

Tax Management Estates, Gifts and Trusts Advisory Board Meeting
New York City
September 18, 2008

**Estate Planning With Alternative Investments –
Or, Problems We'd All Like to Have and Some Possible Solutions**

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The growth of the “alternative investment” industry and the corresponding growth in the number of professionals and investors who manage those investments have highlighted the unique opportunities and challenges of transferring wealth from alternative investments to future generations. Estate planning for a client with an asset that is expected to explode in value is fun, satisfying and profitable for both the client and the planner. The classic example of this situation involves an entrepreneur who has built a successful business, and now plans to sell it in a private sale or through an initial public offering. When selling a business, the client and planner can usually determine with a fair amount of accuracy the amount of the sale and, of course, the asset to be sold. Alternative investment professionals, on the other hand, often own a variety of investments that may explode in value, but predicting which investments will generate the highest returns, when the returns will be realized, and what the returns might actually look like, is far from certain.

1. What are “Alternative Investments”?

“Alternative investments” is a catch-all category that includes investments other than the traditional stock, bond and mutual fund portfolio familiar to most 401(k) investors. Because alternative investment fund managers often prefer to avoid SEC regulation, investments are typically only available to “accredited investors” (as defined under Federal securities laws)¹. Often times these investments are illiquid, either due to fund

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restrictions or because there is no traditional public market available. For example, in the case of a typical private equity fund an investor contributes capital that is used to make a series of investments in businesses the fund's managers identify as undervalued or underperforming. The capital is used to rehabilitate or improve business performance, and after a set term of years the fund's investments are liquidated, and, if the fund is successful, the fund investors receive their capital contributions and a percentage of the appreciation.

Many of these types of investment opportunities, such as hedge funds, venture capital funds, and private equity funds, have been around for decades, but in the last several years institutional investors have poured money into these types of funds as they have shifted to the modern portfolio theory approach to investing (e.g., investing with an eye toward a portfolio's total return), fueling unprecedented growth in alternative investment funds.² The investment professionals who manage these types of assets usually have the opportunity to participate in the investment fund's growth in various ways, and the form of this type of participation is radically different than the stock option and ownership plans typically available to executives employed by public companies or closely held businesses. This Article discusses estate planning and wealth preservation opportunities

¹ Generally, in order to be an "accredited investor," an individual must have individual or joint net worth in excess of \$1,000,000 or income in excess of \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year. Employee benefit plans, charitable organizations and trusts with assets in excess of \$5 million also qualify as accredited investors. See 17 C.F.R. §230.501 for the full definition of what constitutes an "accredited investor." See also Moore, Douglas, Leveraging the Benefits of Alternative Investments in Estate Planning, Estate Planning Journal Vol. 29, Number 7, July 2002.

² See, e.g., Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, September 2003, p. vii. In a press release dated June 23, 2008, Watson Wyatt, a financial and human resources consulting firm, reported that its most recent survey of pension funds indicated a 40% increase in "alternative assets...managed on behalf of pension funds by the world's largest 99 investment managers...to US\$822bn [in 2007] from US \$586bn the year before."

for individuals with significant wealth derived primarily from the management of alternative investments, such as private equity or venture capital interests.

2. Initial Planning

As with any type of financial planning, it is always best to consult an estate planner before circumstances force you into it. Clients need to do some hard thinking about what their objectives are with respect to their family, charitable organizations, and their own lifestyles. Clients often ask estate planners what the “typical” or “normal” client transfers to a surviving spouse and children. Obviously, an estate planner can help a client talk through this issue, but each client is different and one person’s “typical” is another person’s stingy or overly generous. Perhaps the more important question for clients to consider is how much wealth they need to maintain their lifestyles, including their charitable objectives during their lifetimes. For this reason, clients with significant wealth should consult with a knowledgeable financial planner before committing to wealth protection strategies beyond the standard documents recommended for all clients of means (e.g., wills, revocable trusts, and ILITs). It is far easier to assist a client to achieve specific, known objectives than to recommend strategies based on what the estate planner guesses are the needs of the client.

