers, endorsers or guarantors to renew existing loans or guarantees. The power to direct the Trustee to guarantee loans shall include the power to direct the Trustee to guarantee the loans of any partnership, limited liability company, corporation, business trust or other business entity (owned in whole or in part by the Trust) in proportion to the Trust's ownership interest in such business entity. Notwithstanding the foregoing, if the Grantor is serving as an Investment Direction Adviser hereunder, the

Grantor shall not have the power to direct the Trustee to lend money to the Grantor or to any beneficiary of the Trust or to guarantee the repayment of any indebtedness of the Grantor or any beneficiary of the Trust. The Investment Direction Adviser (other than the Grantor) shall hold and exercise the full power to direct the Trustee with respect to lending money to the Grantor and the beneficiaries of the Trust or with respect to guaranteeing the repayment of any indebtedness of the Grantor or any beneficiary of the Trust. In the event no Investment Direction Adviser other than the Grantor is then serving, the Trust Protector shall hold and exercise the full power to direct the Trustee with respect to lending money to the Grantor or to any beneficiary of the Trust or with respect to guaranteeing the repayment of any indebtedness of the Grantor or any beneficiary of the Trust. In the event no Investment Direction Adviser is then serving, the Trustee shall hold and exercise the full power to lend money to the Grantor or to any beneficiary of the Trust or to guarantee the repayment of any indebtedness of the Grantor or any beneficiary of the Trust. The Investment Direction Adviser shall also have the specific authority to direct the Trustee to create partnerships, limited liability companies, corporations, business trusts or other business entities and to transfer any portion of the Trust estate to such entity.

(d) Partnership, Limited Liability Company ("LLC") and Other Entity Management. The Trustee shall not take any action, render any advice or oversee or review any activities with respect to any partnership, LLC, or other entity owned by the Trust and the Investment Direction Adviser shall have the obligation to direct the Trustee to manage such interests as the owner thereof. The Trustee shall be directed by the Investment Direction Adviser as to all activities associated with the Trust owning any interest in the applicable entity. Whenever the Trustee serves as the manager of a LLC or the general partner of a partnership, it shall exercise all of its

management powers only upon the direction of the Investment Direction Adviser. The Trustee shall have no duty to oversee the Investment Direction Adviser as it relates to such activities.

(e) Directions to Trustee. Any investment direction to the Trustee shall be in writing, delivered by mail, courier, facsimile transmission, electronic mail, or otherwise in such form as the Trustee may specify from time to time by written notice to the Investment Direction Adviser. The Trustee shall have no obligation to investigate or confirm the authenticity of directions it receives or the authority of the person or persons conveying them, and the Trustee shall be exonerated from any and all liability in relying on any such direction from a person purporting to be the Investment Direction Adviser without further inquiry by the Trustee.

(f) Liability of Trustee. At any time that an Investment Direction Adviser is serving, the Investment Direction Adviser shall have sole responsibility (and the Trustee shall have no responsibility) for the investment and management of the assets of the Trust and the Trustee shall make only such sales and investments as the Investment Direction Adviser directs. The Trustee shall be under no obligation to review the Trust assets, make any investment recommendations with respect to them, solicit any direction from the Investment Direction Adviser, value the assets if they are non-marketable, or insure the assets. The Trustee need not review whether the Investment Direction Adviser is satisfying its responsibilities hereunder. As provided in 12 Del. C. § 3313(b), the Trustee shall incur no liability for any act or failure to act by the Investment Direction Adviser, or for acting on a direction of the Investment Direction Adviser or with respect to its implementation of any such direction of the Investment Direction Adviser and the Trustee shall not be liable for any loss resulting from action taken by the Investment Direction Adviser, or taken by the Trustee in accordance with the Investment Direction Adviser's direction. As provided in 12 Del. C. § 3313(e), the Trustee shall have no duty to monitor the

conduct of the Investment Direction Adviser, provide advice to the Investment Direction Adviser or consult with the Investment Direction Adviser or communicate with or warn or apprise any beneficiary or third party concerning instances in which the Trustee would or might have exercised the Trustee's own discretion in a manner different from the manner directed by the Investment Direction Adviser. Furthermore, in accordance with 12 Del. C. § 3302(e) and § 3586, the Trustee shall have no liability under this Trust to any Trust beneficiary or any other person whose interest arises under this Trust for the Trustee's good faith reliance on the provisions of this Article TENTH or any other provisions of this Agreement concerning investment decisions (unless the Trustee has acted with willful misconduct proven by clear and convincing evidence in the Court then having primary jurisdiction over the Trust which such Court shall be the Delaware Court of Chancery for so long as Delaware remains the situs of the Trust). The Trustee shall be deemed to have acted within the scope of its respective authority, to have exercised reasonable care, diligence and prudence, and to have acted impartially as to all interested persons unless the contrary may be proved by clear and convincing evidence in the Court then having primary jurisdiction over the Trust which such Court shall be the Delaware Court of Chancery for so long as Delaware remains the situs of the Trust. The Trustee and the Investment Direction Adviser shall not be liable for the acts or defaults of each other or any other Adviser.

(g) Liability of Investment Direction Adviser. In accordance with 12 Del. C. § 3303, the Investment Direction Adviser need not inquire into the Trustee's performance of its duties, and shall not be held liable for any loss whatsoever to any trust hereunder, unless it results from actions taken in bad faith or through willful misconduct proven by clear and convincing evidence in the Court then having primary jurisdiction over the Trust, which such Court shall be the

Delaware Court of Chancery for so long as Delaware remains the situs of the Trust. Notwithstanding the foregoing or the provisions of Article FOURTEENTH of this Agreement relating to the Waiver of Prudent Investor Rule, the instrument of appointment appointing any Investment Direction Adviser may provide that such Investment Direction Adviser shall be required to abide by the prudent person standard imposed by 12 Del. C. § 3302(a), or in any corresponding provision of law which may be later enacted.

(h) Indemnification. The Trustee shall, to the extent of the Trust assets and solely payable from the Trust assets, indemnify the Investment Direction Adviser for all losses, costs, damages, expenses and charges, public and private, including reasonable attorneys' fees, including those arising from all litigation, groundless or otherwise, that result from the performance or non-performance of the powers given to the Investment Direction Adviser under this Agreement (unless the Investment Direction Adviser has acted in a manner that does not comply with the standard of liability applicable to the Investment Direction Adviser).

(i) Resignation of Investment Direction Adviser. Any Investment Direction Adviser serving hereunder may resign at any time by providing written notice to the Trustee, the Trust Protector and the Notice Recipients. Such resignation shall become effective at such time as the resigning Investment Direction Adviser shall provide in the notice of resignation.

(j) Removal of Investment Direction Adviser. The Trust Protector shall have the power to remove any Investment Direction Adviser (other than the Grantor, unless due to incapacity) by providing written notice to such Investment Direction Adviser, the Trustee and the Notice Recipients. The removal shall become effective at such time as the Trust Protector indicates in the notice of removal.

(k) Appointment of Additional or Successor Investment Direction Advisers. The Trust Protector shall have the power to appoint additional Investment Direction Advisers if at such time there are fewer than three Investment Direction Advisers serving and shall have the power to designate a successor Investment Direction Adviser upon the death, resignation, removal or incapacity of the last serving Investment Direction Adviser by providing written notice to such additional or successor Investment Direction Adviser, the Trustee and the Notice Recipients; provided, while the Grantor is living and competent, the Trust Protector must obtain the prior written consent of the Grantor to appoint additional and successor Investment Direction Advisers. The appointment of additional or successor Investment Direction Advisers shall become effective at such time as the Trust Protector provides in the instrument of appointment and upon written acceptance by the designee.

(l) Power to Hire Agents. The Investment Direction Adviser shall have the power to employ agents and pay such agents reasonable compensation. The Investment Direction Adviser may at any time and in its sole discretion provide investment and management services through a subadviser of the Investment Direction Adviser's selection. The Investment Direction Adviser shall be solely responsible for the supervision and oversight of any subadviser. The Investment Direction Adviser shall notify the Trustee in writing of its selection of any subadviser, and the Trustee shall be entitled to rely upon information and direction received from any subadviser until it receives written notification from the Investment Direction Adviser of its termination of such subadviser.

(m) Compensation. The Investment Direction Adviser may be entitled to reasonable compensation for its services as agreed upon by the Investment Direction Adviser and Trust Protector.

EXHIBIT B – SAMPLE SPECIAL HOLDING DIRECTION ADVISER LANGUAGE

ELEVENTH Special Holdings Direction Adviser. At any given time, the assets of the Trust may consist of assets defined as Special Holdings. Notwithstanding any other provision of this Agreement, at any time that the Trust estate includes any Special Holdings, the Trustee shall act with respect to Special Holdings only upon the written direction of the Special Holdings Direction Adviser (the "Special Holdings Direction Adviser" or "Special Holdings Direction Advisers") to serve in accordance with this Article. The Special Holdings Direction Adviser shall serve in a fiduciary capacity and conform to the purposes of this Agreement.

(a) Initial Appointment of Special Holdings Direction Adviser. The initial Special Holdings Direction Adviser shall be ____________________. In the event that _________________ shall be unable or unwilling to serve as Special Holdings Direction Adviser, _______________, provided ___________________ is competent, shall serve as the first successor Special Holdings Direction Adviser. [All/All other] additional and successor Special Holdings Direction Advisers shall be appointed in the manner provided in section (l) of this Article. Unless otherwise expressly provided herein, to the extent that more than two persons are serving as Special Holdings Direction Advisers at any time, an affirmative vote of a majority of such Special Holdings Direction Advisers must be reached with respect to any decisions, actions taken or direction given; and if two persons are serving as Special Holdings Direction Advisers, they must act unanimously. Notwithstanding the foregoing, to the extent that more than one Special Holdings Direction Adviser is serving, the Special Holdings Direction Advisers may designate one such Special Holdings Direction Adviser to communicate all directions to the Trustee.

(b) Role and Function. Subject to the express exceptions set forth in this Article, but notwithstanding any other provision herein, whenever a Special Holdings Direction Adviser is

serving, the Special Holdings Direction Adviser shall hold and exercise the full power to direct the Trustee as to all investments and investment decisions for the Special Holdings of the Trust, including, but not limited to, the power to direct the Trustee to purchase, sell, acquire and retain Special Holdings, the power to direct the Trustee to exercise voting, subscription, conversion, option and similar rights with respect to Special Holdings and to participate in and consent to any voting trust, reorganization, merger, dissolution or other action affecting any Special Holdings, and the power to direct the Trustee to lend, borrow, pledge, mortgage, lease, insure, abandon and manage property and to make guarantees with respect to Special Holdings, and all other powers to make investment decisions as such term is defined in 12 Del. C. § 3313(d) with respect to Special Holdings; provided, however, that powers to make Loans to Beneficiaries described in section (n) of Article TWENTY-FIFTH, of any Special Holdings, shall not be considered investment or management powers that are within the Special Holdings Direction Adviser's discretion and power to direct. Instead, the exercise of the Trustee's powers to make any Loans to Beneficiaries shall be within the discretion of the Distribution Fiduciary. Whenever a Special Holdings Direction Adviser is serving, the Trustee shall follow any such direction of the Special Holdings Direction Adviser, and shall only exercise its powers with respect to such matters upon the written direction of the Special Holdings Direction Adviser. In the event no Special Holdings Direction Adviser is serving, the Trust Protector shall hold and exercise the full power to manage and invest the Special Holdings, as if it were the Special Holdings Direction Adviser.

(c) Valuation of Assets; Additional Duties. With regard to Special Holdings and in addition to the Special Holdings Direction Adviser's duties herein, the Special Holdings Direction Adviser shall have the duty (i) to confirm to the Trustee, in writing, the value of the Special Holdings at least annually and upon the request by the Trustee, (ii) to manage or participate in

the management of any entity owned by the Trust as Special Holdings, to the extent such entity's governing instruments or applicable law require the owners to manage the same, (iii) to direct the Trustee with respect to making any representation, warranty or covenant required to be made in order to maintain any Special Holdings investment, and (iv) to direct and instruct the Trustee on the future actions, if any, to be taken with respect to such representations, warranties and covenants.

(d) Directions to Trustee. Any direction to the Trustee from the Special Holdings Direction Adviser shall be in writing (which may be in the form of electronic mail), delivered by mail, courier, facsimile, electronic mail, or any other form that the Trustee may specify from time to time by written notice to the Special Holdings Direction Adviser. The Trustee shall have no obligation to investigate or confirm the authenticity of investment directions it receives or the authority of the person or persons conveying them, and the Trustee shall be exonerated from any and all liability in relying on any such direction from a person purporting to be the Special Holdings Direction Adviser without further inquiry by the Trustee, except in cases of its own willful misconduct proven by clear and convincing evidence in the court then having primary jurisdiction over the Trust. The Trustee shall have no duty to conduct an independent review of documents presented to it by the Special Holdings Direction Adviser in furtherance of the Special Holdings Direction Adviser's written direction to the Trustee and shall sign the same as presented.

(e) Liability of Trustee. At any time that a Special Holdings Direction Adviser is serving, the Special Holdings Direction Adviser shall have sole responsibility (and the Trustee shall have no responsibility) for the investment and management of the Special Holdings and the Trustee shall make only such sales and investments with respect to the Special Holdings as the Special

Holdings Direction Adviser directs. Whenever a Special Holdings Direction Adviser is serving, the Trustee shall be under no obligation to review the Special Holdings, make any investment recommendations with respect to them, solicit any direction from the Special Holdings Direction Adviser, value the Special Holdings, or insure the Special Holdings. The Trustee need not review whether the Special Holdings Direction Adviser is satisfying its responsibilities hereunder and shall incur no liability for any act or failure to act by the Special Holdings Direction Adviser. Notwithstanding any other provision herein, except in cases of willful misconduct on the part of the Trustee, the Trustee shall incur no liability with respect to its implementation of any direction of the Special Holdings Direction Adviser, or, as provided in 12 Del. C. § 3313(b), for any loss resulting directly or indirectly from acts taken (or not taken) by the Trustee in accordance with the direction of the Special Holdings Direction Adviser. As provided in 12 Del. C. § 3313(e), the Trustee shall have no duty to monitor the conduct of the Special Holdings Direction Adviser, provide advice to the Special Holdings Direction Adviser or consult with the Special Holdings Direction Adviser or communicate with or warn or apprise any beneficiary or third party concerning instances in which the Trustee would or might have exercised the Trustee's own discretion in a manner different from the manner directed by the Special Holdings Direction Adviser. Furthermore, in accordance with 12 Del. C. § 3302(e) and § 3586, the Trustee shall have no liability under this Agreement to any Trust beneficiary or any other person whose interest arises under this Agreement for the Trustee's good faith reliance on the provisions of this Article or any other provisions of this Agreement concerning the investment of the Special Holdings. When acting at the direction of the Special Holdings Direction Adviser, the Trustee shall be deemed to have acted within the scope of its respective authority and not to have

participated in actions outside the scope of such authority, unless the contrary is proven by clear and convincing evidence in the court then having primary jurisdiction over the Trust.

(f) Liability of Special Holdings Direction Adviser. In accordance with 12 Del. C. § 3303, unless expressly provided otherwise herein, the Special Holdings Direction Adviser shall not be held liable for any loss whatsoever to any Trust hereunder or for any of its acts or omissions except for actions taken, or a failure to act, in bad faith or with willful misconduct proven by clear and convincing evidence in the court then having primary jurisdiction over the Trust. The Special Holdings Direction Adviser shall have no duty to monitor the conduct of the Trustee or any other Adviser, and shall not be liable for the acts or defaults of any of them. A successor Special Holdings Direction Adviser shall not be liable for the actions or omissions of any predecessor Special Holdings Direction Adviser and shall be specifically relieved of any duty to examine the acts or accounts of its predecessors.

(g) Indemnification. The Trustee shall, to the extent of the Trust assets and solely payable from the Trust assets, indemnify each Special Holdings Direction Adviser for all losses, costs, damages, expenses and charges, public and private, including reasonable attorneys' fees, including those arising from all litigation, groundless or otherwise, that result from the performance or non-performance of the powers given to the Special Holdings Direction Adviser under this Agreement (unless the Special Holdings Direction Adviser has acted in a manner that does not comply with the standard of liability applicable to the Special Holdings Direction Adviser). The provisions of this section shall apply regardless of whether the indemnitee is acting as Special Holdings Direction Adviser or has ceased to act at the time when the cost or expense is paid or incurred.

(h) Resignation of Special Holdings Direction Adviser. Any Special Holdings Direction Adviser serving hereunder may resign at any time by providing written notice to any co-Special Holdings Direction Adviser, the Trustee, the Trust Protector and the Notice Recipients. Such resignation shall become effective at such time as the resigning Special Holdings Direction Adviser shall provide in the notice of resignation. In the event that an individual Special Holdings Direction Adviser becomes incapacitated, he or she shall be deemed to have resigned hereunder, without further act by anyone.

(i) Removal of Special Holdings Direction Adviser. The Trust Protector shall have the power to remove any Special Holdings Direction Adviser (other than the Grantor's Spouse) for any reason, with or without cause, by providing written notice to such Special Holdings Direction Adviser, the Trustee and the Notice Recipients. The removal shall become effective at such time as is indicated in the notice of removal.

(j) Appointment of Additional or Successor Special Holdings Direction Advisers. After all persons specifically named in section (a) of this Article have ceased to serve, the Trust Protector shall have the power to appoint additional Special Holdings Direction Advisers if at such time there are fewer than three Special Holdings Direction Advisers serving and shall have the power to designate a successor Special Holdings Direction Adviser upon the death, resignation or removal of the last serving Special Holdings Direction Adviser by providing written notice to such Special Holdings Direction Adviser, the Trustee and the Notice Recipients. The appointment of additional or successor Special Holdings Direction Advisers shall become effective at the time provided in the instrument of appointment and upon written acceptance by the designee. At no time may the Grantor serve as the Special Holdings Direction Adviser of any Trust created by or

pursuant to this Agreement. Each successor Special Holdings Direction Adviser shall have all of the powers of the Special Holdings Direction Adviser as if originally named herein.

(k) Power to Hire Agents. The Special Holdings Direction Adviser shall have the power to employ agents and pay such agents reasonable compensation. The Special Holdings Direction Adviser may at any time and in its sole discretion provide investment and management services through a subadviser of the Special Holdings Direction Adviser's selection. The Special Holdings Direction Adviser shall be solely responsible for the supervision and oversight of any subadviser. The Special Holdings Direction Adviser shall notify the Trustee in writing of its selection of any subadviser, and the Trustee shall be entitled to rely upon information and direction received from any subadviser until it receives written notification from the Special Holdings Direction Adviser of its termination of such subadviser.

(l) Compensation. The Special Holdings Direction Adviser (other than the Grantor's Spouse) may receive reasonable compensation for its services as agreed upon by the Special Holdings Direction Adviser and Trust Protector, and each Special Holdings Direction Adviser shall be entitled to reimbursement for reasonable costs and expenses incidental to serving as Special Holdings Direction Adviser.

