

## Trusts, Fiduciary Duties, and the Family Enterprise

A trust is a legal relationship in which the legal title to property is severed from the equitable title. In the United States, trusts are a matter of state law, as opposed to federal law. There are three participants in every trust relationship: (1) a “grantor,” “settlor,” or “trustor” (hereinafter “settlor”), who establishes the trust and provides the property to be held in trust; (2) a “trustee,” who is charged by the settlor with the responsibility of managing the trust in accordance with the settlor’s instructions; and (3) a “beneficiary,” who receives the benefits from the property held in trust. Restatement (Third) of Trusts § 2 (2001). Legal title to

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the property is held by the trustee; equitable title is held by the beneficiary.

The trustee is charged with a series of express or implied fiduciary duties to the beneficiary. Restatement § 3. Under the common law, these duties are (1) to manage the trust in accordance with the instructions of the settlor; (2) to act always in good faith, which requires the trustee to put the best interests of the trust ahead of his own; (3) to act always with prudence, which requires the trustee to manage the trust property with the same degree of skill that a prudent person would exercise in his or her own affairs; and (4) to preserve and to protect the trust assets so as to be able to satisfy both present and future claims against the trust. Restatement § 170. A breach of any of these duties subjects the trustee to liability to restore the trust assets to what they would have been had there been no breach of duty.

For purposes of this discussion, the primary focus will be on the duty to act with prudence regarding the investment of trust assets. The requirement that the trustee manage the trust property with the same degree of skill that a prudent person would exercise in his or her own affairs is known as the “prudent investor rule.” The Restatement (Third) of Trusts provides the most recent formulation of this rule as interpreted by a majority

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# BVI VISTA Trusts and Preserving the Family Enterprise

By Robert Wiegand II and Christina Kouch



of the states, stating that the trustee has a “duty . . . to invest and [to] manage the funds of the trust as a prudent investor would,” exercising reasonable care, skill, and caution “in light of the purposes, terms, distribution requirements, and other circumstances of the trust,” and balancing risks and returns in a manner suited to these circumstances. Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992).

### **The Prudent Investor Rule vs. Retaining Control of the Family Enterprise: The Hershey Trust**

Many large family enterprises choose to use a trust as a vehicle for business succession. Business succession by way of familial succession can offer a number of potential benefits for a business. It can continue the original vision of the founder; it can also help the founder maintain a close interest in, and indirect influence on, the workings of the organization. Family businesses, however, typically carry a significantly greater degree of financial risk than well-diversified investment portfolios, and trustees sometimes feel obliged to sell shares in a non-income producing company or in a company whose business is deemed economically risky. The trustee’s duty to diversify may conflict with the settlor’s wishes to continue the operations of the company.

A case in point is the Hershey Trust Company, an independent trust company founded by chocolate industrialist Milton S. Hershey in 1905. The Hershey Trust Company is the trustee of three entities: (1) the nonprofit Milton Hershey School, (2) the nonprofit M.S. Hershey Foundation, and (3) the Milton Hershey School Trust. In turn, the Milton Hershey School Trust owns 100% of the Hershey Trust Company, 31% (representing a 77% voting interest) of the Hershey Company (subsequently re-named the Hershey Food Corporation), 100% of Hershey Entertainment and Resorts, and voting interests in other various investments.

In the case of the Hershey Trust, it was clearly the intent of Milton Hershey to keep control of the Hershey Company with the Hershey School

Trust and to provide a school, as well as employment and income, to the town and residents of Hershey, Pennsylvania. The trustees’ goal (and obligation) of diversification through sale of the company most likely would defy the settlor’s intent and frustrate the residents of the town of Hershey, the indirect beneficiaries of the trust. But how can a trust hold onto an unprofitable or economically risky business investment without violating the prudent investor rule?

