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HOW THE RICH STAY RICH:  
USING A FAMILY TRUST COMPANY TO SECURE A FAMILY FORTUNE

Iris J. Goodwin\*

*He started a story that began, "The very rich are different from you and me." Someone said, "Yes, they have more money."*

- Ernest Hemingway, *The Snows of Kilimanjaro*

*We're not a family... we're a firm!*

- King George VI about the British Royal Family<sup>1</sup>

This Article is about family trust companies and the way they are used by very wealthy families to preserve great fortunes. A family trust company is a corporation formed to provide fiduciary services to a single family or related group of people, in contrast to banking institutions established to offer similar services to a larger public. The province of the mega-rich (who remain very much upon the American landscape, the recent economic crisis notwithstanding<sup>2</sup>), the family trust company is generally thought to be a vehicle for families with a net worth of at least \$200 million.<sup>3</sup> While the family trust company has long been important in securing the fortunes of some of the nation's wealthiest families, scant attention has been paid to it by the academic bar. This Article aims to redress this longstanding oversight, especially in light of recent changes in the law that make these entities far more accessible to the very wealthy.

Family trust companies are not new in the U.S., but first appeared in the late nineteenth and early twentieth centuries, in the wake of the Gilded Age, when a few of the nation's wealthiest families created

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<sup>1</sup> SIMON HALL, *THE HUTCHESON ILLUSTRATED ENCYCLOPEDIA OF BRITISH HISTORY* 147 (Paul Davis ed., Taylor and Francis 1999).

<sup>2</sup> While the recent economic crisis has been consequential for the very rich (as for everyone else) and many great fortunes currently reflect the decline in the market, many of the America's wealthiest families remain among the nation's – and the world's -- most financially fortunate people. "The rich haven't gotten richer – or poorer – this year." See *Forbes* 400, [http://www.forbes.com/2008/09/16/richest-american-billionaires-lists-400list08-cx\\_mm\\_dg\\_0917richintro.html](http://www.forbes.com/2008/09/16/richest-american-billionaires-lists-400list08-cx_mm_dg_0917richintro.html) (last visited Mar. 30, 2009).

<sup>3</sup> Pierce H. McDowell III, *Family Owned Private Trust Companies*, ABA TRUSTS AND INVESTMENTS, May-June, 2008 at 44..

them.<sup>4</sup> The family trust companies of this earlier era were usually organized under the same laws and regulatory requirements that would govern any state-chartered trust company serving the public. Recently, however, following upon the economic boom of the last twenty-five years (what some have dubbed America's "Second Gilded Age"<sup>5</sup>), the law in some states has become much more accommodating, making these entities far easier to create and to operate – much more accessible to wealthy families looking to preserve their fortunes far into the future.<sup>6</sup> But to appreciate the significance of the family trust company, we must not only attend to the particulars of recent laws that so effectively facilitate establishment of these entities. We must also examine this entity *in situ*, as the very wealthy employ it, as the masterstroke in a series of aggressive planning techniques – tax-driven and otherwise -- that potentially secure and indeed grow a fortune for untold generations to come.

Great fortunes tend to dissipate for a number of reasons. The most obvious source of pressure (or so it would seem) emanates from the federal wealth transfer tax regime -- of which the estate tax is the principle tax. This tax was enacted for the precise purpose of ensuring the exhaustion of great fortunes within a few generations.<sup>7</sup> Be this as it may, however, the estate tax is now and has been from its inception a voluntary tax – at least for the very rich.<sup>8</sup> While the transfer tax regime has continued to evolve and indeed over time has become more exacting in its demands, in every era the very rich and those that advise them in the intergenerational transfer of assets have responded with

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<sup>4</sup> Some of these are still around and now, in addition to serving multiple generations of the founding family, they have opened their doors to the public. See, e.g., RICHARD R. DAVIS, *THE PHIPPS FAMILY AND THE BESSEMER COMPANIES* 76 (Turner Publishing Company 2007).

<sup>5</sup> Ronald D. Aucutt, *The Nuts and Bolts of Private Trust Companies and Family Offices* (March 8 & 9, 2008) (unpublished manuscript, on file with Iris Goodwin of the University of Tennessee College of Law).

<sup>6</sup> Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 690-91 available at SP020 ALI-ABA 675.

<sup>7</sup> See, CAMPFIELD, DICKENSON & TURNIER, *TAXATION OF ESTATES, GIFTS AND TRUSTS* 22 (23d ed. West Group 2006)

<sup>8</sup> James Casner, noting the extraordinary effectiveness of generation-skipping transfers in circumventing the transfer tax regime, remarked to the House Ways and Means Committee, "[i]n fact, we haven't got an estate tax, what we have, you pay an estate tax if you want to; if you don't want to, you don't have to." *Estate and Gift Taxes: Hearing Before H. Comm. on Ways & Means*, 94<sup>th</sup> Cong. 2d Sess. Pt 2, 1335 (Mar. 15-23, 1976) (statement of Professor A. James Casner). See also Edward J. McCaffery, *A Voluntary Tax? Revisited* USC Olin Research Paper No. 01-5 at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=269352](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=269352); George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161(1977). This point obtains, notwithstanding recent populist lamentations about the "death taxes." Thus, while there is no doubt that the advent of the Obama administration and the Democratic majority in both Houses of Congress has restored the infamous tax to the political *terra firma*,<sup>8</sup> for the super-wealthy this sea-change in Washington makes for little moment. Jonathan Weisman, *Obama Plans to Keep Estate Tax Democrats Want to Freeze Levy at Current Levels* WALL STREET JOURNAL, January 12, 2009 at A1. The privately-owned, family-operated, family trust company

ever more complex techniques to minimize the burden of this tax. Whatever the era, however, such strategies must be employed unless the tax is to exert its dissipating force. Our era is no different and, in fact, can be distinguished only by the sophistication of the more popular strategies and the magnitude of their ambition – and by their frequent reliance upon the privately-owned, family-operated, family trust company as their crowning implement.

But in our era, not only does the family trust company play a role in various tax-planning strategies that minimize the pressure of the federal fisc, but these entities are also established as a bulwark against other important but less obvious sources of pressure on great wealth. The very wealthy and their advisers have long been aware that other powerful, dissipative forces are in play with respect to great fortunes. Indeed, these forces are so significant that in the face of them the benefits of sophisticated tax planning can be reduced to naught in short order. In these other battlegrounds in securing the wealthy in their privilege, attention has come to center on what happens to great fortunes after they have been transferred into trust (often done as part of a strategy to shelter wealth from the transfer tax regime). The transfer of wealth into trusts benefiting successive generations of the family (with the location of control outside the family<sup>9</sup>) has in and of itself augured a diminution in fortunes over time. There is an old joke among trust beneficiaries: “How do you make a small fortune? Give a bank a large one to manage in trust!”<sup>10</sup>

The super-wealthy of today, particularly those who earned their fortunes in the economic boom of the last twenty years, believe that important among the reasons that great fortunes dissipate is that large banking institutions manage money too conservatively, especially money in trust.<sup>11</sup> Whatever the era, the fundamental reason that a super-rich family forms a family trust company is the desire to invest its own wealth, even after (for reasons of transfer tax planning) it has been transferred into trust.<sup>12</sup> This was the case in earlier times,<sup>13</sup> but it is especially so today. These families are now prepared to make their own determination of risk, even if their wealth is in trust, bringing an

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<sup>9</sup> There are many legal reasons to name a third-party as trustee. For example, naming the donor of the trust as trustee limits the discretion the trustee can be granted unless the transfer is to run afoul of a number of provisions of the Internal Revenue Code applicable to transfers in trust that will cause inclusion of the trust in the donor’s estate. *See, e.g.*, I.R.C. § 2036(a)(2) (2008); Treas. Reg. § 1.2036 (2007).

<sup>10</sup> Jesse Dukeminier & James F. Krier, *The Rise of the Perpetual Trust* 50 *UCLA L. Rev.* 1303 (2003) 1335.

<sup>11</sup> *See*, Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II*, *TRUSTS & ESTATES*, October 1998, at 68.

<sup>12</sup> Pierce H. McDowell III, *Family Owned Private Trust Companies*, *ABA TRUSTS AND INVESTMENTS*, May-June, 2008 at 43-44.

<sup>13</sup> *See, e.g.*, RICHARD R. DAVIS, *THE PHIPPS FAMILY AND THE BESSEMER COMPANIES* 59-60 (Turner Publishing Company 2007).

entrepreneurial mindset to bear on their funds. The same mindset that they believe was essential to the creation of their fortunes is the mindset they believe can maintain those fortunes.<sup>14</sup> The problem has been getting into the driver's seat and it is here that the family trust company appeals.

Until about twenty years ago, the law of fiduciary duty would not have readily encompassed an entrepreneurial mindset with respect to investing funds in trust, whoever was in the driver's seat. If banking institutions managed money conservatively, this posture was consonant with the law.<sup>15</sup> About twenty years ago, however, the law governing the investment of trust assets began to change and it is this change in the law that wealthy families intend to exploit to the fullest once their wealth is in trust and the family trust company is at the helm.<sup>16</sup> In our era, determination of the risk profile appropriate to any portfolio has become (consistent with the law) as much an art as a science and is ultimately governed by the totality of facts and circumstances surrounding the account. This means that, if the account is large enough and the horizon long enough, even highly speculative investments such as venture capital and private equity can become appropriate investments for property in trust.<sup>17</sup>

But size does matter. Even under the new standard of care, an aggressive investment strategy must be justified, and a very large corpus in a long-term trust can justify taking a greater degree of risk in investing the account. Here is the point where the advanced planning techniques permitting a wealthy family to transfer tens of millions of dollars into trust with little to no transfer tax liability (either at the creation of the trust when property is transferred or later as assets still in trust serve successive generations of the family) become truly important. The family trust company is then established not simply to implement various tax-planning strategies or to secure their benefits, but to exploit those benefits to justify an aggressive investment posture consonant with the law. Without the drain upon family funds (and the dissipating pressure) that the transfer tax burden would otherwise constitute, much of the family fortune can be transferred into trust in tact, justifying an aggressive investment strategy once the funds are held there. Then, with a sufficiently entrepreneurial spirit at the helm, the new standard of care makes it possible to do with property in trust

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<sup>14</sup> Pierce H. McDowell III, *Family Owned Private Trust Companies*, ABA TRUSTS AND INVESTMENTS, May-June, 2008 at 43-44.

<sup>15</sup> *See infra*,

<sup>16</sup> *See, infra*,

<sup>17</sup> *See infra*,

what has rarely been done before<sup>18</sup> -- and potentially great fortunes do not merely cease to wane, but can actually appreciate.

Whatever control of investing a family may garner by establishing a family trust company, however, this control will be useless if the family cannot muster from generation to generation from within its ranks the financial acumen and expertise and indeed the discipline to make state-of-the-art investment decisions. Interestingly, as part of the effort to end what some advisors have termed “financial entropy” within wealthy families, there has emerged a literature offering guidance in “financial parenting” so that wealthy children come of age free of the self-indulgence and accompanying desuetude that is said to commonly characterize the lives of second- and third-generation members of such families.<sup>19</sup> Such character flaws (so this literature claims) ensure that, strategies to minimize the toll of the transfer tax regime notwithstanding, great fortunes are soon lost, lending truth to the proverb “shirtsleeves to shirtsleeves in three generations.”<sup>20</sup> According to this literature, the antidote lies in the cultivation across generations of attitudes about money, investing and risk, with the intent of fostering an awareness not only of the magnitude of their privilege but also its financial underpinnings.<sup>21</sup>

And here again, in this “financial parenting,” the family trust company enters to play an instrumental role. If the operation of a family trust company requires certain skills and attitudes, the trust company itself (so this literature observes) can serve as a forum in which education in these skills and attitudes can take place. Senior executives (the older generation) can school junior executives (the younger generation) in the course of making investment decisions. But further, within the framework of the family trust company, families are encouraged to recruit outside experts, from financial sages to psychologists, to hold seminars for family members about wealth -- even about “feelings”

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<sup>18</sup> See, e.g., RICHARD R. DAVIS, *THE PHIPPS FAMILY AND THE BESSEMER COMPANIES* 81-104 (Turner Publishing Company 2007).

<sup>19</sup> See JESSIE O'NEILL, *THE GOLDEN GHETTO: THE PSYCHOLOGY OF AFFLUENCE* (Affluenza Project 1997). Ms. O'Neil was the granddaughter of the former president of GM. Drawing upon her own experience, she developed the term “affluenza” as a summary reference to the flaws often developed by children of the very wealthy. See also, Linda C. McClain, *Family Constitutions and the (New) Constitution of the Family*, 75 *FORDHAM L. REV.* 833, 861 (2006); Pierce H. McDowell III, *Family Owned Private Trust Companies*, *ABA TRUSTS AND INVESTMENTS*, May-June, 2008 at 43-44.

<sup>20</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 3 (rev. ed. Bloomberg Press 2004)

<sup>21</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 116-18 (rev. ed. Bloomberg Press 2004).

about being wealthy – all with the object of thwarting financial entropy.<sup>22</sup>

Finally, the family trust company and its applications in the perpetuation of great fortunes bear normative implications that any treatment of this entity should not overlook. It has long been a commonplace of democratic theory that, while democracy is largely immune to some degree of material difference within a polity, intransigent, radical differences in means are problematic.<sup>23</sup> For this reason, the dissipation of great fortunes has been viewed as salubrious in a democratic polity.<sup>24</sup> “Shirtsleeves to shirtsleeves in three (or so) generations” is more than a proverb; it is an operating condition of a healthy democracy.<sup>25</sup>

For many theorists of democracy, the virtually tax-free transmission of wealth from generation to generation within wealthy families has not been deemed politically or socially consequential, however, because there has been a failsafe: fortunes are quite precarious, whatever their size, as they dissipate in the ordinary course (even if they escape tax as they move between generations).<sup>26</sup> If great fortunes do indeed dissipate in the ordinary course, then, where democracy is concerned, the effectively voluntary nature of the estate tax is seemingly less consequential – provided that fortunes do in fact dissipate. If the family trust company succeeds where advisers claim it can, however, the financial entropy that has been thought to inhere in great fortunes – and to be at least a background condition of a thriving democracy -- will be a thing of the past.

In this regard it is worth returning to uses of the family trust company in financial “financial parenting” to make one additional preliminary observation. As wealthy families are encouraged to gather within the family trust company in order to embrace their privilege self-consciously, thereby to eliminate the precarious nature of their fortune,

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<sup>22</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 116-18 (rev. ed. Bloomburg Press 2004).

<sup>23</sup> THE FEDERALIST NO. 10 at 44 (Liberty Fund ed., George W. Carey & James McClellan eds. 2001).

<sup>24</sup> JOHN RAWLS, *A THEORY OF JUSTICE* 277 (1971). Rawls defends inheritance taxes “not to raise revenue...but gradually and continually to correct the distribution of wealth and to prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity.”

<sup>25</sup> See, e.g., Alexis De Tocqueville, *Introduction to Volume One and Part 3 Section 3 “Social State of the Anglo-Americans”* in ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA*, pp. 50 (Anchor Books, 1969) (1835). See also B. Douglas Bernheim, *Does the Estate Tax Raise Revenue?* in 1 *TAX POLICY AND THE ECONOMY* 113, 121-32 (Lawrence J. Summers ed. 1987); Michael J. Boskin, *An Economist’s Perspective on Estate Taxation*. in *DEATH, TAXES AND FAMILY PROPERTY: ESSAYS AND AMERICAN ASSEMBLY REPORT* at 65 (Edward C. Halbach, Jr., ed. 1977); and Gary Solon, *Intergenerational Income Mobility in the United States* 82 *AM. ECON. REV.* 393-398, 403-05 (1992).

