Slicing & Dicing Trusts & Trustees: Decanting, Directed Trusts, and Private Trust Companies

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Historically, an irrevocable trust could only be changed by a court order and the office of trustee was held by an individual or a bank with trust powers.

But now, through decanting and other paths, trusts can be changed; and through directed trusts and private trust companies, the role of “trustee” can be sliced and diced.
“Irrevocable”... doesn’t mean immutable

“If it ain’t broke, don’t fix it”
But, if it is broke, then fix it

How to clean up or improve an old, moldy trust agreement:

- Judicial Modification
- “Decanting”
- Divisions & Combinations
- Powers of Appointment
Texas Trust Code § 112.054 Judicial Modification, Reformation, Or Termination Of Trusts

• Modification vs Reformation

• Grantor’s intent is key
  • Conforms as nearly as possible to the probable intention of the settlor

• Historically, really the only ground for a judicial ruling was to allege circumstances not known to or anticipated by the settlor (112.054 (a)(2))

• Current statute is much broader:
  • (a)(3) prevent waste
  • (a)(4) achieve settlor’s tax objective
  • (a)(5)(B) relief is not inconsistent with a material purpose of the trust
  • (b-1)(3) correct a scrivener’s error

• Added requirements:
  • (a)(5) relief requires consent of all beneficiaries
  • (b-1)(3) requires proof by clear and convincing evidence
Four Paths: “Decanting”

- Trust “decanting” has been around for decades
  - Common law
  - Express language in the trust agreement
  - Applicable statute

- An act by the trustee to distribute all or part of the assets of an existing trust into new trust

**Common law** - If a trustee can distribute all of the rights to an asset outright, she can distribute less than all the rights to an asset

*Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940)

**Express language in the trust agreement** – see outline for sample language
Texas Trust Code §§ 112.071 - 112.087 contains the statutory authority for decanting in Texas.

• Key distinction between “Full Discretion” Trusts and “Limited Discretion” Trusts

  **Full Discretion**
  Distributions of principal that are not limited

  **Limited Discretion**
  Distributions of principal pursuant to a mandatory or ascertained standard (i.e. HEMS)

• A trustee with **full discretion** can decant into a new trust that:
  a) Excludes one or more of the beneficiaries of the first trust; or
  b) Expands the permissible appointees under a power of appointment

• A trustee with **limited discretion** may not change the beneficiaries or powers of appointment via decanting
Four Paths: Decanting

• A trustee with limited or full discretion can alter the administrative provisions of a trust via decanting
  • Commonly used to alter successor trustee provisions

• Notice to the beneficiaries is required (but not consent)

• Limitations on statutory decanting – a trustee cannot:
  • Decrease its liability
  • Extend the RAP period
  • Eliminate right of removal over the decanting trustee

• Decanting must be done “in good faith, in accordance with the terms and purposes of the trust, and in the interests of the beneficiaries”
Texas Trust Code § 112.057 allows a trustee to divide or combine trusts as long as such action:
   a) doesn't impair the rights of any beneficiary or
   b) adversely affect the achievement of the purposes of the trusts

This is an act taken by the *trustee*, with 30 days written notice to the beneficiaries

**DIVISIONS**
Situations to use:
- desire for different trustees
- desire for different tax treatment
  (ie, possibly turning off "grantor trust" status for one of the divided trust, but not the other)

**COMBINATIONS**
Situations to use:
- simplify and "slim down" a structure ("Whack-a-trust")

Most well-drafted trust agreements provide for the ability to merge and divide trusts
Four Paths: Powers of Appointment

• The exercise of a power of appointment is an action taken by the donee of the power named in the trust agreement
  • The donee of a power of appointment is often the primary beneficiary

• Flavors of powers of appointment:
  • General vs. Limited (or sometimes called "Special")
  • Testamentary vs. Inter vivos