EXHIBIT C – SAMPLE DISTRIBUTION ADVISER LANGUAGE

ELEVENTH Distribution Adviser. Notwithstanding any other provision of this Agreement, there may at any time be one or more Distribution Advisers (the "Distribution Adviser" or "Distribution Advisers") to serve in accordance with the provisions of this Article ELEVENTH. The role and function of the Distribution Adviser is set forth in this Article ELEVENTH. The Distribution Adviser shall serve in a fiduciary capacity and conform to the purposes of this Agreement.

(a) Initial Appointment of Distribution Adviser. The initial Distribution Adviser shall be ___________________. All additional and subsequent Distribution Advisers shall be appointed in the manner provided in section (i) of this Article ELEVENTH. To the extent that more than two persons are serving as Distribution Adviser at any time, an affirmative vote of a majority of such Distribution Advisers must be reached with respect to any decisions, actions taken or direction given. Otherwise, the Distribution Advisers must act unanimously. Notwithstanding the foregoing, to the extent that more than one Distribution Adviser is serving, the Distribution Advisers may designate one such Distribution Adviser to communicate all directions to the Trustee.

(b) Role and Function. The Distribution Adviser shall hold and exercise the full power to direct the Trustee to distribute income and principal of the Trust pursuant to the standards established under this Agreement. The Trustee shall follow the direction of the Distribution Adviser with respect to all matters concerning the distribution of income or principal of the Trust. In the event no Distribution Adviser is then serving, the Trustee shall hold and exercise the full power to make discretionary distributions of income and principal of the Trust pursuant to the standards established under this Agreement.

(c) <u>Directions to Trustee</u>. Any distribution direction to the Trustee shall be in writing, delivered by mail, courier, facsimile transmission, electronic mail, or otherwise in such form as the Trustee may specify from time to time by written notice to the Distribution Adviser. The Trustee shall have no obligation to investigate or confirm the authenticity of directions it receives or the authority of the person or persons conveying them, and the Trustee shall be exonerated from any and all liability in relying on any such direction from a person purporting to be the Distribution Adviser without further inquiry by the Trustee.

(d) <u>Liability of Trustee</u>. Provided a Distribution Adviser is then serving, the Distribution Adviser shall have sole responsibility (and the Trustee shall have no responsibility) for all discretionary actions involving any distribution of income or principal of the Trust. The Trustee shall make only such distributions of income or principal as the Distribution Adviser directs. The Trustee shall be under no obligation to review the beneficiaries' needs or requests for income or principal distributions, make any recommendation with respect to such distributions, solicit any direction from the Distribution Adviser, calculate the impact of any distribution on the likely duration of the Trust, or ensure the equality of distributions among the beneficiaries. The Trustee need not review whether the Distribution Adviser is satisfying its responsibilities hereunder. As provided in 12 <u>Del</u>. <u>C</u>. § 3313(b), the Trustee shall incur no liability for any act or failure to act by the Distribution Adviser, or for acting on a direction of the Distribution Adviser and it shall not be liable for any loss to the Trust or any claim of inequality, partiality or unreasonableness resulting from any action taken at the direction of the Distribution Adviser, or taken by the Trustee in accordance with the direction of the Distribution Adviser. As provided in 12 <u>Del</u>. <u>C</u>. § 3313(e), the Trustee shall have no duty to monitor the conduct of the Distribution Adviser, provide advice to the Distribution Adviser or consult with the Distribution Adviser or communicate with or warn

or apprise any beneficiary or third party concerning instances in which the Trustee would or might have exercised the Trustee's own discretion in a manner different from the manner directed by the Distribution Adviser. Furthermore, in accordance with 12 Del. C. § 3302(e) and § 3586, the Trustee shall have no liability under this Trust to any Trust beneficiary or any other person whose interest arises under this Trust for the Trustee's good faith reliance on the provisions of this Article ELEVENTH or any other provision of this Agreement concerning distribution decisions (unless the Trustee has acted with willful misconduct proven by clear and convincing evidence in the Court then having primary jurisdiction over the Trust, which such Court shall be the Delaware Court of Chancery for so long as Delaware remains the situs of the Trust). The Trustee shall be deemed to have acted within the scope of its respective authority, to have exercised reasonable care, diligence and prudence, and to have acted impartially as to all interested persons unless the contrary may be proved by clear and convincing evidence in the Court then having primary jurisdiction over the Trust, which such Court shall be the Delaware Court of Chancery for so long as Delaware remains the situs of the Trust. The Trustee and the Distribution Adviser shall not be liable for the acts or defaults of each other or any other Adviser.

(e) Liability of Distribution Adviser. In accordance with 12 Del. C. § 3303, the Distribution Adviser shall not be held liable to any beneficiary for any distribution decision made hereunder, unless it results from actions taken in bad faith or through willful misconduct proven by clear and convincing evidence in the Court then having primary jurisdiction over the Trust, which such Court shall be the Delaware Court of Chancery for so long as Delaware remains the situs of the Trust.

(f) Indemnification. The Trustee shall, to the extent of the Trust assets and solely payable from the Trust assets, indemnify the Distribution Adviser for all losses, costs, damages, expenses and charges, public and private, including reasonable attorneys' fees, including those arising from

all litigation, groundless or otherwise that result from the performance or non-performance of the powers given to the Distribution Adviser under this Agreement (unless the Distribution Adviser has acted in a manner that does not comply with the standard of liability applicable to the Distribution Adviser).

(g) Resignation of Distribution Adviser. Any Distribution Adviser serving hereunder may resign at any time by providing written notice to the Trustee, the Trust Protector and the Notice Recipients. Such resignation shall become effective at such time as the resigning Distribution Adviser shall provide in the notice of resignation.

(h) Removal of Distribution Adviser. The Trust Protector shall have the power to remove any Distribution Adviser by providing written notice to such Distribution Adviser, the Trustee and the Notice Recipients. The removal shall become effective at such time as the Trust Protector indicates in the notice of removal.

(i) Appointment of Additional or Successor Distribution Advisers. The Trust Protector shall have the power to appoint additional Distribution Advisers if at such time there are fewer than three Distribution Advisers serving and shall have the power to designate a successor Distribution Adviser upon the death, resignation, removal or incapacity of the last serving Distribution Adviser by providing written notice to such additional or successor Distribution Adviser, the Trustee and the Notice Recipients. The appointment of additional or successor Distribution Advisers shall become effective at such time as the Trust Protector provides in the instrument of appointment and upon written acceptance by the designee. At no time may the Grantor, the Grantor's Spouse, any beneficiary of this Trust, or any party who is a related or subordinate party to the Grantor, the Grantor's Spouse, or any beneficiary of this Trust under Section 672(c) of the Code, serve as Distribution Adviser of any trust created by or pursuant to this Agreement.

(j) Compensation. The Distribution Adviser may be entitled to reasonable compensation for its services as agreed upon by the Distribution Adviser and Trust Protector

EXHIBIT D – SAMPLE TRUST PROTECTOR LANGUAGE

TWELFTH Trust Protector. Notwithstanding any other provision of this Agreement, there shall at all times be one or more Trust Protectors (the "Trust Protector" or "Trust Protectors") to serve in accordance with the provisions of this Article TWELFTH. The role and function of the Trust Protector is set forth in this Article TWELFTH. Unless otherwise indicated in this Agreement, the Trust Protector shall serve in a fiduciary capacity and conform to the provisions of this Agreement.

(a) Initial Appointment of Trust Protector. The initial Trust Protector shall be ____________. All additional and subsequent Trust Protectors shall be appointed in the manner provided in section (i) of this Article TWELFTH. To the extent that more than two persons are serving as Trust Protector at any time, an affirmative vote of a majority of such Trust Protectors must be reached with respect to any decisions, actions taken or direction given. Otherwise, the Trust Protectors must act unanimously. Notwithstanding the foregoing, to the extent that more than one Trust Protector is serving, the Trust Protectors may designate one such Trust Protector to communicate all directions to the Trustee.

(b) Role and Function. The Trust Protector shall have the following roles, powers and duties as well as any other powers conferred upon the Trust Protector pursuant to the provisions of this Agreement:

(1) To amend the administrative and technical provisions with respect to any trust created by or pursuant to this Agreement in accordance with Article SIXTEENTH of this Agreement, at such times as the Trust Protector may deem appropriate for the proper administration of the Trust and for tax purposes.

(2) To designate the law of any jurisdiction (under which the terms of any trust created by or pursuant to this Agreement shall be capable of taking effect) to be the governing law of any trust created by or pursuant to this Agreement, as provided in Article TWENTY-FIRST of this Agreement.

(3) To terminate the Grantor's or Trust Protector's power to reacquire or acquire Trust property in accordance with Article THIRD of this Agreement. The Trust Protector's power to terminate the Grantor's or Trust Protector's power to reacquire or acquire Trust property shall be exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity.

(4) To acquire any Special Holdings (and, in the event of the Grantor's incapacity, any other assets) constituting the Trust estate by substituting therefor other property of equivalent value as set forth in accordance with Article THIRD of this Agreement. The Trust Protector's power to acquire any Special Holdings (and, in the event of the Grantor's incapacity, any other assets) constituting the Trust estate by substituting therefor other property of equivalent value shall be exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity.

(5) To terminate the Trustee's power to distribute Trust income and principal to the Grantor for purposes of reimbursing the Grantor for income tax liability in accordance with section (c) of Article THIRD of this Agreement. The Trust Protector's power to terminate the Trustee's power to distribute Trust income and principal to the Grantor for purposes of reimbursing the Grantor for income tax liability shall be exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity.

(6) *OPTION IF YOU ARE GIVING POWER* To direct the Trustee to divide the Trust estate as set forth in section (c) of Article SECOND of this Agreement.

(7) To remove and replace the Trustee as provided in Article SEVENTEENTH of this Agreement.

(8) To remove any Investment Direction Adviser and appoint additional and successor Investment Direction Advisers as provided in Article TENTH of this Agreement.

(9) To hold and exercise the full power to direct the Trustee with respect to the management and investment of the Special Holdings at any time the Grantor is serving as sole Investment Direction Adviser in accordance with section (b) of Article TENTH of this Agreement.

(10) To remove any Distribution Adviser and appoint additional and successor Distribution Advisers as provided in Article ELEVENTH of this Agreement.

(11) To appoint additional and successor Trust Protectors as provided in this Article TWELFTH.

(12) To delegate any powers conferred upon the Trustee pursuant to this Agreement to an Adviser or such other person or entity as the Trust Protector so determines.

(13) To appoint a Special Fiduciary in accordance with Article NINETEENTH of this Agreement and to remove any Special Fiduciary and appoint successor Special Fiduciaries.

(14) To enter into fee agreements with the Trustee, the Investment Direction Adviser and the Distribution Adviser.

(15) To appoint or add to the class of Notice Recipients in accordance with the provisions of section (h)3 of Article TWENTIETH of this Agreement.

(c) Directions to Trustee. Any direction to the Trustee from the Trust Protector shall be in writing, delivered by mail, courier, facsimile transmission, electronic mail, or otherwise in such form as the Trustee may specify from time to time by written notice to the Trust Protector. The Trustee shall have no obligation to investigate or confirm the authenticity of directions it receives or the authority of the person or persons conveying them, and the Trustee shall be exonerated from

any and all liability in relying on any such direction from a person purporting to be the Trust Protector without further inquiry by the Trustee.

(d) Liability of Trustee. The Trustee need not review whether the Trust Protector is satisfying its responsibilities hereunder. As provided in 12 Del. C. § 3313(b), the Trustee shall incur no liability for any act or failure to act by the Trust Protector, or for acting on a direction of the Trust Protector and it shall not be liable for any loss to the Trust resulting from any action taken at the direction of the Trust Protector, or taken by the Trustee in accordance with the direction of the Trust Protector. As provided in 12 Del. C. § 3313(e), the Trustee shall have no duty to monitor the conduct of the Trust Protector, provide advice to the Trust Protector or consult with the Trust Protector or communicate with or warn or apprise any beneficiary or third party concerning instances in which the Trustee would or might have exercised the Trustee's own discretion in a manner different from the manner directed by the Trust Protector. Furthermore, in accordance with 12 Del. C. § 3302(e) and § 3586, the Trustee shall have no liability under this Trust to any Trust beneficiary or any other person whose interest arises under this Trust for the Trustee's good faith reliance on the provisions of this Article TWELFTH or any other provision of this Agreement concerning actions of the Trust Protector (unless the Trustee has acted with willful misconduct proven by clear and convincing evidence in the Court then having primary jurisdiction over the Trust, which such Court shall be the Delaware Court of Chancery for so long as Delaware remains the situs of the Trust). The Trustee shall be deemed to have acted within the scope of its respective authority, to have exercised reasonable care, diligence and prudence, and to have acted impartially as to all interested persons unless the contrary may be proven by clear and convincing evidence in the Court then having primary jurisdiction over the Trust, which such Court shall be the Delaware Court of Chancery for so long as Delaware remains the situs of the Trust. The Trustee and the Trust Protector shall not be liable for the acts or defaults of each other or any other Adviser.

(e) Limitations of Responsibilities. The Trust Protector shall have no duty to monitor the conduct of the Trustee, the Investment Direction Adviser and the Distribution Adviser, and shall not be liable for any exercise or failure to exercise the powers granted herein, provided that the Trust Protector shall consider in good faith the advisability of their exercise if and when requested to do so by a beneficiary, his or her guardian or a member of his or her family.

(f) Indemnification. The Trustee shall, to the extent of the Trust assets and solely payable from the Trust assets, indemnify the Trust Protector for all losses, costs, damages, expenses and charges, public and private, including reasonable attorneys' fees, including those arising from all litigation, groundless or otherwise, that result from the performance or non-performance of the powers given to the Trust Protector under this Agreement (unless the Trust Protector has acted with willful misconduct proven by clear and convincing evidence in the Court then having primary jurisdiction over the Trust which such Court shall be the Delaware Court of Chancery for so long as Delaware remains the situs of the Trust).

(g) Resignation of Trust Protector. Any Trust Protector serving hereunder may resign at any time by providing written notice to the Trustee and to the Notice Recipients. Such resignation shall become effective at such time as the resigning Trust Protector shall provide in the notice of resignation.

(h) Removal of Trust Protector. The following individuals, in the order named, shall have the power to remove any Trust Protector by providing written notice to such Trust Protector, the Trustee and the Notice Recipients. The removal shall become effective at such time as indicated in the notice of removal.

1. The Grantor, while he is living and competent;
2. The Grantor's Spouse, while she is living and competent;

3. Prior to the division of the Trust estate in accordance with section (c) of Article SECOND of this Agreement, a majority of the Grantor's Children who are competent and have attained the age of thirty-five (35) years; and

4. After the division of the Trust estate in accordance with section (c) of Article SECOND of this Agreement, the Primary Beneficiary with respect to his or her trust, if the Primary Beneficiary is competent and has attained the age of thirty-five (35) years; provided, if the Primary Beneficiary is under the age of thirty-five (35) years or incapacitated, the Grantor's eldest descendant who is competent and has attained the age thirty-five (35) years).

(i) Appointment of Additional or Successor Trust Protectors. The Trust Protector shall have the power to appoint additional Trust Protectors if at such time there are fewer than three Trust Protectors serving and shall have the power to designate a successor Trust Protector to serve upon the death, removal, resignation or incapacity of the last serving Trust Protector by providing written notice to such additional or successor Trust Protector, the Trustee and the Notice Recipients. The appointment of additional or successor Trust Protectors shall become effective at such time as the Trust Protector provides in the instrument of appointment and upon written acceptance of the designee. Upon the removal, resignation, death or incapacity of the last serving Trust Protector, and provided a successor Trust Protector has not been designated in accordance with the provisions of this Article TWELFTH, then the person(s) then authorized to remove the Trust Protector shall appoint a successor Trust Protector by providing written notice to the successor Trust Protector, the Trustee and the Notice Recipients. The appointment of a successor Trust Protector shall become effective at such time as provided in the instrument of appointment and upon written acceptance by the designee. At no time may the Grantor, the Grantor's Spouse, any beneficiary of this Trust, or any party who is a related or subordinate party to the Grantor, the Grantor's Spouse, or any beneficiary of this Trust under Section 672(c) of the Code, serve as Trust

Protector of any trust created by or pursuant to this Agreement. In the event of a vacancy in the office of Trust Protector, and provided no successor Trust Protector has been appointed within sixty (60) days, the Trustee shall petition the Court then having jurisdiction over the Trust for the appointment of a successor Trust Protector. All costs of such petition, including reasonable attorneys' fees, shall be a proper charge to the Trust estate.

(j) Agents and Advisers. The Trust Protector is authorized to hire agents and advisers to assist the Trust Protector in carrying out its duties, and to pay such agents and advisers reasonable compensation.

(k) Compensation. The Trust Protector shall be entitled to reasonable compensation for its services as agreed upon by the Trust Protector and the person(s) then authorized to remove and replace the Trust Protector

Special Session III-B

Simplifying the Complex: Demystifying Directed Trusts, Family Offices and Private Trust Companies

Section 2

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PART II: FAMILY OFFICES

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AN INTRODUCTION TO FAMILY OFFICES [*]

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I. <u>Introduction.</u>

A. Defining a Family Office. The term *family office* means different things in different contexts. Primarily, however, it refers to a privately held company that handles investment and wealth management for one or more ultra-high net worth families. The purpose of a family office typically is to grow and transfer wealth across generations.[1] The famous adage is: "If you've seen one family office, you've seen one family office." Some may argue this statement is slightly less true now than it once was as the industry creates more repetition in structures, governing instruments and recommended best practices. But the general idea remains accurate that each family office will be as unique as the family or families served.

B. Types of Family Offices. When referring to a family office on its own, one generally is referring to a "Single Family Office" ("SFO") meaning that the family office is owned by and exists to serve one family where the family members are related by blood or law. In its simplest form, an SFO is just a private business owned by a family of significant wealth to serve its unique financial and personal needs. In contrast, a "Multi-Family Office" ("MFO") exists when two or more families share the same family office. An MFO can be owned by one or more of the families utilizing the services or it can be an independent wealth management firm that serves select families as a family office.

C. Vital functions of a family office may range from:

1. Acting as the family's investment "brain trust," though the role usually goes far beyond asset management.

2. Promoting the family's values and providing a central hub for governance, legacy, succession planning and cohesion.

3. Supporting the education, development and well-being of family members and coordinating communication across the family.

4. Acting as the keeper and administrator of the family's wealth.

5. Coordinating and facilitating the family's interactions with other advisors and service providers.

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[*] The following outline is based on materials graciously provided by Anita M. Sarafa, Managing Director, J.P. Morgan Private Bank, from her Austin Fleming award recipient presentation on *Fostering Longevity for Family Wealth and Legacy: Critical Structural and Governance Decisions*, Sept. 13, 2023, at the Chicago Estate Planning Council. The materials have been edited, supplemented, and modified into their current form by Kim Kamin.

[1] See, e.g., Kirby Rosplock, *The Complete Family Office Handbook: A Guide for Affluent Families and the Advisors Who Serve Them* (John Wiley & Sons, Inc., 2nd Ed. 2021), p.1.

