by Brian M. Malec and Scott A. Bowman

Florida Family Trust Companies: Tax and Nontax Considerations

On June 13, 2014, Governor Scott signed the Florida Family Trust Company Act, creating F.S. Ch. 662. The act, which becomes effective October 1, 2015, governs the formation and operation of family trust companies (FTC) in Florida. At least 14 other states[1] currently have legislation authorizing FTCs (private trust companies). The act, together with favorable trust law and the absence of a state income tax, should allow Florida financial, banking, accounting, and legal service providers to gain a share of the growing FTC business. However, unresolved federal income and transfer tax issues continue to loom over the use of FTCs, whether in Florida or elsewhere. This article provides an overview of the act and discusses key tax and nontax considerations related to FTCs.

FTC Basics

The purpose of an FTC is to provide fiduciary services to a limited class of family members or trusts created by or for the benefit of family members. Common FTC services include serving as trustee, investment adviser, agent or personal representative, as well as tax planning, tax preparation, budgeting, and family wealth education and management. In general, an FTC is similar to a public trust company, except that it does not provide fiduciary services to the public. As a result, an FTC is typically subject to less regulation and lower capitalization requirements than a public trust company.

Under the act, a "family trust company" is specifically defined as 1) a corporation or limited liability company (LLC); 2) that is exclusively owned by family members; 3) that is organized or qualified to do business in Florida; and 4) acts as a fiduciary for family members.[2] An FTC may not serve as a fiduciary for nonfamily members other than up to 35 individuals who are current or former employees of the FTC or a trust or entity that is a family member, as families utilizing FTCs often have longtime employees they wish to treat as part of the "family."

The term "family member" is defined broadly under the act. Relatives within the sixth degree of lineal kinship or ninth degree of collateral kinship to a designated relative[3] are included, as well as spouses and former spouses of a family member and relatives of such spouses within the fifth degree of lineal kinship. Trusts are included as "family members," provided they are created and funded exclusively by family members or all noncharitable qualified beneficiaries are family members. A trust composed exclusively of charitable beneficiaries qualifies as a family member if all of the beneficiaries are charitable entities in which a majority of the governing body is composed of family members. Family entities in which one or more family members own, control, or have the power to directly or indirectly vote more than 50 percent of a class of voting securities of that entity are included as family members, as well as charitable entities in which a majority of the governing body is composed of family members.[4]

The term "family member" is also defined under the act to include the probate estate of a family member or of a nonfamily member if all noncharitable beneficiaries of the estate are family members.[5] An FTC is specifically prohibited, however, from serving as a personal representative or co-personal representative of a probate estate administered in Florida.[6]

Importance of FTCs

FTCs are often utilized when a family needs an independent trustee, but does not wish to designate an unrelated individual or public trust company. An FTC may have several advantages, including: Protection of family privacy; limited liability for decisionmakers who would otherwise be personally liable if serving individually; continuity of trustee upon the death, resignation, or removal of a decisionmaker; quick decisionmaking; flexible fee schedules (often designed to break even); and establishment of a resident trustee in a state with favorable trust law and no state income taxes. An FTC may also be preferred where closely-held businesses are involved, as ownership can be managed by a team of trusted family members and advisers through the formal structure and protection of an entity.

FTCs have some notable disadvantages, however. The largest deterrent is the expense. The team of professionals for an FTC often will include attorneys with expertise in fiduciary and trust law, tax law, business law, banking law, and securities law, as well as accountants. Financial professionals also play a vital role if the FTC will provide investment services in-house. Another disadvantage is the depth of expertise in an FTC may not be as extensive as a public trust company, as an FTC is limited to its relatively small team of professional advisors. Finally, the tax issues involved in structuring and operating an FTC are complex and unsettled. As discussed below, the Internal Revenue Service

(IRS) has yet to issue final guidance clarifying the tax treatment of an FTC as trustee, and has suspended private letter rulings on this issue.

