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Structuring Trust Arrangements to Hold Family Business Interests

Financial Planning Association of Northeast Ohio

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I. **Business Interests.**

a. Closely Held Business Interests. Closely held business interests are the ownership interests in a corporation, a partnership, a limited liability company or a sole proprietorship where ownership is held by an individual or is concentrated in a small group of individuals. The ownership interests are thinly traded or not traded on any securities exchange.

b. Family Business. A "family business" is an enterprise in which ownership and management are dominated by members of an emotional kinship group. This group not only includes spouses and lineal family members but collateral relatives, such as siblings, cousins and in-laws. Eighty per cent of the businesses in the United States are considered "family dominated" according to a study by the Raymond James Institute. Many of the businesses were formed by members of the baby boomer generation and are now facing issues concerning the succession of ownership and management.

According to the Small Business Administration, family-owned businesses make up 90% of all business enterprises in North America. The Census Bureau reported that as of 2014 employers with fewer than 2,500 employees are responsible for over 53% of U.S. employment and employers with fewer than 100 employees still are responsible for 41% of U.S. employment.

i. Key Attributes. The key attributes of a family business, which often lead to its success, are also issues that make succession more difficult.
   - More centralized decision-making process
   - Control systems are less formal
   - Family members have lifetime and personal stake in the firm
   - Business owners have indefinite time horizon
   - Business failure has dramatic effect
   - Low risk of family members' employment being terminated
   - Organizational performance tends to be correlated with compensation
   - Family business conflicts are circular
   - Non-family employees perceive limits

ii. Family Business Succession Planning. Business succession planning may be defined as present planning for the transfer of ownership and management of a closely-held business to others. Business succession planning incorporates many familiar estate planning methods. But it also goes beyond traditional estate planning to encompass a comprehensive plan for the introduction of successor management and the eventual transfer of operating control to the current owner's chosen successor. The concept includes assuring the owner-manager and his family the greatest economic benefits possible both in terms of investment security as well as minimization of taxes. According to a survey conducted by the Raymond James Institute, 79% of family business owners want the business to remain as a family business.

II. Why do so many Family Businesses Fail to Achieve Goals?

According to the Williams-Pressier Study, the leading causes for family businesses failing to transition between generations are:

Relationships among family members: **60%**
Heirs not being adequately prepared: **25%**
Lack of planning and control issues: **10%**
Lack of organizational structure: **5%**

Lack of a Common Enemy?

For years the threat that the payment of federal estate taxes would impede the ownership succession of family businesses was enough to cause the family members to unite against the perceived common enemy— the Internal Revenue Service. However

with the rapid increase in the exemptions in the estate and generation-skipping transfer taxes, the need to "unite" against the common enemy has diminished.

The rapid increase in the exemptions from estate and generation-skipping transfer taxation as well as the introduction of portability have reduced or eliminated completely the fear that the lack of planning will cause family controlled businesses to fail to transition between generations. In 2016, only .2% of decedents' estates pay any federal estate tax.

On April 16, 2015 the House of Representatives passed the Death Tax Repeal Act of 2015. The bill would repeal estate and generation-skipping transfer taxes for estates of decedents dying or for transfers made on or after the date of enactment. The gift tax would be capped at 35% with a lifetime exemption of $5,000,000 adjusted for inflation.

In 2017, the House Ways and Means Committee "Blueprint" states:

"This Blueprint will repeal the estate and generation-skipping transfer taxes. This will eliminate the Death Tax, which can result in double, and potentially even triple, taxation on small businesses and family farms."

What about gift taxes and basis adjustment under IRC §1014?

What are estate planning practitioners nationwide doing in light of the uncertain future of federal transfer taxation?

Intra-family business disputes can destroy even the wealthiest families and businesses.

See *Brawl in the Family,* Cleveland Scene Magazine, January 20, 2000 for an account of the T.W. Grogan Company.

Kathryn Mennen et al. v. Wilmington Trust Company et al., Delaware Court of Chancery

The Pritzker Family. See *The Wall Street Journal, November 26, 2013*

and Lawyers get Sued As Well!

Which Biglaw Firm Just Got Hit With A $200 Million Malpractice Verdict? *Above the Law, November 17, 2015*

III. Documenting the Business Succession Plan

The business succession plan has three sub-plans:

- Financial Succession Plan – the manner in which stock or other financial interests are transferred inside or outside the family.
- Organizational Succession Plan – Who will assume the role of CEO, of President, of Treasurer? At which times –death, disability, retirement? Who will serve on the Board of Directors?
- Operational Succession Plan – will the successors be trained in operating the business? By whom? Over what periods of time?

In family business succession planning, there are three elements in this discussion, with the acronym "ICE"

- I Income. What are the current and future sources of income for the business owner and spouse? Is cash being drawn out of the business in the form of salary? If the business owner were to die or become disabled, could a spouse draw cash out of the business? How will the non-active family members receive income from the business? In the form of dividends such as received from preferred stock? In the form of S Corporation distributions? In the form of real estate owned by a family limited partnership? Only when a business owner, spouse and family members are assured a steady stream of income will the discussion about succession continue. Income can be assured through contractual arrangements such as employment agreements, bonuses, deferred compensation, consulting and director's fees, in addition to stock appreciation rights.

- C Control. Who will control the day-to-day operations of the business? Control can be affected through stock ownership such as voting and non-voting common shares or preferred shares. Contractual arrangements can set forth the control of the business through articles of incorporation, the code of regulations, by-laws, voting trusts, close corporation agreements and buy/sell agreements.

- E Equity Ownership. Who will have and benefit from the equity ownership of the business? When, if ever, will the value of the ownership be realized?

The business succession plan and the elements of the plan are generally embodied in five documents, these being:

1. Buy-Sell Agreements
2. A Written Succession Plan
3. Employment Agreements

4. Estate Plans for the Key Executives (both family and non-family)
5. Corporate Governance documents, such as

    - Close Corporation Agreement
    - Partnership Agreement
    - LLC Operating Agreement

See *Terms to Consider When Drafting Corporate Buy-Sell Agreements*, James Dickinson, *Estate Planning* Magazine, September, 2010

Does a Trustee have the authority to enter into such agreements? Can the Trustee be bound by such agreements if they are adverse to the interests of the beneficiaries?

IV. Use of Trusts to Hold Family Business Interests.

What goals can a trust arrangement achieve for the current owners and managers of a family business? Trusts have historically been used to separate the legal ownership of assets from the equitable interests associated with ownership of the assets for the benefit of the trust's beneficiaries. Control of the asset has been divorced from the economic benefit of owning the asset.

a. Consolidation of Ownership

    i. Voting Control. During the term of the trust the voting control of the business interests will be determined by the terms of the trust agreement. Voting control can also be affected by the capitalization of the entity's interests (common vs. preferred interests, voting vs. non-voting interests), the organizational documents (e. g., codes of regulation, operating agreements, partnership agreements). Control can all be can also be affected by contractual arrangements such as buy-sell and close corporation agreements. The trust instrument can direct by whom the authority to vote the business interests will be given by specifically naming the entities or by describing those entities by the percentage owned and held in trust.

    ii. Continuity of Management. The instructions contained in the trust document can direct the trustee in its duties when certain named managers are guiding the company.

b. Timing of Distributions. The trust instrument can also determine when the legal and equitable interests will be merged by dictating when, if ever, the interests will be distributed to the beneficiaries.

c. Protect the Interests of Non-Active Family Members. The trust agreement can instruct the trustee to take steps to protect trust beneficiaries who are not active in the management of the business interests from the mismanagement of those who are.

d. Creditor Protection. Spendthrift provisions and other restrictions on the ability of the creditors of beneficiaries from attaching the beneficial interests are often the most important reasons for holding the business interests in trust.

   i. Domestic Asset Protection Trusts (DAPTs),e.g., Ohio Legacy Trusts

   ii. Off-Shore Asset Protection Trusts

   iii. Trusts Created by Third Parties, e.g., parents

e. Training Next Generation. Trust agreements can be designed to provide an "endowment" fund for the training of successor generations of owners in the successful operation of the family business.

   i. ROTE Trust

   ii. Family Educational Advancement Trust

f. Choice of Law. Every jurisdiction has different rules concerning the scope, availability and applicability of the methods for altering the trust arrangement, the tax consequences of holding the assets in trust as well as the availability of forums for the resolution of disputes.

g. *In Terrorem* Clauses. *In terrorem* clauses express the settlor's wishes that the validity of the trust arrangement not be challenged by any beneficiaries. Such clauses can also be used to limit a beneficiary's ability to challenge the conduct of the trustee. Only Indiana and Florida expressly prohibit the enforcement of *in terrorem* clauses by statute.

h. Arbitration. Five states have expressly allowed the use of mandatory arbitration clauses in probate and trust disputes by statute or case law. Trust litigants are forced to seek remedies by arbitration rather than judicial review. Only the District of Columbia expressly prohibits the use of mandatory arbitration clauses in testamentary documents.

i. Tax Avoidance and Minimization. It is often the primary purpose of trust arrangements to reduce estate and generation-skipping taxes by limiting the rights

of beneficiaries. The burden of income taxation can also be affected by the terms of the trust agreement.

