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THE FAMILY ADVANCEMENT SUSTAINABILITY TRUST: INVESTING IN YOUR FAMILY, NOT DISTRIBUTING TO YOUR FAMILY

By Marvin E. Blum & Thomas C. Rogerson

In working with (and studying) many wealthy families and family business owners over the years, we have come to better appreciate why some families flourish over the generations and, unfortunately, why many more fail. In a nutshell, too many families focus their planning, often exclusively, on money: investment management, banking, retirement planning, and estate tax planning. Although they may do a great job of preparing the money and business for the family, they rarely have focused intentionally on preparing the family for receiving these complex assets. As an example, over 70% of family business owners desire to transfer their business to the next generation, yet less than 30% of the time the family is prepared or has the skills necessary to successfully receive it.

We believe that there is a solution that is based on first educating and assisting families with "relationship skills:" teaching constructive communication skills, intentional family team building, philanthropic vision, legacy planning, succession planning, and entrepreneurial education—and then incorporating these critical issues into a comprehensive plan. The program begins by first helping families to become aware of the issues that many wealthy families and families in business face. The knowledge of best family practices combined with cutting edge strategies and insights helps to first establish better communication skills while clarifying and committing to family values. Family members are then asked to engage within family committees to start working towards the future direction and agendas for family meetings, and to establish a family education platform and curriculum. Once this foundation has been laid, then a family business team helps families to develop a meaningful and engaging family governance structure, with associated processes and systems.

At the heart of that governance structure is the Family Advancement Sustainability Trust ("FAST"). Often the generation that creates the wealth (Generation 1 or "G-1") begins best practices like family retreats, preparing heirs, educating heirs on finances, philanthropy, entrepreneurship, and preserving family heritage and values and pays for them during their lifetimes. But, after G-1 is gone, the second generation ("G-2") doesn't take the time to continue the best practices or doesn't want to pay for them. A FAST does two things. First, it provides the funds to pay for the infrastructure (advisors, meetings, etc.) to implement the best practices. Second, it creates a leadership structure to make sure the best practices happen, using a system of trustees and committees who are paid to run the FAST and are charged with the responsibility of carrying out these tasks. It isn't enough for G-1 to implement best practices and just hope that the family will continue them after their deaths. In order to beat the odds and overcome the "Shirtsleeves to shirtsleeves in three generations" adage, G-1 needs to put a structure in place. G-1 creates a FAST during their lifetimes and begins funding it, and then may pour more assets into the FAST at death.

I. TRUST STRUCTURE

A. Directed Trust. Structurally, a FAST is a dynasty trust created in Delaware or another state with Directed Trust laws. With a Directed Trust, decision-making authority is not concentrated solely in the trustee, but instead can be split among one or more advisors to the trust. Specifically, decisions regarding administrative matters, trust investments, and trust distributions may be assigned to separate co-trustees, advisors, or trust protectors. Thus, the significance of the Directed Trust is that it allows family members and trusted advisors of the family to directly participate in the governance of the trust.

The FAST itself is structured with four separate decision-making bodies, as follows.

i) Administrative Trustee. Typically, a corporate trustee serves as the Administrative Trustee. The Administrative Trustee has no control over investment or distribution decisions but rather deals strictly with generic trust-related tasks such as recordkeeping, tax filings, and maintaining custody of trust assets.

ii) Investment Committee. The Investment Committee is commonly comprised of three members: two family members and one professional advisor. The professional advisor could be a peer (such as a family investment advisor or some other type of fiduciary) or could be a hired investment advisor. The Investment Committee is charged with making all decisions relating to the investment of trust assets and coordinates with the Distribution Committee to make sure the FAST generates the cash needed to pay for best practices activities.

iii) Distribution Committee. The Distribution Committee is comprised of several members, such as: two family members, a family legacy planning consultant, an individual that is a like-minded peer to the grantor(s), and a professional advisor who brings knowledge of the family. Whereas in other trusts a Distribution Committee makes decisions regarding the disbursement of trust assets, in a FAST the Distribution Committee is charged with spending trust assets to preserve and strengthen the family institution.

iv) Trust Protector Committee. The Trust Protector Committee may be comprised of three professional members such as the family's attorney, CPA, financial advisor, and/or a trusted fiduciary. Family members could serve as consulates to the Trust protector Committee. (One should avoid family members serving on this committee to prevent the trust assets from being subject to a general power of appointment.) The Trust Protectors are individuals charged with playing the role of the grantor once the grantor is no longer able to do so. Some typical Trust Protector duties include removing or appointing the trustees, committee members, or other advisors, and amending the governing instrument of the trust to efficiently administer the trust or to address unforeseen circumstances that adversely affect accomplishment of the trust's purpose.