Unlicensed Versus Licensed FTCs

A Florida FTC must be licensed or unlicensed. The choice often will depend on the scope of services the FTC intends to provide. As discussed below, the Securities and Exchange Commission (SEC) regulates investment advisers. If an FTC will provide investment services, then, under SEC rules, the FTC must either register with the SEC or qualify for an exemption. An FTC that satisfies the SEC definition of a "family office" is exempt from registration and may choose to be unlicensed. If an FTC will not fall within the family office exception, then it is more likely to seek licensing under state law in order to qualify for the SEC exemption for FTCs operating under state license. An FTC that will not provide investment services should be outside the scope of SEC regulation and is, therefore, more likely to be unlicensed.

Both licensed and unlicensed FTCs are required to maintain a minimum capital account of at least $250,000; have a principal office in Florida; maintain a minimum of three directors (if a corporation) or managers (if an LLC); and have a deposit account with a state-chartered or national financial institution that has a principal branch in Florida.[7] However, only a licensed FTC is required to maintain fidelity bonds and an errors and omissions policy of at least $1 million on all active management.[8] In lieu of maintaining fidelity bonds, a licensed FTC may increase its minimum capital account by $1 million.[9] Further, a licensed FTC must file an application with the Office of Financial Regulation (OFR) and pay an initial fee of $10,000; an unlicensed FTC must only register with the OFR and pay an initial fee of $5,000.[10]

Additionally, an unlicensed FTC may serve only relatives within the fourth degree of lineal kinship or seventh degree of collateral kinship to a designated relative.[11] A licensed FTC may serve relatives within the sixth degree of lineal kinship and ninth degree of collateral kinship to a designated relative.[12] A licensed FTC also may have up to two designated relatives. An unlicensed FTC is limited to one designated relative.[13] Thus, the operational costs of an FTC can be shared between two families and provide a mechanism for future business dealings together. Permitting a single FTC to serve two families may prove to be a selling point for Florida, as many other states limit an FTC to a single family.

Authorized and Prohibited Activities

An FTC is authorized to perform a variety of services for family members under the act, including serving as trustee, advisery agent, conservator, custodian, escrow agent, financial adviser, guardian, investment adviser, and investment manager.[14] These services may be performed inside and outside Florida, at least to the extent authorized by other jurisdictions. An FTC may delegate duties and authority to other professionals, including a bank trust department or public trust company to assist.[15] For example, an FTC may choose to delegate investment functions to an agent.

There are certain activities that the act prohibits an FTC from performing. Most importantly, an FTC may not provide fiduciary services to the public, as this would conflict directly with a principal purpose of the act. Additionally, an FTC may not engage in commercial banking, such as accepting deposits and cashing checks. This limitation does not prevent an FTC, however, from establishing accounts at financial institutions for its own purposes or on behalf of family members. Finally, an FTC may not serve as a personal representative of a Florida probate estate or as an agent under a Florida durable power of attorney.[16]

State Regulation

The OFR generally is responsible for regulating the Florida banking, finance, and securities industries. Although FTCs are not "financial institutions" within the meaning of the financial institutions code,[17] the OFR has been charged with enforcing the provisions of the act. Consequently, FTCs must make initial and annual filings with the OFR to operate in Florida.

An entity seeking to become a licensed FTC must pay an application fee and file with the OFR an application containing background information on owners, directors, officers, and the FTC.[18] The OFR is required to investigate the criminal and professional background of individuals who will serve as directors, officers, or managers.[19] Additionally, the OFR is required to investigate the FTC to confirm that it satisfies the act's organizational requirements, such as appropriate bonds and adequate capitalization.[20] A licensed FTC also must file an annual renewal attesting that it operated in full compliance with the act during the prior year.[21]

An entity seeking to operate as an unlicensed FTC must register with the OFR in lieu of filing an application.[22] The registration is intended to provide the OFR with background information, but not to the same extent as a licensed FTC. Similar to a licensed FTC, an unlicensed FTC must file an annual renewal application with the OFR to disclose any updated information and attest that it complied with the act during the prior year.[23]