A. Grantor Retained Annuity Trust.

Under Section 2702, a grantor retained trust can take the form of either an annuity or a unitrust. Because of the low interest environment, most grantor retained trusts are in the form of a grantor retained annuity trust ("GRAT"). A GRAT can be an extremely attractive means of transferring to younger generations of family members, at little or no gift tax cost, interests in an asset that it is anticipated will appreciate substantially and rapidly. An asset which is anticipated to be sold at a significant gain within the next several years is also an ideal candidate for being contributed to a GRAT.

A GRAT is an irrevocable trust pursuant to which the creator of the trust transfers property to the trust but on the condition that the trust will pay the creator an annuity for a term of years. Upon the termination of the term of years, the remaining assets pass to designated remaindermen (usually children, with the assets being kept in the trust until the children reach specified ages). The annuity reserved by the creator is substantial, in order to minimize the size of the gift being made currently. The annuity can be paid by transferring back to the creator some of the assets he transferred to the trust. If the assets held in the GRAT appreciate at a rate greater than the applicable federal rate (which for April, 2017 is 2.6%) then the excess transfers gift tax-free to the remaindermen.

If the business interest were sold during the term of the GRAT, then all of the excess appreciation could be transferred to the children in a tax efficient manner. As the GRAT is a grantor trust for income tax purposes, the business owner would be responsible for the payment of any capital gains tax on the sale of the assets held in the GRAT, thus increasing the value passing to his heirs.

If the business interest is not sold during the annuity term, then the business interest would be returned to the business owner. A business owner would have paid little, if any, gift taxes or used little, if any, of his applicable lifetime exclusion in making the initial transfer. A business owner could then recontribute the interests to another two-year GRAT and continue the process until the business interest is eventually sold. To harmonize this estate planning technique with asset protection measures, an asset protection trust (such as the Ohio Legacy Trust) could be the designated remainder beneficiary of the GRATs.

Walton case. In December, 2000, the Tax Court issued its decision in a case involving Audrey Walton, an heir to the Walmart stores fortune. A.J. Walton v. Commissioner, 115 T.C. 41 (2000)

Mrs. Walton created two identical, two year GRATs for her children. She funded these GRATs with substantial shares of Walmart stock and provided that she would

receive, under the terms of each GRAT, 49.35% of the initial trust value the first year and 59.22% of the trust value the following year.

The GRAT specified that if Mrs. Walton died during the trust term, the annuities would be paid to her estate. What remained in each trust at the end of the two year term would go to the daughter designated as beneficiary. Obviously, the intent was that the Walmart stock would appreciate substantially in value over the two year period, allowing the trust to pay Mrs. Walton the fixed percentage value, with the appreciation accruing to the benefit of her daughters. Unfortunately for the Waltons, the stock actually went in the wrong direction and there was no residuary value in the trust at the expiration of its term.

The IRS, however, disregarded this reality and taxed the creation of the GRAT as a taxable gift, citing example 5 of Treas. Reg. 25.2702-3(e). The IRS argued that the annuity was for the shorter of her life or two years and that the payment to her estate wouldn't qualify as an annuity. Therefore, if there was a possibility she might not live for the entire two year period, the GRATs themselves resulted in a substantial gift of a residuary interest to her daughters. The IRS assessed $3.8 million in federal gift taxes on the transfer and creation of the GRATs.

The Tax Court disagreed with the IRS's position, essentially stating that example 5 under the Regulations was an inappropriate application of the underlying law and reduced the value of the remainder interest in the GRATS to zero, no gift tax due.

This creates the ability to engage in so-called zeroed-out GRAT planning wherein an asset that should substantially appreciate in value may be transferred with essentially no gift tax, therefore, no reduction of the exemption equivalent, yet the GRAT results in the substantial transfer of value for estate and gift tax purposes.

The Obama Administration's Green Book would require a minimum term for a GRAT of 10 years. The language in the Green Book states:

"The proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created and would prohibit any decrease in the annuity during the GRAT term. Although a minimum term would not prevent "zeroing-out" the gift tax value of the remainder interest, it would increase the risk that the grantor fails to outlive the GRAT term and the resulting loss of any anticipated transfer tax benefit."

B. Sale to Intentionally Defective Grantor Trust ("IDGT")

A sale to a defective grantor trust is essentially an installment sale of an asset to an irrevocable trust created by the donor/seller. The donor/seller receives in return a promissory note with adequate interest so that the value of the note exactly equals the value of the asset being transferred. It is highly recommended that a qualified appraiser give an opinion with respect to the relative values of the promissory note and the value of the asset.

Because the purchaser, that is the trust, is intentionally made a "grantor trust" for income tax purposes, the sale of the stock will not be recognized for income tax purposes. Rev. Rul. 85-13, 1985-7 I.R.B. 28. Interest paid on the installment note will not be taxable to the seller either for it is as if the seller is paying interest to himself. When the note is retired, the trust can be terminated and the assets distributed to the beneficiaries of the trust. Note, however, that because the transfer is not tied to the seller's death or involved in a recognized sales transaction, there is no step up in basis in the hands of the transferees.

The donor/seller's cash flow is not changed during the payoff of the note. This is because the cash dividends or distributions from the corporation or other business entity received by the trust will be used to amortize the installment obligation. The seller is responsible for the payment of the income taxes on all of the income generated by assets held by the trust.

All post-transfer appreciation in the value of the stock is shifted to the beneficiaries of the trust. As the promissory note is paid off, the original value of the property is effectively removed from the donor/seller's estate. If the assets in the trust are not distributed when the promissory note is satisfied, other assets can be sold to the trust. Alternatively, the grantor trust status can be terminated and the trust can become a non-grantor trust.

Sales to defective grantor trusts work best with pass-through entities such as S corporations, partnerships and limited liability companies. There must be sufficient cash flow generated to amortize the debt. The donor/seller should have a likelihood of living out the term of the note.

Sales to defective grantor trusts should not be used when the donor/seller is in poor health or has achieved an advanced age. The assets held in the trust must produce sufficient cash flow to make the loan payments. The donor/seller must be prepared to face the risks of an IRS audit of this technique as it is aggressive as it applies very technical rules to achieve the solution.

If the donor/seller dies before the note is fully repaid, many commentators believe that there is an income tax cost to the decedent's estate. This requires review of alternatives to mitigate this risk.

Recent Tax Cases:

Estate of Trombetta v. C.I.R., T.C. Memo. 2013-234, 2013 WL 5708437 (U.S.Tax Ct.), 106 T.C.M. (CCH) 416, T.C.M. (RIA) 2013-234, 2013 RIA TC Memo 2013-234

Estate of Donald Woelbing v. Commissioner, Docket Number 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket Number 30260-13 (filed December 26, 2013).

Karen S. True v. Commissioner, Tax Court Docket No. 21896-16 and *H.A. True III v. Commissioner,* Tax Court Docket No. 21897-16 (petitions file October, 11, 2016).

In the Green Book, the Obama Administration proposed killing this technique as follows:

> "If a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust, then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner. The proposal would reduce the amount subject to transfer tax by any portion of that amount that was treated as a prior taxable gift by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.
>
> The proposal would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code, including without limitation the following: grantor retained income trusts; grantor retained annuity trusts; personal residence trusts; and qualified personal residence trusts. Similarly, it would not apply to any trust having the exclusive purpose of paying deferred compensation under a nonqualified deferred compensation plan if the assets of such trust are available to satisfy claims of general creditors of the grantor. It also would not apply to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor's spouse."

C. Incomplete Non-Grantor Trusts

Seek to avoid the state and local income taxes imposed by the domicile of the trust's creator.

At the 2017 ACTEC Annual Meeting, Howard Zaritsky reported as part of his Hot Topics presentation:

> **"IRS Continues to Approve INGs -- PLRs 201653001 – 201653009 (Dec. 30, 2016); 201650005 (Dec. 9, 2016); 201614006 – 201614008 (April 1, 2016); 201613007 (March 25, 2016); 201550005 – 201550012 (Dec. 11, 2015)**

Grantor created an irrevocable trust for the grantor's own benefit and that of certain other family members. During Grantor's lifetime, the trustee must distribute net income and principal to Grantor and the other beneficiaries as directed by the distribution committee and/or Grantor, as follows: (a) at any time, the trustee, pursuant to the direction of a majority of the distribution committee, with Grantor's written consent, must distribute to Grantor or the beneficiaries such net income or principal as directed by the distribution committee; (b) at any time, the trustee, as directed by all of the distribution committee members, other than Grantor, must distribute to Grantor or the beneficiaries such net income or principal as directed by the unanimous distribution committee; and (c) at any time, Grantor, in a nonfiduciary capacity, may distribute to any one or more of the beneficiaries such amounts of the principal (including the whole thereof) as Grantor deems advisable to provide for their health, maintenance, support, and education. The initial distribution committee is Grantor, her children (through guardians acting on until their majority), and her stepchildren. The distribution committee must always have at least two members other than Grantor.