D. Family Office Design. Designing the correct strategy and structure for a family office is critical to ensure that long-term value is realized for the family.

E. Family offices typically evolve over time.

1. As the value and complexity of the wealth increases and as the number of households and family members served grows, family offices typically get larger and more complex.

2. The passing of a matriarch and/or patriarch can be the genesis of the family office evolution as governance issues often become trickier, requiring more involvement of outside board members and/or other professionals.

3. Generational shifts may also bring about other changes in the family office, such as: (a) risk appetite may become more conservative as generations evolve; (b) operating businesses may be sold; (c) the family may seek more direct investments to maintain purchasing power as the generations expand; and (d) liquidity needs may accelerate as family grows.

4. It's important to balance exponential growth of the family against slower growth of the assets. Modeling of future spending becomes critical to manage family member expectations.

5. Sometimes an SFO may be restructured as a private trust company, or it may become part of an MFO. These transitions typically result in a significant increase in complexity, including heightening regulatory oversight.

II. <u>History and Evolution of Family Offices</u>.

A. The roots of the family office concept go back to the 6th century in Europe after large families liquidated portions of their real estate holdings.[2]

B. The modern American version of the family office dates back to the late 19th century during the gilded age. The Rockefeller family office, founded in 1882, is considered to be the first full-service SFO in the U.S.[3]

C. Meanwhile, the term "family office" as we use it today began to be used more commonly in the 1980's. This corresponded during that time period to the founding of the Family Office Exchange ("FOX") by Sara Hamilton in 1989.[4]

D. While the concept of family offices isn't new, over 60% of those in existence appear to have been formed over the past two decades.[5]

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[2] *Id.* at p. 12.
[3] *Id.* at p. 13. After 135 years of functioning as an SFO, in 2018, the office evolved into Rockefeller Capital Management, an MFO. See https://www.rockco.com/about-rcm/.
[4] *See* https://www.familyoffice.com/about-fox/our-history.
[5] One analysis in 2019 noted that 68% of the 360 family offices they surveyed had been founded in or after 2000. KPMG, *The Emergence of the Family Office*, https://kpmg.com/xx/en/home/insights/2019/11/the-emergence-of-the-family-office.html citing *The Global Family Office Report* 2019, UBS and Campden Wealth.

E. Thus, despite their long history, they may feel like a recent phenomenon.

1. According to a study by J.P. Morgan and the World Economic Forum, after the 2008 Great Financial Crisis, many affluent families began to question how their wealth was being managed, resulting in a growing interest in the family office concept as a way to preserve and foster wealth. The family office took on the roles of both investment manager and risk manager for the wealthiest families.

2. Over the decades, that role has also expanded to include family engagement and communication, rising generation education, and development, philanthropy and impact.

3. It is unclear how many family offices exist. Some sources estimate there are between 3,000-6,000 SFOs in the United States and as many as 20,000 worldwide.[6] Another source in 2019 put the figure in the United States at 7,300 in 2019.[7]

4. Explosion in wealth.

   a. According to the most recent Forbes list, the world now has 2,640 billionaires worth $12.2 trillion.[8]

   b. Another recent study found that the wealth held by the top 0.1% of families in the U.S averaged $50 million in wealth per family in 2016 and increased from 13.4% to 15.7% between 2001 to 2016.[9]

   c. Additionally, between 70-90% of the world's private organizations are family-owned and controlled.[10] Approximately one-third of the S&P 500 companies are family-controlled in complex family enterprises.[11]

   d. The explosion of family wealth is leading to greater complexity and, for many families, more institutionalization of shared family wealth.

III. <u>Catalysts Driving Family Offices Today.</u>

A. What are the catalysts that spark the need for a family to consider forming or joining a family office? Many factors exist that make a family office a good option, such as:

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[6] *2023 Global Family Office Compensation Benchmark Report* (KPMG and Agreus), p. 3.

[7] *How Many Family Offices are there in the United States?* By Hilary Leav, Director of Research, Family Office Exchange (Aug 9, 2019) *citing* Shields, M, Hirt, O (July 16, 2019). *Burgeoning family offices manage $5.9 trillion,* Campden. Reuters Online, https://www.familyoffice.com/insights/how-many-family-offices-are-there-united-states#.

[8] *World's Billionaires List: The Richest in 2023, Forbes,* by Rob LaFranco and Chase Peterson-Withorn in partnership with Richard Mille (2023), https://www.forbes.com/billionaires/.

[9] Matthew Smith, Owen Zidar, Eric Zwick, *Top Wealth in America: New Estimates under Heterogeneous Returns,* PrincetonEconomics (Oct. 2021), https://economics.princeton.edu/working-papers/top-wealth-in-america-new-estimates-under-heterogenous-returns/.

[10] Moreover, according to a study by Family Firm Institute in 2017, family businesses contribute 70%–90% of the global GDP. See, https://entrepreneurship.babson.edu/approach-sustaining-family-business/#.

[11] 33.6% of S&P 500 firms are family businesses in which the founding family's average equity ownership is 18%. *See*, e.g., Family Business Alliance (2023), https://www.fbagr.org/resources/cited-stats/#.

1. Increased complexity and/or size of wealth.

    a. As the family wealth continues to grow and especially as it becomes more liquid (as a result of a sale of a business or other event), retail wealth management options may no longer fit a family's strategic goals.

    b. They may need deeper expertise, collaboration and coordination.

2. Family reasons.

    a. A growing family, family dynamics and the need for preparation for the future (*e.g.*, succession).

    b. Need for better communication across the family.

    c. Desire for a clear strategy and structure to keep family working together to preserve and share wealth across generations.

3. Investment reasons.

    a. Making greater investment returns than standard wealth management solutions.

    b. Maintain private business or diversify.

    c. Opportunity to deploy "patient," long-term capital and be less constrained than other investors.

        (1) Trend toward direct and co-investment opportunities (but need to be able to conduct due diligence or rely on a trusted partner).

        (2) Pooled investment vehicles such as LLCs may hold investments across trusts and individual accounts in order to gain economies of scale, provide greater diversification and often hold and manage long-term illiquid investments in operating business and/or real estate across the family.

    d. Looking for opportunity to reduce investment fees (or improve tax deductibility).

    e. Seeking to foster entrepreneurship in the younger generations.

4. Administrative challenges and need for oversight and risk management.

    a. Finding professionals dedicated to family to address needs.

    b. Management of hard/use assets (such as residential real estate, planes, boats, art collections, horses, etc.).

    c. Desire to create economies of scale for expanding family.

    d. Centralizing oversight and/or preparation of accounting, tax and legal work.

    e. Coordinating and overseeing estate planning and philanthropy.

5. Other reasons.

a. Some families want to establish a separate entity and "business presence" when dealing with vendors and service providers. This can have multiple benefits including enhancing the family's privacy with regard to financial transactions.

b. Succession planning for transition of ownership.

c. Cyber security concerns.

d. Protection against liabilities by shifting personal employees to employees of entities with limited liability.

IV. **Family Office Design and Structural Considerations.**

A. Families who are interested in a family office have a number of choices for the type of family office structure they want to create or utilize. The following are the primary options for types of structure they could utilize: (1) Fully out-sourced family office, known as a Virtual Family Office ("VFO"); (2) An embedded family office within a family's operating business (a.k.a."Corner Office"); (3) Classic SFO Structure; (4) SFO with a profits interest structure; (5) MFO that is regulated as a registered investment advisor; and (6) Private Trust Company ("PTC").

B. Virtual Family Office ("VFO")

1. Rather than creating formal family office infrastructures, some families work directly with outside financial institutions, tax and legal providers to provide all or most of the advice and services needed by the family.

2. This approach can include use of trusts and pooled investment vehicles to manage family wealth consistently across generations.

a. Some families rely on corporate trustees, often in attractive trust jurisdictions, to handle many administrative functions for them and their descendants, institutionalizing the trustee function.

b. In many cases, family members or family committees may oversee the investments of the trust but may fully outsource investment management to third parties.

3. Some families with outsourced family offices do hire one or two employees to handle bill pay or other concierge-type services for them. There are certain companies that can provide employer of record support for household staff to reduce the administrative and liability risks associated with such hires.

4. Pros and Cons.

a. Pros:

(1) Least complexity.

(2) Can potentially achieve many of the benefits of a family office without creating the infrastructure of a separate company staffed with employees.

(3) Flexibility to easily add or subtract services, as needed.

(4) No need to hire or retain talent and instead can simply cherry-pick best-in-class providers based on the family's needs, which can change over time.

(5) Typically lower cost than establishing an SFO or PTC.

b. Cons:

(1) Lack of individualized customization and often lack of personal attention as service providers may serve a large number of other clients so each family receives reduced personal attention.

(2) Lack of formal structure for control and governance of the family's activities and decision-making.

(3) Higher burden on family to coordinate services and providers.

(4) Family must monitor and perform diligence (across providers) and on investments.

C. Embedded Family Office in a Family Operating Business ("Corner Office")

1. The impromptu single-family office, run out of the proverbial corner of a family-run business, with company employees typically serving as the part-time family office staff. Approximately 25% of family offices are structurally embedded into an operating business.[12]

2. Considerations. This is the starting point for many families who have (or had) operating businesses. It is particularly common where the operating business is professional investing such as in hedgefunds, private equity, venture capital and/or real estate.

a. Primary services: investments, accounting, reporting and taxes.

b. Typically, just a small handful of employees who often serve multiple functions. There is significant overlap between key employees in the business (*e.g.*, the CFO, General Counsel and Executive Administrative Assistant) and the family office staff.

c. Family members may also be heavily engaged in the family office with lots of outsourcing. If the family's business isn't investing, then the investment management is typically outsourced and overseen by the founder(s) and perhaps other family members.

3. Founder or senior family member is accustomed to being like a dictator/ emperor who wields complete and absolute authority and the shift to shared family wealth can be challenging. There is often more consideration of the family office and often its evolution when there is a sale or monetization event of the family-owned business (*e.g.*, IPO or private equity transaction) or when the

[12] *Id*. at p. 112.

business is making substantial cash distributions that grow the family's outside asset base.

4. Core Questions.

   a. Can the embedded family office provide the required services?

   b. Is there sufficient privacy between the family's private affairs and the business?

   c. Depending on the answers above, can key people be pulled out of the business to focus exclusively on the family without jeopardizing the business?

   d. Evaluate the strategy and intent. Ultimately, the amount of wealth is not the determining factor regarding whether this model works. What is the founder/business owner's intent? Does the business owner want to develop a strategy that grows and preserves the family wealth in perpetuity? If retaining the family business, is the family best served with an embedded family office?

5. Pros and Cons.

   a. Pros:

      (1) No separate entity for family affairs.

      (2) Costs and expenses often passed through the business tax efficiently.

      (3) Key employees (typically CFO, General Counsel and the Executive Administrative Assistant) in the business often provide necessary support, advice and services to founder and senior family members in the business and perhaps other family shareholders.

      (4) No need for separate offices, service agreements, HR functions, admin services.

      (5) No separate registration with the SEC.

   b. Cons (putting risks of potential lack of diversification aside):

      (1) Typically, not all family needs are met.

      (2) Extensive outsourcing for many services.

      (3) Those family members out of the business are not always getting attention or communication.

      (4) Lack of privacy between business and family issues.

      (5) Employees not fully dedicated to meeting family's needs given dual roles with the business.

      (6) Business employees may lack expertise to deal with growing investment assets outside of the business, trust administration matters, and other personal family issues.

(7) Often messy recordkeeping.

(8) If client brings on a private equity partner, it may be difficult to justify the company carrying what might be viewed as personal expenses.

D. Classic Single Family Office Structure

1. The traditional single-family office often starts with a founder, having sold their business, who hires staff, rents an office, buys furniture and equipment, and runs an operation for their own family in order to control, coordinate and manage investments, business interests, philanthropy and other administrative and personal services.

2. Some family offices are small, managing more limited assets, while others become substantial wealth management institutions with teams of experienced investment professionals overseeing all aspects of the family's investments.

3. Typical Characteristics.

a. The founder often wishes to play an active role in overseeing investment management. Family engagement can be strong but, over time, may be more at a strategic level.

b. The family office has an established organizational structure and can hire substantial in-house resources.

c. The operation of the family business and family office are separate though it is very common for the family office to play a role in the business management.[13]

d. Similar services as an embedded family office but also philanthropy and perhaps concierge services. Some strategic outsourcing is typical.

e. Limited overlap of employees with the family business (generally a small number of such employees with well-defined roles).

f. The family office manages complex pools of investments and personal assets, often with a long-term focus. There is frequently an investment committee of family members and unrelated family office executives or other employees.

g. Must meet family office exemption under SEC rules to avoid SEC registration and compliance.

4. Some Core Questions.

a. Choice of entity: Pass through (LLC, S-Corporation, Limited Partnership) or C-Corporation?

b. Services: What services will be provided?

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[13] *The 2023 Global Family Office Compensation Benchmark Report*, supra. at p. 112. In a survey of 625 family office professionals worldwide, 64% indicated that the family they work for also manages an operating business of which 32 percent said they play apart.

c. Costs: How will expenses of the family office be met? Fixed fees, guaranteed amount, hourly rate or percentage of assets under management?

d. Ownership and Control: Who owns the family office? If the founder(s) (known in the industry as "G1") owns, perhaps they are covering costs in exchange for 100% ownership but what will happen in the future? Some families create or utilize an existing family trust to own the family office.

e. Employees: What personnel is needed and how will their role and job responsibilities be defined? How will they be sourced? How will they be compensated?

f. Technology and reporting: How will they be addressed?

5. Pros and Cons.

a. Pros:

(1) High degree of privacy and confidentiality.

(2) Greater governance and control over holdings.

(3) In-house team supports family's needs and reduces administrative burden for family members.

(4) Access to greater investment opportunities and purchasing leverage, fee minimization and cost savings by pooling family assets.

(5) Oversight and support of wealth management and estate planning across the generations.

(6) Customized services to meet the requirements of the family and support of the family's legacy.

(7) Strategic outsourcing for some services and coordination and management of outsourced service providers.

(8) Risk management, controls and compliance.

(9) Not required to register with the SEC because of the Family Office Exemption under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[14]

b. Cons:

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[14] Until the adoption of Dodd-Frank, the Investment Advisers Act of 1940 had a broad registration exemption for "small advisers" with 14 or fewer clients in any rolling 12-month period. Dodd-Frank eliminated that exemption, triggering the requirement that most investment advisers were required to register. However, Dodd-Frank also included a Family Office Exemption to exclude a family office from the definition of "investment adviser" under Rule 202. The SEC describes "family offices" as "entities established by wealthy families to manage their wealth and provide other services to family members, such as tax and estate planning services." The ownership is limited to "family clients" which includes broad definition of family, including stepchildren, former spouses, most trusts and entities, and certain key employees. But control of the family office must also be limited to family members.

(1) Structure is not tax efficient. In most cases, expenses are not fully deductible.

(2) Can be expensive to operate and staff.

(3) Competing for talent with wealth management firms, professional service providers and other family offices.

(4) Technology must be robust, and many family offices fail to optimize due to lack of execution or even awareness of solutions.

(5) Cyber security threats and need for robust data security.

(6) Investors are limited to extended family and key employees only under the SEC Family Office Exemption.

6. Please refer to Exhibit A for an illustration of a Classic SFO structure that has been provided by McDermott Will & Emory.

E. Single Family Office with Profits Interest Structure

1. An SFO with a profits interest structure is utilized to institutionalize the family office by creating an opportunity for family office to produce sufficient revenue to cover its expenses (*e.g.*, transition from G1 covering costs of family office to the family office becoming self-sustaining) and/or to attract top talent.

2. Overview.

a. For the families that choose to organize their family office with a profits interest structure, the family office essentially becomes the investment manager and provides investment advisory services (*e.g.*, strategy, due diligence, manager selection, monitoring, reporting) to the various family funds in exchange for a share of the future profits. The family office, as investment manager, employs all necessary personnel and pays all outside advisors related to the management of the various family funds.

b. Two landmark legal developments in December 2017 independently altered planning considerations for family offices. First came the Tax Court decision in favor of Lender Management, LLC.[15] For some owners of family offices who want to maximize the deductibility of the office's expense, *Lender* offers one example of how it is possible to do so.

c. Nine days later, the importance of that decision was heightened by the passage of the 2017 Tax Cuts and Jobs Act ("TCJA"), one of the provisions of which suspended through 2025 the individual deductibility of many previously deductible family office expenses, including investment management fees. Importantly, the TCJA left

[15] *Lender Mgmt., LLC v. Comm'r*, T.C Memo 2017-246.

untouched the Internal Revenue Code ("IRC") Section 212 that permits deductibility of trade or business expenses.[16]

d. In finding that the Lender family office was a trade or business, the court created precedent that family offices that qualify as trades or businesses can deduct the costs of running the office, including investment management fees, personnel and payroll costs, as well as other office administrative costs despite the changes in the TCJA limiting such deductions for individuals.[17]

(1) Although managing one's own investments isn't a trade or business,[18] the *Lender* court acknowledged that investment management, or selling one's investment expertise to others, is no less of a trade or business than selling, for instance, legal or medical expertise. The court also stated that an otherwise *bona fide* investment management trade or business does not lose its status as such merely because a taxpayer invests their own funds alongside those managed for others.

(2) Family offices have often analogized their role to that of a general partner in an investment fund. The court in *Lender* analogized the services the *Lender* family office provided to its clients to those provided by a hedge fund manager, finding that those services went far beyond the activities of a "mere investor" (*e.g*., record keeping and collection of interest and dividends).

e. Since these two developments, many families have been analyzing the income tax benefits of organizing or restructuring their family offices in a *Lender*-type fashion. Although some families with an appropriate fact pattern might restructure their operations, not all (even those with similar facts to *Lender*) will want or be able to organize their family offices as a trade or business. This is the case even though the choice not to reorganize would increase the after-tax cost of running the family office compared to both the *Lender* structure and the pre-2018 period when many expenses were deductible. One reason a family might choose not to implement a *Lender*

[16] Before the passage of the TCJA, individual deductions for IRC §212 were often lost due to one of three limitations: (1) the “2% floor” on miscellaneous itemized deductions, (2) the Pease limitation which reduced the value of itemized deductions above a threshold, and (3) the AMT which made certain miscellaneous itemized deductions non-deductible. Due to these differences in treatment, the owners of the Lender family office fought to have the expenses associated with running the family office classified as trade or business expenses under IRC §162 rather than as expenses for the production of income under IRC §212.

[17] Profitable family offices that collect fees for the services provided to family member have always been able to deduct their expenses against the fee income. However, the family members may not deduct the fees paid to the family office under current law.

[18] *Higgins v. Comm’r*, 312 U.S. 212 (1941).

structure is the unpredictability of cash inflows to support the significant costs of operating the office.

f. For the families that do choose to organize their family office with a profits interest structure, the family office becomes the fund/investment manager and provides investment advisory services to the various family-related investors (individuals, trusts and co-investment entities) in exchange for a share of the future profits.