FTCs operating under the act are subject to OFR examination. Generally,

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the OFR is required to examine an FTC at least once every 18 months.[24] In addition to scheduled examinations, the OFR also has authority to examine an FTC at any time it deems necessary to confirm that the FTC has not violated the act.[25] The examined FTC must pay the fees and costs, including travel and salary expenses, incurred by the OFR in conducting any examination.[26]

It is too early to determine exactly what an OFR examination will entail. It is anticipated, however, that the examination process for a licensed FTC will be similar to the examination process of a public trust company. Although this may seem onerous, thorough examination bolsters a licensed FTC's claim of exemption from SEC registration. A cursory examination process could jeopardize a licensed FTC's exemption, which would deter families from locating their FTCs in Florida. It is expected that an examination of an unlicensed FTC will be less intensive, as unlicensed FTCs do not rely on OFR oversight for SEC exemption.

These examination requirements remain subject to debate. There are currently two bills in the 2015 Florida legislative session that, if enacted, would eliminate mandatory examinations of unlicensed FTCs and extend the time period for mandatory examinations of licensed FTCs from 18 to 36 months.[27] The OFR would still retain discretion to examine any FTC at any time. Such treatment would bring Florida more in line with other FTC jurisdictions.

The OFR has a variety of ways to enforce the act. Specifically, the OFR may revoke an FTC's license, issue a cease and desist order, levy monetary fines, and remove a family trust company-affiliated party.[28] An FTC may dispute or mitigate such actions pursuant to a hearing under F.S. §§120.569 and 120.57. The OFR also has authority to penalize an FTC if it discovers a breach of fiduciary duty.[29] Therefore, an FTC may be subject to an administrative proceeding with the OFR in addition to any judicial proceeding initiated by a beneficiary.

Federal Regulation of FTCs

As mentioned above, an FTC that provides investment services must be sensitive to its classification as an investment adviser under SEC regulations. The SEC regulates "investment advisers" primarily under the Investment Advisers Act of 1940. SEC registration requirements for investment advisers include 1) filing a Form ADV with the SEC, which must be kept current; 2) annual filings with the SEC of an audited balance sheet; 3) an annual examination by an independent public accountant to verify client assets; and 4) inspections and examinations by SEC staff.[30] An "investment adviser" is any person who, for compensation, engages in the business of advising others, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.[31] An FTC that provides investment services generally falls within the definition of an "investment adviser" and, therefore, would be required to register with the SEC. However, there are two notable exemptions.

The first is the "family office" exemption. "Family offices" are excluded from the definition of an investment adviser and, thus, are not subject to regulation under the Investment Advisers Act of 1940.[32] An unlicensed FTC providing investment services must qualify for this exemption in order to avoid SEC registration. To constitute a family office, an FTC generally must 1) have no clients other than family clients (with a one-year transition period for certain successors in interest); 2) be wholly owned by family clients and exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and 3) not hold itself out to the public as an investment adviser.[33] Importantly, a family office serving more than one family cannot qualify under this definition, and the definition of a family member under the family office exception may be narrower than under the act.

The second is a state regulation exemption. Under this exemption, an FTC may avoid SEC registration if it operates under a state charter or license, regardless of whether it qualifies as a "family office."[34] Effectively, the FTC is trading SEC regulation for state regulation. The act intends that a licensed FTC be exempt from SEC registration by virtue of the state regulation exemption. However, there is no bright-line test for determining whether a state-regulated FTC qualifies for this exemption. Our view is that a Florida FTC should qualify for the state regulation exemption if the OFR's examination of the FTC is similar to the examination it would conduct for a public trust company. With that said, some states have passively overseen licensed FTCs. Although it is not apparent that any of those licensed FTCs has been targeted by the SEC, concern remains among families operating in those states that their exemption may not be upheld. To avoid such uncertainty, we anticipate that OFR will develop examination procedures aimed at satisfying SEC state regulation standards.

Tax Issues Related to FTCs

The use of an FTC as a fiduciary of family trusts presents unresolved federal income and transfer tax issues. Although the IRS initially issued private letter rulings[35] in this area, it has stopped doing so in anticipation of issuing public guidance.