The IRS stated that, as long as there is a distribution committee, the trust is not a grantor trust (absent application of Section 675, on which the IRS declined to rule), contributions of property to the trust are not a completed gift by Grantor, distributions of property by the distribution committee from the trust to Grantor will not be a completed gift by any member of the distribution committee, and distributions of property by the distribution committee from the trust to any beneficiary, other than Grantor, will not be a completed gift subject to federal gift tax, by any member of the distribution committee, other than Grantor. The IRS evaluated grantor trust status by considering the powers of the distribution committee under Section 674. It declined to rule about grantor trust status under Section 675, because the application of those rules depends upon the actual administration of the trust."

V. The Ethical Dilemmas of Representing the Family Business

Sources of the Ethical Rules –

The American Bar Association Model Rules of Professional Conduct (MRPC)

Ohio Rules of Professional Conduct (effective February 1, 2007; as amended effective April 1, 2015) with Comments

The American College of Trust and Estate Counsel (ACTEC) Commentaries on the MRPC

Various Internal Revenue Code provisions and Rules in Treasury Circular 230

The Restatement (3rd), Law Governing Lawyers

Who is the Client?

The Business Owner who creates the trust?

The Family Business?

A Potential Beneficiary, e.g., a spouse?

The Trustee?

A Third Party Advisor, e.g., a Trust Advisor?

Regardless of who is the client, the drafting attorney needs the approval and "buy-in" of all of these parties in order to prepare successfully the structure of the trust intended to own and operate family business interests.

VI. Defining the Duties and Responsibilities of Trustees.

The law in Ohio concerning the duties and responsibilities of trustees is generally contained in Chapters 5801 to 5811 of the Ohio Revised Code and is often referred to as the Ohio Trust Code (hereinafter referred to as the "OTC"). While the OTC became effective January 1, 2007, OTC section 5811.03 (A) (1) states that Chapters 5801 to 5811 of the Revised Code shall apply to all trusts created before, on, or after their effective date. OTC section 5801.05 states that the common law of trusts and principles of equity continue to apply in Ohio except to the extent modified by Chapters 5801 to 5811 or another section of the Revised Code.

a. Duties Upon Assumption of Trusteeship.

The OTC imposes duties and responsibilities on the trustee upon the assumption of a trusteeship. A trustee owes a duty to the beneficiaries of a trust to conduct due diligence in obtaining an understanding of the nature of the assets being held in the Trust as well as the needs and goals of the beneficiaries.

OTC §5809.04 describes the duties of a trustee at the inception of trusteeship. That section states:

"Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of trust assets in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and in order to comply with the requirements and standards of the Ohio Uniform Prudent Investor Act."

In his authoritative treatise, *Fiduciary Management of a Closely-Held Business*, Sheldon G. Gilman states that upon the assumption of a trusteeship, the trustee should engage in due diligence in understanding the closely-held businesses that will constitute the corpus of the trust. Mr. Gilman states:

"The fiduciary should prepare a list that identifies each person who has some kind of connection with the business, and then determine if any of these persons (organizations, fiduciaries, etc.), are either a beneficiary of any other trust or associated with the fiduciary who is responsible for administering the estate or trust which owns the business. If a conflict exists, the fiduciary must determine how such conflict is material, if it is material, whether it will prohibit the fiduciary from acting, and whether disclosure and consent of related parties is necessary in order to continue to serve as fiduciary.

The following parties in interest should be identified:

- all shareholders, their immediate family members, and any attributed ownership interests;
- all officers, including honorary, emeritus, or "of counsel" relationships;
- all members of the Board of Directors and advisory boards;
- all advisors including accounting and law firms and owners of these advisors;
- substantial customers of business that may be affected, positively or negatively, from the success or failure of the business; and
- substantial creditors, including the fiduciary, of the estate or trust and whether they may be affected, positively or negatively, from the failure of the business.

Gilman, Sheldon G., *Fiduciary Management of a Closely-Held Business*, section 4.3 (UK/CLE) (2007) (hereinafter cited as "Gilman").

At section 5.2, Gilman states:

The fiduciary should determine the nature of the decedent's interest in the business and the most immediate steps to protect the beneficiaries' interests. The fiduciary should have a meeting with all persons who will be responsible for the management of the decedent's business, review appropriate courses of action, including taking control of the business. Most importantly a prudent fiduciary would confirm such actions in writing.

A redacted version of the policy manual of an Ohio bank is attached as Exhibit A.

Under common law and prior statutory law, trusts and estates were generally limited or prohibited in continuing the operation of businesses. See Bogert & Bogert, Trusts and Trustees (2 Ed. Rev.1980) 303-304, section 573 ("The power to authorize continuance [of the business] applies to sole proprietorships, and to cases of partnerships * * *. It also applies to the continuance of a business through complete or majority stock control of a corporation * * *."). See, also, *In re Estate of Kurkowski,* 487 Pa. 295, 301, 409 A.2d 357 (1979).

Since 1981 O.R.C. 2113.30 specifically prohibited the executor of an estate from continuing to operate a business more than one month following the date of appointment without the approval of a probate court. The Supreme Court of Ohio applied this restriction to businesses operated in corporate form. *Sudnek v. Klein,* 84 Ohio St. 3d 1243, 705 N.E. 2d 359 (1999). O.R.C. §2113.30(B) now specifically excludes corporations from this restriction and applies it only to sole proprietorships.

b. On-Going Duties of the Trustee Holding Closely-held Business Interests.

Whenever a trustee intends to own and operate a closely-held business, including in corporate form, extraordinary measures must be undertaken to fulfill the fiduciary duties to the beneficiaries of the trust.

See the attached bank checklist that contains the requirements for the bank's ongoing administration of closely held stock at Exhibit B.

In *Huntington National Bank v. Wolfe & Huntington National Bank*, the fiduciary brought a declaratory action in probate court to seek determination of his authority to sell stock of a family corporation and distribute cash. The fiduciary acknowledged that he had a conflict of interest in sale of stock, but that he had selected an independent appraiser to determine the value of the stock, obtained approval of independent bank fiduciary, and advised beneficiaries of his intended actions and sought probate court approval. The appellate court dismissed the beneficiaries appeal from a decision in favor of fiduciary. *Huntington National Bank v. Wolfe & Huntington National Bank*, 99 Ohio App.3d 585, 651 N.E.2d 458 (10th Dist. 1994).

c. Failure to Diversify Assets of the Trust.

> Chapter 5808 of the OTC sets forth the duties of the trustee in the administration of a trust. OTC section 5809.03 states the trustee may invest in any kind of property or type of investment provided that the investment is consistent with the requirements and standards of the Ohio Uniform Prudent Investor Act. The section goes on to say that a trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. The limitations imposed on investment powers of all fiduciaries are limited by R. C. 2109.37 "except as otherwise provided by law, or by the instrument creating the trust,"

Even before the adoption of the Ohio Trust Code, Ohio courts held that a corporate trustee had mandatory duty to diversify trust assets, unless there were special circumstances that excused diversification, even though trust specifically permitted the corporate trustee to retain its own stock that was already in the trust when the corporate trustee was appointed; retention clause merely permitted the conflict of the trustee owning its own stock and plain language of trust did not permit trustee to ignore requirements for diversification. *Wood v. U.S. Bank, N.A.*, 160 Ohio App. 3d 831, 2005-Ohio-2341, 828 N.E. 2nd 1072 (1st Dist. 2005) citing R.C. §§1339.54(B), 1339.56.

The *Wood* court held that even if the trust document allows the trustee to "retain" assets that would not normally be suitable, the trustee's duty to diversify remains unless there are special circumstances. Of course, a trustee's duty to diversify may be expanded, restricted, eliminated, or otherwise altered by the terms of the trust. But this statement is true only if the instrument creating the trust clearly indicates an intention to abrogate the common-law, now statutory, duty to diversify.

Another Ohio appellant court considered the issues of diversification in *National City Bank v. Noble*. In this case the trust contained the following provisions:

> "The Trustees are empowered to retain as an investment, without liability for depreciation in value, any part or all of any securities...from time to time hereafter acquired by the Trustees as a gift, devise or bequest from the Grantor or any other person,...even though such property be of a kind not ordinarily deemed suitable for trust investment and even though its retention may result in a large part of all of the trust property's being invested in assets of the same character or securities of a single corporation.... Without limitation upon the generality of the foregoing, the Trustees are expressly empowered to retain as an investment, without liability for depreciation in value, any and all securities issued by The J.M. Smucker Company, however and whenever acquired, irrespective of the proportion of the trust properly invested therein....

The Trustees are empowered to invest and reinvest any part or all of the trust property...in such securities...as they may select, irrespective of any limitation prescribed by law or custom upon the investments of trustees and even though the trust property may be entirely invested in common stocks or other equities."