<sup>26</sup> Michael J. Boskin, *An Economist’s Perspective on Estate Taxation*. in *DEATH, TAXES AND FAMILY PROPERTY: ESSAYS AND AMERICAN ASSEMBLY REPORT* 65-66 (Edward C. Halbach, Jr., ed. 1977).

they potentially secure themselves in a world apart – precisely what the wealth transfer tax was meant to preclude.<sup>27</sup> The sustained process of gathering together within the family trust company for the purpose of preserving and growing wealth encourages these families to discern and indeed embrace the special circumstances – and privileges -- of great wealth, for the precise purpose of securing them into the future. The family trust company is designed to be privilege-sustaining, indeed privilege-enhancing.

One last point: In the wake of the recent economic turmoil, we might think that anyone with an entrepreneurial mindset would feel chastened, particularly given that many speculators have suffered enormous losses and speculative excess is what – so many say -- has brought the U.S. economy to its knees. And the many of the wealthy have seen a decline in the value of their holdings like everyone else. Be this as it may, however, with pundits disagreeing about the effectiveness of various antidotes to the crisis and no one confidently auguring the light at the end of the tunnel, the time could not be riper for the wealthy to want to manage their own risk, to protect against further downside as well as to position portfolios to take advantage of early opportunities that will appear when the U.S. economy starts to recover.<sup>28</sup> And this is no less the case where the property is held in trust.

Part I of this Article examines those recent changes in the laws in some states that allow for ease of set up and operation of a trust company serving a related group of people. This Part sets the stage for appreciating the role that these entities potentially play in forestalling the erosion of great fortunes.

Part II recognizes that size matters in justifying fiduciary investment decisions and provides an overview of the valuation alchemy commonly brought to bear on great fortunes as they are being transferred into perpetual trusts. Among other strategies, we consider the “Note-Sale,” a strategy commonly employed to transfer enormous wealth into trust with virtually no transfer tax liability. If size matters in justifying investment decisions under the Prudent Investor standard, then these strategies for transferring wealth with little to no tax consequence are crucial to empowering the trustee to invest some portion of the trust corpus aggressively.

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<sup>27</sup> JOHN RAWLS, A THEORY OF JUSTICE 277 (1971).

<sup>28</sup> Indeed, for many very wealthy people this economic crisis represents an opportunity of sorts. With asset values reduced, assets may be transferred within the family at substantially reduced value transfer tax costs. See, Deborah L. Jacobs, *As Economy Declines, Donors Rethink Estate Planning*, NEW YORK TIMES, Nov. 11, 2008 at F 27.



Part III treats the Prudent Investor statute and the opportunity it has created under the law to grow assets in trust if other circumstances are congenial and an entrepreneurial mindset is at the helm in the capacity of fiduciary.

Part IV explores the use of the family trust company as a platform by which to cultivate within the family financial expertise and attitudes concerning money calculated to end financial entropy and secure a family in its privilege for generations to come.

### I. The Modern Family Trust Company

Continuing to invest the family fortune after it has been transferred into trust has long held significant appeal for wealthy families and, for well over a century, family trust companies have been used as a means to that end. Family trust companies first appeared in the late nineteenth and early twentieth centuries. Then they were organized as state-chartered and state-regulated banks under the same laws and regulatory requirements that would govern any state-chartered trust company serving the public.<sup>29</sup> In our era, a family trust company can still be organized this way,<sup>30</sup> but recent changes in the law (at least in some states) make this unnecessary.

a. The new regulatory regimes. While a wealthy family can still create a national bank (regulated by the Office of the Comptroller of the Currency) or a state bank (regulated by state banking authorities), it is now possible to create an unregulated or a “lightly regulated” trust company, if the entity is limited in its purpose to serving as trustee of trusts<sup>31</sup> benefiting a group of related people.<sup>32</sup> In one group of states,

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<sup>29</sup> In fact, a number of these earlier family trust companies have grown into banking institutions that serve a larger public. Created to serve the family of Henry Phipps, Bessemer Trust opened its doors to the public in 1972. See Bessemer Trust, <https://www.bessemer.com/portal/site/bessemernew/> (last visited Mar. 30, 2009). Pitcairn Family Office was established to manage the fortune of the descendants of John Pitcairn, co-founder of what is now PPG Industries. The firm opened its doors to other wealthy families in 1987, providing (among other financial services) fiduciary services. See Pitcairn Family Office, <http://www.pitcairn.com/> (last visited Mar. 30, 2009). Rockefeller Trust was established 125 years ago by John D. Rockefeller to manage money for his descendants. See Rockefeller, <http://www.rockco.com/> (last visited Mar. 30, 2009).

<sup>30</sup> The entity is unlikely to be organized as a national bank or a state bank, unless the family plans to open a business effectively and to take deposits and offer other conventional banking services. See Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 689 available at SP020 ALI-ABA 675.

<sup>31</sup> Family trust companies also serve as executors of the estates of family members. See Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 689 available at SP020 ALI-ABA 675.

<sup>32</sup> Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 689 available at SP020 ALI-ABA 675. Interestingly, states do not always specify what is meant by the requirement of a “related

legislatures have responded with new and separate private trust company charters, so that trust companies serving only a related group of people can be subject to “lighter” requirements than those imposed on trust companies serving the general public.<sup>33</sup> In certain other states, liberalization of the law has occurred by simply allowing a limited purpose corporation to act as a trust company under the general statutes of the state.<sup>34</sup> Some states make available both options – light regulation or no regulation.<sup>35</sup> Whichever scheme a family elects, these innovations at the state level have reduced the costs of formation and operation for these new entities.

(i) The “lightly regulated” family trust company. The “lightly regulated” family trust company is still chartered by the state and subject to state supervision, although not on a level comparable to a bank or trust company serving the general public, provided the organizing documents limit the purpose of the entity to the provision of fiduciary services to members of a family or a group of related people and, further, prohibit the trust company from soliciting business from the public at large.<sup>36</sup> Even a so-called “lightly” regulated family trust company will usually have to have a minimum number of directors<sup>37</sup> (and perhaps with one or more directors resident in the state), a minimum number of board meetings per year<sup>38</sup>, a physical office in the state<sup>39</sup>, and a minimum number of employees.<sup>40</sup> Further, there must be

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group of people.” *See, e.g., S.D. CODIFIED LAWS § 51A-6A-1 (2007). But see NEV. REV. STAT. § 669.02(1)(b) (YEAR); N.H. REV. STAT. ANN. § 392:40-a(I)(a) (2006).*

<sup>33</sup> States permitting a “lightly regulated” family trust company include Delaware (*DEL. CODE ANN. tit. 5, §§ 773, 774, 779 (2001)*), New Hampshire (*N.H. REV. STAT. ANN. §§ 392.40-a, 392.40-b (2006)*); *South Dakota and Alaska.*

<sup>34</sup> States permitting an unregulated family trust company include Virginia (*VA. CODE ANN. §§ 6.1-32.1 (1999)*).

<sup>35</sup> States allowing both include Massachusetts, Nevada (*NEV. REV. STAT. § 669.080(1)(o)*), and Wyoming.

<sup>36</sup> With respect to family trust companies, especially where unregulated but even where lightly regulated at the state level, some advisors have been concerned that these entities could be subject to registration with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Because these entities offer trustee services (and with this investment advice), some advisors have worried that they were potentially subject to the 1940 Act. And in that they are not regulated by state banking regulators to any meaningful degree, they would not qualify under the “bank” exemption there. This would mean that, while changes in state law would exempt these entities from one form of regulation (state banking regulation), by exempting them from this regulation they would be subjected to another regulation (1940 Act). *See, e.g., Carol Harrington & Ryan M. Harding, Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 694 available at SP020 ALI-ABA 675. In 2007, upon the representation that the family trust company organized as a limited liability company under Wyoming law did not hold itself out to the public as an investment adviser, the SEC issued an order of exemption under Section 202(a)(11)(F) of the Advisers Act. *See Investment Advisers Act of 1940, Release No. 2599, March 20, 2007.*

<sup>37</sup> *NEV. REV. STAT. §§ 669.080(1)(o), 661.135 (YEAR); N.H. REV. STAT. ANN. §§ 392:40-a(II), 384:3(IV) (2006); S.D. CODIFIED LAWS § 51A-6A-13 (2007).*

<sup>38</sup> *NEV. REV. STAT. §§ 669.080(1)(o), 661.165 (YEAR); N.H. REV. STAT. ANN. §§ 392.40-a(II), 384:7 (2006) S.D. CODIFIED LAWS § 51A-6A-15 (2007).*

<sup>39</sup> *NEV. REV. STAT. §§ 669.080(1)(o), 660.015(1) (YEAR); S.D. CODIFIED LAWS § 51A-6A-58 (2007).*

in place a formalized risk-management discipline, which will be periodically reviewed by state regulators. This discipline can include bylaws, a policy manual (setting forth, among other things, a committee structure and decision rules for those committees), annual reports<sup>41</sup>, and appropriate record-keeping<sup>42</sup>. Capital requirements vary state by state but are universally modest (with some states as low as \$200,000<sup>43</sup> and others up to \$2 million<sup>44</sup>). Some states imposing lighter capital requirements (e.g., South Dakota and New Hampshire) also require a surety bond of \$1 million.<sup>45</sup>

(ii) The unregulated trust company. Some states offer an even more liberal regime, however. In these states a state-issued charter is not required to establish a family trust company nor will be the state exercise subsequent regulatory oversight.<sup>46</sup> States that allow family trust companies to form without any regulation typically permit the family to create a limited purpose corporation that then acts as a trust company under the general statutes of the state. The organizing documents (as was the case with the lightly regulated regime) must limit the purpose of the entity to the provision of fiduciary services to members of a family and, further, prohibit the trust company from soliciting business from the public at large. For entities organized under these regimes, there are usually no capital requirements. The simpler procedures for organization, the absence of periodic examinations, and the absence of capital requirements allow a family trust company to be quickly and easily established and make it less expensive to operate.<sup>47</sup>

b. Organizing the Family Trust Company: Type of Association and Where Located? Creation of a family trust company begins with a determination as to the type of business association and the governing structure of this entity. The family must also decide the state in which the family trust company will be organized and operated. These decisions are crucial if the family is to realize the potential of the

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<sup>40</sup> S.D. CODIFIED LAWS §§ 51A-6A-31 to -32 (2007). For example, in South Dakota, the requisite minimum number of employees is one and state examinations occur only every eighteen months. *See also* NEV. REV. STAT. §§ 669.080(1)(o), 669.110, 665.135(2) (YEAR).

<sup>41</sup> NEV. REV. STAT. §§ 669.080(1)(o), 669.110, 665.105 (YEAR); N.H. REV. STAT. ANN. § 392.40-b (2006); S.D. CODIFIED LAWS § 51A-6A-34 (2007).

<sup>42</sup> S.D. CODIFIED LAWS § 51A-6A-30 (2007).

<sup>43</sup> *See* DEL. CODE ANN. tit. 5, §§ 779, 745 (2001).

<sup>44</sup> N.H. REV. STAT. ANN. §§ 392.40-a(II), 392.25(I) (YEAR); S.D. CODIFIED LAWS § 51A-6A-19 (2007).

<sup>45</sup> S.D. CODIFIED LAWS § 51A-6A-19 (2007). *See also* Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 709 available at SP020 ALI-ABA 675.

<sup>46</sup> *E.g.*, Massachusetts, Nevada, Pennsylvania, Virginia, and Wyoming. The Virginia statute only authorizes an unregulated private trust company. *See* VA. CODE ANN. §§ 6.1-32.1 (1999).

<sup>47</sup> Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 690-91 available at SP020 ALI-ABA 675.

family trust company, first as a significant component within an advanced tax planning strategy and later as a vehicle by which to secure the family fortune into the future.

(i) Organization and Governance. A variety of considerations can drive this decision as to the type of business entity to be used. Since states that have liberalized their laws with respect to the formation of family trust companies usually permit these to be organized as limited liability companies, most families will organize as a limited liability company, although some still form a corporation.<sup>48</sup> To take advantage of those state statutes that have recently liberalized the regulatory framework applicable to family trust companies, the entity is typically organized for the limited purpose of providing trust services to a particular family or group of related individuals.<sup>49</sup>

Once a decision is made with respect to the type of business association to be used, the family must put in place a governance structure so that the family can, through the various administrative arms of the trust company, effectively control the investment of trust funds (among other things).<sup>50</sup> The ownership interest is usually vested in individual family members.<sup>51</sup> Family members also serve on the board of directors. The board can also include outside advisors of longstanding.<sup>52</sup> To the extent that the applicable state statute requires that one or more directors be resident in the state where the trust company has been created and where it will operate, local attorneys and other advisers can be named. In all events, however, states that permit

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<sup>48</sup> A partnership would not be used because the entity would terminate when one of the partners died. This would defeat one of the purposes of creating an entity to serve as trustee rather than relying upon an individual.

<sup>49</sup> Ronald D. Aucutt, *The Nuts and Bolts of Private Trust Companies and Family Offices* (March 8 & 9, 2008) (unpublished manuscript, on file with Iris Goodwin of the University of Tennessee College of Law).

<sup>50</sup> While control of investing the trust corpus rarely has adverse tax consequences for the family, control of distributions of income or principal by family members to family members can have disastrous transfer tax consequences. Because the desire to control of distributions is usually not the primary reason that a family establishes a family trust company, decision-making within the family trust company can usually be structured so that adverse tax consequences. *See* I.R.S. Notice 2008-31 I.R.B. 261.

<sup>51</sup> Trusts established for the benefit of family members can also hold some or all of the ownership interest in a family trust company – a further step that, among other things, removes the ownership interest from family members' estates. Indeed, it is not uncommon for the trusts for which the family trust company is the trustee to own the family trust company. This circularity may appear to present questions with respect to fiduciary duty and enforceability, as this structure renders the beneficiaries themselves, though their beneficial interests in the trust, economically identical to the trustee. While there are elements of irony here, however, in truth the situation is not fundamentally different from the situation where individual family members are the trustees of trusts benefiting the family. *See* Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 694 *available at* SP020 ALI-ABA 675.; Ronald D. Aucutt, *The Nuts and Bolts of Private Trust Companies and Family Offices* (March 8 & 9, 2008) (unpublished manuscript, on file with Iris Goodwin of the University of Tennessee College of Law).

<sup>52</sup> Ronald D. Aucutt, *The Nuts and Bolts of Private Trust Companies and Family Offices* (March 8 & 9, 2008) (unpublished manuscript, on file with Iris Goodwin of the University of Tennessee College of Law).

a family to create a lightly-regulated or unregulated family trust company also permit the family to control the board, the necessary presence of others notwithstanding.

ii. Caveat: Liability. For the family that objects to bureaucratic red-tape, the unregulated family trust company has appeal, at least at first glance. Ease of formation and operation notwithstanding, however, a reason for creating a family trust company is to overcome one of the drawbacks in naming an individual as trustee – that is, the personal liability of the trustee. If the trustee is organized as a corporation or a limited liability company, then the trustee’s liability should be limited to the amount of any required formation capital and the value of any surety bond. So, for example, in South Dakota where capital in the amount of \$200,000 is required for formation along with a \$1 million surety bond, liability would be limited to \$1.2 million. This is the case, however, unless the corporate veil is pierced. If this occurs, then those members of the family deemed the principals are potentially liable.<sup>53</sup> Thus, even a family that dislikes red-tape may decide that some degree of regulation and such organizational niceties as bylaws, a policy manual, a committee structure with formalized decision-making processes, and good record-keeping lend a crucial element to the entity, that is, organizational integrity.<sup>54</sup>

iii. Trust Company State *Situs*. Because not every state allows a family to establish a modern family trust company, obviously the entity must be organized and operated in a state where the law has been liberalized, unless, of course, the entity is to be organized under one of the legal regimes governing those trust companies serving the public.<sup>55</sup> The state in which the trust company is organized and operated is important for other reasons as well, however. The *situs* of the trust company will also supply the *situs* and governing law for any trusts established by the family where the trust company is named as

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<sup>53</sup> Of course, the beneficiaries suing for breach of trust will be the children, siblings, cousins, nieces and nephews of those serving in a decision-making capacity in the trust. Suffice it to note that this can happen.