Importantly, IRS Notice 2008-63 (notice) contains a proposed revenue ruling

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that provides safe harbor guidance on income, gift, estate, and GST tax consequences of using an FTC as the trustee of trusts in which family members are grantors and beneficiaries. As provided in the notice, the intent is

> [T]o 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 the 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.

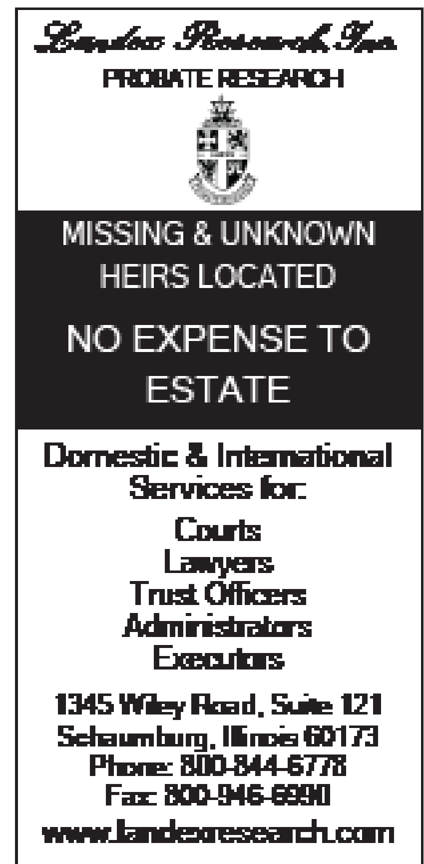
The proposed revenue ruling addresses two situations. Under situation 1, an FTC is created in a state that requires a discretionary distribution committee (DDC) to make all decisions regarding discretionary distributions from each trust for which it serves as trustee. In addition, state law has the following "firewalls": 1) no family member serving on the DDC may participate in making discretionary distribution decisions with respect to any trust of which that person or his or her spouse is either a grantor or a beneficiary, or with respect to any trust of which the beneficiary is a person to whom the family member or his or her spouse owes an obligation of support; 2) only officers and managers may participate in decisions regarding personnel of the FTC; 3) nothing in state statutes or in the company's governing documents may override a more restrictive provision in the trust instrument of a trust for which the FTC is acting as trustee; and 4) no family member may enter into any reciprocal agreement regarding discretionary distributions from any trust for which the FTC is serving as trustee.

Under situation 2, an FTC is created in a state that does not have legislation governing the formation and operation of a private trust company. However, the governing documents of the FTC have the same firewalls that are imposed under state law in situation 1. In addition, the governing documents create an amendment committee, a majority of which must be neither family members nor related or subordinate to family members. By majority vote, the amendment committee may change the governing documents regarding the creation, function, or membership of the DDC or the amendment committee, and any of the firewalls.

Based on the firewalls and the proposed facts, which address various family trusts along with family members serving on the DDC and as officers of the company, the IRS proposed to make several rulings. First, the appointment of the FTC as trustee of the family trusts will not alone cause the value of trust assets to be included in a grantor's gross estate under I.R.C. §§2036(a) or 2038(a). Second, the appointment of the FTC as trustee of the family trusts will not alone cause the value of trust assets to be included in a beneficiary's gross estate under I.R.C. §2041. Third, the appointment of the FTC as trustee of the family trusts in which the trustee has discretionary power to distribute income and principal to the grantor's descendants will not alone cause the grantor's transfers to the trust to be treated as incomplete gifts under I.R.C. §2511, or any distribution from the trust to be a gift by any DDC member. Fourth, the appointment of the FTC as trustee of the family trusts will not alone affect the GST exempt status of the trust under Treas. Reg. §26.2601-1(b)(1)(i), or change the inclusion ratio. Fifth, the appointment of the FTC as trustee of the family trusts will not alone cause the grantor or beneficiary to be treated as the owner of the trust under I.R.C. §§673, 676, 677, or 678; however, the IRS stated 1) the application of I.R.C. §674 will depend upon the particular powers of the trustee and may depend on the proportion of the members of the DDC with authority to act with regard to that trust who are related or subordinate to the grantor; and 2) the operation of the FTC could cause a grantor to be treated as an owner under I.R.C. §675, depending upon the specific facts and circumstances.