The court rejected a claim based upon a failure to diversify in an amount so that the Smucker holding did not exceed ten percent of the trust's value. The opinion states:

"The issue of diversification was recently addressed in *Wood v. U.S. Bank, N.A.*, 160 Ohio App. 3d 831, 828 N.E.2d 1072, 2005-Ohio-2341, where the first district held that "even if the trust document allows a trustee to 'retain' assets that would not normally be suitable, the trustee's duty to diversify remains unless there are special circumstances." The court went on to hold that this duty is true *only* if the instrument creating the trust "clearly indicates an intention to abrogate the common-law, now statutory, duty to diversify."".

The language contained in Welker Smucker's Trust Agreement is clear on its face that the trustees could retain investments without liability for depreciation. The trust went even one step further to insulate NCB as the corporate trustee, providing specifically that it had no duty to review or to make recommendations without the specific request of the individual trustee.

Unlike *Wood, supra*, where the majority of stock held in the trust was actually that of the trustee, there is no allegation that Welker Smucker's Trust contained an inordinate amount of NCB stock. While the trust certainly contained a large amount of stock in the family company, it is unquestionable that the value of the trust increased since its inception – providing both for the retention of Smucker stock and for the benefit of the beneficiaries.

Moreover, the trust was clear on its face that Dampeer [an individual trustee] retained almost unfettered discretion over the trust until his own death, providing that if the trustee exercises his discretion to retain the trust assets, he may do so...without liability for depreciation in value.... Based on this clear intent of Welker Smucker, the Smucker Defendants have failed to allege sufficient facts to support that both NCB and Dampeer's retention of the stock was done for their own pecuniary gain.

Nat'l City Bank v. Noble, 8th Dist. Cuyahoga No. 85696, 2005-Ohio-6484.

Restatement of the Law 3d, Trusts (1992), section 227(b) states, "In making and implementing investing decisions, the trustee has a duty to diversify the investments unless, under the circumstances, it is not prudent to do so." With regard to a trustee's duty regarding

original investments, the comments to the Restatement indicate that a broad generalization is not enough to relieve a trustee of its duty to diversify.

The powers and duties of a trustee are controlled by the terms of the trust instrument. To abrogate the duty to diversify trust assets, the trust must contain specific language authorizing or directing the trustee to retain in a specific investment a larger percentage of the trust assets than would normally be prudent. R.C. section 1339.54(B), 1339.56.

The leading case in Ohio continues to be *Stevens v. National City Bank* , 45 Ohio St.3d 276, 544 N.E.2d 612 (1989), in which the Ohio Supreme Court found that "a trustee, except as otherwise provided by the terms of the trust, is under a duty to the beneficiaries to distribute the risk of loss within the trust by prudent diversification, limiting the proportion of the total assets which are invested in any one stock or class of securities." This duty includes the disposal or sale of investments in the trust at the time of its creation which, although otherwise proper investments to retain, are improper because such are not properly diversified.

Among the many statutory duties imposed upon a trustee is the duty to "diversify the investments of a trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." R.C. 5809.03(B). Thus, a trustee is required "to distribute the risk of loss within the trust by prudent diversification, limiting the proportion of total trust assets which are invested in any one stock or class of securities." *Stevens v. Natl. City Bank*, 45 Ohio St.3d 276, 281, 544 N.E.2d 612 (1989). This duty includes the sale of investments " which, although otherwise proper investments for the trustee to retain, are improper because not properly diversified." *Id.* However, the duty to diversify "may be expanded, restricted, eliminated, or otherwise altered," even if the trust agreement does not make express reference to the statutory duty. R.C. 5809.01(C). *Rebecca Schauerte Puhl, et al., v. U.S. Bank, N.A.*, 2015-Ohio-2083, 34 N.E.3d 530 at 534 (12th Dist. 2015).

See, also, Matter of Littleton, 2014 N.Y. Misc. LEXIS 2586 (2014); *Matter of Strong,* 2013 N.Y. Misc. LEXIS 5447 (2013); *J. P. Morgan Chase Bank, et al. v. Loutit, et al.*, 2013 N.Y. Misc. LEXIS 452 (2013).

VII. Ability of Trustee to Delegate Duties and Responsibilities.

The Ohio Uniform Prudent Investor Act authorizes a trustee to delegate investment and management functions of a trust "that a prudent trustee having comparable skills could proper properly delegate under the circumstances." OTC §5809.06 (A). OTC §5808.07 requires a trustee to exercise reasonable care, skill and caution in the delegation of its responsibilities.

Gilman at §5.10 states "A fiduciary may not delegate certain acts and duties to another except where permitted by law or the instrument, and it is questionable whether such provisions would be effective for protecting the fiduciary."

Delaware also recognizes the "delegated trust". A delegated trust is a trust in which the trustee hires an agent to advise it concerning trust investments. Delaware Code Annotated Title 12, §3322.

VIII. Ohio Corporate Fiduciary Standards.

a. Directors.

In an article by Renée M. Gabbard in the March 2015 issue of *Estate Planning* magazine entitled "Fiduciary Factors for Drafting Trust With Closely Held Stock" the author stated at page 19:

"The fiduciary standards governing corporate fiduciaries also originate from multiple sources, including the operating agreement or bylaws, civil code provisions, corporate code provisions, tort and agency provisions and the development of case law. It is also important to distinguish whether the person acts as a board director, a majority shareholder or an officer. A typical fiduciary charge to a director would be, 'to perform the duties of a director, including duties as a member of any committee of the board on which the director may serve, in good faith, in a manner the director believes to be in the best interests of the corporation and its shareholders, and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.'"

O.R.C. §1701.59 sets forth the authority and duties of corporate directors, the standard of care required of them and the defenses available to them. Subsection (B) states:

(B) A director shall perform the director's duties as a director, including the duties as a member of any committee of the directors upon which the director may serve, in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances. A director serving on a committee of directors is acting as a director.

Subsection (F) sets forth to whom the director owes the obligations:

(F) For purposes of this section, a director, in determining what the director reasonably believes to be in the best interests of the corporation, shall consider the interests of the corporation's shareholders and, in the director's discretion, may consider any of the following:

(1) The interests of the corporation's employees, suppliers, creditors, and customers;

(2) The economy of the state and nation;

(3) Community and societal considerations;

(4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

b. **Officers.**

On February 24, 2016 the Ohio House of Representatives passed Senate Bill number 181. The Act adds sections 1701.641 and 1705.292 to the Ohio statutes.

Corporations.

Sec. 1701.641. (A) Unless the articles, the regulations, or a written agreement with an officer establishes additional fiduciary duties, the only fiduciary duties of an officer are the duties to the corporation set forth in division (B) of this section.

(B) An officer shall perform the officer's duties to the corporation in good faith, in a manner the officer reasonably believes to be in or not opposed to the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances. In performing an officer's duties, an officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, that are prepared or presented by any of the following:

(1) One or more directors, officers, or employees of the corporation who the officer reasonably believes are reliable and competent in the matters prepared or presented;

(2) Counsel, public accountants, or other persons as to matters that the officer reasonably believes are within the person's professional or expert competence.

(C) For purposes of this section, both of the following apply:

(1) In any action brought against an officer, the officer shall not be found to have violated the officer's duties under division (B) of this section unless it is proved by clear and convincing evidence that the officer has not acted in good faith, in a manner the officer reasonably believes to be in

or not opposed to the best interests of the corporation, or with the care that an ordinarily prudent person in a like position would use under similar circumstances.

(2) An officer shall not be considered to be acting in good faith if the officer has knowledge concerning the matter in question that would cause reliance on information, opinions, reports, or statements that are prepared or presented by any of the persons described in division (B)(1) or (2) of this section to be unwarranted.

(D) An officer shall be liable in damages for a violation of the officer's duties under division (B) of this section only if it is proved by clear and convincing evidence in a court of competent jurisdiction that the officer's action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation. This division does not apply if, and only to the extent that, at the time of an officer's act or omission that is the subject of the complaint, either of the following is true:

(1) The articles or the regulations of the corporation state by specific reference to division (D) of this section that the provisions of this division do not apply to the corporation.

(2) A written agreement between the officer and the corporation states by specific reference to division (D) of this section that the provisions of this division do not apply to the officer.

(E) Nothing in this section affects the duties of an officer who acts in any capacity other than the officer's capacity as an officer. Nothing in this section affects any contractual obligations of an officer to the corporation.

Limited Liability Companies

Sec. 1705.292. (A) Unless either a written operating agreement for the limited liability company or a written agreement with an officer establishes additional fiduciary duties or the duties of an officer have been modified, waived, or eliminated as contemplated by section 1705.081 of the Revised Code, the only fiduciary duties of an officer to the limited liability company or its members are the following:

(1) If the individual is a member of the limited liability company or serving as the representative of a member and the individual is not a manager of the limited liability company, then the individual owes the duties that would be owed by a member.

(2) If the individual is a member of the limited liability company or serving as the representative of a member and the individual is a manager of the limited liability company and in that capacity owes the duties that would be owed by a member, then the individual owes the duties that would be owed by a member.

(3) If divisions (A)(1) and (2) of this section do not apply, the individual owes to the limited liability company the duties of an officer set forth in division (B) of this section.