<sup>54</sup> DON KOZUSKO, PRIVATE TRUST COMPANIES, OPEN-ARCHITECTURE TRUSTS, FAMILY OFFICES, TRUST PROTECTORS AND ADVISORS: WHATEVER HAPPENED TO THE PLAIN OLD TRUSTEE, OCTOBER 17-18 (2007); Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 693 available at SP020 ALI-ABA 675.

<sup>55</sup> In fact, a number of these earlier family trust companies have grown into banking institutions that serve a larger public. Created to serve the family of Henry Phipps, Bessemer Trust opened its doors to the public in 1972. See Bessemer Trust, <https://www.bessemer.com/portal/site/bessemernew/> (last visited Mar. 30, 2009). Pitcairn Family Office was established to manage the fortune of the descendants of John Pitcairn, co-founder of what is now PPG Industries. The firm opened its doors to other wealthy families in 1987, providing (among other financial services) fiduciary services. See Pitcairn Family Office, <http://www.pitcairn.com/> (last visited Mar. 30, 2009). Rockefeller Trust was established 125 years ago by John D. Rockefeller to manage money for his descendants. See Rockefeller, <http://www.rockco.com/> (last visited Mar. 30, 2009).

trustee.<sup>56</sup> If the family trust company is to be the masterstroke in a sophisticated estate plan, it is also crucial that it be located in a state where the law is optimal for the realization of all aspects of the plan. Fortunately, for the families undertaking these complex estate plans, many of the states that have liberalized their laws with respect to forming privately owned, family trust companies have also changed their laws governing the creation and administration of trusts to make them attractive to those looking to place significant wealth in trust with their own trust company as trustee.<sup>57</sup>

d. Alternative Fiduciaries – “Big Banks” and Private Individuals.

Families of extraordinary wealth would almost always<sup>58</sup> be welcome clients of existing banks and trust companies – those that, for a fee, readily serve as fiduciary for members of the public. Or, in the alternative, these families could avoid using a big bank by naming an individual as trustee, either a person expert in fiduciary matters (e.g., a lawyer specializing in trusts and estates) or someone without professional expertise, perhaps a family member. Either of these choices would allow a family to avoid the burdens of establishing and then operating a trust company of its own. Both a big bank trustee and an individual fiduciary have significant limitations for people with considerable wealth who want to provide for multiple generations of their families by transferring this property into long-term trusts.

(i) “Big Banks.” Big banks now typically offer their wealthier clients state-of-the-art estate planning assistance, along with structures and services consonant with changes in the law particularly attractive to the very wealthy eager to transfer their property into trust. For example, these institutions now commonly have subsidiaries in states that allow for the creation of perpetual trusts. Further, consistent with the prudent investor statute, these institutions often offer a platform of cutting-edge investments appropriate to the risk-profile of large privately-held fortunes, even those in trust.

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<sup>56</sup> The *situs* of the trust company will supply the *situs* for any trust for which the family trust company or some other trustee (banking institution or resident individual) in the state is the original trustee.

<sup>57</sup> That is, trusts that name the family trust company as the initial trustee. Trusts for which the family trust company is successor trustee are another question. The family trust company cannot create nexus with respect to all important legal issues for a trust that names as initial trustee a person domiciled in another jurisdiction or another trust company located in another jurisdiction.

<sup>58</sup> Certain banks and conventional trust companies are reluctant to accept in trust volatile or hard-to-manage assets such as real estate, operating companies, or a non-diversified portfolio consisting in an ownership interest in either a closely-held company or a publicly-traded one where the family does not want the portfolio diversified. See Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 689 available at SP020 ALI-ABA 675.

For families establishing privately owned, family trust companies, however, these available structures and services are not enough. With respect to state *situs*, for example, not only is the possibility of establishing a perpetual trust at issue for these families, but there are other provisions of state law that can also be advantageous in establishing a trust. One state may allow perpetual trusts, but another may allow these plus have a more attractive law with respect to asset protection. Prudent Investor statutes also vary state by state. In establishing a trust, these families want to elect the state *situs* that is optimal for them, not one determined by a large institution to be optimal for its client-base.

And with respect to investments, notwithstanding any platform of sophisticated vehicles offered by existing banks and trust companies, these families want to continue to invest their property, even after it has been placed in trust. Prudent investor notwithstanding, a trustee has a duty not only to invest but to conserve the assets of the trust in accordance with statutorily mandated fiduciary standards. Any investment program subject to fiduciary standards is to look to the interests of income beneficiaries and remaindermen, both born and unborn.<sup>59</sup> This is a tall order and a big-bank trustee is mindful that, for any risk profile established by a it, the standard of review looks to common fiduciary investment practice.<sup>60</sup> This means that banks and trust companies serving the larger public are generally loathe to invest an account more aggressively than they anticipate their competitors would invest, given the risk profile. Also, while trustees are not required to guarantee results as they invest a trust portfolio, the duty of care encourages these institutions to attend to deliberative processes carefully recorded, as a prudent process is usually a good defense to a bad result.

There are opportunity costs, however, attendant upon convening committees and reaching decisions in accordance with procedural dictates and there are those that believe such tentativeness to be ultimately unproductive, especially where the account is of significant size and the time horizon is that of the perpetual trust. Many families establishing privately owned, family trust companies want to be free of such constraints. These families are seeking to ensure full exploitation of any prudent investor statute by developing their own, more nuanced risk-profile to govern investment decisions for their property placed in

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<sup>59</sup> Suzanne M. Trimble, *Lilife's Hard Choices* "Why Choose a Corporate Trustee?", 14-SEP CBA Rec. 44 (2000). See also David S. Prince, *Sutton's Law and Economic Applied to the Professional Fiduciary: Helping the Trustees to avoid Predatory Litigants*, 119 BANKING L.J. 17 (2002).

<sup>60</sup> John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 657 (1995). The standard of prudent investing has been the standard of industry practice – what other trustees similarly situated were doing. See also John H. Langbein, *The Uniform Prudent investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 644 (1996).

trust and want, where possible, to be free of bureaucratic red-tape so that they can turn on a dime in making investment decisions.<sup>61</sup> In short, these families are seeking to exploit prudent investor to the max. They want a trustee that is willing and able to facilitate the realization of goals consistent with their own risk-assessment.

(ii) Alternatives – Individual Trustees. Of course, these families could avoid using a big bank by naming an individual as trustee, either a person expert in fiduciary matters (e.g., a lawyer specializing in trusts and estates) or someone without professional expertise, perhaps a family member. But to the extent that these families are seeking to establish their trusts in a state with statutes optimally advantageous for their particular purposes, an individual – expert or otherwise – cannot provide the nexus necessary to create *situs* unless he or she is domiciled in the desired state.<sup>62</sup> Further, even if an appropriate individual can be located in the desired state, individuals go on vacation, become incapacitated, die and resign.<sup>63</sup> This fact is usually of modest moment in a garden-variety trust, one of moderate size, established to last one or two lifetimes. In the case of a perpetual trust holding a fortune in cutting-edge investments, however, such limitations can be consequential indeed. If an individual trustee is contemplated, what will be needed (vacations notwithstanding) is an unbroken line of succession from one honest, experienced, informed and ideally astute individual to the next, each residing in the appropriate jurisdiction. And ultimately, this succession of individual fiduciaries must potentially serve with respect to multiple trusts, all with slightly different rationales.

Further, given the complexity of the provisions in a typical perpetual trust and the challenges that inhere in investing a portfolio of great size, an individual trustee (even a person with professional expertise) must commonly resort to a bank or other financial services provider (or a collection of providers) to serve as agent for the trustee in any number of capacities.<sup>64</sup> This does not mean that the individual trustee will delegate fiduciary responsibility as he or she always retains a duty to

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<sup>61</sup> And to the extent a big bank might be willing to look beyond its own investment platform to accommodate a particular family's investment interest, any investment direction would still be subject to the bank's deliberative process – red-tape that these families want to avoid.

<sup>62</sup> Certain objections to big banks can be overcome by naming an individual as co-trustee and assigning this person certain responsibilities, making the bank a “delegated” or “directed” trustee. This alternative can have consequences of its own, however, as some states tax the income earned by trusts according to where the individual trustees reside. See DON KOZUSKO, PRIVATE TRUST COMPANIES, OPEN-ARCHITECTURE TRUSTS, FAMILY OFFICES, TRUST PROTECTORS AND ADVISORS: WHATEVER HAPPENED TO THE PLAIN OLD TRUSTEE, 22 2007.

<sup>63</sup> Carol Harrington & Ryan M. Harding, The Nuts and Bolts of Private Trust Companies and Family Offices, ACTEC Annual Meeting, March 8 & 9, 2008, Seminar G, SEMG-13-CAH.

<sup>64</sup> DON KOZUSKO, PRIVATE TRUST COMPANIES, OPEN-ARCHITECTURE TRUSTS, FAMILY OFFICES, TRUST PROTECTORS AND ADVISORS: WHATEVER HAPPENED TO THE PLAIN OLD TRUSTEE, 16-17 October, 2007.



monitor an agent's performance.<sup>65</sup> Nevertheless, when an individual trustee is named to serve alone, investment advice, custody and sometimes even record-keeping and tax return preparation are commonly contracted out to large corporate institutions.<sup>66</sup>

Finally, trustees are personally liable for breach of fiduciary duty – something that is always of concern but is of particular moment here where the plan contemplates a relatively aggressive posture on the part of the fiduciary with respect to investments. Many families in naming an individual as trustee will attempt to redress this vulnerability by including an indemnification provision in the trust instrument, especially since individual trustees often find insurance coverage limited or unavailable.<sup>67</sup> Under current law, however, the legal force of such indemnifications is uncertain, with many commentators arguing that, to bind, these must be limited in the trust agreement to particular assets or specified situations.<sup>68</sup> In addition, the intractable problem of personal liability here makes for yet another obstacle to finding individuals willing to serve as trustee, not only initially but successively. In contrast, the liabilities of a family trust company (and of any employee serving there) are more easily managed.<sup>69</sup>

A family trust company can avoid the perceived opportunity costs inherent in the use of a big bank as trustee as well as other limitations (including potential liability) attendant upon naming an individual. The family trust company (itself a corporate entity) then becomes an attractive alternative, blending the structural advantages of a corporate trustee with the discretionary latitude of an individual one.<sup>70</sup>

## Part II: Valuation Alchemy: Creating the Trust Corpus

To justify an aggressive posture under Prudent Investor, the trustee must look to the totality of facts and circumstances surrounding the trust, and the case for investing aggressively is better made where the corpus is considerable and the term of the trust, extended. Strategies for transferring the family fortune into trust with little to no transfer tax

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<sup>65</sup> Iris J. Goodwin, *Delegation of Fiduciary Investment Responsibility: Trustees Explore the Once Taboo*, TRUSTS & ESTATES, Mar, 1999.

<sup>66</sup> Carol Harrington & Ryan M. Harding, *Private Trust Companies and Family Offices: What Every Estate Planner Needs to Know*, ALI-ABA CONTINUING EDUCATION, Sept. 4-5, 2008 at 689 available at SP020 ALI-ABA 675.

<sup>67</sup> DON KOZUSKO, PRIVATE TRUST COMPANIES, OPEN-ARCHITECTURE TRUSTS, FAMILY OFFICES, TRUST PROTECTORS AND ADVISORS: WHATEVER HAPPENED TO THE PLAIN OLD TRUSTEE, 19 October, 2007.

<sup>68</sup> E.g., Melanie Leslie, *Common Law, Common Sense, Fiduciary Standards and Trustee Liability*, 27 CARDOZO L. REV. 2713 at 2728 (2006).

<sup>69</sup> *Supra*,

<sup>70</sup> DON KOZUSKO, PRIVATE TRUST COMPANIES, OPEN-ARCHITECTURE TRUSTS, FAMILY OFFICES, TRUST PROTECTORS AND ADVISORS: WHATEVER HAPPENED TO THE PLAIN OLD TRUSTEE, 17-18 October, 2007.

liability then constitute an important prelude to the exercise of fiduciary investment discretion in ways that the family wants, because any tax paid is likely to reduce the funds that ultimately find their way into trust. Also important for minimizing the overall tax burden on a family fortune is placing funds in a trust of extended duration. In this section we consider the advantages of establishing a long-term trust and examine one particularly powerful strategy for transferring funds to it with little to no transfer tax liability – the Note-Sale. If the Note-Sale is not adequate to shelter the family fortune, other strategies can be brought to bear on what remains – among the more popular being the “zero-ed out GRAT.” These various techniques make possible the transfer into perpetual trust of what is effectively tens of millions of dollars without the family ever having to pay transfer tax.

a. The Long-Term Trust. To take a step back, the need to invest subject to the Prudent Investor standard would not arise but for the family fortune being in trust. If the members of family held family assets outright, then each generation of the family (as it came into its inheritance) would be free to invest – and indeed to risk -- the funds as it saw fit. The question that occurs then is why, for a very wealthy family eager to minimize its transfer tax burden, property is likely to be transferred into trust.

The simple transfer-tax reason<sup>71</sup> that wealthy families put their fortunes into trust is that only the initial transfer into trust – the transfer in fee simple from the donor to the trustee – is subject to transfer tax. And this is the case, even though multiple, successive generations of the family subsequently benefit from the property (as equitable owners). In contrast, if the family fortune were transferred outright from parent to child and then from child to grandchild, and so on, each of the transfers (all in fee simple) would trigger a tax. Taken together, the multiple instances of taxation as property descended from one family member to another, generation to generation, would make for a great drain on the family fortune. But if the property is transferred into trust, it is not subject to transfer tax again until the trust terminates and the property goes outright to the beneficiaries (termed “remaindermen”). Only after the trust terminates, when those remaindermen (now holding the property outright and free of trust) choose to transfer the property, will the property again be subject to

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<sup>71</sup> Placing assets in trust can also protect them from beneficiaries’ creditors as, generally, credits of a trust beneficiary can only “stand in the beneficiary’s shoes” and claim the income or principal that the beneficiary is legally entitled to receive at the time he or she is entitled to receive it. *See* UNIF. TRUST CODE § 501(2005); RESTATEMENT (THIRD) OF TRUSTS § 60 (2003). *See also* Charles D. Fox and Michael, J. Huft, *Asset Protection and Dynasty Trusts*, 37 REAL PROP. PROB. & TR. J. 287 (2002).

transfer tax.<sup>72</sup> If the property can stay in trust in perpetuity, the property is put beyond the transfer tax regime forever.

So, not only is the overall transfer tax burden on multiple generations lessened substantially if the property is placed in trust, but also the longer the trust lasts – and the more generations of a family that can benefit from the property while it is in trust, the greater the overall tax savings. In short, the longer the term of the trust, the more “tax-efficient” the trust is.