Although taxpayers may find some comfort in the notice and its fundamental principle that the tax consequences of an FTC not be more restrictive than the consequences that could have been achieved by the taxpayer directly, the lack of final guidance coupled with certain ambiguities in the notice continue to cause uncertainty. Until final guidance is released or the IRS resumes issuing private letter rulings, families cannot be certain how the IRS will treat an FTC for income and transfer tax purposes. As commentary has suggested,[36] several points remain to be clarified in the final revenue ruling, when (and if) it is issued. We focus on two major areas of concerns.

First, the restrictions placed on the DDC appear unnecessarily restrictive with respect to I.R.C. §2041. The firewall provides that no family member serving on the DDC may participate in making discretionary distribution decisions with respect to any trust of which that person or his or her spouse is either a grantor or a beneficiary or with respect to any trust of which the beneficiary is a person to whom the family member or his or her spouse owes an obligation of support. This firewall is unnecessarily restrictive because it prohibits a beneficiary from participating in making discretionary distributions to anyone. However, had that beneficiary been a trustee of the trust directly (rather than a member of the DDC), the beneficiary could authorize discretionary distributions to 1) himself or herself, subject to an ascertainable standard (health, education, maintenance, and support); and 2) other discretionary beneficiaries if such distributions would not discharge



a support obligation. The mere existence of a support obligation should not bar a beneficiary from participating in distribution decisions if the particular distribution being authorized is not being made to discharge that obligation. Further, the expansion of the firewall to include prohibitions with respect to a grantor's or beneficiary's spouse is overly broad. Spouses regularly act as trustees of trusts that are created by their spouse or of which their spouse is a beneficiary, and a spouse's obligation of support should not be imputed to the trustee.

Although these provisions of the notice may cause concern, to the extent they deviate from statutory provisions causing estate tax inclusion, we think they can be disregarded. To this end, careful drafting of both the underlying trust instrument for which the FTC will act and of the FTC governing documents is necessary. As in any trust, a beneficiary acting as trustee should be prohibited from making distributions to himself or herself in excess of an ascertainable standard or to discharge a support obligation. Additionally, mirror language should be included in the FTC governing documents. For example, if by the terms of the FTC governing document, a member of the DDC who is a trust beneficiary is prohibited from authorizing a discretionary distribution in excess of that beneficiary's health, education, support, and maintenance needs, there appears to be no statutory basis, notwithstanding the notice, for causing estate tax inclusion to the beneficiary under I.R.C. §2041.

Second, the notice leaves uncertainty as to grantor trust attribution, primarily as it relates to I.R.C. §674.[37] To be clear, this uncertainty should be relevant only in those cases in which the objective is to avoid grantor trust attribution; if grantor trust attribution is desired, it can be achieved as easily with an FTC as with an individual or public trust company (*e.g.*, simply by including a power of substitution that satisfies I.R.C. §675(4)(C)). When grantor trust attribution is to be avoided, an FTC creates uncertainty. The general rule of I.R.C. §674(a) causes grantor trust attribution if beneficial enjoyment is subject to a power of disposition in the grantor or a nonadverse party. An exception in I.R.C. §674(c) provides that the general rule does not apply if no more than half of the trustees are related or subordinate parties who are subservient to the wishes of the grantor. In considering an FTC, the notice takes a practical and sensible approach of applying a look-through rule to members of the DDC in analyzing I.R.C. §674(c). The complication, however, arises when evaluating whether pursuant to I.R.C. §672(c)(2) a nonfamily member who is an employee of the FTC will be considered related or subordinate to a grantor who owns the voting stock of the FTC or is an officer or director of the FTC. With regard to the voting stock, the notice concludes that the DDC provides adequate insulation from voting control of the grantor, and, therefore, ownership of the voting stock is not "significant." With regard to the grantor's status as an officer or director of the FTC, the notice simply recites the definition of I.R.C. §672(c)(2), which includes as a related or subordinate party "a subordinate employee of a corporation in which the grantor is an executive." What constitutes a "subordinate" employee and whether the grantor, as an officer or director of the FTC, would be considered an executive remain unsettled. If grantor trust attribution must be avoided, caution dictates that the grantor not hold any position as an officer or director of the FTC.