3. Additional Typical Characteristics.

a. Compensation under a profits interest structure.

(1) The management company/family office is compensated through a true profits interest and not a guaranteed payment or a disguised fee under IRC Section 707.

(2) In *Lender*, the percentage of the profits interest the family office received from the investment LLCs it managed was *not* equal to the percentage ownership the family office owners held in the investment LLCs. This disparity suggested that the profits interest was something other than the family office owner's expected returns as investors (*i.e.*, compensation for services provided to others). Specifically, the fact that the family owned only a minor percentage of the investment LLCs demonstrated that the office's intent in managing money for the investment LLCs was not to receive a return on investment, but to make a profit by providing investment management services. Moreover, the uncertainty and entrepreneurial risk associated with the interest reinforced the family office's nature as a for-profit enterprise.

b. Expense Deductibility.

(1) As a general matter, a family office that is the general partner of investment entities and that engages outside investment firms for investment advice as part of its due diligence to carry out its investment responsibilities should not only be able to deduct expenses associated with the administrative services, but also investment research and consulting fees.

(2) In *Lender*, the family office claimed deductions for, among other things: salaries and wages, repairs and maintenance, rent, taxes and licenses, depreciation, retirement plans, employee benefit programs and guaranteed payments to partners.

(3) Deductibility of fees associated with underlying investments should be separately analyzed.

c. Disparate Interests.

(1) In a profits interest structure, it is important to establish evidence of a diversity of ownership of the family office and the investment funds and show that the family office is not on "both sides of the table" but is engaged in an arms-length arrangement with third parties.

(2) In the *Lender* case, the fact that the family members owned both interests in the family office and in the Investment LLCs subjected the family office to heightened scrutiny, but they were able to satisfy this additional scrutiny and be considered a trade or business able to deduct its expenses under IRC Section 162 in part because:

(a) The family members who owned the family office were different from those who predominantly invested in the LLCs.

(b) The family was geographically dispersed and had different investment goals. They did not "act collectively or with a single mindset."

(c) The *Lender* family office did not make investments on behalf of the family as a group, but rather provided customized investment services to each of its clients individually, based on their needs.

(d) The ability of the Investment LLC investors to withdraw their investments if they became dissatisfied suggested an arm's-length relationship.

(e) The profits interest compensation arrangement subjected the family office's compensation to business risk and led to the possibility that it might not be able to cover its fixed costs.

d. Business-Like Arrangement. A family office's status as trade or business is bolstered by conducting its operations in a continuous and business-like manner. Such formalities might include:

(1) Consideration by the family office of whether to engage legal, accounting, investment advisory or other services.

(2) Having non-family, full-time employees.

(3) Payment of compensation to family members working at the family office who are not owners of the family office.

(4) Holding regular meetings.

(5) Family members directly engaging the family office for services.

(6) Having formal contracts in place.

(7) Owning or renting physical office space.

e. Entity Considerations.

(1) Family offices are commonly organized as general partners of flow-through entities, retaining a profits interest for the management of assets on behalf of various investment entities.

(2) However, it is becoming increasingly common for the family office to be organized as a C-Corporation to be afforded technical deference as a trade or business. The C-Corporation typically operates at low margins to minimize both double taxation and the risk of triggering accumulated earnings taxes. Compensating a C-Corporation family office with a profits interest that is respected as a distributive share will not allow it to maintain those annual low profit margins. Rather the family office is likely to have very profitable years and even loss years.

f. Some Core Questions.

(1) How closely will the family office resemble a third-party trade or business, such as a traditional money manager? In other words, will the family office be able to show that it is managing investments for others?

(2) Will income exceed expenses? How will the family office meet expenses when income is lumpy and unpredictable?

(3) Will there be adequate capitalization and funding?

(4) Who or what entity will own the family office and be subject to the significant entrepreneurial risk?

(5) What type of entity will be used, namely a C-Corporation or pass through entity (S-Corporation, Limited Partnership or Limited Liability Company)? Some considerations include: one level of taxation vs. double taxation, treatment of business losses, 3.8% Net Investment Income Tax, personal holding corporation treatment for a C-Corporation.

(6) How will the amount of the profits interest be determined? What will be the frequency of the profits allocation (monthly, quarterly, annually)? How will success be measured? Will a benchmark be used? Will the hurdle reset or set a high-water mark?

(7) Will the family office be able to stay within the SFO exemption and avoid SEC registration under the Investment Advisers Act of 1940?[19]

[19] *See* Dodd-Frank and the final rule establishing the scope of the exemption, Securities and Exchange Commission Release no. IA-3220, 76 FR 37983 (June 2011).

g. Pros and Cons

(1) Pros:

(a) Managing the family office as a for-profit enterprise can help the family office to attract top talent and thereby deliver the best services to the family.

(b) Provides tax efficiency through the ability to deduct expenses, including investment management fees, as business expenses.

(c) Can institutionalize/formalize the family office, increase internal controls and deepen the services it provides.

(2) Cons:

(a) Complexity increases (*e.g.*, structure becomes more complex, often with more asset pools, greater reporting and asset aggregation needs, additional accounting and tax compliance needs, and analyses of annual profits interest).

(b) Greater potential for tax challenges, particularly income tax challenges with deductibility if there are different fact patterns than the one that passed muster in *Lender*.[20]

(c) Gift and estate tax risk that structure could result in "deemed gifts" when the younger generations own the management company (which manages assets for the senior generation(s)).

(d) Staffing needs often increase (*e.g.*, a Chief Investment Officer and other staff who may invest in many asset classes in-house).

(e) Intended benefits of profits interest structure can be lost due to improper structuring.

4. Please refer to Exhibit B for an illustration of an SFO structure with profit-sharing that has been provided by McDermott Will & Emory.

F. Multi-Family Office (MFO)

1. When a family doesn't want to create, pay for, or run a full-service SFO on their own and doesn't have the appetite to form a new MFO with other similarly situated families, they may instead decide to work with an existing

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[20] For example, *Hellmann v. Commissioner* settled after the U.S. Tax Court denied summary judgment on the issue of whether expenses incurred by an SFO with a profits interest structure were deductible as trade or business expenses under IRC §162. While not precedent, the Tax Court suggested that a profits interest allocated proportionately among the relevant family members wouldn't be evidence of a trade or business, since they would essentially receive the same investment return as if they were fractional equity investors. The Tax Court also contrasted *Lender* by highlighting that the facts indicated that the SFO managed investment assets for fewer family members, that those family members were close both geographically and personally.

MFO. An MFO is usually a boutique investment and wealth management firm that is either (i) owned by another family who wanted to reduce costs and increase scale by bringing in non-family members as clients, (ii) is independently owned by its senior executives and service providers, or (iii) is owned by a third party. The MFO will be subject to regulatory oversight and typically will be a Registered Investment Advisor ("RIA") that is regulated by the SEC.

2. Core questions for a family considering an MFO will include:

   a. Does the family actually want to establish their own fully functioning single family office or would they prefer a more turn-key solution?

   b. Does the family have a sufficient asset base to justify the costs of creating and operating their own independent SFO, including all the annual costs of upkeep?

   c. Where will they find the talent to hire who can run the family office? How will they handle talent transitions as employees inevitably turn-over?

   d. Do they want to be in control of all the investment, client service and other operations of the family office enterprise?

   e. Can they find alternatives in the marketplace that can provide all or most of the services they are seeking?

3. Pros and Cons

   a. Pros:

      (1) Economies of scale can reduce costs of services and allow expanded service offerings.

      (2) Larger pools of assets may increase access to investment opportunities.

      (3) Larger operation may facilitate attracting and retaining talented professionals.

      (4) For a family-owned MFO, the enterprise may be a profit center for the founding family.

      (5) Expenses at the family office level are deductible when registered as an RIA, but this will not impact most families who join an MFO unless they also have an ownership interest in the MFO.

   b. Cons:

      (1) The MFO that is an RIA is required to register with the SEC and is highly regulated (which is a con if the family wants to set one up, but could be a pro for the family joining an existing MFO as such regulation typically provides comfort)

(2) Potentially less privacy than a single family office in the sense that services will be provided to the family by principals or employees of the MFO rather than by the family's own employees.

G. Private Trust Company ("PTC").

1. Some families might organize their SFO as a PTC (or transition an existing SFO to the PTC rather than operating both). Since most of the family's wealth will be held in trusts, the PTC can serve as trustee of the many trusts established by family members, often over the course of many generations.

2. While Part III of these materials will focus entirely on PTCs, below are some considerations and other information relating to use of a PTC as the SFO.

a. Having a PTC as the SFO can alleviate the need to hire a public trust company to serve as trustee for the trust or to ask family members or family office executives to serve as trustee. If a family office executive is willing to serve as trustee, the family should secure fiduciary liability insurance as they would for any individual trustee who isn't otherwise carrying malpractice insurance that covers the role and who isn't a beneficiary or a parent of a beneficiary.

b. The Board of Directors of the PTC can be composed of family members and/or trusted advisors familiar with the family, bringing a sense of insight, empathy and flexibility that they believe another corporate trustee may not have.

c. Provides continuity and ensures the family's legacy in that it can (1) solve for long-term succession planning for the trusteeship rather than relying on individuals; (2) ensure the family continues to own and control any family business(es) and other assets; and (3) potentially limit ability of future generations to sell the family business.

d. Provides opportunities for family involvement and ongoing education of future generations (*e.g.*, family members can serve on the Board or on an investment, advisory or protector committee).

e. A PTC often implements a formalized governance structure for the long-term management and administration of the family's wealth.

f. Centralized and personalized trusteeship can potentially help manage expectations and avoid disputes.

g. Having a centralized and streamlined reporting structure can ensure effective and efficient flow of pertinent information to the family members and increase communication and engagement with trust beneficiaries.

h. Additional Benefits include:

(1) Increased trustee latitude and flexibility.

(2) Liability protection for individuals who were previously serving as trustee and will be making distribution decisions on behalf of the PTC.

(3) Potentially minimize state income taxes applicable to trusts.

(4) Platform for efficient administration of all trusts.

(5) Management of unusual assets and business interests.

(6) Ability to implement unique investment goals and strategies.

(7) Providing investment advice and an investment platform to family and affiliated persons.

(8) Contain and manage privacy and private communications.

(9) Customize policies and procedures to institutionalize trustee functions and processes.

(10) Potential reduction in fiduciary costs.

(11) Ensuring sound risk management practices for administering trusts.

3. Ideal Candidates for a PTC.

a. Families with significant wealth (typically at least $500 million in trust assets, but more often in excess of $1 billion) who have shared goals, values, and purposes, and who seek a family governance solution.

b. Families that have trusts with concentrated positions.

c. Trusts benefitting family members, including multiple generations; specific trust purposes (*e.g.*, maintaining family-owned business ownership in trust with plans for continuing family ownership).

d. Trusts currently paying state income tax and/or subject to state transfer taxes that want to change jurisdictions.

e. Families seeking to replace long-time trusted advisors serving as trustee due to retirement.

f. Families with a need for unique/customized services that are not practical or profitable for a corporate trustee.

g. Families wanting to provide trust services to certain persons who are affiliated with the family including investment advice and participation in family investments that otherwise do not meet the definition of family under the SEC Single Family Office Rule.

4. Core Questions and Considerations.

a. Regulated or non-regulated? (If non-regulated, the expense hurdle considerations may be lower.)

b. State Jurisdiction. In what state will the PTC be formed? Will the PTC hire staff in that state or hire a local provider? (Consider that

key decisions will need to be made in the PTC state.) If building an office in that state, will the PTC be able to attract top talent? Is there a nearby university that can serve as a pipeline for talent? If so, does the university have a program in wealth management or other relevant coursework?

c. The economics have to be favorable before embarking on the formation of a PTC. Families must determine the costs of organizing a PTC, hiring a trust services provider in a particular state and making the requisite regulatory and tax filings. These costs should be compared to the cost of fiduciary fees that might be paid to hire a public trust company.

d. Regulatory burdens and capital costs should be considered. By virtue of the fact that a PTC is not doing business with the general public, the general regulatory requirements for family trust companies should be less than for retail trust companies, along with lower capital requirements, but the family needs to consider regulatory burdens.

5. Pros and Cons

a. Pros:

(1) Family oversees and controls family trusts where, over time, most of the family assets are held.

(2) Family's goals can be met more easily because the entity is not required to meet profitability and performance standards.

(3) Trustee continuity, long-term governance and succession.

(4) Exempt from federal and state securities registration regulations (if formed as a regulated trust company).

(5) Family participation in the management of investments is permitted, subject to the limitations in IRS Notice 2008-63 and other IRS guidance (*e.g.*, family member cannot vote stock of corporation in certain situations).

(6) Public trust companies may be compelled to diversify assets even when reducing an ownership stake in the family business is not an attractive option. While PTCs are subject to the same fiduciary duties as other trustees, they may have more latitude in weighing the relevant factors. Moreover, they are generally located in states with the most favorable trust laws.

b. Cons:

(1) Significant startup costs and time commitment.

(2) Can be expensive to obtain charter, meet state capital requirements and fund ongoing regulatory costs.

(3) Ongoing operational costs, which can also be significant.

(4) Operating a trust company adds material complexity to the family's affairs.

(5) Requires experienced, dedicated trust, trust operations, and risk management personnel. Can be a significant number of additional people depending on the family situation.

(6) If regulated, subject to state regulator supervision and periodic audits.

(7) Unregulated PTCs can be riskier to operate because oversight is less robust.

(8) Need to protect against adverse tax exposure (*e.g.*, family member in management viewed as controlling trust distributions).

 (a) Board must have some (presumably paid) independent members to avoid gift and estate tax consequences.

 (b) Similarly, independent parties should make tax sensitive decisions, which is often implemented through a Discretionary Decisions Committee, members of which typically cannot be removed during their term without cause.

(9) Only able to form in certain states (with key regulatory framework for family trust companies and usually no fiduciary income taxation). May need to maintain an office and employees in state of jurisdiction or develop relationship with local provider.

(10) May need to travel to state of jurisdiction for key decision-making.

(11) Privacy concerns with regard to exposure of private family member information to other family members (*e.g.*, spending and lifestyle distributions). Can be designed-around and managed, but may be of concern.

(12) Unless outsourcing to an existing trust company, may not have access to a corporate trustee's extensive administrative, compliance and risk management processes and experience or extensive discretionary decision-making process and experience.

(13) PTC could be exposed to potential liability.

(14) Trust beneficiaries have no real recourse if the PTC commits a breach of trust. Aggrieved beneficiaries can only go after the assets of the PTC, which may be poorly capitalized and already belong to the family.

V. **Key Decisions When Starting a Family Office.**

A. Identify the purposes for the family office.

1. It is very important at the beginning to align the family's goals with that of the family office, family business (if one exists) and the family philanthropic entities. While the senior generation is frequently determining the initial purpose and mission of the family office, there should be recognition that it will likely evolve over time with the younger generations taking on leadership and decision- making roles.

2. Many of the catalysts identified earlier become part of the mission of the family office. This may include organizing and simplifying the wealth management across the family, preservation and growth of the family wealth, fostering family unity, education and development of family members, implementing a governance framework for decision-making and fulfilling the family's philanthropic goals.

B. Define a strategy for stewarding family capital. Here are some critical questions and considerations.

1. What services does the family require and/or desire? The family, in consultation with its advisors, must evaluate its needs and determine the desired outcomes. Services provided by many family offices include:

   a. Investment management, including but not limited to, investment policy development, portfolio construction, manager selection, custody of assets, and comprehensive performance reporting.

   b. Integrated financial services, including but not limited to, consolidated balance sheet reporting, cash flow planning, retirement planning and life insurance analysis.

   c. Tax review and compliance, including but not limited to, individual, trust and entity tax returns, managing estimated tax payments and other tax compliance.

   d. Succession and wealth transfer planning, including but not limited to, diagrams and analysis of plans, developing objectives and considering various legal and tax strategies, implementation of planning strategies, assistance with letters of wishes, and trust and estate administration.

   e. Client information management, including but not limited to, information technology, secure online access to custom reports, cash flow analysis, legal documents, tax returns, and other record keeping;

   f. Lifestyle enhancements, including but not limited to, personal billpay, domestic help and payroll, property management, travel planning, private aviation, healthcare management and other concierge services.

g. Family philanthropy, including but not limited to, determining family values and objectives, composing mission statements, private foundation and donor advised fund grant-design and implementation, negotiating structured gifts, philanthropic or non-profit entity management for private foundations, private operating foundations, supporting organizations and social welfare 501(c)(4) organizations.

h. Family continuity and education, including but not limited to, rising generation family education planning, family governance design and implementation, design and facilitation of family meetings, fostering entrepreneurship, providing or arranging counseling, mentoring and coaching, and coordinating outside advisors.

i. Liability/risk management, including but not limited to, property and casualty insurance, fiduciary liability insurance, cybersecurity, personal security, collectibles inventories, appraisals, and storage.

j. Please see attached Exhibit C for a sample chart of family office services, Exhibit D for the services SFO's have reported to the Family Office Exchange that they provide to families themselves, and Exhibit E for services reported as outsourced by SFO's.

2. What is the best way to meet the family's objectives, including tax efficiency (trends toward increasingly complex structures)?

3. Who is the family office/family wealth meant to serve?

a. Definition of family members (*e.g*., are spouses, ex-spouses, in-laws and stepchildren included?) Note that as may be discussed in more detail in Part III of these materials, for a PTC, must consider SEC definition for family office exception, which may not be the same as the governing state's definition.

b. Number of households?

c. Number of current generations?

d. Jurisdictions touched, both domestically and internationally?

e. Anticipated longevity of the family office? Is it desired that it will serve future generations even after the founder and the founder's spouse are deceased? It can be a lot to ask for siblings, first cousins, and eventually very remotely related cousins to be expected to continue to invest and/or donate together long term.

4. Question of whether to "build it or buy it"?

a. Many founders are natural empire builders, but it may be more efficient for them to "buy it" than "build it" when it comes to a family office or any services that can be outsourced.

b. One of the big questions for a family is what will be outsourced and what will be done in-house?

c. If done in-house, how will families recruit and retain highly experienced professionals they trust for all the roles that need to be filled?

5. Investment Management.

a. Investment management is a prime example where the family will need to carefully evaluate whether to handle in-house or to outsource. Can the family afford and find a Chief Investment Officer (CIO) and in-house investment team? Considerations of cost-efficiency, performance measurement, liquidity management and talent. The family needs to decide how they will evaluate an in-house investment team and when to fire them if they are not performing.

b. Direct investing has become substantial activity that "institutional" family offices do. It includes controlling and minority investments in companies. This is done both individually by the family as well as co-investing with other families, private equity funds and sovereign wealth funds.

(1) Family enterprises have a strategic advantage with their private capital. Their "patient capital" provides them a longer time horizon than most other investors. This may create a greater risk tolerance. If the family runs or sold a successful operating business, it may also have specific industry and/or operational expertise it can utilize.

(2) Direct investing gives families greater control. It appeals to entrepreneurial families and rising generation family members who want to be more hands on. But direct investing also comes with corresponding risks.