In 2002, Hershey Trust Company CEO Michael Vowler sought to diversify the trust investments by causing the Milton Hershey School Trust to sell



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its 77% voting share of Hershey Food Corporation. The sale was blocked by the state Attorney General, and Vowler was ultimately replaced as CEO. *In re Milton Hershey School Trust*, 807 A.2d 324, 335 (Pa. Commw. Ct. 2002). The issue of whether the trustees ignored the prudent investor rule was never addressed.

### **The British Virgin Islands Special Trusts Act (VISTA)**

The British Virgin Islands Special Trusts Act, enacted in 2003 (VISTA 2003), enables the creation of a special type of trust, known as a VISTA trust, that can be used to circumvent the conflicts between the settlor’s desires and the trustee’s duties.

The primary purpose of the VISTA

trust, as defined in the legislation, “is to enable a trust of company shares to be established under which (i) the shares may be retained indefinitely (subject to the BVI 99-year Rule Against Perpetuities) and (ii) the management of the company may be carried out by its directors without any power of intervention being exercised by the trustee.” VISTA trusts are a carefully targeted response to what are characterized as the unintended and inappropriate consequences of the trustee’s duty of prudent investment. See Christopher McKenzie & John Glasson, *VISTA Trusts*, available at [www.bvibarassociation.com/articles/BVI-VistaTrusts.pdf](http://www.bvibarassociation.com/articles/BVI-VistaTrusts.pdf).

This legislation is aimed at avoiding risks, removing power from the trustee, and giving authority to the directors of the company. The act enables trustees to retain shares in BVI companies irrespective of the financial benefits of holding the shares. The legislation allows the complete removal of the trustee’s monitoring and intervention obligations (unless the settlor requires otherwise), allows the settlor to direct the trustee to intervene to resolve specific problems, and allows trust instruments to set rules for the directors’ appointment and removal. In addition, many of the negative aspects associated with the prudent investor rule (such as increased administration costs, the trustee’s liability and exposure to claims, and strict limits on director control) are removed. Especially for closely held and family businesses, the elimination or modification of these rules will improve the chances that the settlor’s wishes will be followed. VISTA 2003 enables special trusts to be established to cater to a settlor’s intention for the company shares to be held for his children, rather than simply sold for a profit or to reduce risk, as in the Hershey case.

In addition to VISTA 2003, a new corporate statute for the BVI called the BVI Business Companies Act 2004 (BCA 2004) was enacted in 2005. This act will eventually replace the extremely popular and highly successful BVI International Business Companies Act, enacted decades previously. BCA 2004 contains a number of specific features that are designed to make the BVI more



attractive as an offshore financial center. These features include restricting the requirement of corporate benefit, abolishing financial assistance in relation to company shares, removing restrictions relating to a share capital of company shares when declaring dividends, increasing the number of types of entities that can be formed, improving the registration process of security interests, introducing statutory minority shareholder protections, and removing the requirement of having a stated corporate object, thereby obviating a number of difficulties relating to the rules of ultra vires and director's duties previously existing under BVI law.



The trust instrument can contain special provisions, known as the “office of director rules,” regarding how the directors are to be appointed, removed, and remunerated.

### General VISTA Trust Requirements

It is important to note that VISTA 2003 does not apply to BVI trusts generally. It does not apply to existing trusts, as existing trusts cannot be made into VISTA trusts; nor can a VISTA trust be created by the exercise of a power conferred by another trust. The trust must be originally established by the settlor with a provision in the trust instrument directing that VISTA 2003 is to apply. Section 4 of VISTA 2003 requires that, to be a VISTA trust, the trust must (1) be created by or under the terms of a written testamentary or inter vivos instrument, (2) name as sole trustee a designated trustee (defined

as a licensed trust company under the BVI Banks and Trust Companies Act 1990), (3) by its own terms require that any successor trustee be a designated trustee acting as sole trustee, and (4) state specifically that it applies to the shares of a BVI corporation (in which designated shares may be identified either specifically or generally).