(B) An officer of a limited liability company shall perform the officer's duties in good faith, in a manner the officer reasonably believes to be in or not opposed to the best interests of the limited liability company, and with the care that an ordinarily prudent person in a like position would use under similar circumstances.

(C) For purposes of division (B) of this section, both of the following apply:

(1) An officer of a limited liability company shall not be found to have violated the officer's duties under this section unless it is proved by clear and convincing evidence in any action brought against the officer that the officer has not acted in good faith, in a manner the officer reasonably believes to be in or not opposed to the best interests of the limited liability company, or with the care that an ordinarily prudent person in a like position would use under similar circumstances.

(2) An officer shall not be considered to be acting in good faith if the officer has knowledge concerning the matter in question that would cause reliance on information, opinions, reports, or statements that are prepared or presented by any of the persons described in section 1705.30 of the Revised Code to be unwarranted.

(D) An officer shall be liable in damages for a violation of the officer's duties under division (B) of this section only if it is proved by clear and convincing evidence in a court of competent jurisdiction that the officer's action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the limited liability company or undertaken with reckless disregard for the best interests of the company. This division does not apply if, and only to the extent that, at the time of an officer's act or omission that is the subject of complaint, either of the following is true:

(1) The articles or the operating agreement of the limited liability company state by specific reference to division (D) of this section that the provisions of this division do not apply to the limited liability company.

> (2) A written agreement between the officer and the limited liability company states by specific reference to division (D) of this section that the provisions of this division do not apply to the officer.

(E) Nothing in this section affects the duties of an officer who acts in any capacity other than the officer's capacity as an officer. Nothing in this section affects any contractual obligations of an officer to the limited liability company.

c. Majority Shareholders.

"A similarly high fiduciary standard is placed on a majority shareholder. A majority shareholder's actions are 'subject to rigorous scrutiny, and when any of their contracts or engagements with the corporation is challenged the burden is on the dominant shareholder to prove not only the good faith of the transaction, but also the inherent fairness of the transaction from the viewpoint of the corporation and those interested in it.'" Gabbard at page 19.

The leading case in Ohio continues to be *Crosby v. Beam*, 47 Ohio St. 3d 105, 548 N.E.2d 218 (1989). The Ohio Supreme Court stated that where majority or controlling shareholders in a close corporation breach their heightened fiduciary duty to minority shareholders by utilizing their majority control of the corporation to their own advantage, without providing minority shareholders with an equal opportunity to benefit, such breach, absent any legitimate business purpose, is actionable. Crosby at page 221.

In his opinion Justice Douglas cited the United States Supreme Court in interpreting Ohio law in *United States v. Byrum* , 408 U.S. 125, 92 S.Ct. 2382, 33 L.Ed.2d 238 (1972) wherein the Supreme Court said that a majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. At footnote 11 the Court cited 13 Ohio Jur.2d, Corporations section 662, pp. 90-91 and stated:

> "Such a fiduciary relationship would exist in almost every, if not every, State. Ohio, from which this case arises, is no exception: "if the majority shareholders, either directly or indirectly, through the directors, to conduct, manage, or direct the corporation's affairs, they must do so in good faith and with an eye single to the best interests of the majority are not always identical with the interests of all the shareholders. The obligation of the majority or of the dominant group of shareholders acting for, or through, the corporation is fiduciary in nature. A court of equity will grant appropriate relief where the majority or dominant group of shareholders act in their own interest or in the interest of others so as to oppress the minority or commit fraud upon their rights."

The Court cited an Ohio case from 1914 for the proposition that an arbitrary disregard of the rights of stockholders to dividends or other improper treatment of the

assets of the company would be relieved against. *See Wilberding v. Miller,* 90 Ohio St. 28, 42, 106 N.E. 665, 669 (1914).

For an example of how another state's court have interpreted the trustee's duties for their entity level actions, see *Rollins v. Rollins, 329 Ga.App. 768 (Ga.App. 2014), 766 S.E.2d 162.*

IX. Directed Trusts.

A directed trust is a trust that removes one or more powers or discretions traditionally held by the trustee and vests that power or discretion in a person as either a special trustee or not a trustee at all. The power or discretion can relate to investment decisions, management decisions, distribution decisions or any other decision affecting the administration of the trust. In general a directed trust is often defined as a trust in which the trust instrument itself instructs the trustee to make investment decisions as directed by a person named in the trust instrument. This practice was codified in 1986 in Delaware in 65 DEL. Laws, C. 422, §5.

The Ohio Trust Code specifically allows "other persons" to direct the trustee and they will be considered a fiduciary except to the extent otherwise provided by the terms of the trust. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty. OTC §5808.08(D).

The Report on H. B. 416 states:

> "A significant difference between UTC § 808(b) and §5815.25 [referenced in §5808.08(B)] is that the UTC provision does not protect a trustee who follows directions if the act the trustee is directed to perform 'is manifestly contrary to the terms the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust.' Section 5815.25, like RC § 1339.43, includes no such limitation on the protection afforded a trustee who follows directions from one with the authority to direct."

OTC §5815.25 is attached as Exhibit C.

The early statutes only dealt with the power in a third-party to direct investment decisions. The statutes currently relieves a directed trustee from the duty to: (1) monitor the advisor's conduct; (2) provide advice to or consult with the advisor; and (3) warn the beneficiaries in instances in which the trustee would have exercised discretion differently. The Uniform Trust Code imposes a duty on the trustee to monitor the advisor's actions.

In its version of the Uniform Trust Code, Ohio expressly relieved the trustee from any liability for failing to monitor the advisor's directions.

Unless the governing instrument provides otherwise, the advisor is a fiduciary. The particular advisor language included in the trust instrument depends upon the purpose for which the trust is created and the reason why the advisor is appointed. There are innumerable reasons why settlors create directed trusts and it would be impossible to include all of the language used over the years creating trusts with trust advisors. The most frequently used terms are:

a. Trust Advisor -- a trust advisor is generally a third party whose responsibility is to advise the trustee with respect to discretionary distributions to the beneficiaries as well as with certain limited investment options.

b. Trust Protector -- a trust protector is generally a third party that holds powers a trustee does not possess such as the ability to remove the trustee, amend trust terms or change beneficiaries. Trust protectors are often given the power to terminate a trust and to order the distribution of its assets. Some trust protectors are given the authority to grant general powers of appointment to named beneficiaries.

c. Investment Advisor or Committee

d. Distribution Advisor or Committee

In 2013 the Court of Appeals of Missouri, Southern District, First Division discussed the liability of a trust protector for failing to replace an errant trustee as well as exercise other duties imposed upon him by the trust instrument. *Robert T. McLean Irrevocable Trust U/A/D March 31, 1999 v. Ponder*, 418 S.W. 3d 482 (Mo. App. S.D. 2013).

Consent Advisor or Directed Advisor? The terms of the trust instrument will require the trustee to either follow the express directions of the advisor or merely to seek the consent of the advisor before taking action. The document should clearly reflect the default if the trustee seeks the consent of the advisor and the advisor fails to respond. Is it still incumbent upon the trustee to make recommendations to an advisor when the document expressly mandates that the trustee follow the directions of the advisor?

Liability for Actions of a Cotrustee. OTC section 5807.03 discusses the liability of cotrustees. Subsection (E) states that a trustee may delegate to a co-trustee duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances. Subsection (G) provides that each trustee shall exercise reasonable care to prevent a cotrustee from committing a serious breach of trust and to compel a cotrustee to redress a serious breach of trust. A trustee is not required to exercise reasonable care of that

nature under this division and a trustee is not liable for resulting losses, when section 5815.25 of the Revised Code is applicable or there is more than one other trustee and the other trustees act by majority vote. Subsection (H) provides that a dissenting trustee who joins in an action at the direction of the majority of the trustees and who notified any cotrustee of the dissent at or before the time of the action is not liable for the action.

A recent case decided by the Delaware Court of Chancery illustrates the risks of being a cotrustee. *Mennen v. Wilmington Trust Company et al.*, Del. Ch. No. 8432-ML, 2015 WL 1897828.

X. <u>Ohio Family Trust Company.</u>

The Ohio Family Trust Company Act, contained in Chapter 1112 of the Ohio Revised Code, became effective on September 14, 2016. The Act defines a "Family Trust Company" as:

> (H) "Family trust company" means a corporation or limited liability company organized under the laws of this state that meets all of the following requirements:
>
> (1) It is organized to serve only family clients.
>
> (2) It is wholly owned by family clients and is exclusively controlled, either directly or indirectly, by one or more family members or family entities. For purposes of division (H)(2) of this section, "family entity" means any of the trusts, estates, or other entities described in division (F)(1) (e), (f), (g), (h), (i), or (k) of this section, except for key employees and their trusts.
>
> (3) It acts as a fiduciary.
>
> (4) It does not transact trust business with, propose to act as a fiduciary for, or accept trust business from, a person that is not a family client.

A "family member" is defined as:

(G)(1) "Family member" means all of the following, provided that the designated relative is not more than ten generations removed from the youngest generation of family members:

> (a) All lineal descendants, including adopted children, stepchildren, foster children, and individuals who were a minor when another family member became a legal guardian of the individual, of the designated relative;
>
> (b) Such lineal descendants' spouses or spousal equivalents.