(3) Does the family have ability to do adequate due diligence? How do they size the opportunities? Will they take majority or minority positions?

6. Tax and Accounting.

a. What services and advice should be centralized?

b. How will the family address issues such as tax compliance and reporting, cash flow and budgeting, general ledger/accounting, income tax projections, identification of tax planning strategies? Preparation of financial statements? What will be done in-house versus outsourced? Who will oversee these services?

c. Does the family need to provide support services to trustees of family trusts, such as: (1) principal and income accounting, (2) payment of trust expenses and fees, and (3) tracking distribution requests and decisions?

7. Wealth Advisory and Financial Planning.

a. How will the family receive strategic advice on estate and financial planning for family members and trusts?

b. Who will provide trust and estate administration?

c. Other areas might include insurance, pre-marital planning and divorce advice.

8. Technology needs can be vast and will need to be upgraded and evolved over time.

a. Some common technology needs, which can be housed on-premise or through cloud-based services, include:

(1) Family portal and document vault.

(2) Asset aggregation, reporting and analytics.

(a) With regard to aggregated reporting, if done in-house, it can be incredibly difficult to find the right provider and customize the reporting for what the family wants and needs.

(b) It is also a huge uplift to get in place and there may be significant costs.

(3) General ledger accounting systems and controls.

(4) Financial administration for management of expenses, accounts receivable and payable.

(5) Investment and analytical tools. If there is an in-house CIO role, the family office will need portfolio management and trading systems, due diligence databases, market data, etc.

b. There must also be a robust process for assessing evolving technology needs, sourcing solutions, execution, training, maintenance and upgrades.

9. Concierge and Lifestyle.

a. Sometimes these services are important to a family but often they are specifically excluded (*e.g.*, family office is more of an investment office).

b. Will the family offer bill pay services and, if so, to whom? How will those services be paid for?

c. Insurance management.

d. Specialized management of family real estate, planes and collections.

e. Oversight of household employees.

f. Travel assistance.

g. The offering of these services can sometimes cause friction where it is perceived that some family members are heavier users. One way

to address is to charge separately for these services—or don't offer them.

10. Rising Generation Education.

    a. How will the family and family office prepare the rising generation for the wealth?

    b. What will the family office be responsible for? How will the family and family office teach and foster age-appropriate learning in business and financial fundamentals, estate planning, philanthropy, leadership and skill development, entrepreneurship?

    c. How will the family address navigating family dynamics and communicating between generations?

    d. Will outside providers and consultants be used?

    e. Define future roles in the family/family enterprise and requirements for those roles.

11. Philanthropic Services.

    a. What is the family's philanthropic strategy?

    b. What services will the family office provide to the family's charitable giving vehicles (Donor Advised Funds, private foundations, charitable trusts)?

    c. Governance of the foundation and family involvement are also considerations.

12. Risk Management Services.

    a. These may include data privacy (*e.g.*, cyber security policies and training; storage and protection of personal data).

    b. Fraud prevention.

    c. Adequate insurance.

    d. Personal security, if needed.

13. Succession Planning. Succession planning for the family decision-makers, trustees, family office executives and family business are critical issues for a family to address.

14. Trend toward greater focus on Well-Being

    a. Forward-thinking families focusing more on purposeful planning and considering what "success" means for the family beyond investment metrics. Rather than viewing wealth just as financial capital, enlightened families are realizing that the well-being of family members is the purpose of the wealth.

    b. Accordingly, family offices are being asked to invest more time and resources to help the family focus on the aspects that actually matter

in their lives such as health, longevity and quality of family relationships.

c. Family offices need to figure out what they can do to foster, promote and maintain well-being.

VI. <u>Cost Overview of Family Offices</u>.

A. Single family offices have significant annual costs. Approximately 40bps is a reasonable estimate for a decent-sized family office. EY estimated costs ranging from $500k to $3 million annually to run a stand-alone, full service SFO, and in many cases it will be much more.[21] According to some observations, a family office overseeing $250 million in AUM can estimate $1 million plus in annual operating costs.[22]

B. There are also startup costs such as legal fees to set up the structure and contracts, family office recruiter fees, and infrastructure expenses for office space, technology purchases and all the other expenses of setting up a new business.

C. Compensation is the biggest cost for almost all SFOs. Approximately 60% of the costs for running a family office go to talent. In recent years, heightened competition for talent has driven compensation costs up.[23]

D. There is also a question of who pays. This is huge issue for families and an ongoing issue within the family office. It can be related to the ownership structure of the family office and the way that costs are allocated.

1. Often a family office may start out with the senior generation bearing the costs but later they may need to allocate expenses.

a. If senior generation is paying, the family office is often run on a budget.

b. If no profits interest structure and senior generation is no longer paying, expenses may be allocated based on capital accounts of family office participants.

2. Profits interest structure can reduce the family's taxable income by allocating a portion of the profits (if any) to the family's management company which, in turn, pays the expenses of the family office.

a. This structure can ease succession issues when the senior generation passes and provide a long-term mechanism to cover the costs of the family office.

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[21] EY Private "How can you build a future that will last for generations? Create a family office to nurture the family legacy" (2022). Likewise, KPMG estimates the cost of running a family office at 0.1%-0.5% of AUM according to 37% of its global family office professionals surveyed. *The 2023 Global Family Office Compensation Benchmark Report*, <u>*supra*</u>. at p. 9.

[22] This observation was made by Anita Sarafa in the original version of these materials.

[23] Botoff Consulting Compensation Survey (2022-2023) reports that 33% of family offices reported higher performance bonuses and 46% of family offices reported higher salary increases than prior year compensation due to strong talent market.

b. However, as cash flows are lumpy, will the management company be able to cover expenses in years when profits do not exceed expenses?

3. Other models exist. For example, instead of utilizing a *Lender* structure, a family might capitalize fees paid to management company so that management company can be paid when the investment is sold.

4. Some families try to allocate expenses based on use of resources which can require the family office employees to keep track of their time. Others look to each family member's assets under management. Some use a fixed fee. Others impose a fee cap or even a minimum fee.

5. Some of the difficult considerations can include:

a. If family branches are not the same size, should costs be allocated by headcount?

b. Use of the family office services is rarely equal. For example, heavy use of an SFO by the family could be by the branch with the smallest pool of assets. Should usage be a factor in cost allocation?

c. Families want to preserve as much as possible in GST exempt trusts. Is it possible to develop a policy that would allow more costs to be allocated primarily to nonexempt trusts?

d. Should costs be allocated generationally, *e.g.*, have the senior generation bear more of the costs to reduce their taxable estates? Moreover, while family offices are not viewed as profit centers, some family offices and management companies are owned by GST exempt trusts so having fees and profits in excess of costs accumulate in such a trust could, over time, benefit younger generations.

VII. <u>Management and Talent Considerations</u>.

A. Hiring for an SFO is complex as the roles and responsibilities vary greatly, especially as offices grow more specialized and service more complex family needs. The KPMG Agreus benchmark report found that of the 625 family office professionals surveyed around the world, family offices most commonly have fewer than 5 employees while 25% have 20 or more.[24]

B. Ensuring that the family office Chief Executive Officer (CEO) and CIO understand the family's best interests is key. What family office executives see as the family's priority does not always match what matriarchs and patriarchs prioritize.

C. Family offices compete for talent for their executives, their investment teams as well as tax and accounting teams. There are also limited candidates who are flexible and skilled enough to take on some of these broad roles. Moreover, many times the roles start broad but become more specialized over time.

D. Key Attributes such as personal integrity and discretion are critical.

[24] *The 2023 Global Family Office Compensation Benchmark Report*, *supra*. at p. 9.

E. Staffing Core questions can include:

1. Who will staff the family office or other entity? How will you identify and recruit talent?

2. How will employees be compensated? Can you compete for top talent?

3. Are roles well-defined?

4. Will family office executives have real authority to act?

5. If hiring multiple people, will you be able to create a cohesive team?

F. Compensation for family office executives and employees is driven by market demand.

1. Sometimes compensation is structured as guaranteed payments which can include:

   a. fixed fees (*e.g.*, tax preparation);

   b. hourly fees (*e.g.*, concierge services, bookkeeping, legal services); and

   c. base salary.

2. Profits Interest structure can include a range of compensation opportunities, particularly for the investment team.

   a. Carried interests, which provide employees with a share of investment profits in excess of a specified return (*e.g.*, an 8% hurdle rate) or grants of carried interests linked to the performance of a private equity or direct investments in portfolio companies;

   b. Co-investment opportunities that allow key employees to co-invest with the family (often financed with loans from the family with or without recourse and often collateralized by the investment);

   c. These forms of compensation can attract and help retain talented professionals, though they may have to wait a long time for investments to pay off (especially in the direct investment space); and

   d. Fee waivers for employees to co-invest.

3. The majority of families also use a range of annual bonuses and/or long-term incentive compensation to align executives' interests with those of the principals. For example, a deferred cash bonus that vests over a three-to-five-year time horizon or phantom equity that tracks some of the family's investments without actual ownership.

VIII. <u>Best Practices and Common Pitfalls</u>.

A. Create a business plan for an SFO.

1. With a family office, the family is creating a new business to manage wealth, and it should have a business plan similar to any other business that is created. Start with the vision of the family and an assessment of where it

is today. In addition to defining the family's objectives, the business plan should create a road map addressing items such as: legal structure, decision-making/governance structure, budgets, staffing, what will be built in-house versus outsourced, how technology needs will be met, tax and accounting and other advisory services and guidelines for investment processes.

2. The business plan should also include how the expenses of the family office will be addressed and the economics should be modeled.

   a. Understand operational costs (rent, salaries, tech, etc.).

   b. If doing profits interest, model cash flows to cover expenses as well as potential tax savings.

3. Need self-awareness of whether family members are willing to put the work in as well as whether there will be universal family buy-in.

4. Running a family office takes a disciplined approach and clarity early on is critical (*e.g.*, liquidity needs, investment policy, division of responsibilities, controls, services).

5. Bring in the right team including family members, legal and tax advisors versed in family office structures and other trusted advisors. Some families also bring in family office consultants.

B. Avoid Overbuilding and Undue Complexity.

1. Too many SFOs overbuild, especially their investment staff. Complexity is easy to create and difficult to unwind.

   a. Increasingly families seem to be considering slimming down their family office investment teams and what they do in-house. Returns are not beating the S&P while in-house talent is expensive (compensation, benefits, HR, etc.).

   b. Families may be questioning whether it make sense to pay someone a large salary simply to manage ETFs. Or the family office head may be concerned that the investments are over-diversified with a web of complexity and costs. Unless returns are significantly better than what a bank or investment firm can do, net of all costs, out-sourcing may be a better option. Some also question how the in-house investment team can stay current and relevant.

2. A best practice is to start slowly. Perhaps start building infrastructure and team based on what will make things easier for the family such as overseeing tax compliance or a controller who can get cash to the right places or someone to do bill pay. Some families start successfully with 1-2 employees, a deliberate process and identified goals—along with lots of outsourcing.

3. Some families also have too many providers in the belief they are getting best- in-class, but that can also add undue complexity and result in relationships where they are not the prized client to their outside advisors and may not be getting the best from those relationships.

4. Design a structure with flexibility to evolve over time. The family may not be concerned about expense deductibility today, or may not have the right fact pattern, but may want profits interest structure in the future.

C. Tax Considerations.

1. When forming a family office, it is essential to think carefully about what is being formed, staying between the bumper guards/rails if doing the Lender structure. Make sure facts and circumstances of the family office and investment vehicles align with the documentation. Moreover, the documents (and correspondence) should articulate the business intent and purpose of the different entities. It should not be created solely for tax benefits.

2. There is not only the family office and management company but often many family co-investment vehicles that have similar estate tax inclusion concerns (IRC Section 2036 or 2038). Making sure to understand and document the business purpose and to keep a close eye on who has control of distributions is imperative.

3. A best practice is to "stress test" the structure not only from an economic point of view but from a tax standpoint to see whether it can withstand tax challenges (specifically regarding IRC Sections 162, 2036, 2038 and 2701).

D. Identify what the family cares about.

1. The family office serves as the execution arm to achieve the desires and needs of the family. But the family needs to identify what it cares about for the office to reach its full potential. If the family doesn't know what it cares about, the professionals running the office will need to help the family define who its members are as a family, what they care about, and what they want their legacy to be.

2. Successful families often define purpose and shared family values. For example, conversations about purpose may involve the family's commitment to "doing well by doing good," perhaps through its operating business or addressing issues such as climate change through its investments and philanthropy.

3. A consistent theme heard from families in a recent J.P. Morgan Private Bank Stewardship and Purpose survey (the "Stewardship & Purpose Study") was that family unity was most important.[25] If the family loses everything, it will still have "the family". One family leader noted that their number one rule is "Protect the holidays!" and "If you don't keep the family together, what is the point?"

4. Legacy is how the family is left, not just what is left to them (*e.g.*, money, businesses). Matriarchs and patriarchs need to think about their families over multiple generations and define what makes them a family.

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[25] *Stewardship & Purpose, Conversations with the World's Wealthiest Families*, J.P. Morgan Private Bank (2023).

5. At the same time, clients need to be aware that their great-grandchild will have eight great-grandparents. The family office they are establishing today and as they focus on family legacy, they need to understand that for a family of wealth, that great-grandchild could potentially have at least three other family offices and family legacies competing for their focus and attention.

6. With each generation trying to force them to remain connected financially to any particular family line can be incredibly restricting, not to mention exhausting. Accordingly, clients should be realistic in what they plan to impose on their descendants and build in as much flexibility and optionality as they can.

E. To this end, it is never too early to prepare and involve the Rising Generation for them to inherit and manage the wealth.

1. Successful families ask: Who is the wealth for? Need to turn things upside down and ask the rising generation what it wants from the family office.

   a. One example of a family that handled things quite well had its family office head, with the patriarch's blessing, spend nearly five years working with the adult members of the rising generation, asking them what they wanted as future wealth owners and what they wanted the family office to do for them. Transparency was key. The rising generation felt it had agency and engagement with the family office and the wealth. When the patriarch passed away, the children and grandchildren felt totally prepared to assume full responsibility for the family office.

   b. Contrast another family with almost 90 family members and multiple living generations. The patriarch has not been comfortable talking about his family or what would happen to the family businesses and the family office once he is no longer able to lead them. Younger family members are not brought in, not prepared, and there appears to be little transparency. Issues beneath the surface seem obvious to the advisors.

   c. Accordingly, a best practice is to communicate with the rising generation. Even if wealth sits in a trust, they will be the inheritors. Ask what they (the members of the rising generation) want the family office to provide and do it before a death of the senior generation happens.

2. The most successful families think about educating their children to be good stewards. They think beyond the financial implications to the human issues and family dynamics. There are many families who have clearly defined values that they share across generations including. Some examples include: family connectivity, religious values, educational focus, strong work ethic, concern about the preservation of the planet for future generations, and/or perhaps a passion for helping their communities.

3. Not telling children early enough about the wealth is often done for what they think are good reasons that might better encourage children to have

meaningful and productive lives as contributing members of society and to develop self-esteem. Other families do not share information for fear of the burdens that can be associated with the family wealth. Many parents simply do not know how to discuss these issues with their children. But "money silence" can lead to children being totally ill-equipped to handle wealth.

a. They may lose chance to children and grandchildren develop the skills and judgment needed to take on a leadership and/or stewardship role. Perhaps even losing opportunity for important discussions regarding values within the family and family history.

b. It can lead to resentment and belief parents did not trust the child.

c. Likely the parents/grandparents can build some guardrails to protect against the downside concerns of sharing information about the wealth but much harder to recover from the downside of not telling them.

d. Adult children might make different life choices if they had more information.

(1) Career choice is a frequent example (*e.g.*, choosing less remunerative but high value careers such as social work or teaching versus a business professional).

(2) But other decisions may also be impacted such as when to start a family, purchase a home or save for their children's college education.

(3) In one family where the matriarch and patriarch are in their late 80s, information about the significant family wealth remains to be shared with their children, who are now in their 50s and 60s. Small trusts were set up for the children but with restrictive terms. One child, a teacher nearing retirement age, is wondering whether they can afford to retire. Another child with medical problems would like a more accessible home, but they are concerned about the cost of modifications or moving. In a situation like this, the lack of transparency and information sharing can seem particularly tragic.

4. It often is best to share information in bite sizes, if for no other reason than so it is easier to digest. Many successful families start with the family history and reflect on the family's values. Perhaps even the parents' own struggles. Share what is age appropriate. Smaller families can be more nuanced with their children. But larger, multi-generational families may need to be more formal (*e.g.*, at age 16, all cousins learn X; at age 18, they execute powers of attorney and basic wills and learn Y, at age 21, they have a withdrawal right from their 2503(c) minors' trusts and engage in their own trust planning; at age 22, they learn Z).

a. The importance of teaching the next generation about the family's history and its lessons from successes and failures is stressed by

many principals to help younger family members maintain their families' values, legacies and successes. Some even have books written about the family. Updating family history is sometimes an activity at family meetings/retreats.[26]

b. Open Door Policy. Many families also desire to foster a culture of openness for younger family members to feel comfortable asking questions and learning about the family and its business or other operations. Some let their children sit in on meetings to help them 'learn by osmosis."[27]

5. Another best practice is to provide a sense of purpose and opportunity to participate. Give responsibility to children as early as possible. Successful families dedicate the time and resources to prepare the next generation of family members for inheriting wealth and provide them with the tools they need to succeed. One principal in the Stewardship & Purpose Study offered a fitting metaphor: "If they're going to inherit a Rolls-Royce, we must teach them how to drive, so that they don't crash."[28]

6. It's ideal to start communicating expectations for roles in the family office early, such as when kids are teens. The goal is to prepare them for the expectations, so they don't become adults and complete their educations just to be informed that they don't have the right educational background or outside employment experience to have a role. The ways some families have handled this is through written employment and compensation policies for family members and communication regarding any prerequisites.

7. Many families also successfully lean on advisors both inside the family office and outside to help frame these conversations as well as educate and empower rising generations.

F. Communication and Transparency.

1. Communication is one of the most critical elements for the success of shared family wealth. A core, recurring theme of successful families is a deep desire to foster effective communication that unites the family and builds stronger connections by making the decision-making process clear.[29]

2. Senior family members and the family office executives must be proactive in sharing information, especially among siblings and cousins. They may not need to be able to look at everything, but family members want to be respected and know what is happening and why. More communication than less is almost always better.

3. Formal: Family meetings, quarterly committee meetings and other channels of ongoing communication (*e.g.*, web-based portals for sharing minutes, committee reports, tax documents). Communication around important

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[26] *Id*. at p.23
[27] *Id*.
[28] *Id*. at p. 21.
[29] *Id*. at p.17

topics such as investments, an operating business or philanthropic activities are primarily communicated through these more formal means.

4. Informal: Family vacations, informal gatherings, phone calls and text messages provide for ongoing relationship building, especially as the family gets larger and more dispersed.

