Structuring a Private Family Trust Company
Welcome

The ownership and governance structure of a private family trust company (“PFTC”) is highly customizable. This is important because all families are different, with different goals, family dynamics, asset composition, family sizes, and family affiliates. A PFTC serving a third generation family (with perhaps ten family members) will look a lot different than a PFTC serving a sixth generation family (with perhaps 100 or more family members). With that in mind, there are some key considerations in structuring the ownership and governance of a PFTC, both tax-related and not tax-related. This paper summarizes these tax and non-tax considerations, and then applies them in the context of choices regarding entity type, entity ownership, and governance structures.

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Non-tax considerations

Non-tax considerations include:

1. Who should initially have a say (and to what degree) in PFTC affairs (including those inside and outside of the family)?
2. What is the mechanism for choosing successors to those who will be in management or have control?
3. How much flexibility should be built into the PFTC?

The goal of a PFTC attorney is to accomplish the unique non-tax goals of the family, while avoiding potential tax pitfalls, which are described below.

Tax considerations

Tax considerations include estate, gift, and generation-skipping transfer ("GST") taxes, as well as state and federal income tax issues. These tax issues can be very complex, but they are extremely important in determining the structure and governance of a PFTC.

As to estate taxes, the structure of a PFTC, specifically the powers that individuals or groups of individuals are deemed to hold with respect to a given trust, could affect whether trust property is includable in an individual trust grantor’s, beneficiary’s, or powerholder’s gross estate and thus subject to federal estate tax (and potentially state death taxes). Relevant provisions include IRC § 2036 (retained rights or powers over trust income and powers over certain voting stock), IRC § 2038 (powers of the grantor to revoke or alter beneficial interests), IRC § 2041 (powers of appointment that could benefit the holder of the power), and IRC § 2042 (incidents of ownership by the insured with respect to life insurance).

As to gift taxes, the structure of the PFTC can also impact whether there is a taxable gift that results from certain trust transactions, and whether an initial transfer to a trust constitutes a “completed gift” for gift tax purposes.

As to federal income taxes (as well as for states that conform to the federal income tax rules), the structure of a PFTC can impact whether a given trust is a “grantor” trust (with its income taxable to the grantor or another person) or a “non-grantor” trust (with its accumulated income taxable to the trust itself). For state income taxes, the structure of a PFTC could potentially impact whether income taxes are owed by trusts to a state other than the state where the PFTC is located (keeping in mind that the most popular PFTC jurisdictions do not impose an income tax on trusts on the basis of the PFTC-trustee being located in the state).

Many of these federal tax issues were discussed in IRS Notice 2008-63. This Notice, while it merely describes a proposed revenue ruling, provides the most direct guidance from the IRS on tax issues with PFTCs. The IRS has also issued numerous private letter rulings regarding PFTC issues. While some aspects of Notice 2008-63 may reflect a more conservative approach than necessary under the tax law, the Notice serves as a useful guide to the tax considerations in structuring a PFTC.

Choice of Entity

PFTCs are typically organized as either a corporation or an LLC for state law purposes. As discussed below, PFTCs typically need to have unique governance provisions in order to accomplish a family’s tax and non-tax objectives. LLCs are generally more flexible than corporations in terms of governance structure, so for this reason, an LLC may be the preferred entity type for a PFTC.

A PFTC is generally operated in a manner where its revenues meet its costs and there is little taxable income for the PFTC entity itself, so the federal tax treatment of the entity (whether as a corporation, partnership, or disregarded entity) is not typically a major concern.
Ownership of PFTC Entity

A key aspect of the ownership structure of a PFTC is that independent persons (i.e., not related or subordinate to any family members) should have exclusive control over tax-sensitive governance provisions of the PFTC. The ownership structure is important because typically, under state law, the owners of an entity can collectively make any changes to the governance of the entity that they please. So if one or more family members could exercise the rights of ownership of the PFTC, that could be seen as an indirect power to affect tax-sensitive functions of the PFTC (like the ability to amend the governing documents, affect discretionary distributions, or control tax-sensitive investment decisions).

One typical structure would be for the PFTC to be controlled by one or more trusts where the trustee of each trust must be one or more independent persons. As an alternative, at least one state’s laws allow a PFTC to be structured in a way that, even if family members own all ownership interests in the PFTC, an independent person, rather than the owners, has exclusive control over tax sensitive decisions, including amending the governing documents. IRS Notice 2008-63, which involved the possibility of family members owning the PFTC directly, assumed that the family members would not have tax-sensitive control under applicable state law, but careful consideration must be given to whether this is actually the case under the state’s PFTC laws and corporate or LLC laws.