Conclusion

Florida's FTC legislation is a significant development in Florida trust law and in the promotion of trust business within the state. The breadth and flexibility of the statutes should allow Florida to be competitive with other states that have enacted FTC legislation. Although FTCs may present some challenging securities law and tax law considerations, many families will find them attractive solutions for the management and preservation of multigenerational wealth.❑

[1] States other than Florida that currently have FTC legislation include: Alaska, Arkansas, Colorado, Delaware, Louisiana, Mississippi, Nevada, New Hampshire, Oklahoma, Pennsylvania, South Dakota, Tennessee, Virginia, and Wyoming.

[2] Fla. Stat. §662.111(12).

[3] Fla. Stat §662.120. The term "designated relative" means a common ancestor of a family, who may be a living or deceased person, and who is so designated in the application for a license or annual license. Fla. Stat. §662.111(9). A licensed family trust company may have up to two designated relatives, while an unlicensed family trust company is limited to one designated relative.

[4] Fla. Stat §662.111.

[5] Fla. Stat. §§662.111(h) and (i).

[6] Fla. Stat. §662.131(3).

[7] Fla. Stat. §§662.121-662.1225.

[8] Fla. Stat. §662.126.

[9] *Id.*

[10] Compare Fla. Stat. §§662.121 and 662.122(3).

[11] Fla. Stat. §662.111(11).

[12] *Id.*

[13] Fla. Stat. §662.120.

[14] Fla. Stat. §662.130(1).

[15] *Id.*

[16] Fla. Stat. §662.131.

[17] *See* Fla. Stat. §§662.005(1)(i) and 662.102.

[18] Fla. Stat. §662.1215(2).

[19] *Id.*

[20] Fla. Stat. §662.1215.

[21] Fla. Stat. §662.128.

[22] Fla. Stat. §662.122(1).

[23] Fla. Stat. §662.128(3).

[24] Fla. Stat. §662.141(1).

[25] Fla. Stat. §662.141.

[26] Fla. Stat. §662.141(5).

[27] *See* Family Trust Companies, Florida S.B. 568 and H.B. 825 (2015).

[28] Fla. Stat. §§662.143-145. A "family trust company-affiliated party" is generally defined as any person determined by OFR who participates in the affairs of an FTC, including, but not limited to, a director, officer, manager, member, or shareholder. Fla. Stat. §662.111(13).

[29] Fla. Stat. §§662.142(1)(i), 143(1)(h), and 145(1)(i).

[30] 15 U.S.C. §80b-3.

[31] 15 U.S.C. §80b-2(a)(11).

[32] SEC Release No. IA-3220; File No. S7-25-10 (June 22, 2011); 17 C.F.R. §275.202(a)(11)(G)-1.

[33] 17 C.F.R. §275.202(a)(11)(G)-1.

[34] 15 U.S.C. §§80b-2(a)(11)(A) and 80b-2(a)(2)(C).

[35] *See, e.g.*, PLR 200523003, 200546055, and 200548035.

[36] *See, e.g.*, Ronald D. Aucutt "Comments on Notice 2008-63 (Private Trust Companies)" (Nov. 3, 2008), *available at* https://www.actec.org/Documents/misc/Aucutt_Comments_Notice_08-63_11_3_08.pdf.

[37] Consideration is also given to I.R.C. §675(3).

Brian M. Malec *is a shareholder in the Orlando office of Dean Mead, P.A. He is board certified in wills, trusts and estates and currently serves as director of the Federal Tax Division of the Tax Section. He also served on the drafting committee for the Florida Family Trust Company Act.*

Scott A. Bowman *is an attorney at Proskauer Rose in Boca Raton. He practices in the areas of domestic and international estate planning, and is board certified in tax law.*

This column is submitted on behalf of the Tax Law Section, Cristin Conley Keane, chair, and Michael D. Miller and Benjamin Jablow, editors.