# How Trusts Impact Business Owners' Creation of Multigenerational Legacies

## By Wallace L. Head and Kim Kamin

One version of the American Dream is to create a successful family business that leads to a multigenerational family legacy supported by that business or its economic value. It has been our experience that trusts can help achieve that dream or, with inadequate design or improper administration, they can hinder or even prevent its achievement.

We have had the privilege of working with a wide range of families who owned or had recently sold an operating business. We helped them attempt to achieve their version of this dream through various estate planning strategies. Here are some lessons from those who have succeeded so far in achieving their dream and others who have failed.

**Common Characteristics of Business-Owning Families**

While families' values, circumstances and versions of the dream vary, certain principles apply to all of them:

- Families are extremely dynamic. Their composition changes constantly as members establish their own lives in or outside their hometown, get married/divorced and have/adopt children. The children themselves are professionally successful/unsuccessful, become or fail to become emotionally mature and flexible, and feel more or less connected to the rest of their family and its dream.
- U.S. tax laws make it challenging to perpetuate significant wealth for multiple generations.
- Estate planning strategies designed to help perpetuate family business ownership and wealth generally require the owners to give up some or most control of assets before they might otherwise choose to do so, usually through the use of irrevocable trusts. Such strategies carry an inherent risk of failure owing to unexpected economic results, ineffective management, dysfunctional family dynamics or adverse tax law changes.
- Many strategies recommended by advisors to reduce income and transfer taxes also reduce over time the family's involvement as owners of family business equity or other wealth in ways that can undercut the family's ability to achieve its dream.
- The best planning helps the family develop communication and governance structures – such as private family trust companies, family oversight of non-family trustees and family councils – that maintain the family's involvement in the management of its wealth.
- It is essential that families work with experienced advisors who: (i) give due consideration to income taxes, at both the entity and the individual levels, and transfer taxes at each generation, and base their recommendations on an understanding of current and projected asset values; (ii) have significant background in planning with similarly sized family businesses; (iii) truly understand the characteristics and personalities of the relevant family members, as well as how they interact with one another; and, (iv) understand human psychology and behavior.

Some well-designed strategies to reduce taxes can work extremely well, such as gifts to grantor retained annuity trusts (GRATs) and gifts or sales to irrevocable "defective" (for income tax purposes) grantor generation-skipping transfer (GST) tax exempt dynasty trusts. Other strategies can be counterproductive to the point of producing economic problems that lead to family discord. Of course, a failure to plan properly can produce similar or worse problems, but our focus here is on the positive and negative results families can experience when planning does occur, and how to minimize the risks that such planning will fail to achieve its intended goals.

What causes some of these strategies to go off track and risk taking the family and its dream with them? In summary, we have seen bad results occur when families and their advisers have focused too much attention on minimizing taxes and too little attention on: (i) how the strategies they adopt might adversely affect family dynamics and governance; (ii) what developments might cause the strategies to not produce the desired results; and (iii) what flexibility can be built into the strategies to avoid or at least minimize bad results.

**Using GRATs to Transfer Anticipated Increases in Value to Children**

A common strategy to transfer to the next generation anticipated increases in the value of equity in a family-owned business is for the senior generation (i.e., the parents) to gift interests in the business to a short-term GRAT. During the period of the GRAT, the parents receive annuity payments; any value remaining at the end of the GRAT period passes to their children or trusts for their benefit. A GRAT holding closely held business interests may run a little longer than the typical two-year rolling GRAT program. When the hope is to grow and sell the business in three to five years, the chosen GRAT period is usually outside the intended window for sale. When it works as intended, this strategy can efficiently reduce estate taxes by removing from the parents' estates the appreciation in the value of the business during the GRAT period, thereby helping preserve the business or the value it creates for future generations.

What can go wrong with such an attractive strategy? It can be unexpectedly successful in terms of reducing the parents' taxable estates when the value of the equity transferred increases much more than expected during the period of the GRAT. We have seen this occur when the family business is sold during the GRAT period for significantly more than was anticipated when the GRAT was funded. However, notwithstanding this benefit: (i) the children may obtain access to more wealth much earlier than was intended; (ii) the parents may have less wealth than they desire; and (iii) future estate tax liabilities for the children may have been created that could have been avoided through better planning, since a GRAT alone cannot utilize the grantor's GST tax exemption to transfer assets to more remote generations.