Elements of Governance

Board

Regardless of whether a PFTC is formed as a corporation or an LLC, it is typical for the PFTC to be managed by a board of directors (or “board of managers,” depending on applicable law—referred to herein as the “Board”). The Board controls the overall management of the PFTC, except to the extent those duties are reserved to a special committee, as discussed below. The Board is elected by the owner(s) of the PFTC. State PFTC laws typically require a minimum number of directors, and some states require that one or more directors be a resident of the PFTC state. Directors can include family members, but for tax reasons, it is advisable to include at least one independent person as a director.

Officers

Officers are selected by the Board. Officers are in charge of the day-to-day operations of the PFTC (which do not involve tax-sensitive decisions). Personnel decisions relating to the PFTC should be made by the officers.

Discretionary Distribution Committee

A discretionary distribution committee (“DDC”) is a mechanism to make sure that tax-sensitive distribution decisions are not made by persons who could cause an adverse tax consequence that results from their involvement in the decision. At a minimum, the PFTC governing documents should provide that a member of the DDC may not participate in making a discretionary distribution decision with respect to a trust of which the member is a grantor or beneficiary, nor make a discretionary distribution decision with respect to a trust of which the DDC member or the member’s spouse owes a legal obligation of support to a beneficiary. However, it is likely advisable for tax reasons that people who are related or subordinate to a grantor or beneficiary of the trust should also be prohibited from participating in DDC decisions regarding the trust. The simplest and most conservative way to accomplish this would be to only allow independent persons to serve on the DDC. The governing documents could provide that distribution decisions are to be made by majority vote of the DDC members who are not disqualified, or the governing documents could provide a more intricate method for making DDC decisions.

Amendment Committee

The Amendment Committee is the most tax-sensitive governance function of a PFTC. The Amendment Committee should only include independent persons because it will be vested with the sole authority to amend the PFTC’s governing documents in a manner that affects the functions of, for example, the Discretionary Distribution Committee or the Amendment Committee. This prevents family members from being deemed to have indirect control over tax-sensitive decisions by way of the ability to change the rules down the road. Situation 1 of IRS Notice 2008-63 seems to assume that, under state law, it is possible to vest the Amendment Committee with this sole control and prevent the owners of the PFTC from affecting this control. This may not be the case under applicable state law, so particular attention should be paid to applicable state law and to the ownership of the PFTC in order to avoid the argument that
family members still have indirect control over these key tax-sensitive functions. In those circumstances, the PFTC should be structured under Situation 2.

**Investment Committee**

The Investment Committee is responsible for making trust investment decisions. This may include selecting investment advisors, choosing investments, monitoring investments, and setting investment policy. The Investment Committee would generally be selected by the Board, and family members may serve on the Investment Committee. However, family members should be precluded from participating in investment decisions that are tax sensitive, such as decisions relating to life insurance on their own life or over certain voting stock that the member transferred to a trust.

**Other Committees**

A PFTC may have other committees (of Board members or otherwise) in order delegate duties or otherwise optimize the PFTC’s governance structure.

An “Audit Committee” could be assigned to provide review and oversight of the PFTC’s operations, such as creation and review of the PFTC’s written policies and procedures, examination of compliance with those policies and procedures, and evaluation of external contracts and vendors.

A “Trust Acceptance (or Onboarding) Committee” could be assigned responsibility for analyzing new trust relationships and ultimately recommending whether to accept a trusteeship, and on what conditions, if any.

A “Beneficiary Committee” could be created to handle contacts with trust beneficiaries, such as keeping beneficiaries informed, getting input from beneficiaries, and gathering information as it related to potential distributions (keeping in mind that actual distribution decisions are vested in the DDC).

Additional committees or governance features can be added to address virtually any particular need that a family may have. There is significant flexibility within the confines of the tax considerations discussed above, and a good PFTC lawyer can work through a myriad of issues in order to accomplish the family’s goals.

**Conclusion**

The forgoing is only a brief summary of the tax and non-tax considerations in structuring the ownership and governance of a PFTC. Structuring a PFTC is a complex task that requires careful consideration of all of the factors involved, and there is no “one-size-fits-all” approach to accomplishing a family’s unique goals. But with careful planning, a PFTC can be customized in a manner that fully integrates the PFTC into the family’s business, charitable, succession, and tax planning and will help to accomplish the family’s objectives over the course of many generations.
Our Team

For nearly 30 years, large, family-owned and closely held businesses, high net worth individuals, family offices including their private family trust companies, and tax-exempt organizations around the world have sought out our team to provide practical tax, business, and estate and trust planning solutions.

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