A separate and related question concerns control – many clients who may feel comfortable having a significant portion of their assets “locked-up” in a trust are uncomfortable with surrendering control over those assets to a third party, whether it be investment control or control over trust distributions to beneficiaries. Further, clients will need to consider the amount of control over trust assets to grant to the trust beneficiaries – not always an easy task for trusts that are expected to last multiple generations or

benefit blended families. Helping a client navigate these decisions is an area where estate planners often fall down by attempting to shoehorn a client into a set of standard trust terms. While there are certain assumptions estate planners routinely (and quite properly) make in the interests of cost effective representation, we recommend providing a client with a primer addressing the different decision points he will need to consider before the first client meeting or shortly thereafter. We find a schedule of this nature to be equally if not more valuable than a personal financial statement in planning an appropriate structure. This is especially true for entrepreneurial and other aggressive clients whose goals and visions often differ from the “norm.” While not every client will choose to educate himself, those that do may appreciate the opportunity to lead a discussion about trust terms based on their own values and ideas rather than relying solely on the judgment of the estate planner.

Of course, the advent of more flexible virtual representation statutes³ and the use of “trust protector” provisions may allow future changes in the event trust terms become undesirable, but these alternatives are not always available where the parties involved (e.g., the trust beneficiaries) have opposing interests.

3. Compensation of Alternative Investment Professionals.

Alternative investment professionals may receive several different types of compensation in addition to a regular paycheck. Typically, and perhaps least importantly if a fund is successful, fund management receives a regular payment, often a set percentage of assets under management, as a management fee. This fee is then distributed to the fund managers as compensation and taxed as ordinary income. In addition, fund managers often choose to (or in the case of private equity funds, are often

³ See, e.g., 12 Del. C. § 3547.

required to) invest some of their own assets in a fund to demonstrate to potential investors that they have their own “skin” in the game. For private equity and venture capital managers, this ownership stake is often referred to as the “capital interest,” and as with the other fund investors, managers may be required to contribute additional capital to the fund at the discretion of fund management. At the fund’s termination or after a set term of years, the capital interest will ideally be returned to the investors along with a percentage of the fund appreciation.

The greatest wealth generator for fund managers is not the management fee or capital interest – it is the ability to participate in the fund’s returns, often at an “incentive” rate that is disproportionate to the returns that may be realized by other passive fund investors. For example, a fund agreement typically incorporates a “distribution waterfall” that provides for a return of investors’ capital interests, followed by a distribution to investors of the fund’s gain up to a set percentage (the “hurdle rate”). After these distributions, fund management collects its preferred share of the gains – often referred to as a “carried interest” – and any remaining gains are allocated among all investors in accordance with the size of their investments. The carried interest is designed as an incentive for fund management, and with a successful fund, that incentive can be quite large – typically, 20% of the investment gains.⁴ These gains are taxed to fund management as capital gain.⁵

⁴ Matz, Kevin, Estate Planning Strategies for Private Equity Fund Managers, Estate planning Journal, Vol. 34, Number 11, November 2007; Mr. Matz’s article provides great detail about the “typical” structure of private equity funds and manager compensation.

⁵ Funds with a track record of success may elect to reduce the management fee in return for greater participation in the fund’s (hoped for) return. This practice, combined with the enormous amount of fund investment gains collected by fund managers relative to management fees (as well as the enormous size of the newest Greenwich mansions), has prompted public scrutiny and criticism of carried interest as simply a method for converting ordinary income to capital gain. Congress held extensive hearings in the summer of 2007 on whether (and how) to close this perceived loophole in the income tax laws. As of this writing, the

