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Use of Special Purpose Trusts in Family Office Structures

Trusts have always played a critical role in the vast majority of family office structures. However, a particular type of trust known as a "special purpose trust" (SPT) or "noncharitable purpose trust" has become an increasingly popular choice for the modern family office. Unlike typical trusts that benefit specific "persons," SPTs may benefit a specific "purpose," such as ensuring that a family business operates in accordance with the family's values.

What Is a Special Purpose Trust?

SPTs are trusts created for lawful, non-charitable purposes, such as the ownership of a closely held business. Not all states permit the use of SPTs, and those that have adopted the use of SPTs by statute may limit their duration (e.g., for 21 years or, in the case of Connecticut, 90 years).

SPTs differ from traditional trusts, which require identifiable beneficiaries, and charitable trusts, which are created for exclusively charitable purposes. SPTs do not require identifiable beneficiaries or a charitable purpose; they exist solely to carry out the stated purpose of the trust. Unlike traditional trusts, in which the beneficiaries enforce the terms of the trust, and charitable trusts, in which the state's attorney general enforces the terms of the trust, SPTs name enforcers or protectors to oversee the trustee's actions and ensure that the trust's purpose is carried out.

In the context of a family office structure, SPTs are typically formed as "directed" trusts, which allows for the bifurcation of the fiduciary roles among different parties:

Trustee. The trustee owns the underlying trust property (e.g., an interest in a closely held business, such as a family office) and is responsible for the administration of the trust for its stated purpose. In a directed SPT that has distribution advisers and investment advisers, the trustee acts only as directed by those parties with respect to distributions and/or investments. For trusts created under Delaware law, the trustee is typically an institutional trustee with an office in Delaware.

Protector. The trust protector (sometimes called the trust enforcer) enforces the terms of the trust.

Investment Adviser. The investment adviser directs the trustee with respect to the trust's investments. This includes directing the trustee with respect to holding its interest in any closely held business.

Distribution Adviser. The distribution adviser directs the trustee with respect to distributions of trust property. For example, in the family office structure described below, the trust typically authorizes distributions of any surplus profits to eligible nonprofit beneficiaries, which can include organizations exempt from taxation under Section 501(c)(3) (charities) and Section 501(c)(4) (social welfare organizations) of the Internal Revenue Code. The distribution adviser directs the trustee with respect to the identity of the recipient organizations and the amounts to be distributed to such recipients.

Use of Special Purpose Trusts Within Family Office Structure

Generally, a family office cannot deduct its operating expenses unless it qualifies as a trade or business. While no particular fact is dispositive in determining whether a family office's operations rise to the level of conducting a trade or business, the Tax Court has signaled that there should be diversity of ownership among the family office and the investment vehicles that it manages. We have previously discussed family office tax benefits in our article, Tax-Structuring Considerations for the Modern Family Office. In situations where ownership of the investment vehicles is concentrated, forming an SPT to own the family office can help diversify ownership. Further, SPTs can help address issues related to succession, advance a family's philanthropic objectives, and help instill and preserve family values for future generations.

Key Considerations

Jurisdiction. Although a number of states permit the use of SPTs, Delaware is often the preferred jurisdiction due to its permissible duration of SPTs and well-developed directed and special purpose trust statutes.

Minimal Income Tax Ramifications. An SPT is a separate, taxable entity. Thus, it is important to monitor the amount of income received by the SPT, the expenses of the SPT, and the distributions to 501(c)(3) and 501(c)(4) organizations. A key difference between the two types of organizations is that SPT distributions to 501(c)(3) organizations may result in an income tax deduction while distributions to 501(c)(4) organizations likely will not. In the case of SPTs that benefit 501(c)(3) organizations, a private family foundation might be a suitable recipient of SPT distributions. However, an SPT must take care with respect to the amount distributed to 501(c)(3) versus 501(c)(4) organizations each year to avoid the SPT being treated as a charitable trust.

Loss of Control. The creator of the SPT, a family member or a family entity may serve as an investment adviser and direct the trustee with respect to the assets owned by the SPT. In some cases, a family member or family entity may also serve as a distribution adviser. However, in order for the SPT to accomplish its objectives, the creator of the SPT must abdicate control over the SPT property (e.g., a family office), and separate parties should serve as trustee, protector, and distribution adviser. In some cases, this relinquishment of control might not be palatable to the creator of the SPT.

Conclusion

SPTs have become increasingly prevalent in modern family office structures. While not without drawbacks, SPTs can play a useful role for some families and are at least worth considering, particularly for those families that are charitably inclined or concerned about long-term ownership of the family office.

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