Until the late 1980s, efforts to extend the time horizon for a trust into the distant future were thwarted by the common law Rule against Perpetuities.<sup>73</sup> A movement to repeal the Rule<sup>74</sup> has been fairly successful, however, and, to date, as many as eighteen states and the District of Columbia have eliminated the Rule altogether or amended their existing statutes to allow donors of trusts to opt out.<sup>75</sup> A trust can now be virtually of infinite duration, provided it is established in a “non-perpetuities” jurisdiction. Leaving aside strategies for funding a perpetual trust, the mere fact that trusts can last in perpetuity constitutes an enormous advantage for wealthy families,

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<sup>72</sup> Many provisions under of the federal transfer tax regime make it advantageous for the trustee to be an independent party, placing the exercise of certain aspects of fiduciary discretion outside the family – and not in the hands of the donor of any trust or any beneficiary. For example, neither the donor of a given trust nor the beneficiaries of it should control of discretionary distributions of income or principal. If the donor retains control of distributions from the trust, this power can potentially cause inclusion of the property subject to the discretion in the donor’s estate. *See* I.R.C. § 2036, 2038 (2008). If a beneficiary can make distributions to herself or to someone for whom she has a support obligation, this control will under certain circumstances be deemed a general power of appointment and cause inclusion of the property subject to the power in her estate. *See* I.R.C. § 2041 (2008). Further, if a family member controls distributions from a trust where she is not a beneficiary, but where other family members are beneficiaries, her control here can also trigger application of the “reciprocal trust doctrine,” especially if she is a beneficiary of a second trust, one where those other family members are trustees. *See* *United States v. Estate of Grace*, 395 U.S. 316 (1969). The consequence of running afoul of these rules is to make property once transferred into trust and (supposedly) beyond the reach of the transfer tax regime again subject to tax. Where the exercise of fiduciary powers through a family trust company is concerned, however, the Internal Revenue Service has recently begun to lay this matter to rest, providing guidance with respect to decision-making structures within a family trust company that will conform to the requirements of the transfer tax regime with respect to discretionary distributions of trust income and principal.

<sup>73</sup> Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 *CARDOZO L. REV.* 2097, 2100 (2003).

<sup>74</sup> This movement was spearheaded by elements of the estate planning bar and certain banking interests. *See* Robert H. Sikoff and Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 *YALE L.J.* 356 (2005); Joshua C. Tate, *Perpetual Trusts and the Settlor’s Intent*, 53 *U. KAN. L. REV.* 595, 596 (2005).

<sup>75</sup> The eighteen states that have eliminated the Rule or allow settlors to opt out are Alaska, Arizona, Colorado, Delaware, Idaho, Illinois, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Jersey, Ohio, Rhode Island, South Dakota, Virginia, Wisconsin and Wyoming. In addition, Florida permits a trust to last up to 360 years and Nevada, 365. Utah allows a trust to exist for 1000 years.

because once wealth is in a perpetual trust it sits beyond the reach of the transfer tax regime forever.<sup>76</sup>

And the fact that to date only eighteen or so states have eliminated the Rule against Perpetuities is no impediment to a wealthy family still living in a perpetuities jurisdiction. Wherever family members live, the family simply needs to name a trustee in a non-perpetuities jurisdiction who then administers the trust in that state.<sup>77</sup> The need for a “nexus” with a non-perpetuities jurisdiction does, however, mean that, for a family planning to place a family trust company at the helm as trustee of a perpetual trust, the family needs to establish its trust company in a state that not only permits a modern family trust company but also has eliminated the Rule against Perpetuities. Fortunately, for the family wanting to establish its own trust company and name that entity trustee of a perpetual trust, many of the states that have liberalized their laws with respect to forming privately owned, family trust companies have also changed their laws with respect to the Rule against Perpetuities to make them attractive to those looking to place significant wealth in trust with their own trust company as trustee.<sup>78</sup>

b. Funding the Trust. The fact that great wealth can escape transfer tax so long as it is in trust does not eliminate the potential tax when the property is initially transferred, an amount that for a family with great wealth can still be considerable. Once a perpetual trust has been established, then the scene shifts to strategies to transfer property into it with little to no transfer tax liability. This is accomplished exploiting the various credits and exemptions from transfer tax under the Internal Revenue Code (included there so that taxpayers of modest means can transfer assets without incurring liability). For the very wealthy, however, the trick is not to use these credits and exemptions “dollar-for-dollar” -- i.e., a dollar of credit or exemption applied to shelter a dollar of family wealth. Instead, sophisticated planning techniques (like the Note-Sale) subject assets to discounting techniques and then in various way “leverage” the credits and exemptions, so that the dollar limitations as per the Internal Revenue Code become more apparent than real.

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<sup>76</sup> BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS 120.1, at 120-1 to -2 (2d ed. Warren, Gorham & Lamont 1993). See also JOEL C. DOBRIS, STEWART E. STERK & MELANIE B. LESLIE, ESTATES AND TRUSTS 822-23 (2d ed. Foundation Press 2003).

<sup>77</sup> Of course, the family could also employ an individual trustee resident in jurisdiction or big bank trustee authorized to conduct trust business in the jurisdiction with the caveats stated *supra*, .

<sup>78</sup> That is, trusts that name the family trust company as the initial trustee. Trusts for which the family trust company is successor trustee are another question. The family trust company cannot create nexus with respect to all important legal issues for a trust that names as initial trustee a person domiciled in another jurisdiction or another trust company located in another jurisdiction.

(i) The Unified Credit and the GST Exemption. Like all non-charitable gratuitous transfers, transfers into trust are subject to Estate Tax (if made at death) or to Gift Tax (if made during life). Shelter from the Estate and Gift Tax is available, however, in the form of the Unified Credit. If the trust benefits grandchildren and more remote descendants, then in addition to Estate or Gift Tax, transfers to the trust will be subject to Generation-Skipping Tax. Generation-skipping transfers can also be sheltered, however -- with the GST Exemption.

With respect to the Unified Credit, every transferor currently has a lifetime Credit sufficient to shelter up to \$3.5 million in transfers made during life or at death. At present, however, only \$1 million of the Credit is available to be used during life, and, accordingly, this amount becomes the operative figure for many planning strategies. This is because, even though the Unified Credit can be applied to transfers made at death, most of the more sophisticated tax planning strategies make use of transfers not at death but during life – gifts essentially. There are reasons for this, the most important of which is that gifts can be timed – effectively giving the taxpayer significant control over the value of the gift. This control over the timing of the transfer – and thereby the value of the gift for transfer tax purposes -- is a large element of not only the note-sale, but also other strategies as well.<sup>79</sup>

But there is an additional transfer tax that is applicable to transfers made to a long-term or perpetual trust – the Generation-Skipping Transfer Tax. The Estate and Gift Tax is designed to tax wealth every generation. Nevertheless, as we have noted, long-term trusts benefiting successive generations can neatly avoid the successive impositions of estate and gift tax even as the property in trust becomes available to grandchildren and more remote descendants. The Generation-Skipping Transfer Tax was devised by Congress in 1986<sup>80</sup> to close this loophole and subject generation-skipping transfers (whether made outright or in trust) to a separate and additional tax. Thus, like all non-charitable gratuitous transfers, generation-skipping transfers are subject either to the Gift Tax (if they occur during life) or to the Estate Tax (if they occur at death). But where the transfer is to or for the benefit of grandchildren or more remote descendants, the transfer is also subject to GST Tax (in addition to Estate or Gift Tax).<sup>81</sup> Taken together, the

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<sup>79</sup> A second reason that gifts are more “tax efficient” than transfers at death is that gifts are tax-exclusive while transfers at death are tax-inclusive. This means that the funds used to pay gift tax are not themselves subject to tax, while funds used to pay estate tax form part of the base against which the rate of taxation is applied. *See*, CAMPFIELD, DICKENSON & TURNIER, TAXATION OF ESTATES, GIFTS AND TRUSTS 12 (23d ed. West Group 2006). This second reason is less relevant here in that no transfer tax will be paid.

<sup>80</sup> A federal tax on generation-skipping transfers was first enacted in 1976. This tax was considered conceptually flawed and it was substantially repealed and a new tax was enacted in 1986. *See*, CAMPFIELD, DICKENSON & TURNIER, TAXATION OF ESTATES, GIFTS AND TRUSTS 727 (23d ed. West Group 2006)

<sup>81</sup> Generation-Skipping Transfer Tax is applicable to transfer made to or for the benefit of a “skip person” as per I.R.C. § 2613(a)(1), meaning any person of a generation more than one below the transferor (such as

Estate or Gift Tax and the GST Tax make for a virtually confiscatory imposition of tax.<sup>82</sup>

For those seeking to circumvent the transfer tax regime with long-term trusts, such is the bad news. There is also good news, however, in the form of a lifetime exemption from the GST Tax, currently in the amount of \$3.5 million, the entire amount of which can be used to shelter transfers made during life or at death. While (unlike the Unified Credit) the entire GST Exemption of \$3.5 million can be used for transfers during life if the taxpayer so chooses, the transfer will also be subject to the Gift Tax – and there the Unified Credit will shelter only \$1 million of the transfer. Consequently, even though a transfer in excess of \$1 million could be sheltered from GST Tax, the excess would be subject to Gift Tax. Therefore, the \$1 million amount sheltered by the Unified Credit operates for most wealthy donors as a cap here as well, as families tend to be disinclined to incur tax for lifetime transfers.<sup>83</sup>

(ii) The Note-Sale. Transfers to a perpetual trust will then be subject both to Gift Tax and to Generation-Skipping Tax and must be sheltered from both unless a tax is to be paid. The Note-Sale is a strategy for sheltering the funding of a perpetual trust and constitutes a two-stroke

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a grandchild). “Direct skips” to such persons are taxable and would include gifts outright and gifts in trusts that benefit solely skip persons. Tax is typically paid when such trusts are established. Where trusts benefit both skip and non-skip (i.e., children) persons, then “taxable distributions” of income and principal from such trusts as well as “taxable terminations” from such trusts (where property goes outright to one or more skip persons) are subject to tax. *See* I.R.C. §§ 2612(b), 2612(a)(1)(A) (2008). *See*, CAMPFIELD, DICKENSON & TURNER, *TAXATION OF ESTATES, GIFTS AND TRUSTS* 735-36 (23d ed. West Group 2006)

<sup>82</sup> *See*, CAMPFIELD, DICKENSON & TURNER, *TAXATION OF ESTATES, GIFTS AND TRUSTS* 735-36 (23d ed. West Group 2006)

<sup>83</sup> Because Gift Tax will have to be paid if the taxpayer makes lifetime transfers in excess of \$1 million, transfers to a perpetual trust are unlikely to be made in excess of \$1 million. This is particularly the case at this time. While paying tax is never appealing, it is especially unattractive in this era which is one of certain change where the transfer tax regime is concerned. The fruition of George W. Bush’s 2000 presidential platform of eliminating transfer taxes (what he called “death taxes”), the Economic Growth and Tax Relief Reconciliation Act of 2001 provided for repeal of the Estate Tax for those dying after December 31, 2009 and for repeal of the Generation-Skipping Transfer Tax for generation-skipping transfers taking place after the same date. When Congress realized the costs of a permanent repeal, however, they back-peddled, deciding to phase out these taxes gradually, over the next nine years, then to have one year (from December 31, 2009 to January 1, 2011) in which these two transfer taxes were repealed, but then (absent additional legislation) to repeal the “repeal” effective January 1, 2011. This means that, absent additional legislation, the repealed estate and generation-skipping taxes and all the phased in changes in rates and exemptions as well as all other changes wrought by the 2001 Act, will come back into effect on January 1, 2011. If no additional legislation is passed and the repeal of the repeal actually occurs, then the Estate Tax and the Generation-Skipping Tax as it existed prior to the 2001 Act would spring back to again be the law of the land. Nevertheless, questions remain concerning the size of the Unified Credit going forward and more than speculation that, whatever the amount of the Unified Credit, it will (like the Generation-Skipping Tax Exemption) be available for use in its entirety during life or at death. Clearly under these circumstances, it would be a rare client indeed who could be advised to incur a gift tax. Jonathan Weisman, *Obama Plans to Keep Estate Tax Democrats Want to Freeze Levy at Current Levels*, WALL ST. J., January 12, 2009 at A1.

finesse of the meager \$1 million of Unified Credit applicable to gifts and the Generation-Skipping Tax Exemption that it effectively caps.

A. Step One: The Valuation Envelope. If the GST Exemption and Gift Tax Credit are applied dollar-for-dollar, \$1 million of GST Exemption and the current Gift Tax Credit will shelter only \$1 million of assets. There are, however, more tax-efficient ways to make gifts and to use the GST Exemption as well as the Gift Tax Credit. Family assets<sup>84</sup> are made eligible for valuation discounting by first (before they are transferred into trust) swallowing them in a family limited partnership, a close corporation, or a limited liability company. This entity will be capitalized into voting and non-voting shares and, for the time being, the head of the family retains both.

At this point the stage is set to make more effective use of the GST Exemption and Gift Tax Credit. The non-voting shares are now eligible for a valuation discount, for both lack of marketability (because they represent an interest in a closely-held entity)<sup>85</sup> and lack of control (because they have no voting rights).<sup>86</sup> Conservative planners would generally apply a 40% discount under these circumstances.<sup>87</sup> So assets that would be worth \$1 million (if held free of the closely-held entity)

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<sup>84</sup> Assets that might be transferred into this closely-held envelope include a family business (an operating company which may itself be closely-held), publicly-traded securities, real estate, private equity, etc. Once the closely-held envelope is created and assets have been transferred to it, the head of the family takes back the voting and non-voting shares. See, Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II*, TRUSTS & ESTATES, October 1998, at 68.

<sup>85</sup> Discounts as high as 35% are commonly applied in valuing interests in closely-held businesses – that is to say, in valuing interests for which there is little to no market because they are not publicly traded. Valuing closely-held interests begins by reference to comparable assets that are publicly-traded. Then, assuming there is as no ready market for the particular interests in question, a discount is applied under the assumption that a buyer would not pay as much for such interests. See Rev. Rul. 59-60. (If any stock is also subject to restrictions on sale, the marketability discount can be substantially greater. See *Estate of McClatchy v. Comm’r.*, 147 F.3d 1089 (9<sup>th</sup> Cir., 1998).) Note, however, that the Internal Revenue Service can resist or seek to reduce a marketability discount where a closely-held entity is holding assets that are readily marketable. See *McCord v. Comm’r.*, 120 T.C. 358 (2003) concerning two limited partnerships, where one-third of one partnership and two-thirds of a second partnership consisted in marketable securities or interests in real estate holding partnerships. The taxpayer claimed a 35% discount for lack of marketability, but the Tax Court reduced the discount to 20%. Even in this instance, however, some discount was deemed justified given the partnership envelope.

<sup>86</sup> The ability to obtain a discount for lack of control even where all the interests in the closely-held entity are owned within a family (or by trusts for their benefit) is the progeny of *Estate of Bright v. Unites States*, 658 F.2d 999 (1981). *Bright* vindicated a long established precedent that attribution should not apply to lump together family members’ stock for valuation purposes under the transfer tax regime. See also, Rev. Rul. 93-12( where the Service acquiesced in *Bright*). See further discussion of the significance of *Bright* in Note , *infra*.

<sup>87</sup> In the past courts have granted a single discount percentage, such as 40%, without segregating the discount attributable to minority status from that attributable to lack of marketability. It is important to recognize the distinction between the discount for lack of control and that for lack of marketability, however, because in recent years the courts have tended (quite properly) to analyze these discounts separately in arriving at a discount appropriate in a given situation. See, *Estate of McClatchy v. Comm’r.*, 147 F.3d 1089 (9<sup>th</sup> Cir., 1998).

can now be valued at \$600,000. Accordingly, \$1 million of the GST Tax Exemption and the Gift Tax Credit can now be used to shelter assets that would have a value of approximately \$1.667 million were they held free of the closely-held entity. Note also that these amounts will double in the case of a married couple planning together.