In addition, alternative investment professionals often make use of a tax-advantaged opportunity available to wealthy investors as well as fund managers - private placement insurance. Generally, private placement insurance allows the owner of a universal life insurance policy to invest in hedge funds (or funds of funds) through a life insurance wrapper. This can have attractive income tax consequences, since transactions that would ordinarily generate ordinary income and short term capital gain tax consequences for an individual investor can be tax-free if made through the insurance policy.⁶

4. Holding Alternative Investments Through Trusts.

As an initial matter, it is important to note that in states that have adopted the Uniform Prudent Investor Act or substantially similar statutes,⁷ trustees may invest trust assets in alternative investments with less fear of breaching their fiduciary responsibilities.⁸ However, as with any type of investment, a trustee that concentrates a trust portfolio in one particular investment will invite additional scrutiny if the trustee's actions are ever challenged. A trustee may concentrate a trust's investments in one investment if circumstances warrant, but under the terms of the UPIA the burden is on the trustee to demonstrate that "special circumstances" support the trustee's decision.⁹ The UPIA comments identify negative tax consequences of diversification and the

issue remains unresolved, and future movement on the issue will likely depend on the results of the upcoming election. We leave it to the reader to speculate about which political party is more likely to champion reform in this area.

⁶ See Zaluda, Jeffrey A. and Wolven, Lauren J., The Use of Private Placement Life Insurance in Tax and Estate Planning, Tax Management Memorandum, 2002.

⁷ As of this writing, the District of Columbia and all but the following states have adopted the UPIA or substantially similar statutes: Delaware, Florida, Georgia, Kentucky, and Louisiana. See The National Conference of Commissioners on Uniform State Laws website, <http://www.nccusl.org>, for current state adoption and bill tracking information.

⁸ See Section 2, paragraph (e) of the UPIA.

⁹ See Section 3 of the UPIA.

preservation of a family business as situations that could be “special circumstances” for purposes of the Act.

Practically speaking, where a client transfers alternative investments to a trust for his or her descendants, the trustee may simply be unable to diversify the trust’s assets due to transfer and sale restrictions attendant upon the investments. Once those restrictions are lifted, however, the trustee should take care to ensure trust assets are diversified in accordance with modern portfolio theory as described under the UPIA, or that special circumstances warrant concentration in a particular investment.¹⁰ A client can provide some protection to a trustee by explicitly providing for and permitting in the trust agreement the concentration of trust assets in a particular investment or type of investment, regardless of the application of the prudent investor standard.¹¹

5. Problems and Opportunities Unique to Estate Planning for this Type of Client

One of the “nice” problems to have with alternative investments is the potential of transferring too much value to a younger generation. Because most gifting strategies seek to transfer investments before they appreciate significantly in order to move future appreciation from an investor’s estate, in certain situations where investments are wildly successful investors may inadvertently transfer far more wealth to the next generation than they intended. This may be particularly problematic in situations where the assets are transferred to a trust over which the beneficiary gains control at a relatively young age. A client may have far different feelings about giving a beneficiary control over

¹⁰ For an interesting discussion on the use of financial derivatives to minimize the risk of overconcentration in one particular asset, see Jacobson, David C., Trustees May Prudently Invest in Financial Derivatives, Estate Planning Journal, Vol. 35, No. 5, May 2008.

¹¹ Such a provision may be particularly useful in situations where the client plans to name a corporate trustee who will make investment decisions. Depending on the particular circumstances, a corporate trustee may be more reluctant than an individual trustee to assume the risk of concentrating a trust’s portfolio in one type of asset without such a provision because of its own internal guidelines.

\$1,000,000 at age 21 (for example, through a general power of appointment) versus giving the same beneficiary control over \$20,000,000 at age 21. For this reason, it is important not only to carefully consider which investments to transfer to future generations, but also the transfer mechanism and the trust terms if assets are to be held in trust.