Individuals may serve on more than one committee, and non-family committee members receive compensation for serving on a committee.

B. Peer Review. Including a peer review system in the FAST is a way to provide clients assurance that the long-term stability and effectiveness of the trust will continue to be monitored after their lifetimes. It's a "check-up" on how well the trust is continuing to meet the patriarch and matriarch's original objectives and holds trustees and committee members accountable to carry out the tasks that have been assigned to them. It could begin on the fifth anniversary of the trust's creation and occur every fifth year thereafter. The Trust Protector Committee administers the process. The peer reviewers would have no enforcement authority. Rather, they would make recommendations to the Trust Protectors, who can then take action (example: remove and replace). The peer reviewers would receive reasonable compensation for their efforts and expenses.

C. Funding. A FAST should be created during the patriarch's and matriarch's lifetimes to allow G-1 to mold the trust to reflect the ideals and values of the family, guide family members and advisors, and establish the direction of the FAST for future generations. The FAST may be minimally funded during the lifetimes of G-1, with additional funds to be contributed to the trust upon their deaths. The amount of funding can be either a fixed amount or a percentage of the estate. During the patriarch's and matriarch's lifetimes, FAST-related activities such as family retreats and educational programs can be paid for either out of the eldest generation's pocket or from the FAST.

In addition to funding a FAST with liquid assets, a FAST can also be the ideal owner of a family's legacy real estate, such as a family ranch or lake house. The FAST would provide the funds necessary to maintain the property and would establish rules for shared use. Note that it's recommended to segregate the real estate in a separate entity (such as an LLC owned by the FAST) to insulate other FAST assets from liability exposure related to the real estate.

Of the many ways to fund a FAST, two available techniques are a special purpose irrevocable life insurance trust ("ILIT") and a 678 Trust (also known as a Beneficiary Defective Irrevocable Trust). Both of these techniques would allow the FAST to be exempt from GST tax. With a special purpose ILIT, a stand-alone trust holds a life insurance policy on the patriarch or matriarch and funnels additional funds into the FAST at G-1's death. With a 678 Trust, at G-1's death (the primary beneficiaries of the 678 trust), GST tax-exempt assets from the 678 Trust "pour over" to the FAST. This pour-over can be achieved by G-1 exercising a special power of appointment directing assets into the FAST, which also allows them to periodically adjust the amount of the pour-over.

For a FAST that is not allocated GST tax exemption, additional factors must be considered. When the last G-2 member passes away, there would be a "taxable termination" for GST purposes, triggering a GST tax, because there would be no beneficiaries remaining at that time other than "skip persons." To avoid a taxable termination, one could include a charity as a beneficiary. The charity would receive an annual payment (such as 5% of the trust's assets), beginning on the date that the last surviving G-2 passes away. Because the charity is a "non-skip person," a taxable termination would be avoided. To the extent that the FAST makes distributions, directly or indirectly, to a third generation or more remote descendant, the distribution will be treated as a "taxable distribution" for GST purposes and a GST tax will be owed by the recipient. The FAST could be drafted to provide for the distribution to be grossed-up to provide the recipient with sufficient cash to pay the GST tax. (This is similar to a Health and Education Exclusion Trust. Note that distributions for educational and medical expenses that would qualify for the exclusion pursuant to Section 2503(e) would not be subject to GST tax.)

D. Tax Implications. There may be income tax implications if the FAST pays for expenses such as family retreats. In the event a FAST expenditure is considered to be a distribution to a beneficiary, and if such distribution carries out distributable net income causing the beneficiary to owe income tax, the FAST should be drafted so as to allow it to make additional "tax" distributions to cover any income tax imposed on the beneficiary. It is unclear what expenditures would be categorized as trust administration expenses and, therefore, deductible on the FAST's Form 1041 income tax return. To the extent that expenditures are not tax deductible, the FAST needs to reserve cash to cover its income tax liability.