Section 5 of VISTA 2003 briefly sets out the duties of the trustee for the designated shares. The principal duty of the trustee is to retain the shares. This duty has precedence over any duty to preserve or enhance the value of the trust fund. This section specifically exempts the trustee from liability for losses arising directly or indirectly from holding, rather than disposing of, designated shares.

The legislation does establish certain limited provisions for the protection of the beneficiary. The trust instrument can provide for circumstances in which interested persons (“enquirers”) can request the intervention of the trustee in the affairs of the company. The trust instrument can contain special provisions, known as the “office of director rules,” regarding how the directors are to be appointed, removed, and remunerated. These rules govern the tenure of office of a particular person, the appointment of a director at a future date or event, the removal of a director in specified circumstances, the number of directors holding office, and the appointment of a trustee acting on the direction of a committee or third party, which also can have fiduciary duties and powers.

VISTA 2003 provides only a limited number of grounds on which it is possible to complain about the lack of intervention by the trustee into the corporate management. Nevertheless, an interested person, or a director or possible future director, can apply to the court in the case of an alleged breach of the fiduciary duty.

VISTA 2003 also modifies the holding in an 1841 case that established a rule of equity to the effect that, if all of the beneficiaries of a trust are of adult age and under no disability, they can require the trustee to transfer the legal estate to them and thereby terminate

the trust. *Saunders v. Vautier*, 4 Beav. 115, 49 Eng. Rep. 282 (1841). Section 12 of VISTA 2003 provides that, notwithstanding any rule of equity or practice of the court to the contrary, but subject to subsection (2), neither a beneficiary who is solely interested in any designated shares, nor all the beneficiaries who together are the persons interested in any designated shares, can call for or direct a transfer of those shares or terminate or modify the trust if this right has been excluded by the trust instrument.

As noted above, the only persons authorized to act as designated trustees under VISTA 2003 are holders of a trust license under the BVI Banks and Trust Companies Act of 1990; those persons also are supervised by the Banking and Fiduciary Division of the Financial Services Commission. A list of the Authorized Registered Trustees of the BVI can be accessed via the BVI Financial Services Commission web site at [www.bvifsc.vg/RegulatedEntities/BankingandFiduciaryServices/ClassITrustLicencesRegisteredAgentStatus/tabid/236/Default.aspx](http://www.bvifsc.vg/RegulatedEntities/BankingandFiduciaryServices/ClassITrustLicencesRegisteredAgentStatus/tabid/236/Default.aspx). Another way to locate an appropriate trust company is to use a professional publication that advertises or lists trustees and fiduciaries in several offshore jurisdictions. One such publication is the *OFC Report* published by Campden Publishing Ltd., e-mail [campden@campden.com](mailto:campden@campden.com).

VISTA 2003 provides a legal regime for trusts of shares in private companies, and only shares of a BVI company can be held directly in a VISTA trust. VISTA trusts can hold shares of a single BVI corporation or any number of shares of any BVI corporations. Other assets, such as property, investments, or shares in non-BVI companies that the settlor wishes to include in the trust under the VISTA regime, must be owned by one or another of the BVI corporations subject to the regime.

VISTA 2003 requires the trustees to leave the management of the BVI corporation and any underlying companies to the BVI corporation directors, discharging the trustees from any liability should the shares under the VISTA regime lose value. In essence, the trustee's monitoring and

intervention obligations are removed, and it is disengaged from all management responsibility in the company. The trustee is thus relieved of its duty to enhance and preserve the trust assets for the beneficiaries.

There is a way, however, for a trust to be both a VISTA trust with limited powers and responsibilities for a VISTA asset (the BVI corporation) and, at the same time, a traditional trust with traditional duties and responsibilities for other assets. Instead of creating a trust that invokes VISTA 2003 at the outset, this Advanced Trust is a form of a convertible trust, in which the settlor has absolute discretion over whether to apply VISTA 2003 to trust assets. See Zac Lucas, *Advanced Trust Instrument Wealth Planning Guide*, available at [www.harneys.com/files/legal-guides/Advanced%20Trust%20Instrument%20-%20WPG.pdf](http://www.harneys.com/files/legal-guides/Advanced%20Trust%20Instrument%20-%20WPG.pdf). Thus, the settlor would be given the power to invoke VISTA for any or all of the shares of BVI companies in the trust at any time during the trust period. Under this Advanced Trust regime, dividends that might be paid by the VISTA regime assets and other assets contributed to the trust may be managed more traditionally by the trustee.