Over the last decade, many states have abandoned the common law rule against perpetuities and adopted new statutes permitting “perpetual trusts.”¹² As a result, clients can transfer significant assets to dynasty trusts that may exist literally for centuries. For this reason, now more than ever it is important to consider carefully the terms of trust agreements. Volumes could be (and have been) written on the pros and cons of various trust provisions and fiduciaries. We won’t add much to the discussion here, except to say that you can save future generations (and trustees) a lot of heartaches and headaches by maximizing flexibility in trust administration. Many clients request very specific, rigid trust terms, particularly concerning distributions to beneficiaries. While these terms may best reflect a client’s desires at a particular moment in time, they do not permit a trustee to adapt trust administration to changing circumstances. This can lead to difficult situations for both the trustee and trust beneficiaries, where adherence to the trust terms may not only cause hardship to the trust beneficiaries but would not reflect a client’s actual wishes. Accordingly, instead of trying to control trust assets from beyond the grave, we recommend that clients choose their trustees carefully and give them the flexibility and discretion to administer the trusts in the best interests of each successive generation of beneficiaries, recognizing that their needs will change over time as circumstances change.

¹² See, e.g., 765 ILCS 305/1; 25 Del. C. § 503(b).

Clients can encourage certain behaviors among their descendants by providing financial incentives in the trust terms for meeting certain goals, or by creating trustee distribution guidelines laying out the behavior the client believes should be rewarded. For example, the Trustee can be directed to distribute trust assets to a beneficiary upon obtaining a college degree, upon marriage, upon starting a business, upon the birth of a child, etc. Alternatively, the Trustee can be directed to withhold trust distributions in certain situations – for example, if the beneficiary has a substance abuse or gambling problem, is unemployed or not contributing to society in some meaningful way, or is too irresponsible to manage his or her financial affairs.¹³ A client may also choose to put a cap on the amount of certain types of distributions that may be made to a beneficiary each year, or give the beneficiary a withdrawal right over a certain amount or percentage of trust assets each year to use as the beneficiary sees fit.

Some clients, no matter how large of a financial cushion they have, may still want the ability to draw assets from an irrevocable Dynasty Trust, particularly if the trust balloons in value. If the client is not necessarily interested in taking the assets back, but does want the ability to divert trust assets to another party, such as a private foundation or other charitable organization, the client's spouse can retain a limited power of appointment over the trust assets as a way of managing the growth of the trust. Alternatively, the trust agreement itself may provide a formula that diverts assets in excess of a specific amount to a charitable organization or other parties. If the client wants to be able to access the funds for her own use, consider granting a testamentary

¹³ In a recent case of first impression, an Illinois appellate court held that a trust provision disinheriting descendants who married outside a certain faith was void as a violation of public policy. As of this writing, the Illinois Supreme Court has not decided whether to hear an appeal of this decision. *In re Feinberg*, No. 1-06-2823 (Il. Ct. App., June 30, 2008).

limited power of appointment to a (trusted) older relative of the client in favor of the descendants of the client's parents. This can provide access to the trust funds down the road if the client's financial position suffers a reversal or other unforeseen circumstances develop. Provisions of this nature are likely to cause grantor trust treatment, so the client needs to be aware of the possible income tax impact.

Another problem that is best discussed upfront with clients is valuation. Most of the strategies discussed below will require a valuation of the assets to be transferred, not always an easy trick in the context of alternative investments, and one that can carry with it substantial costs. This is one area where some estate planners may choose to adopt a "wait and see" approach - submitting a bare bones valuation with the client's gift tax return and crossing their fingers in the hopes that the return is not audited.¹⁴ The sticker shock many clients experience when reviewing appraisal quotes is often a contributing factor. However, this strategy has become more risky for attorneys and their clients with the enactment of the Small Business Tax Act of 2007, which changed the reporting requirements for "tax return preparers" (e.g., anyone who prepares a substantial portion of a tax return¹⁵) and associated penalties under Code Section 6694. In order to avoid accuracy related penalties, tax return preparers must now disclose any position they believe could result in an underpayment of tax unless they believe it is more likely than not that the position would be sustained on its merits. This is a far higher bar than the prior standard, which applied only in the income tax context and only required disclosure if the preparer believed a position had less than a 33% chance of being sustained. In addition, the associated penalty has now increased to the greater of \$1,000 or 50% of the

¹⁴ In 2007, the audit rate for gift tax returns was 0.6%. *See* IRS Data Book 2007, Table 9.