The head of the family then transfers \$1 million in cash or equivalents to the perpetual trust.<sup>88</sup> Under the Note-Sale strategy, this transfer (the “seeding” of the trust) is the only transfer that is actually a “gift” for Gift Tax purposes and it is here that the Gift Tax Credit and \$1 million of the GST Exemption are applied.

(B) Step Two: Purchase of Discounted Assets. The placement of a family’s wealth into a closely-held entity and the establishment of a perpetual trust are preliminary steps. While some advantage would be gained if the non-voting (now discounted) shares were simply contributed to the perpetual trust, this would not realize the full potential of the Exemption or the Credit. At this juncture the trustee of the trust (here the Family Trust Company) steps forward and purchases \$10 million of the non-voting shares from the head of the family and gives back an installment note<sup>89</sup> in the amount of \$9 million, along with the \$1 million (just received when the trust was seeded) as a down payment. Per the note, the trustee is required to pay interest-only during the term, with principal due in nine years (at the end of the term) in the form of a balloon payment, with a right of prepayment.<sup>90</sup>

Courtesy of the trustee’s purchase of the assets in exchange for the note, the fair market value of the assets that ultimately fund the trust is \$10 million instead of \$1 million (the amount contributed gratuitously). Further, because the assets were initially placed in a closely-held entity, the \$10 million of assets that ultimately fund the trust would be worth

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<sup>88</sup> Either cash or discounted assets can be used here, although the real advantage of the discounted assets materializes in Step Two. See Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II*, TRUSTS & ESTATES, October 1998, at 68.

<sup>89</sup> The terms of the loan are governed by many considerations under the transfer tax regime. First, the loan will be an intra-family loan and so, to avoid gift-loan treatment under I.R.C. § 7872, it must bear an interest rate of at least the Applicable Federal Rate. This is a market rate of interest determined by reference to the average yield on United States government obligations. As it works out, however, the rate is generally more than fair to the borrower when compared to rates that are likely to be commercially available. The nine-year term will make it a long-term loan under § 7872 and make it eligible for the long-term interest rate (usually a lower rate than the shorter term rates). See I.R.C. §§ 7872(f)(2), 1274(d)(1)(C) (2008). The Applicable Federal Rates are re-determined each month. I.R.C. § 1274(d)(1)(B) (2008). For term loans of more than three years, the market interest rates for longer term obligations are used, depending on the term of the loan. In the case of a term loan, the Applicable Federal Rate for the entire period of the loan is determined by the rate for the month in which the loan is made. I.R.C. § 7872(f)(2)(A) (2008). In the case of a demand loan (which has no application in the Note-Sale), the rate varies from month to month as the Federal rates are re-determined. I.R.C. § 7872(f)(2)(B) (2008).

<sup>90</sup> The loan will be an intra-family loan. So to avoid gift-loan treatment the interest rate will be determined by Applicable Federal Rate. The 9-year term will make it a long-term loan. See I.R.C. § 7872 (2008).



approximately \$16.67 million if they were held free of this entity – or \$20 million and approximately \$33.3 million, respectively, in the case of a married couple.

The \$10 million amount of the note is only ten times the \$1 million gift, a margin that is not too great that it vitiates the claim that the entire transaction has a business purpose,<sup>91</sup> thereby placing the transaction beyond the scope of the transfer tax regime. The goal here is to eliminate any implication that the loan is a donative transfer for purposes of the transfer tax regime. Under the Gift Tax Regulations, the transfer is not a gift if it is “a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, arm’s-length, and free of any donative intent).”<sup>92</sup> Other elements of the transaction also lend support to the claim that the Note has a business purpose, including the timing of the purchase of the shares relative to the funding of the trust where at least a six-month’s lag is recommended.<sup>93</sup>

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<sup>91</sup> The business purpose of the closely-held entity also lends support to the business purpose of the entire transaction. The closely-held entity needs a genuine business purpose beyond its role in a tax-minimization strategy. Such a purpose could be, for example, the need to bring managerial integration to a diverse and complex portfolio of assets. Absence of some bona fide business purpose will invite numerous objections (see Note , *infra*) from the Internal Revenue Service and the courts such that the closely-held entity is likely to be viewed a mere tax avoidance artifice. This is especially the case where this “wrapper” holds largely passive investment assets (such as marketable securities) that could just as well be held outright. See Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II*, TRUSTS & ESTATES, October 1998, at 68. Regarding the inclusion of passive investments, see *McCord v. Comm.*, 120 T.C. 358 (2003), discussed in note , *infra*. In addition, care must be taken that the closely-held entity is used in a way consistent with a business purpose. For example, all assets should not be transferred into the closely-held entity necessitating the payment of household obligations out of the closely-held entity. See also, Note , *infra*.

<sup>92</sup> Treas. Reg. § 25.2511-1(g)(1) (2007). To escape Gift Tax treatment, it is also important here to establish that the transfer was for “adequate and full consideration in money or money’s worth.” *Id.* The element of consideration not only removes the transfer from the realm of the gift tax, but also ensures that the value of the trust will not be includible in the donor’s estate under Sections 2036 and 2038 if she were to die during the term of the Note. Attention to the valuation of assets transferred into trust is then important. (The plan here is to have the note repaid before the donor dies – thus the prepayment provision of the Note.) In the event, however, that the donor dies during the term of the Note, the Note itself will be in the donor’s estate, but it may be eligible for discounting because of its long-term and low interest rate. Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II*, TRUSTS & ESTATES, October 1998, at 68. Furthermore and most importantly, however, if the Note winds up in the donor’s estate, the appreciated assets of the trust do not. See “opportunity shifting,” *infra*, .

<sup>93</sup> Recently, the Internal Revenue Service has attacked the use of closely-held entities as discounting devices by relying on I.R.C. Section 2036(a). Several decades of case law (in which the Internal Revenue Service has acquiesced) preclude the Service from attacking the discount by aggregating the interests of family members (and trusts for their benefit) in determining whether the value of closely-held interests should be discounted for lack of control. See *Estate of Bright v. United States*, 658 F.2d 999 (1981) (in which the Internal Revenue Service acquiesced in Rev. Rul. 93-12). In two cases with similar facts, the Internal Revenue Service has more successfully applied Section 2036(a), however, as it includes in the decedent’s gross estate any asset as to which the decedent has retained a right to the income from the property. In two cases with similar facts, the Internal Revenue Service has successively applied Section 2036(a) to include the underlying assets held in any entity in a decedent transferor’s estate where the partnership was formed only shortly before the decedent’s death (lending an aura of the testamentary

The Note-Sale also exploits aspects of the income tax regime. The trust will be drafted so that, during the life of the donor, it will be a “grantor trust” for income tax purposes. This “grantor trust status” is created by turning to the parts of the Internal Revenue Code that govern the income tax regime and including a provision in the trust that intentionally violates one or more of the grantor trust rules under IRC Sections 673 through 679 -- -- for example, by giving the donor the right to exchange property in the trust for property of equivalent value.<sup>94</sup> Whatever power is included here, it is unlikely that the donor will exercise it. This does not matter. The mere presence of the power in the trust agreement will ensure that the donor is considered the “owner” of trust assets for income tax purposes and – most importantly – transactions between the trust and the donor (the Note-Sale, for example) will be ignored for income tax purposes.<sup>95</sup> Thus, while the sale of the non-voting shares to the trustee would otherwise be a realization event for income tax purpose, no gain will have to be recognized. For income tax purposes, it is as if the trust does not exist and the transaction did not happen.<sup>96</sup>

(iii) Other Strategies. Effective as the Note-Sale might be for transferring tens of millions of dollars with the application of only the \$1 million Gift Tax Credit and \$1 million of the GST Exemption, many families still find themselves with considerable wealth remaining in the hands of the donor generation. Other strategies with which to transfer

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substitute to the transaction) and the decedent transferred nearly all his net worth to the closely-held entity, necessitating that he rely on income from the entity for his support until his death (the last being critical to the application of Section 2036(a). Finally, the entity was funded almost entirely with marketable securities. *See Strangi v. Comm’r.*, 417 F.3d 468 (5<sup>th</sup> Cir. 2005); *Estate of Thompson v. Comm’r.*, 382 F.3d 367 (3<sup>rd</sup> Cir. 2004). In another case, however, *Estate of Kimbell v. United States*, 371 F.3d 257 (5<sup>th</sup> Cir. 2004), the Fifth Circuit reached a contrary result. While as in *Thompson* and *Strangi*, the decedent had transferred property to a family limited partnership not long before his death, in *Kimbell* there were good business reasons for placing the assets (which included oil and gas working interests) in a partnership. Further the transferor retained sufficient property to provide for his own support. Advisers maintain that care must be taken to see that the closely-held entity is created well in advance of the death of the transferor, that there is a business purpose (other than tax avoidance) for creation of the entity, that all the formalities of maintaining and operating the closely-held entity are observed, that assets transferred to the entity are operating assets requiring management (rather than passive investment assets, such as marketable securities), and that the decedent has retained sufficient wealth to support herself without receiving income from the entity.

<sup>94</sup> This planning opportunity is possible because the grantor trust rules (which are primarily creatures of the income tax regime) do not work in *pari materia* with the gift tax regime. Care must be taken, however, to make certain that this retained power offends only with respect to the income tax regime, but does not vitiate the transfer for purpose of the transfer tax regime. For purposes of the Estate and Gift Tax or indeed the Generation-skipping Tax, it is essential that the transfer be complete.

<sup>95</sup> The IRS has opined in Rev. Rul. 85-13 and in several private letter rulings. *See, e.g.*, Rev. Rul. 85-13, 1985-1 C.B. 184.

<sup>96</sup> Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II, TRUSTS & ESTATES*, October 1998, at 6. *See also* Randall D. Roth, *The Intentional Use of Tax-Defective Trusts*, Presentation at the University of Miami, 26<sup>th</sup> Institution. On Estate Planning (1992).

additional wealth with little to no transfer tax are available, however, and this is the case even if the donor generation has completely exhausted its \$1 million (\$2 million in the case of a couple) gift tax Unified Credit. Indeed, especially popular in such circumstances is the Grantor Retained Annuity Trust (GRAT) and in particular its most aggressive application, the “zeroed out” GRAT.

The GRAT is a creature of reforms enacted in 1990 that resulted in the addition of Chapter 14 of the Estate and Gift Tax with its special valuation rules.<sup>97</sup> These strict valuation rules are applicable to certain transfers in trust, especially those where the donor generation retains a present interest (structured as an annuity<sup>98</sup>), while transferring a remainder interest to the donee generation (thereby making a gift to them).

Consistent with the Chapter 14 valuation rules, if the income interest retained by the donor generation is large enough, the actuarial value of the remainder – the gift to the donee generation – will be zero or very close to it, making for a “zeroed-out GRAT.”<sup>99</sup> Where the value of the remainder is zero or nearly so, there will be little to no gift tax due on the transfer – a welcome outcome where the donor generation has already exhausted its gift tax Unified Credit. The value of the remainder interest will be zero where the donor generation retains a very large income interest. To satisfy this income interest will require (pursuant to the required valuation methodology) not only the income produced

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<sup>97</sup> These valuation rules were meant to eliminate certain capitalization strategies by which closely-held companies were capitalized so that the donor generation could retain a preferred interest in a family business, while the younger generation received common stock. These interests were subjected to various favorable valuation techniques so that the interest passing to the donee generation was often valued at a fraction of its worth at the time of the transfer. *See*, CAMPFIELD, DICKENSON & TURNIER, *TAXATION OF ESTATES, GIFTS AND TRUSTS* 230-36 (23d ed. West Group 2006).

<sup>98</sup> Of course, the value of the gift also reflects the retained annuity. This income interest must consist in annual payments of either (1) a fixed dollar amount or (2) an amount equal to a fixed percentage of the trust value, determined annually. *See* I.R.C. §§ 2702(b)(1)-(2) (2008). Where an income interest does not conform to these requirements, the income interest will be valued at zero – potentially making for an expensive gift to the donee generation of 100% of the value of the property transferred into trust. By imposing such constraints upon the terms of the retained interest (if it is to be deemed worth anything at all for transfer tax purposes), the Congress has sought to ensure that the future interest transferred to the donee generation will submit to valuation techniques that realistically capture what that generation is receiving. I.R.C. § 2702(a)(2)(A) (2008).

<sup>99</sup> The “zeroed out” GRAT was for some time deemed controversial as the Internal Revenue Service and the estate planning bar argued about the meaning and interpretation of Example 5 under Reg. 25.2702-3(e). The IRS had argued that the retained interest should be valued as an annuity payable for the shorter of the term of the retained annuity or the grantor’s death. This analysis would reduce the value of the retained interest and therefore increase the value of the remainder (the gift). The Tax Court, examining the legislative history of section 2702 and concluded that Reg. 25.2702-3(e) Example 5 is an “unreasonable interpretation and invalid extension” of section 2702. *Walton v. Comm’r* 115 T.C. 589, 604 (2000). The Commissioner has since acquiesced in the Tax Court holding and has issued Regulations affirming the result in the case. *See* Rev. Rul. 2003-72, 2003-2 C.B. 964; Treas. Reg. 25.2702-3(e) (2007) Examples 5, 6, and 8.

by the trust assets, but also a return of principal. At the end of the annuity term, nothing will be left to be distributed to the donee generation – or at least per the Chapter 14 valuation rules.<sup>100</sup> Of course, these calculations are predicated on the value of the property on the date it is transferred into trust together with the imputed rate of appreciation. The donor is betting, however, that the reality will be very different – a point to which we will return momentarily.

But there are drawbacks to the GRAT. Probably its biggest disadvantage is that it does not readily lend itself to a perpetual trust. The donor's GST Exemption cannot be applied to shelter the property transferred to the GRAT until the expiration of the donor's present interest. By that point, if all has gone according to plan, the assets will have appreciated far in excess of their initial worth. In short, this means that the GST Exemption cannot be leveraged here, but must be applied dollar-for-dollar.<sup>101</sup> For this reason GRAT remaindermen are always children and not more remote generations (to avoid generation-skipping liability).<sup>102</sup> Absent application of the GST Exemption, transfers to subsequent generations will be subject to transfer tax.

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<sup>100</sup> Some practitioners refer to this as a "Walton GRAT" as it was used rather famously by Audrey Walton, a member of the family that founded Wal-Mart Stores, to make transfers in trust for her daughters. The mother transferred 7.2 million shares of Wal-Mart Stores, Inc. into trusts for her daughters, the value of the stock transferred into each trust being \$100,000,000. The trusts were to last two years and at the end of this period the remaining principal was to be transferred outright to the daughters. Each of the trusts by its terms provided that in the first year the mother would receive a payment equal to 49.35% of the trust value and in the second year she would receive a payment equal to 59.22% of the trust value. Any property in the trust remaining at termination would go tax-free to the daughters. Taking into account the imputed rate of appreciation under section 7520 in effect for April of 1993 (when the transfers into trust were made), the actuarial value of each daughter's remainder was \$6,195. As it turned out, the price of Wal-Mart stock declined and the payments to the mother exhausted the trust so that in truth the daughters received nothing. If Wal-Mart stock had risen in value, however, a great deal of value might have been passed to the daughters at minimal tax cost. At inception it was anticipated that, as per Chapter 14 methodology, the value of the total payments to be made to the mother from each trust would be \$109,000,000. If the Wal-Mart stock in each trust had risen in value to \$119,000,000 by the time the trust terminated, however, each daughter would have received \$119,000,000 less \$109,000,000 or \$10,000,000. And this would have been the case even though as per the valuation at the creation of the trust each daughter's interest was worth only \$6,195.