5. Some families have found that when family leaders are open to different opinions, family members outside of the family enterprise often ask insightful questions and offer clear-headed perspectives.

G. Family Office Member Governance Decisions.

1. Successful families engage in family governance conversations with trusted advisors to address questions such as:

   a. How does the family want to use the wealth and are there any shared purposes the family wealth can serve (*e.g.*, benefit family, non-family members, charities)?

   b. What guiding principles and agreed upon policies can be put in place for the future (*e.g.*, guidelines for the family business, philanthropy, investment and distribution decisions)? What values, priorities and factors will influence these decisions?

   c. How will long-term success be defined? How will this look in 10-15 years? What values do you want to pass on?

   d. What practices can the family put in place to implement family governance (*e.g.*, convening regular family meetings on specific topics, family council meetings and election of decision-makers as family grows larger, education curriculum for family members)?

2. Families often start family offices after a liquidity event believing that managing the wealth is the most significant challenge. However, over time, preserving the family itself, and preparing the rising generation for the wealth, often becomes the biggest challenge and priority.

3. It is often difficult planning in the present for situations that may not occur for many years, but some families have found that putting a family mission statement, charter or constitution together in writing early, and getting broad family buy-in, can help maintain order and avoid awkward conversations later.

   a. When conflicts do come up, the family has direction on how to proceed with decision-making. This is similar to a family business that puts shareholder agreements and bylaws in place. Often, you won't need it until you do.

   b. Family members often do not know what is in the family charter, *e.g.*, its basic tenets and agreed upon family values. A best practice is to renew or affirm these documents from time to time (*e.g.*, every three years at a family meeting), which also creates an opportunity

to address concerns, make changes and instill values in younger generations.

c. These documents frequently address common themes, including:

(1) Establishing a strong sense of family culture (*e.g.*, "how we do things").

(2) Formalize communication and decision-making structures, such as voting and third-party participation.

(3) Address conflict resolution, often by emphasizing frequent, in- person contact and shared values, such as "we discuss and debate, but we don't argue."[30]

4. The smaller the family, the less that is written down. But, if the family grows from a "sibling society" to a "cousin coalition", then there will be a need to redefine values and be clearer about policies, with flexibility to adjust to evolving needs. What does it mean to be a family today? Successful families recognize that governance is a continuing process, not one single event. The framework is often iterative and as new family decision-makers are added, changes are common and healthy.

5. Family Assemblies. Some larger more dispersed family offices also see the value of an inclusive family-wide assembly to overcome the dynamic of having some family members involved and others who are not. This is simply a regular family gathering that brings everyone together and provides a mechanism for communication and transparency as well as family bonding. They are sometimes structured around a family trip and combine quality family time alongside formal communication.

6. Family Committees. Sometimes committee systems are put in place, but not used. This may be because the founder (or another senior family member) just makes the decisions regardless of whether there is a formal committee or board. A one-person decision-making process is still a process as long as everyone recognizes it. But what happens when that decision-maker is disabled or deceased?

a. Sometimes a third-party consultant or other professional can help parents relinquish control. If done while they are living, they have the ability to "course correct" the family. But when control is relinquished too late, they can lose that ability to help develop the family decision- making framework.

b. For example, the family can establish an Investment Committee to oversee and approve investments. Having other people on the committee to vet investments using established investment policy criteria when one family member brings an idea can be very helpful to provide objectivity. Then it is less likely to be perceived as a

[30] *Id*., at p 18.

personal attack against the family member who proposes the investment if the investment proposal is ultimately rejected.

c. Sometimes committees exist but family members don't want to participate. This isn't an easily solved problem and can be the bellwether that it is time to restructure and reorganize.

H. Conflict Management.

1. Communication and openness generally are acknowledged to be the keys to preventing destructive conflict. This can include setting clear expectations in areas such as requirements to access money, access vacation homes and understand personal expenses versus family expenses. Expectations for spouses and other partners are also important, such as whether a premarital agreement is required, the ability to vote, what happens in the event of divorce or death? Everyone does not need to be happy, but they need to be informed.[31]

2. Including an "exit strategy/escape clause" for family members to pursue their own path is also a best practice. In the Stewardship & Purpose Study, families reported that when family members feel like they can leave, they are more likely to stay.[32]

    a. Exit process should be written in advance, with a timeline. For example, timeline may indicate a 10-year time frame to exit from the most illiquid investments and/or discounts that would be applied to illiquid assets upon decision to exit. A written exit policy, communicated in advance, removes emotion.

    b. Some families are also well served by creating an incentive system for staying in the family office. For example, there may be a forced exit if a family member does something to embarrass the family or is creating a toxic environment (*e.g.*, untreated mental illness or substance abuse).

3. If pursuing a *Lender* profits-interest structure, an exit path is essential to showing that the family office is operating similar to a third-party trade or business. If an exit opportunity isn't there, how much control do individual family members really have?

4. It has become incredibly common to see family offices that are unlikely to last beyond a generation or two. Is this normal? There are many catalysts for family members wanting to branch off or to start their own family office.

    a. In hindsight, the well-known break up of a large Chicago-based family back in 2011 due to conflict was actually a huge success story. The siblings and cousins had an organized process of selling off family assets over many years that optimized and preserved the wealth. Senior family members were given autonomy to start their

[31] Id., at p.25
[32] Id.

own family offices and focus on their nuclear families. Today many collaborate and co-invest. There is no visible animosity today.

b. After death of a matriarch or patriarch, or even a major business event, there can be reassessment of the family office. A surviving spouse or children might struggle with who all the people are in the family office and bristle at people telling them when they can access funds. We are seeing several examples of this playing out today in families with well- established family offices where the surviving spouse and/or children are re-examining whether to continue to remain part of the family office.

c. Succession in a family office can also be a catalyst for family members to reassess. In one situation, one branch pulled significant wealth out of the family office as generational shifts were happening in both the family and with the retirement of the family office head. Having a succession plan for senior roles and raising family awareness of it ahead of time may help limit the uncertainty that arises when these inevitable events occur.

I. Autonomy.

1. Give family members ability to independently make certain financial decisions separate from the confines of shared family wealth/capital. It can help family members develop independent identities and accountability.

2. Lack of some autonomy can also lead to the breakup of pooled investments. Members of the rising generation are often the ones with this request. It is common for members of the rising generation to take pieces of their wealth out and pursue their own agenda.

3. Some families are also successfully looking to and empowering the rising generation to be entrepreneurial and build their own networks as a way to gain insight and continue to find opportunities for the family to invest (often collaborating with other peer families). While these opportunities are usually funded with shared family wealth, they can reward and motivate younger family members.

J. Staffing.

1. When starting a new family office, families often ask whether they should hire senior executives from the operating business. It is common to hire executives (*e.g.*, Chief Financial Officer, General Counsel) from the operating business given the significant trust in that person, culture fit and the employee's competency, but families and executives need to recognize there is a large learning curve. Those individuals need to spend time learning from family office peers, family office organizations, and other resources to fill in their knowledge gaps, learn best practices and avoid being siloed.

2. Family offices struggle when the CEO isn't provided with proper direction for the role and doesn't have decision-making power to do what is being

asked of them. It's very important for the senior members of the family office to have well-defined roles and responsibilities.

3. A common theme in newer family offices is that a few people do everything. It is important to either hire experts or outsource services that are not a direct strength of the family office team.

4. Identifying the right family office leaders (including family members) can be tremendously difficult. A special person is needed to lead the family office, cannot be self-interested and must be a good culture fit. Successful families understand the quality and attributes of the person they wish to hire.

5. Value is not in providing bill pay but in finding someone who can help the family develop a cohesive vision and continue to grow together.

6. Best practices in hiring for the family office include:

    a. Hire family office employees for the long term.

    b. Consider professional background important, but also prioritize personal character, integrity and agreement with the family's value system. The degree to how much trust and value system are prioritized over the applicant's professional background depends on the staffing model and sophistication of the family office.

    c. Family offices must trust but verify their employees.[33]

7. Senior Family Office employees, in turn, need to be patient and build trust with the family. It takes time to bring a family office through a change like switching the CEO/head of family office. Therefore, being patient is key. Additionally, those who take the time to learn about the families (*e.g.*, their values, goals, dynamics) seem to be more successful as they are able to make decisions tailored specifically to the family.

    a. Senior family office employees also need to develop relationships across the family, including across generational lines, and be able to manage transitions.

    b. If branches of the family or younger generations feel the CEO and other members of the family office are or were connected only to matriarch/patriarch or one branch of the family, divisions can develop leading to potential loss of confidence.

8. How do you align the goals of the family office team, particularly on the investment side? Sometimes giving them carry or other incentive compensation tied to the investment performance can align goals.

K. Succession planning.

1. It is very common for matriarchs and patriarchs to name successors who are the same age (*e.g.*, name siblings or friends as successor trustees, board members, investment committee members). Senior family members often do not think enough about succession and who will be the trustee/board

[33] *The Single Family Office Today,* supra at p. 19.

member/family office leader not only for the children but for future generations. Who will have the right experience and skills? Successful families consider multi-generational succession planning and take proactive steps to foster the skills needed for future family leaders.

2. Family offices do not solve family dynamic issues. In one family, for example, the control was given to one son and the patriarch intentionally left certain children out of leadership roles in the family business and family office. There was no succession plan for the son who died suddenly. The family is now struggling regarding the future of the family enterprises and divisions and resentments within the family are rising to the surface. We see similar issues in other families as well. Succession planning should exist for both family leaders and family office leaders. Families can't wait for someone to die to address succession planning because the risks are so great.

3. A trend we see as families transition from G1 to G2 and beyond is the desire to bring in a "professional" family office head, but it can be difficult to bring someone new into an existing family office. Institutional knowledge is hard to replicate. Best practice is to develop a transition plan.

L. Technology.

1. Family office technology continues to be weak. Data aggregators do an adequate job but there are limitations and they do not always match up to reporting from outside providers.

   a. These services are expensive and time consuming to implement. And there is potential liability if the family relies on information to make tax decisions and the information is incorrect.

   b. There is no easy solution available as there is no industry-leading provider to date but important to find software that fits the purpose, provides meaningful reporting and integrates with existing systems (often requires an RFP process). But it is best to consider both in-house and outsourced options.

2. Cyber security continues to be a threat and family offices are a high-value target. Best practice is that family offices need to address not only their systems and processes but ensure the family office staff and family members themselves have taken proactive steps to reduce risk. Many families also utilize their external partners to provide education, help assess current processes and implement stronger protocols.

3. Generational issues exist when it comes to technology and some younger generation family members may prefer to receive information in real time through interactive technology. Family offices have found ways to deliver information in multiple formats including the use of secure portals.

M. Creating a Team of Strategic Advisors.

1. Families typically have trusted advisors both inside and outside of the family office or other family entity. Family office teams, in their gatekeeper

roles, often keep advisors from talking to one another. But collaboration can lead to better problem solving, creative thinking and quicker results.

2. Also ensure that the families' strategic advisors are known throughout the family to provide continuity across generations and secure buy-in not just by the patriarch/matriarch.

3. It can also be helpful for advisors to bring in younger members of their team who may be able to better identify with and develop trusted relationships with younger family members.

N. Ongoing Evaluation and Evolution.

1. As stated earlier, there are many catalysts driving families to create structures that will allow them to share family wealth for generations to come. However, there are also many pressures that can cause families to rethink whether that structure is still working for them, or working in the way it was originally intended. We sometimes see families that fail to recognize the early signs of those pressure points and, therefore, may not be able to take prompt action.

2. Some of those areas that can put pressure on the family enterprise include:

   a. Family lacking cohesion. As the family and generations grow, it becomes more difficult to maintain unity with a common vision, priorities and set of values. Such families may not be able to overcome differences in opinions or generational shifts. Preserving the family itself can be the most challenging issue for wealthy families.

   b. Growth of the family and households being served that is disproportionate to the size of the family office or other structures. Tension develops between expectations of the family and the services and resources that the family office staff is able to provide.

   c. Costs become prohibitive.

   d. On the investment side, while successful family offices may have a competitive edge on allocating their capital, not all family offices share the same success. Performance may not materialize as expected due to market, industry or other factors, or the wealth simply may not be sustainable to keep up with the exponential growth in the family and its needs.

   e. Family office leader retires or passes away without adequate succession planning and transition resulting in potential losses of significant institutional knowledge and trust.

   f. Complexity can be more than the family expected. For example, many family offices have a difficult time keeping up with ever changing technology and cyber security needs.

3. It is common for the family office to evolve over time. They may start in a family business, but then evolve into larger, more sophisticated

organizations with more staff and resources -- and more complexity. The sale of a family business or the passing of a matriarch and/or patriarch may also be the genesis of the family office evolution.

a. Designing flexible structures that can evolve over time to address the family's developing needs, provide efficiency, and respond to a rapidly changing world is crucial.

b. Family leaders should regularly evaluate the evolving needs of the family, identify the challenges facing the family office and seek potential solutions.

IX. Conclusion.

The successful stewardship of wealth utilizing any version of a family office goes beyond managing capital soundly. It involves cultivating and nurturing the family itself.

Significant wealth can be a force for good, but it can also destroy families. Family offices should have a crucial role in helping families not only preserve and grow their financial capital, but also providing many non-financial benefits. The most successful family offices will help each family member thrive within the trusts and structures created for them – addressing their long-term visions and the broader needs of other family members, from building unity to fostering talent and leadership and social impact. The families who create or work with family offices that help attend to these areas are more likely to manage through generational transitions, conflict and future challenges.

X. Exhibits

Exhibit A – Classic Single Family Office Structure

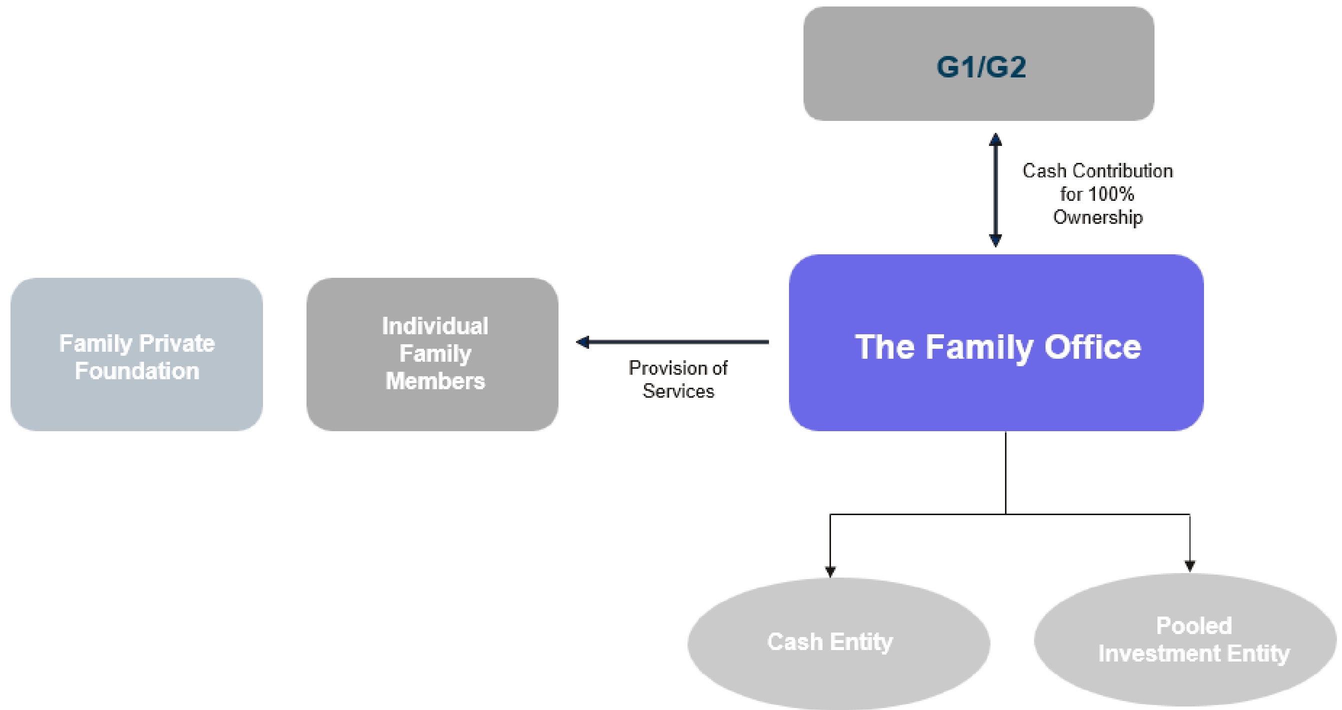

Exhibit B – Single Family Office Structure with Profits Sharing

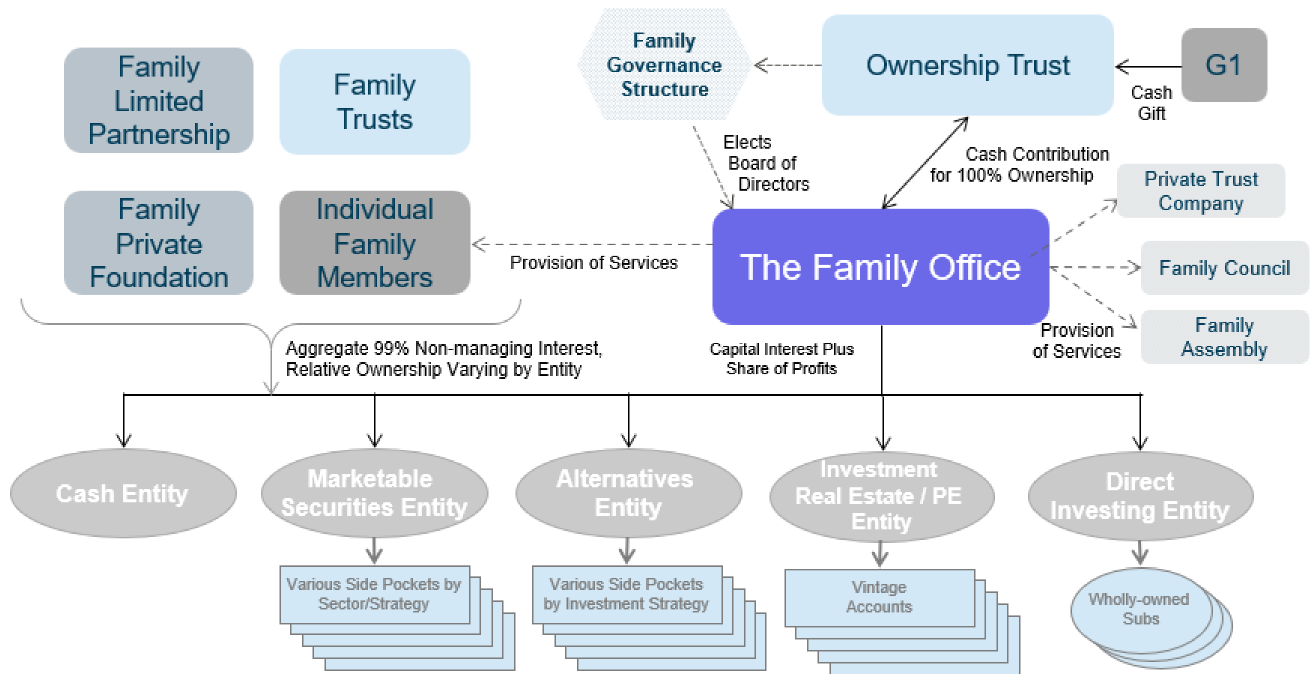

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Exhibit C– Detailed Family Service Offices

Services are customized to address a wide spectrum of long-term family needs.