¹⁵ I.R.C. § 7701(a)(36)A).

tax return preparer's fees.¹⁶ Finally, new penalties on appraisers themselves make it more unlikely that any reputable appraiser will provide a flimsy appraisal on a shoestring budget.

With assets that are particularly difficult to value, estate planners can minimize the risk of an overvaluation (and consequent increase in gift tax) through the use of a formula gift clause. The use of formula gift clauses remains an unsettled area of law and is not free from controversy. The IRS has long taken the position that the use of formula gift clauses should be disallowed in the interests of public policy, since a formula gift by its very nature removes any incentive for the IRS to audit the associated gift tax return. Many courts (most notably, the Fourth Circuit in Procter v. cite) have respected this argument and invalidated adjustment provisions in formula gifts that required a return to the donor of that portion of gifted assets subject to gift tax.¹⁷ However, not all formula clauses are necessarily adjustment clauses. In 2006, the Fifth Circuit in McCord v. Commissioner held that a formula gift clause that limited gifts to non-charitable donees to securities with a specific dollar value would be respected.¹⁸ Notably, the IRS did not raise the issue of public policy in McCord to buttress its attack on the formula gift clause, and the Fifth Circuit did not address the argument in its opinion. At least one commentator has suggested that, even if the public policy argument was not explicitly addressed by the Fifth Circuit, the court's decision to uphold the validity of the formula gift tacitly implies that the clause does not violate public policy.¹⁹ Still, it remains

¹⁶ I.R.C. § 6694(a)-(b) and IRS Notice 2007-54.

¹⁷ Ward, Estate of McClendon; cite to Mulligan, Michael D., Formula Transfers: *McCord* is Pro-Taxpayer, but Other Developments Are Likely, Estate Planning Journal, Jul 2007.

¹⁸ McCord v. Commissioner, 461 F.3d 614 (5th Cir., 2006).

¹⁹ Mulligan, Michael D., Formula Transfers: *McCord* is Pro-Taxpayer, but Other Developments Are Likely, Estate Planning Journal, Jul 2007.

possible and perhaps likely that the IRS will resurrect this argument in the future and be successful.

Clients using formulas to set a purchase price (for example, in the context of a sale to a grantor trust, discussed below) appear to be on firmer footing. The Tenth Circuit has held to be valid a purchase price formula that provides for adjustment in the event the IRS determines the fair market value of the purchased property to be higher than the agreed price.²⁰ The Tenth Circuit recognized that this type of formula was a reasonable method for determining fair market value in the context of a bona fide sale between related parties. *Id.*

The risk of an undervaluation can be avoided altogether, or substantially minimized, through the use of a Grantor Retained Annuity Trust (GRAT), discussed below.

6. Strategies for Transferring Wealth

As mentioned in the introduction, there are some obvious choices when estate planning for a client who holds an asset that is expected to skyrocket in value – either through the sale of a business, an initial public offering, or some other similar event. The Grantor Retained Annuity Trust (“GRAT”) is a very attractive strategy given this scenario, since it allows the client to transfer the future appreciation of the asset (often many multiples of the asset’s current value) to future generations with little or no associated gift tax. Generally speaking, a GRAT is a statutorily permitted trust agreement where the trust grantor transfers assets to a trust that will pay the grantor an annuity payment over the course of a term of years, for the remainder of the Grantor’s

²⁰ *In the Matter of King*, 39 AFTR 2d 77-353 (10th Cir., 1976).

life, or the shorter of the two.²¹ The amount of the gift made to the trust is determined by calculating the current value of the annuity stream to the Grantor based on the Section 7520 rate provided in the Internal Revenue Code.²² Any appreciation of trust assets in excess of the Section 7520 hurdle rate can therefore be transferred to a remainder trust for the Grantor's descendants free of transfer tax at the end of the trust term. However, if the Grantor dies during the trust term, all or a portion of the trust assets are included in the Grantor's estate.