<sup>101</sup> Where the grantor of a trust has retained an interest in the trust, GST Exemption cannot be applied to the trust until the termination of the donor's interest when the trust is not longer potentially an asset of her estate (the "estate tax inclusion period" as per IRC Section 2642(f)). This is generally referred to as an "ETIP" problem. In short, the GST Exemption cannot be leveraged when it is applied to a GRAT, but must be applied dollar-for-dollar. The constraint imposed by Section 2642(f) is not a problem with respect to the Note-Sale because the grantor of the perpetual trust retains no interest in it. See, Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II*, TRUSTS & ESTATES, October 1998, at 68.

<sup>102</sup> There are other drawbacks to the GRAT. First, in utilizing the Note-Sale strategy, it is advantageous if the grantor of the perpetual trust (and holder of the Note) survives the term of the Note so that the Note does not wind up an asset of his estate. (SCIN) But it does not entirely scrub the plan if in fact the grantor dies before this happens. In the case of a GRAT, the grantor of the trust must survive the term of the retained annuity or all the property in the trust will be restored to his estate for estate tax purposes under IRC Section 2036(a). Second, with respect to the Note-Sale, the rate of return that must be applied to the Note is almost always going to be lower than the rate used to value the GRAT remainder because of the

Other “high-tech” strategies also remain – large designs that again allow a wealthy family to minimize its transfer tax liability, even where the Unified Credit and Generation-Skipping Tax Exemption have been exhausted. For example, the charitable lead trust is a split-interest trust that can allow a family to transfer significant wealth to children and more remote generations with little to no transfer tax liability. As with the GRAT, the donor can effectively “zero out” the charitable lead trust by setting the payments to charity high enough so that the present value of the lead interest to charity will be equal to (or almost equal to) the full value of the assets contributed to the trust. If the donor zeros out the trust, the value of the gift to the donee generation will be zero or close to it and again no transfer tax will be owed.

(iv) Beating the Imputed Rate of Appreciation. If any of these strategies are to “work,” however, at a minimum the assets have to appreciate at a rate higher than the interest rate on the loan (in the case of the Note-Sale) or higher than the imputed rate of growth under Chapter 14 (in the case of the GRAT or the charitable lead trust). In the case of the Note-Sale, this is highly likely to happen. The discounting of the assets by virtue of the closely-held “wrapper” ultimately ensures the assets that make their way into the trust are more valuable than the amount the trustee has paid for them.

Finally, valuation discounts and leveraging notwithstanding, any of these strategies realizes its greatest potential where the underlying assets (those transferred to the closely-held entity) hold significant appreciation potential. The prospects for transferring wealth between generations without having to pay transfer tax increase exponentially if the property placed into the closely-held entity is a business just being formed, a new product being developed, a new location for an existing business, an investment opportunity, or a closely-held business soon to go public. Ideally, the assets transferred into the “envelope” are significant interests in a venture that can reasonably be predicted to explode in value. It is here that \$33 or so million (itself transferred without paying transfer tax) can easily become \$100 million.<sup>103</sup>

Of course, if these assets are going to be transferred into trust (even as non-voting share of a closely-held wrapper), the family requires a

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difference in requirements of the valuation regimen applicable in each case. The consequence is that the rate of appreciation that must be achieved for the Note-Sale to be successful is likely to be lower than the rate for the GRAT. See, Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II*, TRUSTS & ESTATES, October 1998, at 68.

<sup>103</sup> The timing of the transfer has to be carefully calculated, however, for example, in the instance of an initial public offering where the stock is to be valued before the public offering. If this value is to be sustained, the more time between the transfer into trust and the public offering, the better.

trustee that is willing to hold such an investment. At this point, the stage is set to consider the legal discretion a trustee might have to do just that.

### Part III: Putting the Pedal to the Metal: Fiduciary Investment Discretion

If the dissipation of assets once they are in trust is indeed the last frontier in the preservation of great fortunes, it is no longer plausible to chalk this up simply to the drain of transfer tax. Indeed, wealthy families whose property has long been in trust (where it was safe from the dissipating pressure of the fisc) have for decades appreciated the perniciousness effects of a conservative fiduciary investment philosophy (supported by a conservative law governing fiduciary investment discretion)<sup>104</sup>. For the more recently wealthy, concern with fiduciary investing has come front and center. These families are relying on tax-minimizing strategies (such as the Note-Sale) that not only transfer assets into trust with little to no transfer tax liability, but make integral to the plan a certain rate of appreciation with respect to transferred assets. These modern strategies can only succeed if the property transferred consists in appreciating, potentially volatile assets – and, moreover, that those assets do indeed appreciate, volatility notwithstanding. Moreover, these families understand the element of risk that was in play in making their fortunes and are looking to bring this entrepreneurial mindset to the management of these assets going forward. The modern fiduciary duty of care can contemplate an aggressive investment posture on the part of a trustee, especially where the trust is holding a large portfolio and the time horizon as per the trust terms is long enough. The new standard of care makes it possible to do with property in trust what has rarely been done before<sup>105</sup> -- and potentially great fortunes do not merely cease to wane, but can actually appreciate. There is simply one proviso – that the fiduciary is willing to embrace the new standard of fiduciary investment responsibility in all its potential.

The common law trust has existed for centuries but only in recent decades has the law governing fiduciary investing done other than encourage trustees to conserve trust property. For many years the trustee's primary duty was to avoid risk, including the risk inherent in investing assets for growth.<sup>106</sup> And a case can be made that this risk-

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<sup>104</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 116-18 (rev. ed. Bloomberg Press 2004).

<sup>105</sup> *See, e.g.*, RICHARD R. DAVIS, *THE PHIPPS FAMILY AND THE BESSEMER COMPANIES*, (Turner Publishing Company 2007)

<sup>106</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 116-18 (rev. ed. Bloomberg Press 2004).

averse attitude comported with donors' expectations, especially in earlier eras when the asset placed in trust was almost certainly land and the only reason to transfer property to future generations in trust (rather than outright) was to avoid transfer tax.<sup>107</sup> When the likely *res* ceased to be land and became a portfolio of marketable securities, however, donors and their beneficiaries began to rankle under a law that looked only to conserve assets at nominal value, while the purchasing power of those assets declined. Donors and beneficiaries alike noted that between inflation and trustees' commissions, assets placed in trust dwindled, however modest the distributions to beneficiaries as per the trust agreement.

a. Prudent Man. This focus on conserving the face value of trust assets was mandated under the earlier law governing investment of trust assets, the Prudent Man Rule, usually dated from the 1830 case, *Harvard College v. Amory*.<sup>108</sup> In *Amory*, the court directed that in investing trustees should proceed as “men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.” Soon canonical, the Prudent Man rule with its emphasis on capital preservation and distaste for speculation made its way into the Restatement of Trusts<sup>109</sup> in 1935 and later in 1959 into the Restatement (Second) of Trusts.<sup>110</sup> Underscoring the duty to preserve capital, the Restatement Second directed the trustee to “to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived[.]”<sup>111</sup>

Under Prudent Man, the methodology of risk assessment required the trustee weigh each asset in isolation rather than as an element of a larger portfolio. This approach had the consequence of prohibiting certain investments entirely and rendering others (such and U.S.

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<sup>107</sup> John Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L. J. 625, at 633 (1995).

<sup>108</sup> *Harvard v. Amory*, 26 Mass. (9 Pick.) 446, 461 (1830). *Harvard v. Amory* augured a degree of progress, however, as in the 19<sup>th</sup> and early 20<sup>th</sup> centuries, most states mandated that trustees confine their investment discretion to a statutory list of investments suitable for trustees – usually government bonds, first mortgages, and preferred stocks. Even common stock was severely discouraged. *Amory* still prohibited investments “for the purpose of speculation” and continued to emphasize the preservation of capital before all else. Finally, between the 1930s through the 1960s, a majority of states finally replaced legal list statutes with the prudent man rule. See Jesse Dukeminier and James F. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1336 (2003). The Massachusetts rule represented a great advance by abandoning the attempt to specify approved types of investment. See also John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641 (1996).

<sup>109</sup> RESTATEMENT OF TRUSTS § 227 (1935).

<sup>110</sup> RESTATEMENT (SECOND) OF TRUSTS § 227 (1959).

<sup>111</sup> RESTATEMENT (SECOND) OF TRUSTS § 227 (1959). See also John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 644-45 (1996).

Treasuries where principle was for all intents and purposes guaranteed) inherently safe. Furthermore, trustees shied away from new types of investments. And delegation of investment authority (something that the introduction of new types of investments might require) was simply *verboten*.<sup>112</sup>

**b. Prudent Investor.** About twenty years ago, however, the law governing the investment of trust assets began to change. Sophisticated studies examining financial markets in light of modern “Portfolio Theory” suggested that complaints of settlors and beneficiaries bespoke economic reality, especially once trusts were no longer invested in land, but rather in marketable securities. The law responded with a new standard to govern the investment of trust funds. Prudent Investor supplanted Prudent Man.<sup>113</sup>

As a theory of efficient markets, modern Portfolio Theory provided a new understanding of the risk inherent in investing (including investing in trust) and suggested a new methodology by which to manage it. At its core efficient market theory teaches us that it is impossible to predict which securities will do better or worse. Simply stated, each security has risks. Even an investment (such as a U.S. Treasury bill) seeming to conserve trust principal at its face value is itself not without risk – if nothing else, the risk of inflation.<sup>114</sup> All that can be done with respect to risk is to manage it.

To manage risk begins by appreciating that every security is subject to risk of two types.<sup>115</sup> Market risk plagues all securities indiscriminately and reflects general economic and political conditions – for example, the risk of an attack by a foreign power (such as the attacks on 9-11), a general economic downturn (such as the current global recession), or a change in interest rates by the Federal Reserve. With respect to market risk, little can be done to mitigate volatility. The only comfort to be had lies in the knowledge that, when the investment is made, the market factors this risk into the return. A higher market risk garners a higher rate of return. Market risk is compensated risk.<sup>116</sup>

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<sup>112</sup> See Iris J. Goodwin, *Delegation of Fiduciary Investment Responsibility: Trustees Explore the Once Taboo*, TRUSTS & ESTATES, Mar, 1999. See also Jerold L. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration including the “Give-Me-Five” Unitrust*, 3 REAL PROP. PROB. & TR. J., 2, 7 (1998); John H. Langbein, *The Uniform Prudent investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 644-45 (1996).

<sup>113</sup> John H. Langbein, *The Uniform Prudent investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 682 (1996).

<sup>114</sup> UNIF. PRINCIPAL & INCOME ACT § 2 cmt (2000). See also John H. Langbein, *The Uniform Prudent investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 649 (1996).

<sup>115</sup> JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 23-25 (2d ed., American College of Trusts and Estates Counsel Foundation 1998).

<sup>116</sup> JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 23-35 (2d ed., American College of Trusts and Estates Counsel Foundation 1998).



In contrast, non-market or industry risk is the risk that something will affect the fortunes of a particular industry or firm – for example, an ore necessary to production of a particular product becomes unavailable. And within a particular firm, there is the further risk that a key person dies unexpectedly or that a fire makes a plant inoperable.<sup>117</sup> Where industry risk is concerned, however, the return does not reflect the risk. The only way to manage industry risk is through diversification of investments within a portfolio – diversification among financial sectors and within financial sectors.<sup>118</sup>

Thus, given that no one can outsmart the market and that risk is inherent in all investing, an investor can only proceed by determining the level of volatility (including the risk of inflation) that she is willing to accept in exchange for the return she hopes to receive. This will determine the level of market risk she assumes. Then, with respect to non-market risk, an investor diversifies her portfolio bearing in mind the level of market risk she has chosen.<sup>119</sup>

In 1987, there began a fundamental revision in the law governing the investment of trust property in light of this theory of efficient markets. Especially important were its implications for the concept of “prudent investment.” The American Law Institute started revising the Restatement of Trusts in 1991 and released the final text in 1992. The Uniform Law Commission followed suit and in 1994 codified the revised Restatement principles as the Uniform Prudent Investor Act.<sup>120</sup> To date, XX states have adopted some version of the Uniform Act.

In this new era, trust investment law has set aside its preoccupation with speculation and speculative investments. “The universe of investment products changes incessantly,” so the Uniform Act counsels. “Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility – in this case, inflation risk – that had not been anticipated.”<sup>121</sup> As part and parcel of this re-framing of the concept of prudent investing, the law also jettisoned the idea that some categories

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<sup>117</sup> JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 22 (2d ed., American College of Trusts and Estates Counsel Foundation 1998).

<sup>118</sup> JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 23-25 (2d ed., American College of Trusts and Estates Counsel Foundation 1998).

<sup>119</sup> Christopher P. Cline, *The Uniform Prudent Investor and Principal and Income Acts: Changing the trust Landscape*, 42 REAL PROP. PROB. & TR. J. 611, 613 (2008).

<sup>120</sup> John H. Langbein, *The Uniform Prudent investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 682 (1996).

<sup>121</sup> UNIF. PRINCIPAL & INCOME ACT § 2 cmt (2000).

of investments are per se prudent and others imprudent,<sup>122</sup> in favor of directing trustees to develop a risk profile appropriate to the particular trust in question. “Trust beneficiaries are better protected by ... close attention to risk/return objectives...than in attempts to identify categories of investment that are per se prudent or imprudent.”<sup>123</sup> The trustee is now to invest for “risk and return objectives reasonably suited to the trust.”<sup>124</sup> And the degree of risk appropriate for a particular trust is highly situational. “Tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries[.]” Indeed, if the “main purpose” of the particular trust “is to support an elderly widow of modest means,” that trust “will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.”<sup>125</sup>

But addressing market risk through appropriate risk and return objectives is not all the law now requires of fiduciaries. Industry risk is not to be ignored either. Portfolio Theory (when it informs the law of fiduciary duty) mandates a diversified portfolio. Although diversification had a place in the old law governing fiduciary investing,<sup>126</sup> the new law enlarges upon its significance. Indeed, the requirement of diversification serves in the new law to propel the entire methodology of Prudent Investor toward a comprehensive perspective, so that attention focuses on the portfolio as a whole with any particular security justifiable only in relation to the rest of the account.<sup>127</sup> As the Uniform Act counsels, “A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole.” The official Comment continues: “An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets.”<sup>128</sup> Not only is no asset without risk, but also no asset is inherently appropriate or inappropriate except in relation to the whole portfolio.

If the requirement of diversification propels the new regime toward a comprehensive perspective in evaluating risk, this same comprehensive perspective can at times argue for a suspension of the requirement of diversification. That is to say, although diversification is central to the

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<sup>122</sup> “A trustee may invest in any kind of property or type of investment consistent with the standards of the (Act).” UNIF. PRINCIPAL & INCOME ACT § 2(e) (2000).

<sup>123</sup> UNIF. PRINCIPAL & INCOME ACT § 2 cmt (2000).

<sup>124</sup> UNIF. PRINCIPAL & INCOME ACT § 2(b) (2000).

<sup>125</sup> UNIF. PRINCIPAL & INCOME ACT § 2 cmt (2000).

<sup>126</sup> *See, e.g.,* First Alabama Bank of Huntsville v. Spragins 515 S.2d 962 (Ala. 1987).