II. FAMILY RELATIONS

Whether a family realizes it or not, the patriarch and matriarch of a family often act as the glue that holds the family together. Once the people in these roles pass away, the dynamics of the family can shift drastically. By establishing a FAST, the leaders of a family are essentially creating a replacement glue that will assume the responsibility of fostering and nurturing family relationships and of maintaining a family identity. There are four aspects of a family that are essential to preserving family relations: (1) Family History; (2) Family Mission; (3) Family Communication; and (4) Family Retreats.

A. Family History. A strong knowledge of family history has been linked to a higher self-esteem and better emotional health in children. According to an article from the New York Times entitled "The Stories That Bind Us," research shows that children who know their heritage—both the good and the bad—and understand they come from a long line of people who have made it through difficult times will be more resilient when facing difficulties in their own lives. The more names and hometowns of great-grandparents they know, the higher their self-confidence. Because family history is integral to maintaining a family identity, the Distribution Committee of the FAST acts as a family historian, ensuring the documentation and dissemination of family history. Practically, each Distribution Committee will carry out their roles differently. Accordingly, overseeing the preservation of family history could include various tasks: ensuring the safe-keeping of family heirlooms, creating a written history of the family that is accessible to family members; or incorporating family history lessons into family meetings or educational curriculum.

B. Family Mission. In addition to family history, a second aspect to family identity is family vision. It is important that families are left with a stated purpose behind which they can unite. Ensuring that the family has a clear understanding of the eldest generation's intentions and vision for the family can be crucial to the family's ability to work together. Creating a family mission statement is a particularly impactful tool in this regard. A FAST serves as the standard bearer of the family mission. The family leaders can essentially charge the FAST with carrying on their vision for the family after they are no longer able to do so. An example of a mission statement might be: (1) We value relationships; (2) We value productive work; and (3) We value meaning in life, whether drawn from spirituality or some other life-giving focus. Much like a large company uses a mission statement to maintain its core values, the FAST holds out the mission statement to the family as a cause behind which they can unite.

C. Family Communication. The matriarch and/or patriarch of a family often serve as the centralized hub for communication. Family members, who may no longer communicate frequently with each other, generally maintain a line of communication to the leader or leaders of the family. This is what makes the loss of those leaders so unsettling and in many cases spurs the fractionalization of family relationships. By creating a FAST, family leaders are installing a kind of replacement hub for communication within the family. The FAST exists to preserve the bonds of the family, and as such it is responsible for fostering healthy and productive communication between family members. Practically, this means that the Distribution Committee also acts as a Chief Operating Officer of the family, addressing family conflicts that may arise (especially within the context of a family business) and serving as a leader to whom other family members may look to for guidance when dealing with family-related issues.

D. Family Retreats. While conflicts and busy schedules are a normal part of any family, real problems emerge when there is no positive force pushing the family closer together and acting as a balance against the stress. One significant way the FAST promotes family relations is through the planning and coordination of an annual family retreat. In addition to typical vacation-type activities that the family can participate in together, a family retreat allows time for meaningful and informative conversations regarding family affairs. Ideally, the retreat serves as a combination of fun, education and decision-making, all of which help to reinforce the stability and connectedness of the family. The Distribution Committee assumes responsibility for the planning of the family retreat, ensuring activities are planned and agendas for formal meetings are set. Additionally, the Distribution Committee can use trust assets to subsidize the cost of the retreat, although the patriarch and/or matriarch of the family could choose to fund retreats out-of-pocket while they are living.

III. FAMILY DEVELOPMENT

Equipping a family to receive and successfully manage an inheritance is no small task, but the best way is to establish an education strategy. The strategy should be a dynamic, multi-faceted plan that aims to instill knowledge and wisdom in the next generation. Because creating and implementing an education strategy to promote family development can be an overwhelming task for any one family member, transferring that responsibility to a FAST can reap great rewards.

A. Education. Taking into account the ages, occupations and sophistication levels of the family members, as well as the characteristics of the family assets, the Distribution Committee would determine what types of programs will be beneficial for preparing the family members to manage their inheritance and function as responsible members of society. A general basic education plan would aim to provide heirs with: (1) an understanding of family virtues, values and history; (2) a basic financial education; (3) the ability to read and understand legal duties; (4) the skills to make competent decisions in coordination with financial advisors; and (5) the desire to participate in family meetings. A more sophisticated education plan would include education of the family business and integrated family wealth management (financial planning, taxes, sustainable spend rates, market cycles, etc.). The Distribution Committee would disseminate materials, schedule outside speakers to lead family meetings, and ultimately ensure (and fund) the successful implementation of the family's education strategy.