A "family client" is defined as:

(F) (1) "Family client" means all of the following:

(a) Any family member;
(b) Any former family member;
(c) Any key employee;
(d) An y former key employee provided that, upon the end of the individual's employment by the family trust company, the individual does not receive investment advice from the family trust company, or invest additional assets with a family trust company-advised trust, foundation, or entity, other than with respect to assets advised directly or indirectly by the family trust company immediately prior to the end of the individual's employment. Nothing in division (F)(1)(d) of this section shall be considered to preclude a former key employee from being a family client if the employee received investment advice from the family trust company with respect to additional investments that the individual was contractually obligated to make, and that relate to a family trust company-advised investment existing, prior to the end of the individual's employment by the family trust company.
(e) Any nonprofit organization, charitable foundation, charitable trust, including a charitable lead trust and charitable remainder trust whose only current beneficiaries are other family clients and charitable or nonprofit organizations, or other charitable organization, so long as all of the contributions to the organization, foundation, or trust came exclusively from one or more other family clients;
(f) Any estate of a family member, former family member, key employee, or former key employee;
(g) Any irrevocable trust in which one or more other family clients are the only current beneficiaries;
(h) Any irrevocable trust funded exclusively by one or more other family clients in which other family clients and nonprofit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries;
(i) Any revocable trust of which one or more other family clients are the sole grantors;
(j) Any trust to which both of the following conditions apply:

(i) Each trustee or other person authorized to make decisions with respect to the trust is a key employee.

(ii) Each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current

or former spouse or spousal equivalent who, at the time of the contribution, holds a joint, community property, or other similar shared ownership interest with the key employee.

(k) Any business entity wholly owned, either directly or indirectly, exclusively by and operated for the sole benefit of one or more other family clients.

Section 1112.04 defines the powers of a family trust company, these being:

(A) A family trust company may do any of the following for the benefit of family clients only:

(1) Act as a fiduciary, including as a personal representative, within and outside this state;

(2) Act within and outside this state as advisory agent, agent, assignee, assignee for the benefit of creditors, attorney in fact, authenticating agent, bailee, bond or indenture trustee, conservator, conversion agent, curator, custodian, escrow agent, exchange agent, fiscal or paying agent, financial adviser, investment adviser, investment manager, managing agent, purchase agent, receiver, registrar, safekeeping agent, subscription agent, transfer agent except for public business entities, warrant agent, or in any similar capacity generally performed by corporate trustees and, in so acting, possess, purchase, sell, invest, reinvest, safe keep, or otherwise manage or administer the real or personal property of other persons;

(3) Exercise the powers of a corporation or limited liability company organized under the laws of this state and any incidental powers to enable it to fully exercise any power authorized under this chapter.

(B) A family trust company shall not do any of the following:

(1) Except as otherwise provided in division (A)(10) of section 1112.05 of the Revised Code, receive money or its equivalent from any individual or entity for deposit, make loans of any nature to any individual or entity, or otherwise conduct a general banking business;

(2) Engage in trust business with, or advertise its services to, the public;

(3) Use "trust" or any direct derivative of that word as any part of its name, unless it is a licensed family trust company.

An Ohio Family Trust can either be licensed or unlicensed. If the Trust goes through the licensure process the potential beneficiaries and powers will be expanded but at the cost of greater reporting requirements and regulation by the Ohio Department of Financial Institutions.

Traditionally, families have chosen as their trustees: family members, advisors and commercial trustees with whom they've had relationships in the past. Family Trust Companies allow advisors and institutions to participate without the liability of them serving individually. The Trust Company can acquire D & O insurance as well as E & O insurance in order to protect the advisors.

XI. Administrative Fiduciary.

HB 479 enacted in 2013 created the Ohio Legacy Trust Act. A portion of that Act amended O.R.C. section 5815.25 in order to introduce the term "administrative fiduciary." The Act provided that if an instrument or other applicable written agreement describes, appoints or directs a fiduciary to handle only the administrative duties and responsibilities of a trust, that administrative fiduciary does not have any duties, responsibilities or liabilities to the trust beneficiaries or to other persons interested in a trust except for those administrative duties and responsibilities specifically described in the instrument or agreement.

Any administrative fiduciary is relieved from any obligation to perform investment reviews and make recommendations with respect to any investments to the extent the grantor, an advisory or investment committee, or one or more other persons have authority to direct acquisition, disposition or retention of any investment. These provisions do not apply to the extent that the instrument under which an administrative fiduciary acts contains provisions that are inconsistent with the statute.

XII. Protection through the Consents of the Beneficiaries.

OTC §5810.09 releases a trustee from liability to a beneficiary for breach of trust if the beneficiary or the beneficiary's representative consented to the conduct constituting the breach, released the trustee from liability for the breach or ratified the transaction constituting the breach unless the consent was induced by improper conduct.

XIII. Seeking Judicial Guidance.

A trustee can always seek a court's direction as to any matter involving the trust's administration, including a request for instructions and an action to declare rights. OTC §5802.01(C)

XIV. **Restricting Subsequent Trust Modifications and Challenges.**

If the settlor is our sole client, he may not wish to have any subsequent modifications to the interpretation or the terms of the trust. OTC §5801.04 (B) states that the terms of a trust prevail over any provision of Chapters 5801 to 5811 except for enumerated provisions.

These restrictions imposed by the settlor can take the following forms:

a. Use of *in terorem* clauses either relating to the initial validity of the trust instrument or to the subsequent administration of the trust or both.

b. Mandatory mediation or arbitration clauses

c. Restricting changes in the choice of law and situs of the trust

d. Opting out of—

    a. decanting (§5808.18)

    b. directed trusts

    c. trust protectors and advisors

    d. nonjudicial settlement agreements

e. limiting the authority of a trustee to delegate

XV. **Tax Provisions.**

a. Income Taxation.

    i. Grantor vs. Nongrantor Status

b. Nongrantor Trusts

    i. Simple Trusts

IRC §651 basically provides that in the case of any trust the terms of which provide that all of its income is required to be distributed currently, and do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in section 642(c) (relating to deduction for charitable, etc., purposes), there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently.

ii. Complex Trusts

IRC §661 basically provides that in any taxable year there shall be allowed as a deduction in computing the taxable income of a trust (other than a trust to which subpart B applies), the sum of any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year) and any other amounts properly paid or credited or required to be distributed for such taxable year, but such deduction shall not exceed the distributable net income of the estate or trust.

c. Grantor Trusts

i. Settlor as grantor

IRC §§671 to 677 set forth when there shall be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under Chapter 1 in computing taxable income or credits against the tax of an individual.

ii. Third Party as grantor

IRC §678 states that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (i) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (ii) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject the grantor of a trust to treatment as the owner thereof.

iii. S Corporation Stock

The Internal Revenue Code permits five kinds of trusts to own S corporation stock, these being:

- Voting trusts (§1361(c)(2)(A)(iv))
- Grantor trusts (§1361(c)(2)(A)(i))
- Testamentary trusts (§1361(c)(2)(A)(ii) and (iii))
- Qualified subchapter S trusts (§1361(d))

- Electing small business trusts (§1361(e))

iv. Section 1411

For taxable years beginning after December 31, 2012, net investment income in excess of certain thresholds is subject to a 3.8% tax. IRC section 1411(a)(2) imposes a 3.8% tax on certain trusts. The tax is imposed on the lesser of—

(A) the undistributed net investment income for such taxable year, or

(B) the excess (if any) of—

(i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over

(ii) the dollar amount at which the highest tax bracket in section 1 (iii) begins for such taxable year.

v. State Income Taxes

The Ohio income tax is imposed on the trust's modified Ohio taxable income. Amended Substitute House Bill 66, 126th General Assembly, made permanent Ohio's income tax on all trusts that meet one of the following requirements:

• The trust earns or receives Ohio source income (income apportioned to Ohio or allocated to Ohio); or

• The trust otherwise has nexus with or in Ohio under the Constitution of the United States.

SLIP OPINION NO. 2016-OHIO-8412
GIDDENS ET AL., APPELLANTS, *v.* TESTA, TAX COMMR., APPELLEE.
[Until this opinion appears in the Ohio Official Reports advance sheets, it may be cited as *Giddens v. Testa*, Slip Opinion No. 2016-Ohio-8412.]

Taxation—Treatment of distribution of C corporation earnings generated before S corporation pass-through selection—Tax commissioner's denial of nonresident tax credit reversed.

(No. 2014-2012—Submitted August 16, 2016—Decided December 28, 2016.)