• The ability to use a power of appointment is set forth in the trust agreement. Unless specifically prohibited, most powers of appointment allow for the appointment to be made in "further trust" thereby allowing the donee of the power to effectively alter and potentially modernize the terms of the trust.
But…Limitations on Changes to Trust Agreements

Lest we get too frisky, a few sobering reminders:

• Trustees owe fiduciary duties to beneficiaries

• The IRS has a few things to say, too:

  "A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.” Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1)

• Enough said...
Slicing and Dicing of the Trustee Role

- Historically, the “Trustee” function was rolled up in one individual or entity
  - Trusted Individual
  - Corporate Fiduciary

**Trusted Individual**
- Trusted Individuals
  - Family Member
    - “Uncle Louie”
  - Selected Professional
    - Outside professional
    - Family Office Personnel
  - Transitions can be difficult
    - People change, go crazy and die

**Corporate Fiduciaries**
- Corporate Fiduciaries
  - Banks with Trust Powers
  - Trust Companies
    - Historically, families were directly affiliated with a bank
    - Current trend toward “unbundling” the trustee function
Slicing and Dicing of the Trustee Role

Directed Trusts and Private Trust Companies provide the structure to “unbundle” the roles of a trustee.
Directed Trusts

Texas Trust Code § 114.0031, enacted in 2015, provides the statutory authority for directed trusts in Texas

- The trustee technically takes the action as directed by the advisor, but is not liable for the action – except in cases of willful misconduct or gross negligence
- Advisor acts in a fiduciary capacity unless trust agreement provides otherwise
WHAT: Is a Private Trust Company

A perpetual entity:

• Owned and controlled ... directly or indirectly ... by a single family ... serving as trustee for only that family and its related entities and individuals

• Legally empowered to provide broad range of fiduciary, financial, and other services
  • Depending on jurisdiction: trustee, executor of an estate, escrow agent, attorney-in-fact, conservator or guardian, investment advisor, investment manager...

• Often a limited liability company and sometimes a state-law corporation

• Explicitly designed to exercise discretion within the applicable tax laws and to act in accordance with the family’s articulated values and guidance

• Provides formality and performance of corporate trustee while facilitating broad family involvement
<table>
<thead>
<tr>
<th>WHEN &amp; WHY: Advantages of a PTC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Family Participation</strong></td>
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<tr>
<td>- Provides a framework within which family members can participate</td>
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<td>- Provides a vehicle for educating younger generations</td>
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<td><strong>Improved Continuity</strong></td>
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<td>- Eliminates Trustee changes due to death, incapacity and retirement of individual trustees</td>
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<td><strong>Flexibility &amp; Adaptability</strong></td>
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<tr>
<td>- A PTC and well drafted trust documents provide flexibility to adapt to changing circumstances through multiple generations</td>
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<tr>
<td><strong>Limited Director &amp; Officer Liability</strong></td>
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<tr>
<td>- Less exposure to personal liability than individual trustees</td>
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<td>- Enhances ability to recruit highly qualified individuals</td>
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<tr>
<td><strong>Choice of Jurisdiction</strong></td>
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<td>- Allows trusts to be situated in a state without income tax and with particular trust law</td>
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<td><strong>Trust Powers</strong></td>
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<tr>
<td>- PTC is able to serve as a fiduciary under state law</td>
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WHO: Flavors of Families

• Initial observations
  • All families are different
  • One size does not fit all
HOW: PTC Structure – Management

Owner
Special Purpose Trust or individual family member

Directors
Generally 3 or more

Private Trust Company
Officers:
President
VP
Secretary

Trusts

Amendment Committee
Independent Person(s)*

Investment Committee
No membership restrictions

Service Providers
Options: Family Office, corporate trustee, CPA, or other service provider

Distribution Committee
At least one Independent Person* should serve

*Independent Person – Not related or subordinate pursuant to IRC 672(c)
HOW: PTC Structure - Management