<sup>127</sup> UNIF. PRINCIPAL & INCOME ACT § 3 (2000). *See also* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt g (1992) (discussing investment planners’ strategies for diversification).

<sup>128</sup> UNIF. PRINCIPAL & INCOME ACT § 2(b) (2000) (portfolio standard of care). *See also*, RESTATEMENT (THIRD) OF TRUSTS § 90 (2007).

methodology of Prudent Investor, even diversification can be set aside if under the circumstances it is prudent to do so. We will return to this point momentarily.

A final point about the influence of modern Portfolio Theory on the law of fiduciary investing: Whereas the Prudent Man statute forbade the delegation of fiduciary investment responsibility,<sup>129</sup> the new law is much more tolerant of delegation and even encourages it in certain situations.<sup>130</sup> Such tolerance is a natural accompaniment to the recognition that any asset is potentially an appropriate investment. If any asset is a possible investment in trust, then a trustee potentially needs to be competent with respect to a breadth of possible investments, including complex, state-of-the-art vehicles heretofore rarely found in fiduciary accounts -- futures, derivatives, private equity, venture capital, closely-held operating companies, etc. Furthermore, not only would the fiduciary need to be competent to determine whether any such investment was suitable for the account but, where the investment was deemed appropriate, she must also be able manage the asset once it was in trust. Few financial managers are sufficiently knowledgeable across the financial spectrum to make such decisions across such a range of complex investments. Accordingly, if the concept of fiduciary prudence is to be informed by modern portfolio theory without equivocation, the law must contemplate delegation of fiduciary investment responsibility to specialized managers where at least certain assets are concerned.

c. Portfolio Theory and the perpetual trust. This new legal order is an invitation to trustees to invest assets in ways heretofore unimaginable for property placed in trust, especially in the case of a perpetual trust holding a great fortune. Prudent Investor recognized that the mix of investments and overall risk profile appropriate to a particular account must speak to the size of the account, the terms of the trust instrument, and the situations of beneficiaries. Because size of account and investment horizon now matter in determining the magnitude of risk appropriate to a trust portfolio, a family that transfers its considerable wealth into a perpetual trust can justify types of securities with magnitudes of risk (and with potential returns) that could not be justified in a smaller trust or in one that would terminate sooner.<sup>131</sup>

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<sup>129</sup> Iris J. Goodwin, *Delegation of Fiduciary Investment Responsibility: Trustees Explore the Once Taboo*, TRUSTS & ESTATES, March, 1999 at 10.

<sup>130</sup> UNIF. PRINCIPAL & INCOME ACT § 9 (2000).

<sup>131</sup> As one commentator explains, it is not risk per se that investors seek to avoid but the substance of risk. See Robert H. Jeffrey, *A New Paradigm for Portfolio Risk*, JOURNAL OF PORTFOLIO MANAGEMENT, Fall 1984, at 33. What must be avoided is needing liquidity when asset values are in a slump. As the Restatement explains as it is applied to property in trust: "Risk tolerance depends on a combination of the regular distribution requirements of the trust and any irregular distributions that may in fact become necessary or appropriate.... Thus, these various distribution requirements facing the trustee effectively serve

Academic commentators are well aware of the perpetual trust but, to date, they tend to view it primarily as a vehicle by which a family exploits the repeal of the Rule against Perpetuities to place its property beyond the reach of the transfer tax regime for untold generations to come. In addition, this literature contains occasional references to the utility of the perpetual trust for asset protection purposes.<sup>132</sup> These observations are correct, so far as they go. The real significance of the perpetual trust cannot be appreciated, however, until we discern how it can serve the family as a multi-generational investment vehicle. Only then can we see how the attributes of tax minimization and asset protection contribute to the determination of the overall risk profile appropriate to the account when portfolio theory governs the investment of trust property. It here that their true value lies.

Arguably then, a trustee of a large perpetual trust can justify within the portfolio certain risks that would not be consistent with its fiduciary duty in other types of trusts. Obviously, the risk calculus now deemed appropriate to property in trust provides an investment advantage to the ultra-wealthy (as compared to the merely affluent) who not only have great wealth to place in trust but whose fortunes are sufficiently large to fund a trust lasting for multiple generations. To say only this, however, would be merely to offer the commonplace observation that the rich are afforded opportunities to get richer that others do not have. The claim extends further. What is noteworthy in the case of the perpetual trust is the magnitude of the opportunity. At this juncture we can begin to discern how the tax saved when a large fortune is placed in a perpetual trust becomes truly valuable. As important as the elimination of a tax burden might be in an era when trusts were invested to preserve the face value of assets, where a perpetual trust is invested subject to portfolio theory, the tax saved contributes to the size of the *res* going forward – and supports the continued justification under the law for investing at least some portion of the account in aggressive – even speculative – securities. As tax is saved with each generation and returns consistent with the risk profile of the account are realized, the perpetual trust potentially becomes an investment juggernaut. Savings achieved when creditors' claims are avoided contribute here as well.

In short, Portfolio Theory when applied to the *res* of a large perpetual trust legitimates – indeed encourages -- an entrepreneurial mindset in a fiduciary which would have been unthinkable in earlier eras. For the family establishing a perpetual trust to realize the investment potential

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to define the consequences of the volatility risk with respect to a particular trust.” RESTATEMENT (THIRD) OF TRUSTS § 227 cmt e (1992).

<sup>132</sup> Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P for the R.A.P.*, 24 CARDOZO L. REV. 2097 (2003). See also Joel C. Dobris, *The Death of the Rule Against Perpetuities, or the RAP Has No Friends – An Essay*, 35 REAL PROP. PROB. & TR. J. 601 (2000).

that a more sophisticated understanding of risk might offer, however, the trustee becomes a crucial figure. Nevertheless, corporate fiduciaries – big banks – remain very conservative when it comes to investing assets in trust. The theory of efficient markets notwithstanding, a recent study of the investment practices of big-bank fiduciaries indicates that Prudent Investor has had at best a modest impact on the way these institutions invest. It might be expected that, in the wake of Prudent Investor, trust portfolios at these institutions would at a minimum exhibit a significant percentage shift away from assets where face value is more secure but returns are limited (debt) toward more volatile assets where return would be greater (common stock). Since the advent of Prudent Investor, however, this shift has occurred only to a modest degree.<sup>133</sup>

But wealthy families seeking to grow their assets in trust are looking for more than a shift from debt to equity. Take, for example, the risk inherent in a decision to hold a concentrated position, that is, to maintain a trust wholly or partially undiversified. Whereas the very wealthy may welcome an investment methodology that sanctions reference to the trust portfolio as a whole, these families often do not want to be encumbered by the finer points of diversification. Indeed, it is not uncommon for a significant portion of the portfolios of the very wealthy to be in holdings such as a large block of founder's stock (possibly with a low tax-cost basis) or a closely-held operating company.<sup>134</sup> While there is no doubt that Prudent Investor places a premium on diversification, an argument can be made that would allow a liberal reading of this requirement, especially where assets are held in a large perpetual trust. First of all, the Uniform Act is only a default regime.<sup>135</sup> But further, even the default rule explicitly allows for an exception where “the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.”<sup>136</sup> Within a large perpetual trust, a case can be

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<sup>133</sup> Max M. Schanzenbach and Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 J.L. & ECON. 681 (2007). Investigating the effect of changes in state prudent trust investment laws on asset allocation in noncommercial trusts. Using state and institution-level data from 1986- 1997, the writers found that after adoption of the new prudent-investor rule, institutional trustees held about 1.5-4.5 percentage points more stock at the expense of “safe” investments.

<sup>134</sup> See also, John H. Langbein, *The Uniform Prudent investor Act and the Future of Trust Investing* 81 IOWA L. REV. 641, 658 (1996).

<sup>135</sup> Christopher P. Cline, *The Uniform Prudent Investor and Principal and Income Acts: Changing the trust Landscape*, 42 REAL PROP. PROB. & TR. J. 611, 635 (2008).

<sup>136</sup> UNIF. PRINCIPAL & INCOME ACT § 3 (2000). See also THE RESTATEMENT (THIRD) OF TRUSTS § 227 (b) (1992) which provides that “the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.” The Comment further elaborates: “The objective of prudent risk management imposes on the trustee a duty to diversify trust investments unless, under the circumstances, the objectives of both prudent risk management and impartiality can be satisfied without doing so, or unless special considerations make it prudent not to diversify in the particular trust situation.” THE RESTATEMENT (THIRD) OF TRUSTS § 227 (b) cmt g (1992).

made that a trustee can justify certain risks that might otherwise not be consistent with its fiduciary duty.

Nevertheless, big banks remain reluctant to hold concentrated positions, especially in assets that are illiquid, for which there is little to no market (like closely-held companies), assets that are common among the significant holdings of the wealthy.<sup>137</sup> Against a more liberal reading of Prudent Investor, these institutions argue that this conservative posture is consonant with current law. First and most basically, Prudent Investor is of relatively recent vintage (so the argument goes) and thus there is relatively little case law to underscore the Uniform Act or to inform its application in myriad particular situations. Indeed, where interpretative authority is not available, some commentators are inclined to fall back on case law arising under the Prudent Man statute to inform the category of “prudence.”<sup>138</sup> Second, what case law there is under the new regime still calls into question the extent to which a trustee can decide not to diversify, even where the concentrated position is authorized under the trust agreement.<sup>139</sup> Finally, the Restatement is more explicitly conservative stating that “trust provisions are strictly construed against dispensing with the requirement of diversification altogether.”<sup>140</sup> Even where the trustee is authorized with respect to a concentrated position, such a provision does not “relieve the trustee of the fundamental duty to act with prudence,”<sup>141</sup> nor does authorization to hold a particular investment and not diversify a portfolio “constitute an exculpatory clause.”<sup>142</sup>

Whatever the debate about inferences legitimately drawn from the Uniform Act, the very wealthy have in important respects moved on. For them, where investing for a large perpetual trust is concerned,

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<sup>137</sup> See Richard A. Oshins and Steven J. Oshins, *Protecting & Preserving Wealth into the Next Millennium Part II*, TRUSTS & ESTATES, October 1998, at 68.

<sup>138</sup> Christopher P. Cline, *The Uniform Prudent Investor and Principal and Income Acts: Changing the trust Landscape*, 42 REAL PROP. PROB. & TR. J. 611, 620 (2008); *First Alabama Bank of Huntsville v. Spragins* 515 S.2d 962 (Ala. 1987) (finding against the trustee that boilerplate language was not sufficient to justify undiversified concentrations of anything, although as per the Alabama Prudent Man Statute, generally taken to rely on general principles of fiduciary investing). *But see Pitts v. First Union National Bank*, 262 F. Supp. 2d 593 (D. Md. 2003).

<sup>139</sup> See, e.g., *In re Strong* 734 N.Y.S. 2d 668 (N.Y. App. Div. 2001) (where the trustee prevailed against beneficiary alleging improper diversification in the face of authorization in the trust instrument to hold a concentrated position); *In re Trusteeship of Williams*, 591 N.W. 2d 743 (Minn. Ct. App. 1999), *aff'd* 631 N.W. 2d 398 (Minn. Ct. App. 2001) (exculpation clause did not protect trustee where only partially diversified concentrated stock holding); *Fifth Third Bank v. Firststar Bank, N.A.*, No. C-050518, 2006 WL 2520329 (Ohio Ct. App. Sept. 1, 2006). (finding against trustee who retained assets not normally suitable in trust, notwithstanding exculpation clause in trust instrument). For a general discussion of these cases and others, see Christopher P. Cline, *The Uniform Prudent Investor and Principal and Income Acts: Changing the trust Landscape* 42 REAL PROP. PROB. & TR. J. 611 (2008).

<sup>140</sup> THE RESTATEMENT (THIRD) OF TRUSTS § 91 cmt f (2007).

<sup>141</sup> THE RESTATEMENT (THIRD) OF TRUSTS § 91 cmt f (2007).

<sup>142</sup> THE RESTATEMENT (THIRD) OF TRUSTS § 91 cmt f (2007).

genuine diversification involves deeper, more sophisticated issues that merely the appropriate allocation between fixed income and equity or a decision to hold a concentrated position. The very wealthy now appreciate that in a large portfolio genuine diversification requires representation of different investment philosophies and the inclusion of investments as wide-ranging as hedge funds, private equity, venture capital funds and real estate, interests not traded in the public securities markets. Indeed, to realize the full potential of Portfolio Theory for purposes of these families, the trustee needs access to state-of-the-art investment opportunities (vehicles not likely to be publicly traded), together with the specialized knowledge to assess risk with respect to such holdings. Large institutional trustees now typically offer a platform of such investments, but even this menu may not satisfy an entrepreneurial family willing to search the world for opportunities.

With the advent of Prudent Investor, these families began to press big bank fiduciaries to accept outside managers, encouraging them to delegate investment responsibility, especially for purposes of state-of-the-art assets.<sup>143</sup> If Prudent Investor is tolerant of delegation of fiduciary investment responsibility and would even appear to encourage it in certain situations,<sup>144</sup> like so many apparently liberalizing aspects of Prudent Investor, delegation remains a controversial matter for the big bank trustee. This is because the initial decision to delegate as well as all subsequent decisions with respect to the delegation are fiduciary acts, carrying with them fiduciary liability. Prudent Investor is clear that the trustee must have good reasons to delegate. Once a sufficient rationale for delegation has been developed, the fiduciary is responsible for the choice of the agent. And after the agent is selected, the fiduciary must continue to exercise discretion, establishing the scope and terms of delegation and conducting period reviews.<sup>145</sup> The Restatement takes a similar position.<sup>146</sup> Regulations issued by the Office of the Comptroller of the Currency, the regulatory authority for federally chartered banks, sound a similar theme,

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<sup>143</sup> A number of years ago, Forbes magazine in its issue on “The 400” reported that, while a decade or so ago approximately 90 percent of the clients of a major money center bank allowed that institution to manage all of their money, now 70 percent of these clients use multiple managers. Robert Lenzner, *Achieving Immortality via the Family Office*, FORBES, October 12, 1998 .

<sup>144</sup> UNIF. PRINCIPAL & INCOME ACT § 227(c)(2) (2000).

<sup>145</sup> UNIF. PRINCIPAL & INCOME ACT § 9 (2000).

<sup>146</sup> Again, the Restatement sounds the more conservative note: In the act of delegating the trustee must act responsibly “In deciding whether, to whom and to what matter to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.” The Comment would have a trustee (1) determine what investment responsibilities to delegate; (2) select an appropriate agent; (3) negotiate the terms of the delegation, and (4) monitor the agent’s performance to an appropriate degree under the circumstances. RESTATEMENT (THIRD) OF TRUSTS §§ 171 cmt, 227(j) (2007).

expressly providing that a bank that delegates its authority over investments is nevertheless deemed to retain “investment discretion.”<sup>147</sup>

Finally, in those instances where the stars align sufficiently so as to justify delegation of fiduciary investment responsibility, the total fees to the trust are likely to be as much as twice the fee that fiduciary would otherwise charge. Fees charged by big bank fiduciaries have long been a source of irritation to wealthy families so that the prospect of paying double makes for a special frustration. While the family might anticipate that the presence of the outside adviser would result in a commensurate reduction in the trustee’s fee, the need for on-going exercise of fiduciary discretion (along with the attendant liability) provides continuing justification for the bank to impose its standard fee (or something close to it). And this is the case, even though an outside agent is providing day-to-day management of certain assets.<sup>148</sup>

If the theory of efficient markets has come to inform the legal standards governing the investment of property in trust, what it has put in place is as much an art as it is a science. Gone are the bright line tests that separated the investment wheat and chaff into the secure and the speculative. Now, at least at the margins – and large perpetual trusts are at the margins – fiduciaries may disagree as to the level of risk appropriate to an account. And it is for this reason that many families establishing large perpetual trusts want to place a privately owned, family trust company at the helm. The complete realization of the potential of Portfolio Theory when applied to a trust *res* ultimately depends on the trustee’s calculus of risk, both in light of an interpretation of the trust instrument and the beneficiaries’ situations. For the family establishing a perpetual trust to realize the investment potential that a more sophisticated understanding of risk might offer, the trustee is all important.