What can be done to avoid or at least minimize these problems? One approach is to design the GRAT with a maximum cap on the value of assets transferred so that the grantor receives an annuity plus any appreciation in excess of a certain amount. An alternative way to achieve this result can be to combine the GRAT with a derivatives contract that mirrors appreciation in the value of what would have been the GRAT assets without actually transferring the assets themselves. This approach can more easily apply a hurdle and a cap to the amounts transferred, and it simply obligates the donor to pay the amount of the contract to a separate grantor trust for the benefit of the children.

A less complicated approach is to include in the GRAT agreement provisions that allow the donor to substitute assets for assets held in it, and then to closely monitor assets in the GRAT for changes in their expected values at its expiration. For example, if the equity in the business held in the GRAT seems likely to increase in value much more than expected, slower-growing assets with the same current value might be exchanged for equity in the business. Alternatively, if the value of assets used to fund the GRAT seems likely to decrease rather than increase in value, this approach can permit the donor to substitute a promissory note for the original GRAT assets and then re-GRAT the original assets at a reduced value and try the strategy again.

It is important to note that some aspects of the strategies described above are not viewed favorably by the current Administration, which has tried repeatedly but unsuccessfully to restrict or eliminate them.

**Using Grantor GST Tax-Exempt Dynasty Trusts to Transfer Value to Future Generations**

Another strategy used to transfer wealth within a business-owning family involves parents gifting and/or selling equity in their family business to irrevocable defective GST tax-exempt dynasty trusts. Dynasty trusts are intended to grow without incurring income tax while the grantor (a parent) is alive, and remain free of estate and GST taxes for as long as is permitted by the governing state law, which may be perpetually, or until the assets are exhausted or the family line dies out. What could possibly go wrong with this “wealth transfer nirvana” strategy?

Many things certainly can go right with this strategy and it can be a powerful way to help perpetuate wealth for future generations. However, the ongoing administration of these trusts, which can be designed to last far beyond the lifetimes of anyone alive when they are created, can be challenging and produce negative results, especially while the trusts own equity interests in the family business.

Although transferred interests in the business will likely represent minority positions with limited rights, the trustees have an obligation to be sufficiently knowledgeable about and involved with the affairs of the business to protect the trusts’ interests. For this reason, business owners often prefer to gift only non-voting interests to the trusts they create for their descendants or to name “special trustees” who are involved with the business to vote the gifted interests, since as donors the owners cannot typically obtain estate tax benefits if they vote those interests.

During this period, it may be natural to have family members serve as trustees, but picking some and not other family members to serve as trustees can result in family discord. If the family business is being managed by family members other than those selected to serve, such as their siblings, family discord is almost certain to arise over time. Such discord can lead to costly intra-family litigation.

If these trusts permit – now or later – discretionary distributions that are not subject to an “ascertainable standard,” as defined by the Internal Revenue Code, the trusts will need to have “independent” trustees who are not related or subordinate parties, as defined by the Code. It is natural to want to use individuals rather than corporate trustees in these roles. But finding qualified people to serve – especially if the trusts still hold interests in the family business – can be very difficult, and there are no assurances the individuals will perform as expected.

Traditional corporate trustees are often unwilling to take responsibility for controlling interests in a family business, and even when they are willing they can have motivations that differ from those of the family. Given the regulatory environment in which banks and trust companies exist today, it is understandable that their risk appetite and other concerns can be inconsistent with the operation of a family business. Similarly, independent individual trustees also can have priorities and conflicts that cause their interests to not be aligned with those of the family. As a result, these trustees can be motivated to sell the family business prematurely so the wealth it represents can be converted to easier-to-manage liquid assets.

It is important to remember that individuals serving as trustees, whether or not they are family members, are personally liable for a failure to perform their duties in a satisfactory manner, as defined by statutes and courts in the applicable state. Furthermore, regardless of whether they are actually liable, trustees are subject to being threatened or sued by beneficiaries, even after their tenure as a trustee has ended. These threats or lawsuits frequently result from disagreements over distribution or investment decisions, and they can involve significant expense, time, distraction and adverse publicity for individuals who serve as trustees.

**Using Family Private Trust Companies and Directed Trusts to Encourage Positive Family Involvement**

How can these problems be addressed? If the family's wealth is large enough -- defined by some as approximately $1 billion -- a family private trust company (PTC) can be a very effective way to provide multigenerational trust administration for the family's trusts and avoid or at least minimize the risk of the problems described above. A PTC can also reduce state income taxes, improve asset protection, increase privacy and allow for more flexible trust administration. Although a PTC must retain some non-family members to handle certain decisions in order to avoid estate tax problems, family members can make many investment and distribution decisions and can select the individuals who make the decisions they cannot make.