B. Distribution Committee: the Mentor. One of the primary advantages of the FAST is the message is it sends to the family—specifically, that the family leaders are not primarily interested in saving taxes or attaching strings to monetary gifts, but rather desire to empower the younger generations of the family. In this regard, the FAST acts as a mentor to the beneficiaries, instead of just as a gatekeeper to the family wealth. Generally, the importance of the FAST role to the family is displayed in a quote by James E. Hughes, Jr.: "In all relationships which are successful learning experiences for both participants, the party with more knowledge at the beginning must offer that knowledge to the party with less knowledge in such a way that the party with less knowledge willingly places herself/himself in the role of pupil."

IV. FAMILY ADVANCEMENT

In supporting the advancement of the family, a FAST carries out the grantor's vision that the trust exists to fund a purpose, rather than a lifestyle. This is accomplished in two foundational ways: (1) Entrepreneurial Development and (2) Family Philanthropy.

A. Entrepreneurial Development. Encouraging budding entrepreneurs not only teaches valuable business and money management skills, but also increases family interaction. The Distribution Committee holds the authority to make decisions regarding whether family funds should be gifted or loaned to a family member for entrepreneurial endeavors. The loans are intended to be small loans and investments—primarily for learning purposes. It's important to note that the FAST itself doesn't gift or loan funds for entrepreneurial endeavors, but rather listens to proposals, advises, and makes a recommendation as to whether family assets should be accessible to the applicant. The actual funds to be gifted or loaned should come from one of two places: if G1 is still living, then the funds should be drawn directly from them; and, if G1 is deceased, then the funds should come from a separate trust or "Family Bank." It is expected that many of the entrepreneurial endeavors will fail financially, while still providing valuable education and experience to the family member. Accordingly, prohibiting the FAST from directly making the investments protects the trustees and other advisors from liability related to poor investment decisions.

A "Family Bank" is a way for families to lend money to younger generation in a way that's empowering and educational. Instead of simply handing money over to a child so that he or she may start a business or buy a home, creating a Family Bank allows the child to gain more of a real-world borrowing experience. The Family Bank can be as formal or as informal as the family prefers. Generally, most Family Banks are structured as a trust or a limited liability company and can be led by a family member or a board of members. The FAST can implement protocols for the borrowing process such that the child must submit a lending request summarizing the purposes of the loan, the proposed loan terms, and how the child plans to repay the money.

Note that even the FAST making a recommendation to have a separate trust fund an entrepreneurial endeavor may potentially create fiduciary liability for the FAST. Creating the FAST as a Delaware trust should help avoid the fiduciary liability due to the fact that Delaware law and Delaware courts seem to allow more flexibility in this area so long as the trust agreement specifically states the guidelines for such decisions and authorizes the committee to make a positive recommendation despite a likelihood that the entrepreneurial endeavor at issue is likely to fail.

B. Family Philanthropy. Statistics show that the use of family philanthropy as a teaching tool is a determining factor in whether a family remains united. Charitable giving shows younger generations the value of helping others and, if done correctly, plays an important role in preparing them to manage their future inheritance. The FAST prepares the next generation to be leaders in the family's philanthropic activities by providing education on how and why to give to helping younger generations select causes and guiding them on appropriate charitable investments.

As with entrepreneurial development, no funds will be distributed directly from the FAST for charitable purposes. The Distribution Committee aids in making recommendations and approving charitable initiatives, and the actual charitable funds are drawn from the family's typical charitable-gifting vehicle such as a Family Foundation or Donor-Advised Fund. Through its role as a philanthropic guide, the FAST encourages, trains, and teaches family members about the benefit of giving to others and the positive effect it has on family unity.

V. CONCLUSION

Nathan Rothschild once famously remarked, "It requires a great deal of boldness and a great deal of caution to make a great fortune; and when you have got it, it requires 10 times more wit to keep it." A FAST is a way for family leaders to set aside resources solely for the purpose of ensuring that future generations of the family maintain the wit necessary to preserve the family legacy, as well as the family's assets.