GRATs are most desirable where (1) your client is relatively young and/or healthy (due to the mortality risk associated with GRATs), and (2) the approximate timing of the appreciation event is known (although if the event has not occurred before the end of the GRAT term, the assets can simply be "re-GRATed" as the annuity payments are distributed to the Grantor). The fact that the Section 7520 hurdle rate has been very low over the last several years only enhances the appeal of GRATs.²³ Further enhancing the GRAT's desirability is its self-adjusting valuation feature – in the event the IRS determines that a client has undervalued the assets transferred to the GRAT, the annuity payout must automatically adjust to account for the annuity shortfall, ensuring that the client will retain control over the amount of the gift made to the trust.²⁴

The GRAT approach does have some drawbacks, however. Aside from the obvious mortality risk, the Grantor is only shifting appreciation out of his estate, not the current value of the assets themselves, which come back to the Grantor in the form of annuity payments. While the Grantor may choose to simply redirect those payments into

²¹ The annuity may also be payable for the duration of two lives. *See* I.R.C. § 2702.

²² I.R.C. § 2702(a)(2)(B).

²³ Since January 2005, the 7520 rate has ranged from a low of 3.2% (May 2008) to a high of 6.2% (multiple months).

²⁴ Treas. Reg. § 25.2703-3(b)(2).

new GRATs, eventually those assets will be included in his estate unless a GRAT fails (spectacularly) or he transfers them using some other mechanism.

An alternative to the GRAT strategy is the sale of an asset to a grantor trust. Many estate planners regularly employ this strategy in one form or another; the client establishes a grantor trust, funds it with an initial gift of “seed money” using his gift tax exclusion, and then sells assets to the trust in exchange for a note. The note may be structured as a term note, a demand note, or, for the more aggressive, a self-cancelling installment note (“SCIN”), with interest payable at a rate equal to the applicable federal rate (AFR).²⁵ The seed money is necessary to establish the credit worthiness of the trust and lend substance to the sale.

This strategy can be particularly useful for private equity fund managers who desire to transfer their carried interest to trusts for their descendants. The transfer of carried interest involves problems virtually unique to this type of interest. In addition to the huge range of values a carried interest can realistically be expected to generate (basically, anywhere from worthless to many millions of dollars), particularly successful clients may end up transferring far more than they intended to trusts for their children. This “risk” can be managed through the trust drafting process; for example, trust assets to be divided among subtrusts for the benefit of descendants can be limited to specific amounts, with any excess distributed to more distant relatives or charitable entities. This may be particularly desirable for those clients who have already established a private foundation or have some interest in doing so once their estates grow to a certain size.

²⁵ The AFR is the lowest rate that may be used without making a gift; the IRS treats any loan with an interest rate lower than the AFR as a “below-market” loan, and assess gift tax on the difference between interest payable at the AFR and interest payable under the terms of the note. A SCIN will require a higher interest rate to account for the cancellation of indebtedness on death feature.

Alternatively, clients can make use of a derivative contract to cap the value of the assets to be transferred. A few practitioners have discussed the use of derivative agreements to maximize the benefits of GRATs and sales to grantor trusts.²⁶ By entering into a derivative contract with a grantor trust (e.g., an option to purchase assets tied to the performance of a specific asset, such as the client's carried interest), rather than transferring the actual carried interest, clients can impose a limit on the amounts transferred to a specific trust upfront and retain control of any "excess" return.