The following types of trusts are excluded from filing Ohio form IT 1041 as per R.C. section 5747.02(E):

- Grantor trusts
- Charitable remainder trusts
- Retirement trusts

vi. Basis Adjustments

IRC §1014 provides that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death. The following shall be considered to have been acquired from or to have passed from the decedent:

- Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;
- Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;
- Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust; and
- Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will.

b. Estate Taxation

i. Inclusion

The gross estate includes all property in which the decedent had an interest at the time of his death. IRC §2031. When a decedent retains some control over gifts of property made during his or her lifetime the property

may be added back to the gross estate. Transfers that are subject to this rule include:

- gifts in which the decedent retains a life estate, or the right to the income, possession, or enjoyment of the property or the right to name who will enjoy the property. IRC §2036;
- gifts in which the decedent retains a right to a reversionary interest that exceeds 5% of the value of the property that has been transferred. IRC 2037(a); and
- gifts in which the decedent holds a power to alter, amend, revoke or terminate the gift. IRC §2038.

On March 17, 2016 the Tax Court, in a memorandum decision, opined on the applicability of IRC §2036. *Estate of Holliday v. Commissioner of Internal Revenue*, 031716 FEDTAX, 8143-13, T.C. Memo. 2016-51

ii. Liquidity with which to Pay Estate Tax liability

a. IRC §303

If a corporation makes a distribution of property in redemption of its stock that has been included in a deceased shareholder's gross estate, the transaction will qualify as an exchange if the amount of the distribution is not greater than the sum total of all federal estate taxes and funeral and administration expenses allowable as deductions. IRC §303(a). To qualify the transaction must satisfy the following conditions:

- The corporation must redeem the stock following the shareholder's death and generally within 3 years and 90 days after the estate tax return is due; and
- The value of the deceased shareholder's stock must exceed 35% of the gross estate, after deductions for allowable funeral and administration expenses and losses.

b. IRC §6166

If an estate includes a farm or closely held business with a value exceeding 35% of the adjusted gross estate, the executor may elect to pay the estate tax in as many as 10 annual installments,

following a deferral period of as long as 5 years. IRC §6166(a)(1). The amount of tax deferred is limited to the tax attributable to the business interest. A special rate of interest is available for a portion of tax deferred. IRC §6601(j).

iii. Eligibility for Marital Deduction

An unlimited estate tax marital deduction is available to the estate of an individual who is married at the time of his or her death. IRC § 2056(a). The marital deduction is allowed for the value of all property included in the gross estate that passes to the decedents surviving spouse in a manner that qualifies for the deduction. IRC §2056(a) and §2056(b).

EXHIBIT A

INVESTMENT MANAGEMENT GROUP

PERSONAL TRUST POLICY MANUAL

Policy No. 700.010

Section: CLOSELY-HELD ENTITIES
Subject: Structure, Organization & Definitions
Issued: 01/01/95
Revised: 02/21/2000

DEFINITION

Unless otherwise indicated in the policies in this section of the manual, a closely held entity is defined as one whose shares are thinly traded or not traded on any securities exchange. Closely held entities include corporations, limited partnerships, limited liability companies, and sole proprietorships.

POLICY

Administration

Closely held entities for which has investment responsibility according to the governing document (and any amendments) are administered by the Closely Held Asset Management Group.

Closely held entities for which has no investment responsibility according to specific language in the governing document (or any amendments) are the responsibility of the Wealth Advisor - Personal Trust. The legal document (and any amendments) determines ! s investment responsibility for the asset.

Board of Directors Representation and Compensation

An officer of ! may serve on the board of directors or governing body of a closely held entity held in a fiduciary account (or accounts) for which has investment responsibility only with the prior authorization of the Director, Closely Held Asset Management Group. Director's fees paid for serving on a board (and any similar fees) shall be credited to the accounts holding the closely held entity proportionate to the total holdings of the asset within the chartered entity. The director's fee shall be made payable to in its fiduciary capacity, rather than to the individual officer serving on the board.

An officer of I s should not serve on the board of a closely held entity for which has no investment responsibility.

Ownership of Closely Held Entities By Personnel

personnel are prohibited from acquiring a personal or financial interest in a closely-held entity that is an asset of a fiduciary account. This shall not be construed as a prohibition against representing a fiduciary capacity in accordance with policies herein.

General Partnerships, Proprietorships, Etc.

in its fiduciary capacity, should not generally serve as a general partner, proprietor, joint venture, or in any similar capacity which exposes to liability beyond the assets of the business or account relationship.

It is recognized that, in some situations such as estates, circumstances exist in which it may be necessary to accept such capacities for a limited period of time during which the capacity is converted to a form of

business limiting the liability of   and/or the account (i.e., corporation, limited partnership, limited liability corporation or similar entity). Where general partnerships have already been accepted they should be managed as if we own the asset directly. Where the general partnership consists of real estate or oil & gas interests we will look through the general partnership to determine if we can manage the underlying asset (i.e. a real estate general partnership will be managed by the Real Estate Management Group as if we owned the real estate directly.)

PROCESS/CONTROLS

The Closely Held Asset Management Group is responsible for the administration of closely held entities where   has investment responsibility, including:

1) Acceptance and purchases. **(Policy No. 700.020)**
2) Annual reviews and valuations **(Policy No. 700.030)**
3) Sales and distributions
4) Voting of shares in closely held entities **(Policy No. 100.090)**
5) Corporate actions (tender/purchase offers, etc.) **(Policy No. 1200.020)**

The Wealth Advisor - Personal Trust is responsible for the administration of closely held entities when   does not have investment responsibility, including:

1) Acceptance and purchases **(Policy No. 700.020)**
2) Annual reviews and valuations **(Policy No. 700.030)**

Compliance with this policy shall be examined at the time of the annual account review and prior to accepting any account in which a closely held entity will be held.

EXCEPTIONS

Assets which constitute a social membership interest and Farm Co-operative Stock **(see Policy No. 700.040)** shall not be subject to the provisions of this policy.

INVESTMENT MANAGEMENT GROUP

PERSONAL TRUST POLICY MANUAL

Policy No. 700.020

Section: CLOSELY-HELD ENTITIES
Subject: Acceptance
Issued: 01/01/95
Revised: 02/21/2000

POLICY

Closely held entities for which has investment responsibility

Assets representing interests in closely held entities (corporations, limited liability corporations, limited partnerships, etc.) where has investment responsibility per the governing document shall not be accepted or purchased without prior approval of a Closely Held Asset Manager.

Closely held entities for which does not have investment responsibility

Assets representing interests in closely held entities where ... does not have investment responsibility shall not be accepted or purchased without prior approval of the Account Acceptance and Opening Unit.

PROCESS/CONTROLS

Closely held entities for which has investment responsibility

The Closely Held Asset Manager shall be notified by the Account Acceptance and Opening Unit if an existing or potential account will hold a closely held asset. Upon notification, the Closely Held Asset Manager will contact the Wealth Advisor - Personal Trust or the Account Acceptance and Opening Unit for information about the asset. Results of the analysis will be communicated to the Account Acceptance and Opening Unit. The Closely Held Asset Manager will sign and date the Acceptance Review Form (**Form No. 300.011**) supplied by the Account Acceptance and Opening Unit.

Proposals to purchase a closely held entity for an existing account shall be handled in the same manner.

Closely held entities for which does not have investment responsibility

Where does not have investment responsibility, approval by the Closely Held Asset Management Group is not required for a proposed new account that holds a closely held entity or a new asset for an existing account. The Account Acceptance and Opening Unit shall confirm that does not have investment responsibility for the asset as part of the account acceptance process described **in Policy 300.010.**

EXCEPTIONS

Assets which constitute a social membership interest and Farm Co-operative Stock (**see Policy No. 700.040**) shall not be subject to the provisions of this policy.

Section	Subject	Issued: 1/1/95
CLOSELY-HELD ENTITIES	Voting of Shares in Closely-Held Entities	Revised:

POLICY

Where the Trust Unit votes the shares of closely-held entities, the vote shall be made in accordance with the provisions of the governing document and applicable guidelines and recommendations.

PROCESS/CONTROLS

The Trust Associate will forward any proxies received to the Closely-held Asset Review Specialist. The Specialist will return a written proxy recommendation to the Trust Associate. The Trust Associate will then forward the proxy vote record to the company or vote the shares at the shareholder's meeting.

The Closely-Held Asset Review Specialist and Trust Associate shall review compliance with this policy during the annual review and evaluation of the asset.

EXCEPTIONS

None.