Investments

- Investment policy development
- Portfolio construction
- Manager selection
- Comprehensive performance reporting

Wealth Transfer Planning

- Develop objectives
- Diagram current plan with assets and amounts listed
- Legal and tax strategies
- Action plan to implement changes
- Trust and estate administration

Family Philanthropy

- Multi-generational objectives
- Personal giving programs
- Private foundation management
- Strategy analysis and implementation
- Foundation/grant administration

Integrated Financial Services

- Balance sheet reporting
- Cash flow planning
- Retirement planning
- Bank financing analysis & negotiation
- Life insurance analysis

Client Information Mgmt

- Consolidated reporting
- Quarterly performance reports
- Online access to custom reports
- Document management and retention
- Record keeping for personal property
- Cash flow forecasting

Family Continuity/Education

- Family governance
- Family education plan
- Family counseling
- Family meeting coordination
- Coaching and mentoring
- Coordination of outside advisors

Tax Review & Compliance

- Review of individual & entity tax returns
- Estimated tax payments
- Year-end tax planning
- Tax legislation updates
- Tax compliance

Lifestyle Enhancements

- Personal bill paying
- Domestic help and payroll
- Property management
- Concierge services
- Private aviation and travel management
- Healthcare advisory services

Liability Management

- Property & casualty insurance assessment
- Specialty lines of insurance
- Cyber, property, and personal security
- Collectibles inventory, appraisal & storage

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Exhibit D – Services Provided by Single Family Offices

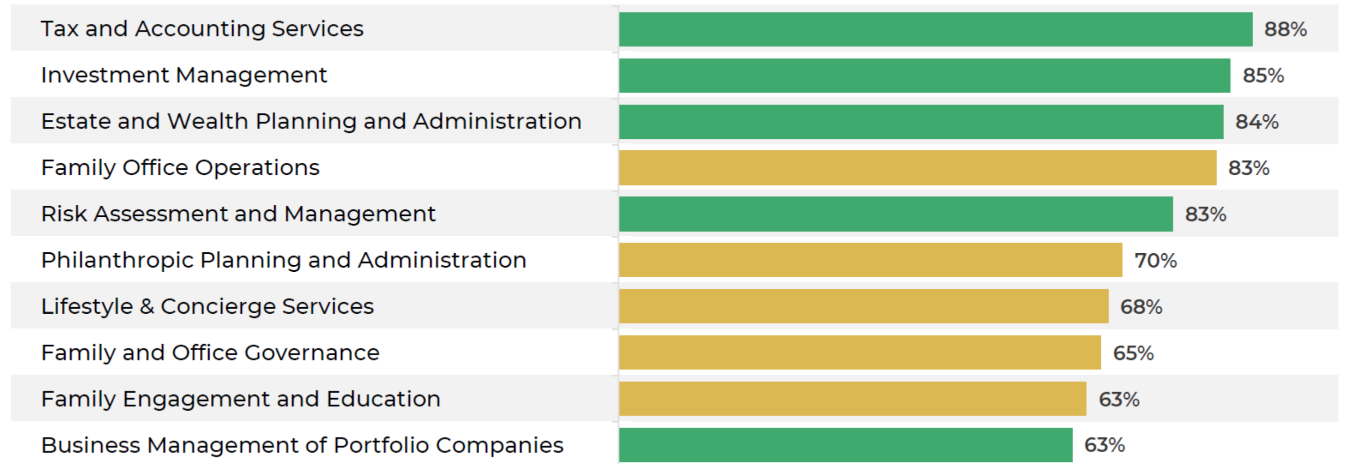

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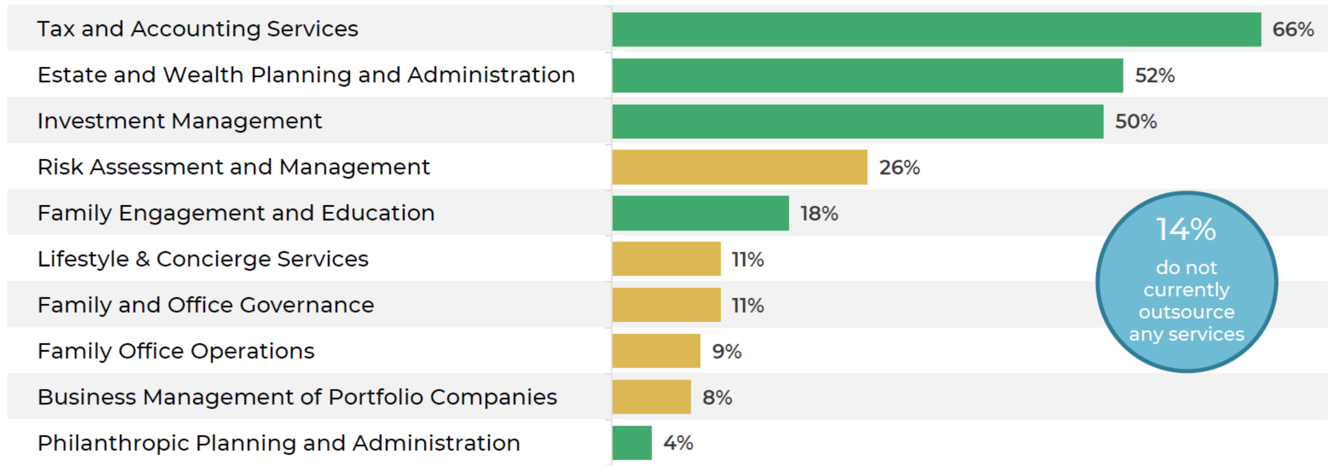
Exhibit E – Services Outsourced by Single Family Offices



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Special Session III-B

Simplifying the Complex: Demystifying Directed Trusts, Family Offices and Private Trust Companies

Section 3

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AN INTRODUCTION TO PRIVATE TRUST COMPANIES

John P.C. Duncan
Kozusko Harris Duncan
Chicago, IL

I WHY CREATE A PRIVATE TRUST COMPANY?

A. Optimal control over the family's wealth by addressing causes of long term decline:

1. Minimizing family dissent and facilitating generational transitions
2. Avoiding fragmentation of asset management
3. Maintaining, and limiting liability for, higher concentrations

B. Optimal platform for bringing younger generations into management in accordance with skills and interests

C. Attract, retain and provide for succession of capable trust officers and advisors to assure fiduciary and tax liability protection

D. Take control of services provided to the family and its trusts and beneficiaries

E. Change state fiduciary income tax situs of trusts

F. Change administrative or substantive laws governing family trusts

G. Implement coordinated risk management to protect family (*i.e.* institutionalize)

II. CONFIDENTIALITY

A. Many families want confidentiality, not only from third parties, but also between branches

Requires:

1. Separate committees for Discretionary Decisions for the branches that wish confidentiality
2. Population by different persons
3. Agreed procedures to create "Chinese Walls" … which must be followed by trust officers
   a. Trust officers often assigned to different branches
4. End result: PFTC management remains informed, at Board level, of the broad-scope of activities of various branch clients but not details
5. There is a more robust path to branch confidentiality, but requires each branch to have their own, full cast of characters and requires each branch to ensure that areas involving confidential information are properly maintained, such as personal asset files for branch members

III. IMPORTANT OPERATIONAL ELEMENTS

A. Proper location of activities

1. To avoid conducting a trust business in the wrong jurisdiction
2. To eliminate or minimize jurisdictional contacts with unfavorable state(s)
3. "True" fiduciary activities - only in home state (state of charter) or from a regulatorily-approved out-of-home-state trust office
    a. Accepting appointment (making the decision and executing the documents)
    b. Deciding on discretionary distributions
    c. Amending trusts or changing trust situs
    d. Delegating functions to third party services providers, including a family office or outside investment advisors (who may be in other states)
    e. Holding tangible personal property or real property
4. Certain administrative activities can occur outside of the home state office or an approved out-of-state trust office

B. What Can't Be Out-Sourced

1. **Accepting Family Trusts**
2. **Distribution Decisions:** However, PFTC can contract with third parties to act as officers, Distribution Committee or Beneficiary Relations Committee
3. **Decisions about use of cash (i.e., whether for investments, distributions or expenses):** But implementation can be delegated and family office or third party can follow budget or policy adopted annually
4. **Certain investment decisions (i.e., setting investment policy objectives):** But investments themselves can be handled by family-owned entities, third parties, or a combination
5. **Major Keys:** These decisions must be made in the home state where the PFTC is chartered because they are the key fiduciary decisions

IV. MAJOR DECISIONS, TIMELINE, AND COST OF CREATING A TRUST COMPANY

A. Major Formation Steps

1. Is a license needed or advisable?
    a. Exempt from registration as investment advisor with SEC
    b. Licensing produces greater regulatory requirements than unregulated trust company, but not burdensome
    c. Improves optics on transfer taxation issues
    d. With a license, can operate interstate offices
    e. Some states provide greater protection and flexibility to licensed trust companies

2. Select Home State

   a. Geographic convenience is an important factor
   b. Generally, good substantive trust laws and dedicated trust judiciary outweigh good banking laws
   c. Required capital varies widely; some regulators are downright hostile
   d. Other factors considered:
      (1) Tax laws impacting the entity and trusts it administers
      (2) Statutory and regulatory requirements, public policy context and judicial environment
   e. Top states: NV, NH, SD, TN and WY…not CA, NY, DE, FL, MA, TX etc.

3. Securities Laws and PFTCs

   a. A PFTC can provide investment advice to its family members pursuant to the "family office exception" under the Securities Laws. The exception exempts the family office and PFTC from registering as a Registered Investment Advisor ("RIA") for family members able to be served by the family office/PFTC
   b. A regulated PFTC is a bank and for SEC purposes is exempt from registering as an RIA under the banking exemption of the Investment Advisors Act of 1940

4. Corporate Transparency Act and Other Details

   a. Formally licensed by a state (i.e., a regulated PFTC, generally over $100 million but usually over $250 million)
   b. Defined as a bank by the Investment Company Act of 1940 and Federal Regulations
   c. The top states are NH, NV, SD and TN **but not Wyoming**, which charges substantial costs to be regulated by the state
   d. A simple, licensed and regulated PFTC for now at least should not be subject to the Corporate Transparency Act, but various versions may be

5. Select/Design Ownership and Governance Structure

   a. Usually an owner trust plus family governing body, with highly specialized governance documents

6. Prepare Detailed Business Plan with Pro-Forma Financials (3 years)

7. Prepare and File Charter Application (if one sought)

8. Prepare to Commence Business Operations

   a. Proper insurance

b. Service provider agreements

c. Space

d. Trust review, etc.

e. Adopt (and Adapt from Time to Time) Policy Manual

f. Formation Meetings and Other Start-Up Preparation and Documentation

B. Formation Timing

1. Typically, 3 to 9 months total, consisting of

2. 3-4 months for client deliberations, designing structure and business plan, and preparing application (if any)

3. 3-6 months for state approval of application (if applicable)

4. 0-3 months preparation for formation meetings and start-up (typically begins once application is filed and while in review)

C. Annual Operating Costs (other than staff): $125,000 - $175,000

EXHIBIT A

[TRUST COMPANY ("TC")]

INITIAL FACT SHEET FOR PREPARATION OF A PROPOSED [STATE] [LICENSED/CHARTERED] [UNREGULATED/UNCHARTERED] [FAMILY/PRIVATE] [RETAIL] TRUST COMPANY

I. GENERAL INFORMATION

A. Proposed Trust Company Name[1]	[Trust Company ("TC")]
B. Target Start-Up Date	[Date]
C. Existing Office?[2] Full Entity Name, Address:	_____ Yes _____ No [Name] [Address] [City], [State] [Zip]
D. Main office location in [Proposed State] (if known)	[Name] [Address] [City], [State] [Zip]
E. Administrative Back-Office Location in addition to main office location[3]	[Trust Company] [Address]

II. [TC] ORGANIZATION INFORMATION

A. [TC] Formation and Ownership	
1. State in which to be Organized (e.g., New Hampshire [Proposed State] or another State)	[State]
2. Entity Type (*i.e.*, limited liability company, corporation or other)	[Limited liability company]
3. Name Reservation—determine whether reserving	☐ Yes ☐ No
4. Organizing Member—recommend an individual who will be a Managing Director who will have an on-going role in [TC] management	[Name]
5. Proposed Principal Owner(s) of [TC]	[Name/Percentage Ownership (rounding to 100%)]
6. If Proposed Principal Owner of [TC] is a trust(s) or another company, is it existing or to be created prior to start-up?	☐ Existing ☐ To Be Created [Name] [Address]

[1] [Cannot contain "Trust Company" unless [an application] is filed with and approved by [State] regulators.]
[2] Typically Client's address.
[3] Typically same response as item C above.

II. [TC] ORGANIZATION INFORMATION

7. [TC] Capital Structure a. Capital b. Surplus	Total: [to be discussed] $[_______________] a. $[Minimum Required or a Greater Proposed Amount] b. $[Surplus]
8. "[Designated Relative][Descendant]"[4] [([can][cannot] be living or deceased)][5] The scope of who may be served should be carefully reviewed to be certain no one needs to be who does not qualify.	[Name] Date of Birth [__/__/____], Date of Death (if applicable) [__/__/____]
B. Board/Managing Directors	
Proposed Managing Directors, and City and State of Residence At least 3-5 Managing Directors recommended in [Proposed State] (1 of whom should be designated as Chairperson).[6]	1. [Name] ,[City] ,[State] Chairperson 2. [Name] ,[City] ,[State] 3. [Name] ,[City] ,[State] 4. [Name] ,[City] ,[State] 5. [Name] ,[City] ,[State]
C. [TC] Officers[7]	
1. President* 2. Vice President 3. Senior Trust Officer* 4. Secretary* 5. Treasurer* 6. Compliance Director*/Bank Secrecy Act Compliance Officer* 7. Chief Financial Officer 8. Trust Counsel** 9. Trust Officers/Assistant Trust Officers 10. Other *Required (required offices can be combined in as few as three people) **Not an officer but required by industry standards	1. [Name] 2. [Name] 3. [Name] 4. [Name] 5. [Name] 6. [Name] 7. [Name] 8. [Name] 9. [Name] 10. [Name] 11. [Name]
D. [TC] Board Committees	

[4] State-specific term.
[5] Check state law.
[6] Confirm there are no state residency requirements.
[7] Confirm there are no state law restrictions on holding certain offices simultaneously.

II. [TC] ORGANIZATION INFORMATION

1. Trust Committee (*required*) Board can act as Trust Committee or can appoint 2-3 Managing Directors or officers as an in effect Executive Committee/Trust Committee. At least 1 member should *not* be an officer or employee of [TC].	1. [Name] 2. [Name] 3. [Name]
2. Audit/Exam Committee (*required*) Board must appoint at least 2 individuals. At least 1 member should *not* be an officer or employee of [TC] or an officer, director or employee of an affiliate.	1. [Name] 2. [Name]
3. Investment Committee If desired, otherwise Trust Committee acts as this committee. Board must appoint at least 1 individual. At least 1 member *should* be a Managing Director or officer of [TC].	1. [Name] 2. [Name]
4. Discretionary Decisions Committee (*required* for federal transfer tax purposes) Board must appoint at least 1 "independent" individual.	1. [Name]
5. Amendments Committee (majority non-family members or related and subordinate parties) Note: Selection and appointment can be deferred until required. *(recommended)* Should be structured with very limited power to amend certain tax-related Operating Agreement and Bylaws provisions.	1. [Name] 2. [Name]
6. Education, Mentoring or Other Committee(s) (*if desired*)	1. [Name]
E. [TC] Services Providers	
1. Primary Administrative Services Provider[8]	[Name] [Address]
2. [State] Administrative Services Provider	[Name] [Address]
3. Will [State] Representative Serve as an Assistant Trust Officer?	☐ Yes ☐ No

III. OTHER INFORMATION

---

[8] Typically Client's address.