Use of a derivative contract also avoids several other thorny issues that may arise when clients transfer a carried interest directly. For example, as mentioned above, private equity fund managers frequently own both a capital interest and a carried interest in the funds they manage. This may cause problems under Code Section 2701, which imposes special valuation considerations when family members transfer certain types of interests to one another, including interests in closely held corporations and partnerships. Specifically, Code Section 2701 provides that, for purposes of valuing a transfer to a family member, any "applicable retained interest" kept by the donor will be valued as zero, with the end result that the value of the gift for gift tax purposes may be substantially greater than the actual value of the asset transferred.

Further, the use of a derivative can avoid problems with transferring unvested assets. The IRS addressed the transfer of unvested stock options in Revenue Ruling 98-21 and concluded that the transfer would not be a completed gift until "the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor" (e.g., until the option vests). The IRS has not specifically addressed the

²⁶ See, e.g., Handler, David A. and Tiesi, Angelo F., Using Derivatives to "Transfer" Carried Interests in Private Equity, LBO and Venture Capital Funds; Goldsbury, John, Increasing a GRAT's Effectiveness with Derivatives, Estate Planning Journal Vol. 30, Number 6, June 2003.

transfer of unvested rights to carried interest or other participation rights, but absent any authority to the contrary the IRS may draw an analogy between unvested stock options with other unvested participation rights.

7. Choice of Fiduciaries

As trusts become larger and last longer and estate planning clients become more sophisticated, clients and estate planners often wrestle with the number, type, nature and permanency of the fiduciaries for their trusts. Simply naming “Uncle Bob” as trustee has lost its appeal for many clients, particularly given the increase in trust litigation and the growing complexity of a trustee’s responsibilities.²⁷ Some clients elect to park all the burdens of a trustee, including administration, investment management, and beneficiary distributions, with a corporate entity. This approach has several advantages. First, the corporate entity is more likely to be viewed as a neutral party by the trust beneficiaries, avoiding some of the arguments that may develop when one family member is the gatekeeper of trust distributions to other family members. Second, a corporate entity has systems in place for trust administration and record-keeping, making it unlikely that details like a tax return filing deadline will be missed. Third, the trust will receive professional investment services and advice. This last point, however, may be a stumbling block for clients interested in alternative investments; although the evolution of the Prudent Investor Rule reduces the exposure of a trustee who invests part of the trust estate in alternative investments, a corporate entity may not be flexible enough or willing to invest as much of the trust estate in alternative investments as an individual trustee. Corporate entities have their own internal standards for trust investment and

²⁷ See Wolven, Lauren J. and Zaluda, Jeffrey A., Practical Strategies for Managing a Trustee’s Liability Exposure, Estate Planning Journal, Vol. 33, No. 9, September 2006.

management designed to limit the trustee's risk, and any request to deviate from those standards is likely to require time consuming review, the outcome of which is not always favorable. An individual trustee, on the other hand, may be more likely to entertain investment proposals over a friendly lunch, head back to the office and implement whatever suggestions the client made over calamari. Finally, all the benefits a corporate trustee provides come at a cost, often dependent on the size of the trust and usually a certain percentage of the trust assets. Depending on the client's perceptions, the corporate trustee's services may not be worth the associated pricetag.

To retain a certain amount of control over trust assets and provide additional investment flexibility, some clients choose to name trust "Investment Advisors" to act in concert with trustees. The Investment Advisor may be the client herself²⁸, the client's personal investment advisor, or some other individual whose investment advice the client considers valuable. The trustee retains the fiduciary responsibilities related to trust administration and beneficiary distributions, with no responsibility or liability for trust investments, which rests with the Investment Advisor. This allows the client to select more aggressive investment management services than may be available from a traditional trustees.