EXHIBIT B

CLOSELY-HELD ENTITY ANNUAL REVIEW

ACCOUNT NAME:____

ACCOUNT NO.____________________ DATE COMPLETED:____________

INVESTMENT RESPONSIBILITY: ☐ Full ☐ Limited/Shared ☐ Directed Account

Describe if Limited/Shared:________________________________

ACCOUNT CAPACITY: ☐ Trustee ☐ Agent ☐ Custodian ☐ Guardian

☐ Executor/Administrator ☐ Co-Fiduciary:____________________(Name)

ASSET DESCRIPTION:____

NUMBER OF SHARES/UNITS:__________ UNIQUE ASSET NO.__________

1. Percentage of Closely-Held Entity owned by account:__________%
2. Percentage of account's market value that Closely-Held Entity represents:__________%
3. Percentage of Closely-Held Entity owned by all accounts in the Trust Unit:__________%
4. Does a market exist for sale of the Closely-Held Entity? ☐ Yes ☐ No ☐ Unknown
5. Form of Business:

   ☐ Sole Proprietorship
   ☐ Limited Liability Company
   ☐ Limited Partnership
   ☐ Closely-Held Corporation
   ☐ General Partnership/Joint Venture
   ☐ Other (please describe) __________

6. Have there been any changes in the limited or general partnership agreement or articles of incorporation since the last review? ☐ Yes ☐ No ☐ Uncertain

   If yes or uncertain, please explain:________________________________

   ____

7. Have there been any changes in the account's governing documents related to the Closely-Held Entity since the last review? ☐ Yes ☐ No ☐ Uncertain

   If yes or uncertain, please explain:________________________________

   ____

8. If a Corporation (any form):

   a. Has the corporation made all necessary filings with the state agency governing the corporation's charter and is the corporation in good standing?
      ☐ Yes ☐ No ☐ Uncertain

      If no or uncertain, please explain:________________________________

      ____

   b. Date of the last: Board of Directors Meeting:______________

      Shareholders Meeting:______________

9. **Describe the Business in which the entity is engaged:**__________________________

   Has this changed since the last review? ☐ Yes ☐ No

   Has there been any change in the products or services provided by the closely-held entity since the last review? ☐ Yes ☐ No

   If either of the above questions are answered Yes, please provide details:________________

10. **Is the closely-held entity currently subject to any actual or threatened litigation or the subject of an investigation, complaint, action, or other matter involving state or federal environmental laws?** ☐ Yes ☐ No ☐ Uncertain

    If yes or uncertain, please explain:____

11. **Has the closely-held entity obtained all necessary environmental permits, licenses, and approvals?** ☐ Yes ☐ No ☐ Not Applicable ☐ Unknown

    If no, please explain; if yes, please list: ____

12. **Since the last review, has the closely-held entity acquired or newly leased real property or an interest in real property?** ☐ Yes (___ Acquired ___ Leased) ☐ No

    If yes, please explain:____

    Have any environmental assessments, reviews, or reports been prepared in connection with the property? ☐ Yes ☐ No ☐ Unknown

    If yes, provide a brief description of them, including type and date, and attach copies:

13. **Parties contacted for completion of questionnaire:**

    Name:____ Affiliation:__________________________

    Name:____ Affiliation:__________________________

    Name:____ Affiliation:__________________________

<u>CERTIFICATIONS</u>

I hereby certify that, to the best of my knowledge and belief, the information contained in this questionnaire is true, accurate, and complete.

Dated:______________ **Signature:**____

Printed/Typed Name:______________________________________

Senior Trust Committee Review and Action:

☐ Asset reviewed and approved for continued retention

☐ Other Action:____

____

____

Date:______________ Chairman's Signature:____________________________

CLOSELY-HELD ENTITIES
ANNUAL REVIEW

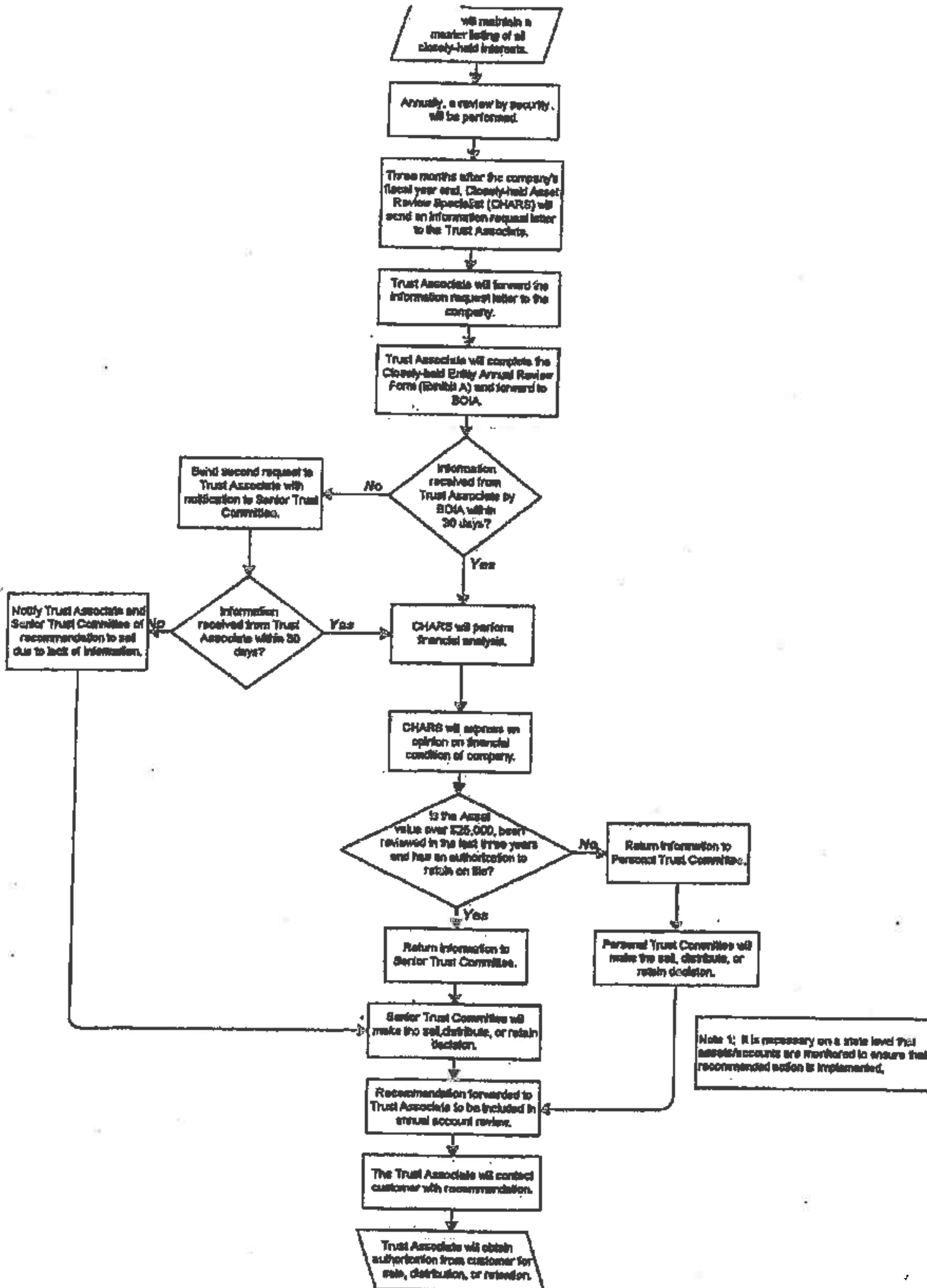

Exhibit C

5815.25 Administrative duties and responsibilities of trust; exclusion of fiduciaries.

(A) As used in this section, "fiduciary" means a trustee under any testamentary, inter vivos, or other trust, an executor or administrator, or any other person who is acting in a fiduciary capacity for any person, trust, or estate.

(B) If an instrument or other applicable written agreement describes, appoints, or directs a fiduciary to handle only the administrative duties and responsibilities of a trust, that administrative fiduciary shall not have any duties, responsibilities, or liabilities to the trust beneficiaries or to other persons interested in a trust except for those administrative duties and responsibilities specifically described in the instrument or written agreement. The administrative duties and responsibilities of a trust under this division may include any of the following:

(1) Opening and maintaining bank, brokerage, financial, or other custodial accounts to receive trust income or contributions and from which trust expenditures, bills, and distributions may be disbursed;

(2) Maintaining and handling trust records, reports, correspondence, or communications;

(3) Maintaining an office for trust business;

(4) Filing any trust tax returns;

(5) Employing agents in connection with the fiduciary's administrative duties;

(6) Taking custody of or storing trust property;

(7) Any other similar administrative duties for the trust.

(C) If an instrument under which a fiduciary acts reserves to the grantor, or vests in an advisory or investment committee or in one or more other persons, including one or more fiduciaries, to the exclusion of the fiduciary or of one or more of several fiduciaries, any power, including, but not limited to, the authority to direct the acquisition, disposition, or retention of any investment or the power to authorize any act that an excluded fiduciary may propose, any excluded fiduciary is not liable, either individually or as a fiduciary, for either of the following:

(1) Any loss that results from compliance with an authorized direction of the grantor, committee, person, or persons;

(2) Any loss that results from a failure to take any action proposed by an excluded fiduciary that requires a prior authorization of the grantor, committee, person, or persons if that excluded fiduciary timely sought but failed to obtain that authorization.

(D) Any administrative fiduciary as described in division (B) of this section or any excluded fiduciary as described in division (C) of this section is relieved from any obligation to perform investment reviews and make recommendations with respect to any investments to the extent the grantor, an advisory or investment committee, or one or more other persons have authority to direct the acquisition, disposition, or retention of any investment.

(E) This section does not apply to the extent that the instrument under which an administrative fiduciary as described in division (B) of this section or an excluded fiduciary as described in division (C) of this section contains provisions that are inconsistent with this section.