

# STEP U.S.A.

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## The multinational family Foreign investment in US real property Purpose trusts and PTCs

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# STEP U.S.A.

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## Welcome

At the time of writing, I have just returned from the STEP Annual Caribbean Conference. The conference, which was held in Panama this year, was outstanding and I was pleased to see many US STEP members in Panama attending the conference. There were a number of presentations from US members that were very informative. However, one of the true benefits of attending was the opportunity to meet with STEP members from all over the world, in order to get to know each other better and to share ideas with respect to current topics of common concern. I believe that one of the most important benefits of STEP membership is the opportunity to discuss issues of interest with other professionals, both in the US and internationally. The need for this type of dialogue has never been more important. We have all seen the reports of the fallout from the disclosures that have come from the LGT Group in Liechtenstein. This and the more recent investigations in the US regarding certain UBS bankers all point to the need for responsible professionals to be able to understand and be sensitive to the issues that are presented in various jurisdictions in representing global families.



All of this presents itself at a time when families seem to be increasingly mobile. One needs to look only at the recent changes that have been made to the rules in the UK to see the importance international families have played in their economy. Mark Summers and Louisa Mannooch of Speechly Bircham in London have written an article on the availability of a foreign tax credit in the US for payment of the new GBP30,000 charge in the UK for certain foreign domiciliaries. In addition, Warren Whitaker has sent us a report on STEP's first Pacific Rim Conference, jointly sponsored by STEP Los Angeles and STEP San Francisco. Bill Norman, Larry Heller and Kathy Davidson have an article in this issue on advising the multinational family, and Chris Armstrong has an article on the use of private trust companies. To round off this issue, Steven Cantor and Tracey Leibowitz have written an article on structuring foreign investments in US real property. With the fall in the US real estate market and the concomitant drop in the value of the US dollar, the US is seen by many to be an appropriate environment for non-residents to invest in US property.

You may note that this issue of the STEP Journal USA Supplement features a new US Editorial Board. We thought that it was important to have the participation of STEP US members on the Editorial Board to ensure that we continue to get a diversity of views from across the US. It was outstanding to see the enthusiasm with which each member of the Board responded when invited to join, and their input is already proving invaluable.

If any of you are interested in contributing to future issues, please let me know. We welcome your participation.

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# Panacea or placebo?

*Christopher S Armstrong* and *Diana M Hastings* consider whether purpose trusts and PTCs are panacea or placebo for lack of trust investment diversification

The estate planner for an individual whose wealth and family identity are closely aligned with a successful business enterprise may be called upon to create a structure to last beyond the lifetime of such individual that would preserve the family enterprise. Aside from the question whether there are surviving family members capable and personally motivated to step into the shoes of the founder for purposes of managing and preserving the business (the answer to which question is beyond the scope of this article), the planner must reconcile the competing vision of his client with the antipathy of modern trust law to the concentration of investment risk in a single company, business or geographic area.

Trustees are often subject to the prudent investor rule.<sup>1</sup> The trustee subject to such rule must consider (a) whether the trust investments are diversified; (b) if they are not, whether the trust agreement speaks to the issue of diversification and if so whether the language directs or merely confers a discretion to hold a concentrated position in an asset; (c) if the trust agreement does direct retention of a concentrated position, whether the direction is enforceable<sup>2</sup>; and (d) if the power to direct is conferred upon a third party (such as a 'protector') whether the trustee is entitled to rely upon such directions as it receives without seeking court confirmation.

## **A non-charitable purpose trust may solve the problem of 'excessive' concentration provided the purpose is not economically ruinous**

The non-charitable purpose trust elevates the importance of the trustor's objectives and

places the beneficiaries' personal interests in a subordinate position. The beneficiaries' interests would include the maximization of investment return and minimization of investment risk. The non-charitable purpose trust thereby enables the planner and his client to preserve the family enterprise. Both the client and the planner need, however, to recognize that there are common sense limits upon the use of this new planning tool.

For many years, legislation has permitted purpose trusts for the care of domestic pets who survive their owners and for the maintenance of gravesites.<sup>3</sup> Commentary has called for the introduction into the United States of broad-based purpose trust legislation similar to that adopted in various offshore jurisdictions, and it has recommended that, in the interim, estate planners consider (where the purpose of a trust is the achievement of a private object of the trustor with benefit to persons being incidental) establishing the trust subject to the law of an offshore jurisdiction<sup>4</sup>. Importation of such private purpose trust legislation into the United States either (i) by carefully planned application of foreign situs law or (ii) by the enactment of private purpose trust legislation, would appear to make possible an unconditional trust directive such as that used by the late Joseph Pulitzer, wherein a company and its newspaper should not be sold under any circumstance<sup>5</sup>, but would it really?

Critics of the *Pulitzer* decision, which invalidated the direction to hold forever a newspaper business '...have suggested that the holding [in *Pulitzer*] could more candidly have been explained by recognizing that the settlor's direction in question was clearly not beneficial to the beneficiaries and served no proper trust purpose, private or charitable

(emphasis added).<sup>6</sup> The court in *Pulitzer* instead indulged the respectful supposition that '[a] man of [*Pulitzer's*] sagacity and business ability could not have intended that from mere vanity, the publication of the newspapers, with which his name and efforts had been associated, should be persisted in until the entire trust asset was destroyed or wrecked by bankruptcy or dissolution...' and grounded its holding upon its power to vary the terms of a trust to prevent ruinous economic consequences to the beneficiaries.