Other clients may choose to name "Distribution Trustees" – fiduciaries whose sole responsibility is to determine how distributions are made to trust beneficiaries. Often this arrangement is used when a client wants to give a family member (such as a surviving spouse) or close associate who knows the client's family dynamics the power to make distributions without the other responsibilities of trust administration, either

²⁸ Depending on the nature of the assets transferred, a client who acts as the Investment Advisor may be required to cede certain decisions related to specific assets to the Trustee in order to avoid inclusion of the assets in his estate. *See* I.R.C. § 2036(b).

because the Distribution Trustee is not investment savvy or simply because the client doesn't want to burden the Distribution Trustee with the day-to-day trust administration responsibilities (which can be considerable).

Some wealthy families are turning to "Private Trust Companies" (or PTCs) in order to retain greater oversight of the investment and distribution of trust assets, as well as trust expenses. Over the last several years, several states have adopted statutes designed to facilitate these types of companies, and a recent proposed IRS ruling addressing the estate and gift tax implications of the use of PTCs may make these types of entities more attractive.²⁹

Generally, PTCs are trust companies created to provide trust administration services for one family's or one group of families' trusts. The family retains control over the trust company through positions on the PTC's Board of Directors and can customize the type and nature of services the PTC provides to suit the family's needs and objectives.

²⁹ In Notice 2008-63, the IRS issued a proposed revenue ruling on whether the management of a trust by a PTC could result in the inclusion of trust assets in the trust settlor's / PTC owner's estates. The IRS addresses two different fact patterns in its proposed ruling. In the first, the trust settlor creates a PTC in accordance with a state statute explicitly enacted for the purpose of regulating PTCs. The statute's requirements include the formation of a Discretionary Distribution Committee to oversee PTC trust distributions. The statute does not limit individuals who may serve on the committee, but does provide that a committee member may not make decisions with respect to a trust of which that member or the member's spouse is the settlor or beneficiary, or with respect to a trust whose beneficiaries the member of the member's spouse owes a duty of support. The statute includes additional provisions designed to restrict a member's control over trusts he or she may have a personal financial interest in. The second situation involves the creation of a PTC in a state without a statute regulating PTCs, but with provisions identical to those considered in the statutory situation. In both cases, the IRS's proposed guidance is that neither the creation nor the appointment of a PTC to act as trustee alone will cause inclusion of the trust assets in the grantor's estate under Code Section 2036(a) or 2038(a), or in the beneficiary's estate under Code Section 2041. In addition, the use of a PTC by itself will not effect a trust's GST exempt status, its grantor trust status, or cause a transfer to the trust to be treated as an incomplete gift under Code Section 2511. This ruling essentially confirms what most estate planners believed to be the estate and gift tax consequences of the use of a PTC, namely that the simple use of a PTC (if correctly designed) should have no estate or gift tax consequences, positive or negative. As stated by the IRS in Section I of Notice 2008-63, "The IRS and the Treasury Department intend that the revenue ruling, once issued, will confirm certain tax consequences of the use of a private trust company that are not more restrictive than the consequences that could have been achieved by a taxpayer directly, but without permitting a taxpayer to achieve tax consequences through the use of a private trust company that could not have been achieved had the taxpayer acted directly."

The creation of PTC is not for everyone, however. Trust company capitalization requirements still apply, and the legal fees associated with establishing a PTC can be prohibitive. However, if a family has many millions of dollars in trust, a PTC may be desirable, particularly if the trust owns unique assets or the family has very specific ideas about investment management, as many investment professionals do.

Regardless of what type of fiduciary arrangement works best for the client, some thought must be given to the removal and replacement of the fiduciaries, particularly with respect to long-lived Dynasty Trusts. As with designing trust distribution terms, it is always preferable to retain the maximum amount of flexibility in this respect. The client herself can retain the power (in most circumstances) to remove and replace trustees, and the power may pass to the trust beneficiaries or other third parties upon the client's death, subject to whatever restrictions or qualifications the client may wish to impose.

8. Conclusion.

Alternative investment professionals often have choices and concerns that are different from those of the "typical" estate planning client (although no client is every really "typical"). Educating these clients ahead of time about their options and the problems unique to alternative investments will ensure a productive and successful relationship.