Directors
- Oversee management of PTC
- Appoint committees and officers

Officers
- Handle day-to-day operations

Discretionary Decisions Committee
- Makes tax sensitive decisions (e.g. discretionary distributions) for trusts and estates administered by the PTC
- At least one member should be an Independent Person

Investment Committee
- Delegated investment authority over trusts and estates administered by the PTC
- No restrictions on membership

Amendment Committee
- To avoid adverse US tax effects, has the sole authority to make certain changes to the “firewalls” in the PTC’s governing documents
- All members must be Independent Persons
WHERE: Potential Jurisdictions for PTCs

Factors to consider when choosing a PTC jurisdiction:

• No state income tax for trusts
• Modern trust laws
• Flexible trust company laws
• Pro-business mentality within state government
• Unlicensed PTCs allowed by statute
## WHERE: Potential Jurisdictions for PTCs

<table>
<thead>
<tr>
<th>Nevada</th>
<th>Wyoming</th>
<th>South Dakota</th>
<th>Texas</th>
<th>Tennessee</th>
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</thead>
<tbody>
<tr>
<td><strong>Scope of family eligible to be served by PTC</strong></td>
<td><strong>10th degree of lineal kinship &amp; 9th degree of collateral kinship from designated relative</strong></td>
<td><strong>No statutory limitation—as defined by the family in the application</strong></td>
<td><strong>Persons related within the 7th degree of consanguinity or affinity to designated ancestor</strong></td>
<td><strong>10th degree of consanguinity or affinity to designated ancestor</strong></td>
</tr>
<tr>
<td><strong>D&amp;O Residency Requirements</strong></td>
<td><strong>One officer NV resident</strong></td>
<td><strong>One director SD resident</strong></td>
<td><strong>One director and one officer TX resident</strong></td>
<td><strong>One officer TN resident</strong></td>
</tr>
<tr>
<td><strong>Physical Office Requirements</strong></td>
<td><strong>Minimal office requirement – may be satisfied through local service provider</strong></td>
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<tr>
<td><strong>Minimum Capitalization</strong></td>
<td><strong>$300,000</strong></td>
<td><strong>$200,000</strong></td>
<td><strong>$500,000</strong></td>
<td><strong>$100,000 ($300k-$500k preferred)</strong></td>
</tr>
<tr>
<td><strong>Periodic reporting</strong></td>
<td><strong>Annual financial statements</strong></td>
<td><strong>Annual report of trust assets and financial condition of company</strong></td>
<td><strong>Annual report of condition and income of company</strong></td>
<td><strong>No specific requirement - Annual financial statements preferred</strong></td>
</tr>
<tr>
<td><strong>Regulatory Examination</strong></td>
<td><strong>Examination by NV Financial Institutions Division every 3 years (unless problems exist)</strong></td>
<td><strong>Examination by WY Division of Banking at least once every 3 years (unless problems exist)</strong></td>
<td><strong>Annual examination by Texas Department of Banking</strong></td>
<td><strong>Annual interview with Commissioner – Further exam as mutually agreed upon</strong></td>
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<tr>
<td><strong>Rule Against Perpetuities</strong></td>
<td><strong>365 years</strong></td>
<td><strong>Unlimited Duration</strong></td>
<td><strong>21 years plus life in being (typically ~ 100 years)</strong></td>
<td><strong>360 years</strong></td>
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Principles & Policies

Statement of Trust Principles
• Adopted by Directors

Policies & Procedures Manual
• Establishes protocols and processes that will be used in regulatory examinations
• Internal controls

Regulatory Matters

Application for Charter
• Vetting of Directors
• Business Plan

Periodic Examinations / Reporting
• Annual financial statements
• Periodic exam by regulatory body

SEC matters

Tax Matters

• Firewalls and internal controls drafted into documents to guard against adverse tax consequences
• Walling off a beneficiary from making decisions that might be viewed as a “general power of appointment”