#### Part IV: Financial Reproduction and the Family Trust Company

While establishing a family trust company might appear to be the final frontier in securing a fortune long into the future, more is required. If wealthy families are going to take unto themselves the role of fiduciary, in order to bring a sophisticated understanding of risk to bear on trusts designed as multi-generational investment vehicles, family members

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<sup>147</sup> See 12 C.F.R. Part 9 (Reg. 9). Reg. 9. Under Reg. 9 a bank is required to conduct an initial post-acceptance review and annual reviews of all assets of fiduciary accounts for which the bank has investment discretion. Furthermore, state-chartered banks are directed to heed any state banking regulations bearing upon the issue of delegation 12 CFR Pt. 9.

<sup>148</sup> Moreover, the fees not only discourage the family from pursuing delegation (and with it the introduction of state-of-the-art investment vehicles), but they also factor into the initial exercise of discretion in deciding to delegate, as Prudent Investor also imposes a duty to minimize costs. See UNIF. PRINCIPAL & INCOME ACT § 9 (2000). See also Iris J. Goodwin, *Delegation of Fiduciary Investment Responsibility: Trustees Explore the Once Taboo*, TRUSTS & ESTATES, March, 1999, at 10.



must be prepared to oversee the day-to-day management of an on-going enterprise, not the least of which includes making state-of-the-art investment decisions. In creating a family trust company and making it trustee of family trusts, financial entropy will not be averted and indeed much of the family's financial security is sure to be jeopardized, unless at least some family members are ready, willing and able to undertake the considerable responsibility of managing the trust company. Further, given that the investment horizon here is multi-generational, this need for financial acumen and indeed personal discipline is also multi-generational. To ensure that every generation has at least some family members prepared to bring facilitating attitudes about money, investing and risk to bear on the family fortune requires attention within the family to the cultivation of such attitudes from generation to generation.<sup>149</sup> Absent sustained talent and discipline, the slow, steady, downward trajectory of the trust portfolios of an earlier era will soon in retrospect bespeak a golden era in the financial life of the family.

In the face of this need to attend to the inter-generational cultivation of attitudes about wealth and investing (in addition managerial expertise), there has grown up a considerable industry to guide the very rich in what might be termed “financial reproduction” or “financial parenting.”<sup>150</sup> The literature of this industry puts forward various techniques for the transmission of attitudes and perspectives calculated to foster prudence and indeed industriousness within the family. But at the end of the day, what this literature counsels is that the family that would preserve its fortune must become quite self-consciously identified to its wealth. And further, the family that would manage and indeed grow its wealth must effectively commit itself to maintain this identity as a wealthy family across generations. Interestingly, some of the literature even goes so far as to draw a parallel between the family that would preserve and grow its fortune and a business enterprise.

This literature of “financial parenting” often takes as its point of departure a phenomenon termed “affluenza,”— that is, myriad species of self-indulgence and accompanying desuetude that supposedly characterize the lives of second- and third-generation members of wealthy families.<sup>151</sup> Investment options notwithstanding, it is this self-

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<sup>149</sup> JAMES E. HUGHES, JR., *FAMILY: THE COMPACT AMONG GENERATIONS* 19 (Bloomberg Press 2007).

<sup>150</sup> In at least some of this literature, attention is also bestowed on nonfinancial attributes of family life, with efforts to make the question of money secondary. But at the end of the day these other aspects of family life are present only as a factor in the maintenance of great wealth. At the end of the day what is at stake here is holding on to the fortune. *See, e.g.*, JAMES E. HUGHES, JR., *FAMILY: THE COMPACT AMONG GENERATIONS* 19 (Bloomberg Press 2007).

<sup>151</sup> *See* JESSIE O'NEILL, *THE GOLDEN GHETTO: THE PSYCHOLOGY OF AFFLUENCE* (Affluenza Project 1997). Ms. O'Neil was the granddaughter of the former president of GM. Drawing upon her own experience, she developed the term “affluenza” as a summary reference to the flaws often developed by children of the very wealthy. *See also*, Linda C. McClain, *Family Constitutions and the (New) Constitution of the Family*, 75

indulgence and desuetude (so this literature claims) that ensures great fortunes are soon lost and lends truth to the proverb “shirtsleeves to shirtsleeves in three generations.”<sup>152</sup>

But for a wealthy family intending to preserve a great fortune (as in the instance of a family establishing its own trust company), more is necessary than simply stemming the tide of second- and third-generation social alienation or indeed decadence. It is not simply a matter of inculcating moral and cultural values in children so as to create persons who are capable of responsible personal self-governance.<sup>153</sup> What a wealthy family is ultimately about (so this literature counsels) is its fortune – not just preserving it, but ideally growing it. To do this, members must appreciate the essential attributes and insights of the generation that made the fortune – the enterprising generation. Taken together, these attitudes and insights make for a particular ethos about wealth and privilege. The goal is to have later generations embrace this ethos with a certain consciousness, knowing that this set of attitudes -- values instrumental in the family’s financial success – along with its extraordinary wealth, set the family apart in the world. Financial educators serving the very wealthy suggest that they engage their children from an early age in discussions about the purpose of family wealth (a process called “wealth education”).<sup>154</sup> The idea is to apprehend the family’s “differentness” – that is, the origin of its privilege as well as the character traits, attitudes and possible expertise that have sustained this privilege (all of which some term “the family story”).<sup>155</sup> Indeed to underscore the importance of this self-conscious identity, one advisor has even likened the multi-generational wealthy family to a “tribe.” “Becoming a tribe requires a family to adopt a form of decision-making that seeks consensus about what actions will likely perpetuate the tribe’s success and thus its survival....”<sup>156</sup>

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FORDHAM L. REV. 833, 861 (2006); Pierce H. McDowell III, *Family Owned Private Trust Companies*, ABA TRUSTS AND INVESTMENTS, May-June, 2008 at 43-44.

<sup>152</sup> JAMES E. HUGHES, JR., FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS 3 (rev. ed. Bloomberg Press 2004)

<sup>153</sup> JAMES E. HUGHES, JR., FAMILY: THE COMPACT AMONG GENERATIONS xxvi (Bloomberg Press 2007).

<sup>154</sup> Linda C. McClain, *Family Constitutions and the (New) Constitution of the Family*, 75 FORDHAM L. REV. 833(2006).

<sup>155</sup> JAMES E. HUGHES, JR., FAMILY: THE COMPACT AMONG GENERATIONS 14-15 (Bloomberg Press 2007). See also JAMES E. HUGHES, JR., FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS 4 (rev. ed. Bloomberg Press 2004)

<sup>156</sup> JAMES E. HUGHES, JR., FAMILY: THE COMPACT AMONG GENERATIONS 104-05 (Bloomberg Press 2007).

Given that these families are seeking to maintain their wealth far into the future,<sup>157</sup> however, this education ultimately requires an institutional framework – a governance structure that will bring discipline to the development of this ethos and then allow for constructive reconsideration of it by subsequent generations.<sup>158</sup> What is needed is “a long series of linked transitions” and a system of family governance that will “guide[] the joint decisions family members must make to successfully complete those transitions.”<sup>159</sup>

It is in this way that the Family Mission Statement found its way into the literature guiding the very wealthy in their efforts at financial reproduction. Adopted from the corporate world where such statements serve to bring specificity and focus to the interactions and endeavors of diverse protagonists,<sup>160</sup> Family Mission Statements were first put forward for families of average means. The idea was to catalyze within the family a discussion of its basic values and then “codify” them into a constitution of sorts. This document is to unify families around fundamental principles that “get built right into the very structure and culture of the family.”<sup>161</sup> Like any constitution, the Family Mission Statement serves as a point of reference as the family moves forward. It can also be revisited and amended in light of fundamental changes in the family or the larger world.

Still embraced by many people of modest means as a tool of the broader endeavor of “social reproduction,”<sup>162</sup> the Family Mission Statement has nevertheless acquired a certain edge as wealth educators now proffer it to the very wealthy in pursuit of the narrower goal of “financial reproduction.” Most basically, these families are advised that the process of developing such a statement provides a context in which a wealthy family can confront the origin and meaning of privilege in its own instance and, further, reinvent itself as a wealthy family from generation to generation.<sup>163</sup> Interestingly, however,

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<sup>157</sup> JAMES E. HUGHES, JR., FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS 8-11 (rev. ed. Bloomberg Press 2004).

<sup>158</sup> JAMES E. HUGHES, JR., FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS 4 (rev. ed. Bloomberg Press 2004).

<sup>159</sup> JAMES E. HUGHES, JR., FAMILY: THE COMPACT AMONG GENERATIONS 104 (Bloomberg Press 2007).

<sup>160</sup> JEFFREY ABRAHAMS, THE MISSION STATEMENT BOOK: 301 CORPORATE MISSION STATEMENTS FROM AMERICA'S TOP COMPANIES (Ten Speed Press 1999) (1995); PATRICIA JONES & LARRY KAHANER, SAY IT & LIVE IT: 50 CORPORATE MISSION STATEMENTS THAT HIT THE MARK (Broadway Business 1995).

<sup>161</sup> STEPHEN R. COVEY, 7 HABITS OF HIGHLY EFFECTIVE FAMILIES 93, 142 (St. Martin's Griffin 1997)

<sup>162</sup> JAMES E. HUGHES, JR., FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS 43 (rev. ed. Bloomberg Press 2004).

<sup>163</sup> JAMES E. HUGHES, JR., FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS 4 (rev. ed. Bloomberg Press 2004).

especially where the very rich are concerned, some of this literature draws parallels between the wealthy family seeking continued financial prosperity and the well-managed business enterprise. The claim is that the business enterprise provides an apt analogy because, like a business, the object of the family is “to organize our financial, intellectual, and human assets for the purpose of the preserving and enhancing each of these in succeeding generations.”<sup>164</sup> One wealth adviser elaborates: “[T]he most important role in the management of an enterprise is arranging for orderly succession.”<sup>165</sup> And further on: “Families attempting long-term wealth preservation often don’t understand that they are businesses and that the techniques of long-term succession planning practiced by all other businesses are available to them as well.”<sup>166</sup>

The wealthy family as business ceases to be a metaphor, however, and becomes a reality when this literature turns to consider the uses of the family trust company. While perhaps not appreciating the magnitude of the investment opportunity presented by these entities (especially under Prudent Investor), this literature still recognizes that the family trust company can serve the family in the mechanics of investing – for example, as a consolidation vehicle, allowing all family holdings to be managed in one place and subjected to a coordinated, long-term investment strategy.<sup>167</sup> More interestingly, however, is the insight in this literature that the family trust company can serve as the primary institutional context for the essential tasks of “financial reproduction” in all its dimensions and across multiple generations. For a very wealthy family, myriad aspects of family life can be coordinated through the trust company. The trust company is a “family seat,” a “repository of the family history” with a “perpetual life,” a locus for governance of many types to take place, a meeting place where the wealthy family interacts and perpetuates its identity as a wealthy family.<sup>168</sup> Most importantly for a family identified to its wealth, the family trust company provides a context in which successive generations can be tutored in long-term wealth preservation consistent

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<sup>164</sup> Linda C. McClain, *Family Constitutions and the (New) Constitution of the Family*, 75 *FORDHAM L. REV.* 833(2006).

<sup>165</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 5 (rev. ed. Bloomberg Press 2004).

<sup>166</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 6 (rev. ed. Bloomberg Press 2004).

<sup>167</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 150-53 (rev. ed. Bloomberg Press 2004).

<sup>168</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 153 (rev. ed. Bloomberg Press 2004).

with the family's particular ethos about money and investing (perhaps articulated in a family mission statement). The family trust company presents a golden opportunity to put into play the attitudes and skills deemed instrumental to the family's historic financial success. As successive generations of a family manage their investment risk to secure their fortune long into the future, successive generations are also given opportunity to rediscover and indeed reaffirm their "differentness" – their privilege.<sup>169</sup>

The suggestion that the family trust company can serve as a context within which a wealthy family can develop an ethos about money and investing (and ultimately an identity as a wealthy family) acquires great resonance when considered alongside the opportunities under the Prudent Investor statute to invest property in trust, especially where the portfolio is large enough and the time horizon extended. To realize the full potential of Prudent Investor as applicable to a large perpetual trust, a trustee needs a sophisticated understanding of risk and skills sufficient to choose investments consistent with the risk profile. If a family is going to take over this role through a family trust company, these aptitudes must somehow be present in every generation going forward. What the literature of financial reproduction makes clear, however, is that the development of these aptitudes in one generation and the transmission of them to another is (of necessity) about so much more than investing. As older and younger generations of a family come together to play various roles in the management of the family fortune – and to exploit the opportunities available under Prudent Investor where a fortune is in trust – what is also happening is the transmission of an identity as a very wealthy and indeed privileged family.

### Conclusion

The tendency of all lawyers (including legal scholars) is to examine laws *seriatim*, one by one, and not pursue the combined effects of rules drawn from diverse areas of the law – neither discerning the extraordinary burdens of such combined effects nor the opportunities created by the layering the benefits of various laws not necessarily intended to be used in concert. The real significance of new laws affording the very wealthy ready access to the family trust company cannot be apprehended if the particulars of these rules are examined in isolation. The opportunity that they afford the extraordinarily rich can only be seen when we attend to the way these wealthy families intend to use the family trust company to exploit other laws applicable to the transfer and administration of funds held in trust. The family trust

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<sup>169</sup> JAMES E. HUGHES, JR., *FAMILY WEALTH -- KEEPING IT IN THE FAMILY: HOW FAMILY MEMBERS AND THEIR ADVISERS PRESERVE HUMAN, INTELLECTUAL AND FINANCIAL ASSETS FOR GENERATIONS* 150-53 (rev. ed. Bloomberg Press 2004).

company beautifully positions a wealthy family to exploit the elimination of the Rule against Perpetuities in certain states to create perpetual trusts, to “leverage” exemptions from or credits against federal transfer tax applicable to the transfers into such trusts, and, most importantly, to make the most of new laws under which the determination of risk for such trusts has become as much an art as a science. In addition, the sustained process of gathering together within the family trust company for the purpose of preserving and growing the family fortune creates for the wealthy a venue for “financial reproduction.” The family trust company invites the older generation to tutor the younger in long-term wealth preservation consistent with the family’s particular ethos about money and investing. As each generation embraces and employs this ethos to preserve the family fortune, each generation becomes quite self-consciously identified to its wealth, cognizant of its privilege.

Finally, we must not overlook the normative dimension of these entities. If intransigent, radical differences in means are problematic in a democracy so that the dissipation of great fortunes has generally been viewed as salubrious, the advent of the family trust company acquires an additional significance for the larger democratic polity. The potential of these entities to forestall the dissipation of great fortunes and the opportunity they provide to the very wealthy to embrace a self-conscious identity as a wealthy family are almost certain to set these families apart in an experience of living quite different from other citizens – precisely what many theorists of democracy would seek to avoid.<sup>170</sup>

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<sup>170</sup> IAN SHAPIRO & MICHAEL J. GRAETZ, *DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH* (Princeton, 2005) .