There are drawbacks that may cause a PTC to be an inappropriate solution, even for families with adequate wealth. Significant expense is involved to establish and maintain a PTC. It requires family involvement, so the family needs a process for determining which members will be involved, and without proper planning and implementation this requirement can lead to family discord. As an operating business, the PTC must be supported with adequate internal and external resources. Additionally, certain policies and procedures must be followed and documented in order for the PTC to provide the intended benefits, requiring a certain amount of discipline by all parties involved with it.

If a PTC is not a viable solution and individual trustees are not an attractive option, new trust agreements can be drafted and some existing trust agreements can be revised in various ways to permit the use of a corporate trustee that is directed by individuals who are appointed to make certain key decisions. The use of such "directed" trusts has become much more prevalent in the past few years as many states have changed their trust laws to accommodate them.

For example, the corporate trustee of a directed trust might be responsible for trust administrative functions, such as keeping the books and records for the trust, preparing reports to beneficiaries, handling tax filings, and being a custodian of trust assets. The corporate trustee would merely implement directions regarding: (i) the investment of trust assets, with directions provided by individuals who are the trust's investment advisors; (ii) the distribution of trust assets to trust beneficiaries, with directions provided by individuals who are the trust's distribution advisors; and (iii) the removal and replacement of the corporate trustee, changes to the trust's legal or tax status and other discretionary decisions, with directions provided by individuals who serve in a "trust protector" role.

If family members serve in these roles or appoint other individuals who direct the trustee, to the extent allowable without creating estate tax problems, they retain much of the control they would have if they had their own PTC. However, it is important to note that some existing trusts cannot or should not be revised to permit this approach. Additionally, the family must have a process for determining which family members will be involved.

Either a PTC or a directed trust arrangement can help a family retain significant control of their assets while they engage in sophisticated estate planning strategies using trusts designed to help them perpetuate their wealth over multiple generations. However, both of these approaches involve risks of family discord, since presumably not all family members will be able to participate equally. A good way to address these risks can be through involvement of a family council in the selection of family members to serve on PTC committees or as advisors who direct a corporate trustee.

**Fiduciary Investment Considerations**

Individuals investing their own assets are free to concentrate their investments, invest on "gut" instincts, and decide not to sell a particular asset for purely emotional reasons. Fiduciaries are not free to make investment decisions in these ways, absent very clear directions in the governing instrument, because they are subject to the default governing law.

However, many owners of family businesses or other wealth want trustees and other fiduciaries, such as trust investment advisors, who will be responsible for managing their business or wealth in the future to have the flexibility to act more like owners and less like fiduciaries. Owners can accomplish this goal by including very specific language in their instruments describing their expectations and both authorizing and directing trustees and other fiduciaries to retain certain assets without regard to concerns about diversification or declines in value.

While such an approach can appeal to wealth owners and offer protection to trustees and other fiduciaries, it can have serious negative and unintended consequences. For example, unless the individuals who exercise this expanded authority have the requisite business acumen, the flexibility it provides may not produce positive results. Unorthodox investment approaches undertaken by fiduciaries that produce negative results, even if authorized or directed, are likely to lead to discord among the individuals the owner intended to benefit and in threatened or actual litigation against the fiduciaries, all of which occurs *after* the wealth has declined in value.

Business or other wealth owners who want to go down this path should: (i) provide the trustees and other fiduciaries who will replace them as the decision maker with ample flexibility to continue or not continue what they started; and, (ii) make very sure they have named competent people to replace them with an effective and durable process for naming successors.

**Concluding Thoughts**

No matter how well-intended, complex or nicely described the strategies may be that are intended to help business and other wealth owners create a multi-generational legacy, they are likely to fail unless they: (i) are flexible with sufficient ability to be responsive to each family's unique circumstances which will evolve over time; (ii) educate the relevant stakeholders and support family involvement in ways that encourage cooperation and minimize discord and disputes among family members; and, (iii) anticipate the ongoing involvement of and ensure the high quality of any non-family fiduciaries. Accomplishing these requirements involves a commitment to properly document and implement grantor intent, provide adequate resources, implement proper processes, and properly communicate to relevant stakeholders.

Building wealth is difficult enough. Putting in place a structure that sustains it and benefits members of multiple future generations is no less challenging.

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