A. Auditors: Annual Corporate Annual Fiduciary (Agreed Upon Procedures)	 1. [Name] 2. [Name]
B. Insurance:	**Amounts**
1. Fidelity Bond Insurer:	☐ Yes ☐ No [$1,000,000] [Name]
2. General Business Insurance Insurer:	☐ Yes ☐ No [Amount] [Name]
3. D&O Insurer:	☐ Yes ☐ No $[Amount] [Name]
4. E&O Insurer:	☐ Yes ☐ No $[Amount] [Name]
C. [State] Bank:	[Name] [Address]

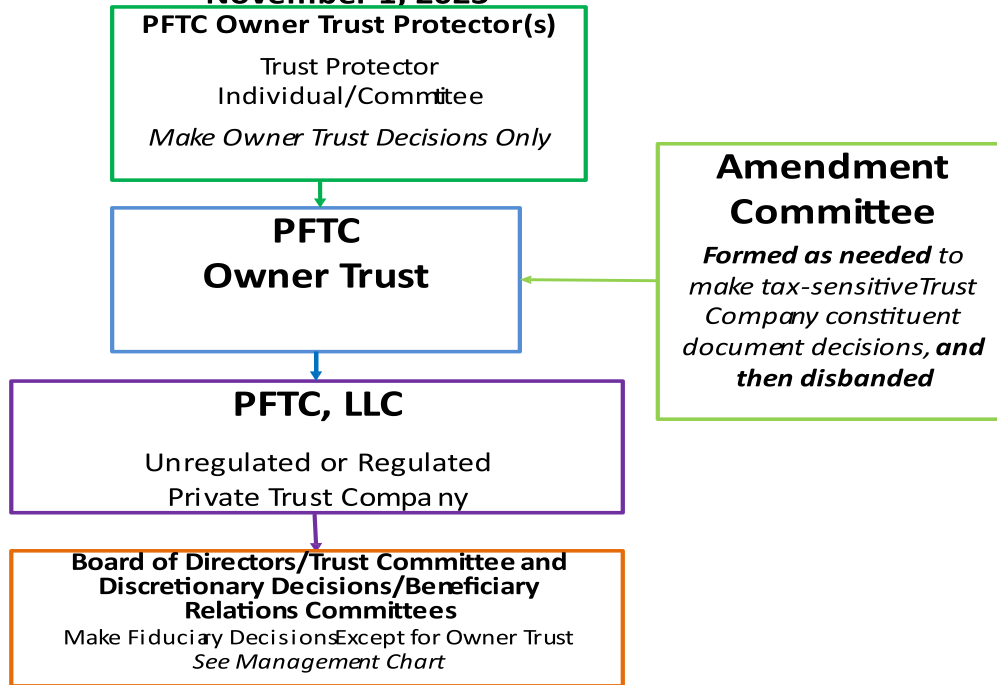
EXHIBIT B

PRIVATE TRUST COMPANY CHARTS

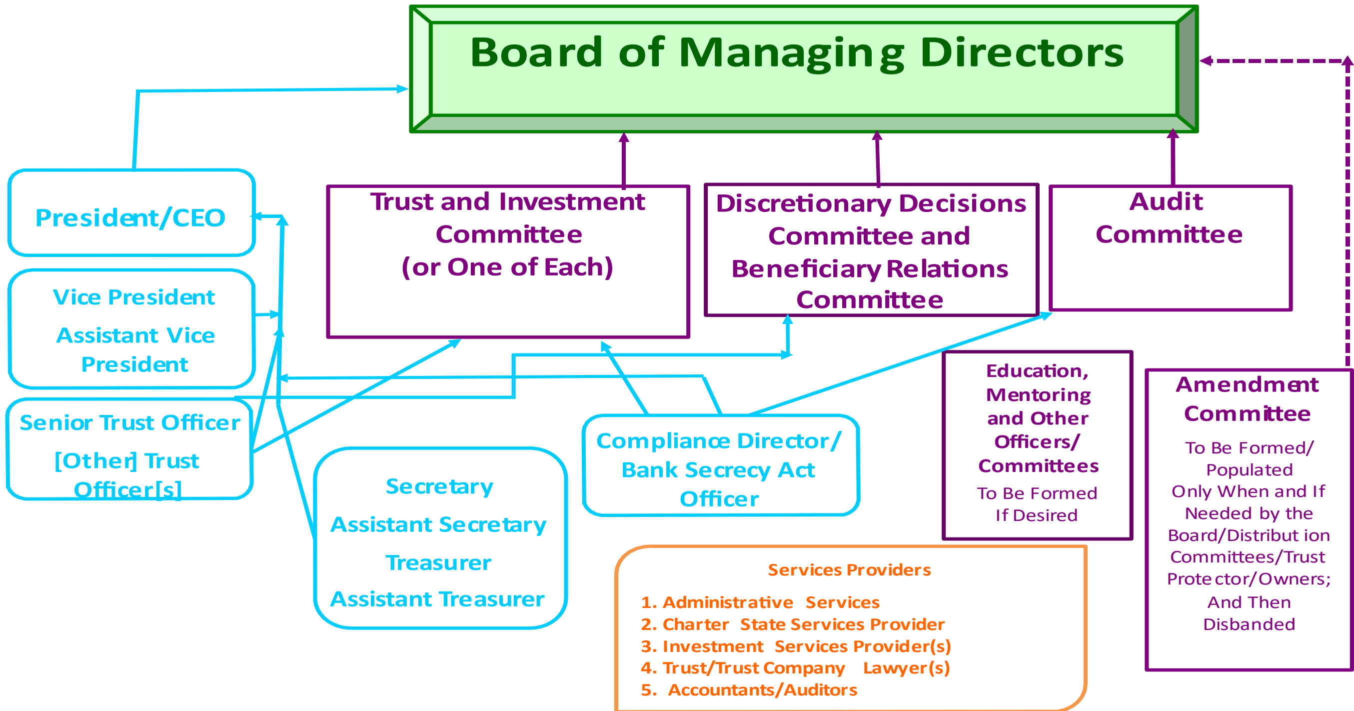
1. **PFTC, LLC Recommended Ownership Structure**

2. **TYPICAL PRIVATE FAMILY TRUST COMPANY OPTIONS – Management Organizational Chart**

3. **FAMILY STRATEGIC STRUCTURES COMPARISON**


PFTC, LLC Recommended Ownership Structure
November 1, 2023
PFTC Owner Trust Protector(s)
Trust Protector
Individual/Committee
Make Owner Trust Decisions Only
PFTC
Owner Trust
Amendment
Committee
Formed as needed to make tax-sensitive Trust Company constituent document decisions, and then disbanded
PFTC, LLC
Unregulated or Regulated
Private Trust Company
Board of Directors/Trust Committee and
Discretionary Decisions/Beneficiary
Relations Committees
Make Fiduciary Decisions Except for Owner Trust
See Management Chart

TYPICAL PRIVATE FAMILY TRUST COMPANY OPTIONS
Management Organizational Chart, November 2023



FAMILY STRATEGIC STRUCTURES COMPARISON

BY PRIMARY FAMILY OFFICE STRUCTURES' STRATEGIC CAPABILITIES

STRUCTURES → ELEMENTS ↓	*BASIC SINGLE ("ALTER EGO)" FO WITH INFORMAL TRUST ROLE*	*SOPHISTICATED SINGLE FAMILY OFFICE WITH FORMAL TRUST ROLE*	*PRIVATE TRUST COMPANY (REGULATED)*	*MULTI-FAMILY OFFICE: SOPHISTICATED; NOT A PFTC; NO TANDEM SFO*
Controls Strategic Assets and Decisions	No	Limited	Maximum	Very Limited
Implements Family Governance Decisions	Moral authority only	Limited legal authority under Family supervision	Complete legal authority under Family supervision	Limited legal authority under Family supervision
Tailored Family Member Wealth Management Roles	Narrow range of Family roles	Broader range of Family roles	Broad and deep range of Family roles	No or narrow range of Family roles
Insulation of Family/ FO Management from Fiduciary Liability	None	Yes, for certain functions prudently delegable to SFO* *But only in each case if properly structured with quality risk management and consistently implemented	Yes*	For trust administration and investment management if delegated to MFO
Exemption from Investment Adviser Registration	Only if Qualifying Family Office (QFO) under SEC FO Rule	Only if QFO (very limited client list)	Yes, if properly structured	No
Choice of Best State Trust and Tax Laws	Must use out-of-state Individual or Institutional Trustee(s) for nexus	Must use out-of-state Individual or Institutional Trustee(s)	Virtually unlimited choice (in states with excellent trust and tax laws available)	Must use out-of-state Individual or Institutional Trustee(s)
State-of-the-Art Fiduciary Risk Management	Requires formal (contractual/ delegation) trust role by the SFO	◆ Requires State-of-the Art policies, procedures and governance ◆ Complex-structures unavoidable	◆ State-of-the Art policies, procedures and governance inherent ◆ No inherent complex structure risk	◆ Requires State-of-the Art policies, procedures and governance ◆ Complex-structures unavoidable
Permanent Trustee Succession Solution	No	No	Yes	No
Persons controlling: ◆ *Family trust assets* ◆ *Strategic decision-making* ◆ *Strategic plan implementation*	◆ Trustees and ◆ Individual Family Members	◆ Trustees ◆ Individual Family Members, and ◆ SFO (to some degree) by contract	◆ PFTC as Trustee and SFO ◆ Family, through PFTC governance structure	◆ Trustees ◆ Individual Family Members ◆ Family as whole (to some degree) by contract

Kozusko Harris Duncan

EXHIBIT C
M E M O R A N D U M

TO: **[Contact Person]**

[Position]

[Client]

FROM: **John P.C. Duncan**

DATE: **November 1, 2023**

RE: **Categorizing Trustee Functions—Interstate Operations Guidance**
[Draft: Subject to revision from time to time as a company's business plan, structure and locations evolve through start-up date]

In connection with the formation and operation of **[Client PTC]**, a proposed **[Charter State]** private trust company, we have prepared this memorandum and attached table regarding recommended locations for trust company activities for fiduciary and state trust company law compliance and for maintaining choice of trust site and governing law. It is based on research in a variety of states including Nevada, New Hampshire, South Dakota, Tennessee and Wyoming.

This memorandum primarily consists of two lists, one of trustee administrative functions and the other of trustee discretionary functions.

While most if not all of the administrative activities in the second list may be conducted in any state without illegally "acting as a fiduciary" or "doing a trust business there," we generally recommend that none of the items on the discretionary functions list be taken *by a trust company* on a regular basis in a state other than where it is:

1. authorized to do a trust business (whether its headquarters/charter state or a state of a properly licensed full service trust office (**"Trust Office"**)) or

2. authorized to act as a fiduciary for a particular trust or other specific fiduciary account.

At a minimum, the trust company should not engage in discretionary functions outside of **[Charter State]** unless it adds a trust office in another state.

This memorandum must be read together with the table entitled **"Recommended Locations for Trust Company Activities For Fiduciary and State Trust Company Law Compliance and Maintaining Choice of Trust Site and Governing Law,"** and attached here (**"Locations Table"**), which we are providing along with this memorandum as our advice as to where various types of activities should be taken.

Trust Taxation Caveat. Please note that although the location of these activities is relevant to a determination of where a company's or a trust's assets or income and gains may be subject to state taxation, *this memorandum has not been provided in connection with such a determination and should not be used for that purpose*. Accordingly we indicate in the **Locations Table** in certain instances where different location advice may be appropriate to achieve your state tax objectives. These indications are based on general knowledge and experience regarding state trust and trust company taxation and there may be action locations mentioned in the table without such indications by us that could also require different location advice. Advice on state tax topics is much more complicated and requires reviewing all relevant factors and applying those factors to the circumstances of a trust company and each trust for which advice on its state taxation is sought.

It has been the experience of our client trust companies that often many of the items on the first list below can be "bundled up" and performed annually at one or two major meeting in the charter or licensing state. Sometimes one or more trips by a board, committee or senior management member is needed in the same year, however. Alternatively, the company may be willing to delegate one or more discretionary decisions to representatives located in the **[Charter State]**.

Neither list should be considered comprehensive, but they include typical discretionary and administrative functions. Any other discretionary trustee function would be included in **List 1** and all non-discretionary trustee functions would be included in **List 2**.

Again, no fiduciary decision should be made by the Board, any committee, officer or employee of the **Client PTC** or any representative of the **Client PTC** except in the **[Charter State]** or another state in which the **Client PTC** is authorized by law to act as a fiduciary with respect to such decision or other action or generally to do a trust business in such location.

List 1*—Common Discretionary Trustee Functions and Other Actions Comprising "acting as a fiduciary"* (discretionary decision-making is referred to in the **Locations Table** as **"Fiduciary Decisions"** but this list also includes certain non-decision-making activities):

1. Accepting an appointment as trustee (making the decision and execution of documents evidencing the decision)
2. Exercising investment discretion (*i.e.*, the trust company, not another company to whom such discretion has been delegated), including particularly delegation of investment functions to one or more investment advisors
3. Managing assets, especially tangible income-producing assets, or the act of delegating such management to others
4. Deciding on discretionary distributions, including so-called decantings
5. Interpretation of trust instruments, including exercising discretion as to the allocation of receipts between income and principal, or deciding whether to seek guidance on their interpretation from a court; amending trust instruments; or changing trust situs
6. The act of delegating administrative or discretionary functions to third party services providers (making the decision and executing documents evidencing the decision)

7. Terminating a trust or resigning as trustee
8. Holding tangible or intangible personal property or real property (generally deemed to be acting as a fiduciary although not a "discretionary" function)
9. Approving and signing tax returns and making determinations regarding material tax elections and positions (does not apply to accountants or other third-party providers to whom tax return preparation has been properly delegated)
10. Settling trust disputes

List 2*—Common Administrative/Ministerial Trustee Functions*

1. Custody (safekeeping) of assets
2. Collection of earnings on investments
3. Paying trust expenses
4. Reporting on trust assets, investment performance and income and expenditures to beneficiaries
5. Other communications, including meetings, with settlors, beneficiaries and other interested persons in a trust (that do not involve approving non-ministerial requests or making fiduciary decisions)
6. *Implementation* of discretionary or mandatory distributions
7. Execution of purchases and sales of assets approved by those with investment responsibility
8. **Other non-discretionary administrative/ministerial activities of trustees too numerous to include here; but examples will be found in each [Client PTC's] Policy and Procedure Manual.**

EXHIBIT D

[CLIENT] TRUST COMPANY LLC (IN ORGANIZATION)
A PROPOSED [CHARTER STATE] PUBLIC TRUST COMPANY
[*DRAFT FOR DISCUSSION PURPOSES ONLY*]

Recommended Locations for Trust Company Activities For Fiduciary and State Trust Company Law Compliance and Establishing or Maintaining Choice of Trust Site and Governing Law[42]

(Relevant But Not Sufficient Guidance for Determining States That May Tax the Trust Company or Any Trust)

• LLC MEMBERS AND MANAGING DIRECTORS		
Member • *[Client Trust Company LLC (Company)] Owner Trust*	Trustee Actions/ Protector Actions	Any State [**state tax advice may differ**]
Board of Managing Directors • [Names]	Annual Meeting	[Charter State]
	Quarterly/Other Meetings:	• [Charter State] or a state with a full service trust office • Majority in [Charter State]
	Policy and Administrative Decisions	[Charter State] or a state with a full service trust office
• COMMITTEES		
Trust and Investment Committee • [Names]	Semi-Annual or Quarterly/Other Meetings	Unless making fiduciary decisions: anywhere, any state

[42] Board members may also serve on any committee but may not act on a Discretionary Decisions Committee/Beneficiary Relations Committee for its own trusts. Otherwise, advice regarding required versus optional committees and officers, what separate offices may be occupied by one and the same person and what committees may have members who serve on other committees will be provided separately.

• Trust Committee may be required by regulators but Board may serve as • Trust/Trust and Investment Committee may act as Executive Committee: advantageous if Board is large		**[advice may differ for state tax law purposes: concentration in one state may be recommended]** If making fiduciary decisions, see below
	Fiduciary Decisions (including choice of investment advisors and delegation of investment authority)	• [Charter State] • On occasion, state of a full service trust office
	Executive, Policy and Administrative Decisions	• Anywhere **[advice may differ for state tax law purposes: concentration in one state may be recommended]**
Audit Committee • [Names]	All Meetings and Decisions that are Non-Fiduciary	• All actions except fiduciary decisions: anywhere **[advice may differ for state tax law purposes: concentration in one state may be recommended]** • When making fiduciary decisions: [Charter State] or on occasion state of a full service trust office
Discretionary Decisions Committee and Beneficiary Relations Committee • [Names]	All Meetings and Decisions	• All actions except fiduciary decisions: anywhere **[advice may differ for state tax law purposes: concentration in**

		one state may be recommended] • When making fiduciary decisions: [Charter State] or on occasion state of a full service trust office
Other Committees (if desired) • [Names]	All Meetings and Decisions	• All actions except fiduciary decisions: anywhere **[advice may differ for state tax law purposes: concentration in one state may be recommended]** • When making fiduciary decisions: [Charter State] or on occasion state of a full service trust office
OFFICERS		
President and Other Executive Officers • [Names]	All Meetings and Decisions)	Unless making fiduciary decisions, any state **[advice may differ for state tax law purposes: concentration in one state may be recommended]** If making fiduciary decisions: [Charter State] or, depending on the matter, another state in which the Company is authorized to act as a fiduciary

<table>
<tr><td rowspan="2">Trust Officers (Senior and all other Trust Officers)
• [Names]</td><td>Client Meetings (no fiduciary decisions)</td><td>Anywhere [advice may differ for state tax law purposes: concentration in one state may be recommended]</td></tr>
<tr><td>All Fiduciary Decisions</td><td>Charter State or depending on the matter, another state in which the Company is authorized to act as a fiduciary</td></tr>
<tr><td>Other Officers (or any other authorized body or person)
• Assistant Compliance Director (TBD)</td><td>Trust Administration (i.e., ministerial decisions/ actions); Assistance with Compliance-Related Functions</td><td>Any state [but advice may differ for state tax law purposes: concentration in one state may be recommended]</td></tr>
<tr><td colspan="3">OUTSIDE SERVICE PROVIDERS</td></tr>
<tr><td rowspan="2">Affiliated/Unaffiliated Administrative Services Providers</td><td>Delegated Trust Investment Decisions</td><td>Anywhere [assuming proper, arms-length controls are in place]</td></tr>
<tr><td>Other Asset Management</td><td>Anywhere</td></tr>
<tr><td>Non-affiliated Investment Advisors</td><td>Asset Management Advice/ Discretion</td><td>Anywhere [advice may differ for state tax law purposes: concentration in one state may be recommended]</td></tr>
<tr><td>Directed Trust Advisors and Protectors</td><td>Fiduciary or Other Trust Decisions</td><td>Depends on Roles</td></tr>
</table>

EXHIBIT E
Draft of a Trust Company
"Beneficiary Relations Committee" Bylaw

Kozusko Harris Duncan
Revised November 1, 2023

Beneficiary Relations Committee. The Directors shall designate and appoint a Beneficiary Relations Committee ("Committee") to exercise discretionary distribution powers, when granted under one or more Governing Instruments, and to fashion and direct the Company's provision of appropriate guidance and assistance to trust beneficiaries with respect to their personal and career development. The Committee shall meet at least quarterly and shall consist of at least two (2) individuals, each of whom shall serve for a term of one year or until his or her successor is appointed or elected. The duties of the Committee are as set forth below.

(a) *Distributions Standards and Procedures.* With respect to each trust whose Governing Instrument permits discretionary distributions to beneficiaries, determine from time to time but at least annually whether such a distribution should be made through a process consistent with and incorporating the following principles and procedures:

(1) Review from time to time the applicable Governing Instrument to confirm its purpose and other terms applicable to the making of discretionary distributions.

(2) Determine the overall circumstances of the trust beneficiaries to determine whether and in what form and amount a discretionary distribution should be made to one or more beneficiaries consistent with the Governing Instrument and the best interests of the beneficiaries, which determination should reflect:

a. Each present and future beneficiary's circumstances including needs, goals and resources, including other trusts as well as non-trust financial resources and intellectual, human, social, and spiritual capital apparently available to that beneficiary; and

b. Each beneficiary's requests for distributions and the purpose and other reasons provided for such requests.

(3) Where deemed appropriate, the Committee may authorize and direct the managing senior or other trust officer to assist beneficiaries in providing the information reasonably required by paragraph (2) above, including identifying any professional assistance required and determining whether trust funds may be used to cover some or all of the costs of such assistance.

(4) Subject to applicable privacy and confidentiality requirements, coordinate with, and gather or provide information from or to other fiduciaries to the

extent considered appropriate by the Committee in performing its above duties.

(b) *Beneficiary Personal and Career Development.* It is the policy of the Committee in addition to assist each beneficiary's personal and career development through obtaining for the beneficiary such counseling, teaching, mentoring, life coaching, estate planning or similar guidance and personal finances management assistance as the Committee determines to be appropriate in collaboration with the beneficiary, if an adult, or, if a minor, one or more parents or guardians of the person of the beneficiary ("beneficiary representative", together with the beneficiary if deemed appropriate by a parent or guardian).

(1) Such services may also include assistance to the beneficiary in developing the information set forth in paragraph (a)(2) above that is reasonably required by the Committee to make distribution decisions. The Committee will have responsibility for implementing these policy, with the support of the Company's trust officers;

(2) The Committee shall provide or cause to be provided such services as agreed upon with the beneficiary or beneficiary representative; and

(3) The Committee shall determine the extent to which the agreement services will be funded from the Company's trustee or other fees and the extent to which reasonable remuneration from the beneficiary or beneficiary representative will be required.