*Christopher S Armstrong*



*Diana M Hastings*

## **The distinguishing features of a PTC that allow greater tolerance for non-diversification**

The private trust company (PTC) as trustee may succeed in retaining concentrated and illiquid positions in family controlled companies where the institutional trustee cannot, or dares not try, because of the prudent investor rule or a limiting application of any purpose trust legislation. The PTC is typically a company with assets limited to those of the family that owns it, dedicated to the service of the family and managed



by members of the family. Family members acting for a PTC hopefully would have not only a sense of obligation to the founder but also a desire to take the risks inherent in the retention of concentrated asset positions for so long as they or other members of the family are involved in the management of such assets.

In order for a PTC to succeed, a family must have the financial resources necessary to make the creation and maintenance of a PTC viable, and it must have family members willing to give of their own time to assure proper trust administration. The advantage of family ownership is vitiated if the PTC is used by dominant family members as a vehicle for advancing their own personal interests. When fiduciary duty is confused with entitlement, no good can come of it<sup>7</sup>. If a PTC (by action of its board of directors) commits a breach of trust, which is not tolerated by other members of the family, the situation may lead to ‘...a civil war in the family,’<sup>8</sup> precisely what the founder doubtless wished to avoid.<sup>9</sup>

Whether the PTC is a viable solution to the diversification conundrum should take into account the concerns of the US Treasury Department regarding suspected abusive use of PTCs<sup>10</sup> and the curious encouragement of such concerns by the New York State Bar Tax Section<sup>11</sup>. Critics of the NYSBA Report have correctly observed that its recommendations are not supported by existing law and practice and that they have adverse implications for family participation in the trust decision-making process that go far beyond PTCs.<sup>12</sup>

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- 1 The Prudent Investor Rule including the obligation of a trustee to diversify is set forth in the *Uniform Prudent Investor Act 1994* §3. *The Restatement (Third) Of Trusts*, § 227(b) published in 1992 was responsible for the integration of the diversification requirement into the concept of prudent investing. §227(b) provides that ‘[i]n making and implementing investment decisions, the trustee has the duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.’
- 2 Compare, *In Re Charles G. Dumont*, 791 N.Y.S.2d 868 (Surr.Ct. Monroe Cty. 2004), rev’d in part 809 N.Y.S.2d 360 (App.Div. 4th 2006) with *Americans of the Arts v. Ruth Lilly Charitable Remainder Annuity Trust #1*, 855 N.E.2d 592 (Ind. Ct.App. 2006)
- 3 UTC §404. The UTC, which is significantly influencing the current development of trust law for states that have not established their own advanced trust laws, provides in §409 that a non-charitable purpose trust may be created for a period not in excess of 21 years, but comment accompanying such section expressly advises that a period longer than 21 years could be prescribed by a state adopting the UTC if it saw fit. The UTC does not alter the basic tenet that in order to be valid, all trusts must have a purpose that is lawful, not contrary to public policy, and possible to achieve.
- 4 See Bove, *Rise of the Purpose Trust*, 144 *Trusts & Estates* 18 (Aug. 2005).
- 5 *Matter of Pulitzer*, 139 Misc. 575, 249 N.Y.S. 87 (Sur. Ct. 1931), aff’d mem., 237 App.Div. 808,

260 N.Y.S. 975 (1932)

- 6 *Restatement (Third) Of Trusts*, §27, Reporter’s Notes.
- 7 See Fitch, *Pritzker v. Pritzker*, 172 *Forbes* 142 (Nov. 24, 2003) and Maremont, ‘Pritzkers Settle Family Lawsuit; Cost: A Fortune,’ *The Wall Street Journal* B1 (Jan. 7, 2005).
- 8 Duckworth, ‘The Trust Offshore’, 32 *Vanderbilt Journal of Transnational Law* 879, 914 (1999).
- 9 Some commentary has suggested that a PTC is an effective device for holding closely concentrated investment positions because the PTC board of directors is governed by the ‘business judgment rule’ rather than the ‘prudent investor rule.’ This distinction is thought to allow the members of the board to make bolder investment decisions than if they were individual trustees. This proposition is dubious, however, because ‘...equity may look through the corporate veil and fasten its rules upon those individuals who speak and act for the corporate trustee... [citation to *In re French Protestant Hospital* [1951] 1 Ch. 567]. See Duckworth, ‘Private Trust Companies: Part 1’, *Private Client Business* [1997] 353, 358.
- 10 The Joint Treasury-IRS 2007-2008 Priority Guidance Plan (and prior Plans) undertakes to issue guidance ‘...regarding the consequences under various estate, gift and generation skipping transfer tax provisions of using a family-owned trust company as trustee of a trust.’
- 11 See NYSBA Tax Section Report (No. 1111) dated May 30, 2006 which infers the possibility of a ‘reciprocal’ arrangement whenever any individual who is a discretionary beneficiary of a trust may participate in a decision regarding the exercise of ‘beneficiary tax-sensitive powers’ over the trust.
- 12 See Kozusko, ‘Reciprocal Trust Doctrine Threatens Family Decision-making’, *Wealth Strategies Journal* (Nov/Dec 2006).