### Procedural Steps for a VISTA Trust

As traditionally envisioned, a corporation first will be set up in the BVI under the BCA 2004 to hold the assets to be included under the VISTA regime. Documents required to establish the corporation include the original certificate of incorporation, a memorandum of association, the articles of association, the minutes and resolutions dealing with the appointment of directors and the allocation of shares, the forms of share certificates, the register of directors, and the register of shareholders.

In the BVI, a corporation so established is a private corporation that is exempt from tax, is suitable for virtually any international business activity, has a flexible organizational structure, is not burdened by excessive reporting and record-keeping requirements, and maintains strict confidentiality provisions. The register of members

(shareholders), the register of directors, and all minutes and resolutions of the company are kept only at the offices of the registered agent. In addition, the only documents held on public record are the memorandum and the articles of association. The VISTA trust will normally be the only shareholder. The BVI corporation can also hold shares in companies registered in other countries.

Next, the settlor gifts the shares of the BVI corporation to the trustee to hold in the trust for the benefit of the beneficiaries. The trustee holds shares of the previously created BVI corporation, and that corporation, in turn, holds the assets intended to be covered by the VISTA regime. These shares will be held in "trust to retain" and the trustee's duty to retain the shares as an asset of the trust prevails over any duty to diversify or to enhance their value. A deed of trust is executed between the settlor and the trustee.

Finally, a letter of intent is drafted to outline the settlor's wishes in relation to the assets gifted into the trust. Normally this letter will be specific regarding the beneficiaries' entitlements both during and after the settlor's lifetime. It also should give clear guidance to the trustee on the settlor's wishes for the administration of the assets while in trust. VISTA 2003 also provides that the trust can include "office of director rules" specifying how the trustee must exercise its voting powers in relation to the appointment, removal, and remuneration of directors. The trustee is generally required to follow these rules.

A trust protector also can be appointed. The protector is a third party, independent from the settlor and trustee, who consents to certain acts of the trustee. Normally the trust deed specifies what the duties of the protector are, and these duties are confined to major transactions or issues that face the trust.

Under the Advanced Trust regime, referenced in the previous section, a trust would be established in two parts. One part would deal with an ordinary trust regime, and one part would deal with such specific assets as can be deeded by the settlor to fall under the VISTA regime. The assets so deeded

under VISTA 2003 can be qualified assets already held by the trust. A provision included in the trust document would give the settlor the power to invoke VISTA 2003 provisions by delivery of a VISTA declaration. To invoke VISTA 2003, the settlor would deliver a VISTA declaration deed to the trustee, which begins the tolling of the VISTA notice period wherein the trustee has the ability to resign and the settlor can replace the trustee with a designated trustee. Once a VISTA declaration deed is in force, the trust will be divided



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effectively into two separate trusts: one governed by VISTA 2003 and one governed by standard trust rules.

### Asset Protection

For the settlor, no specific asset protection is provided by the use of a VISTA trust. As with any self-settled trust, any asset protection depends on the terms of the VISTA trust and the circumstances under which it is established.

For the beneficiaries, there are two levels of asset protection. In the first place, the payment, *vel non*, of dividends from the BVI corporation that is the asset under the VISTA regime is completely within the control of the directors of that corporation. Neither the trustee nor the beneficiaries have any method by which to force such

payment of dividends. By the same token, the shares of the nondividend-paying corporation cannot be sold or otherwise converted into cash. In the second place, even if there were non-VISTA assets in the trust (which is possible only in an advanced VISTA regime), standard spendthrift language would prevent any creditor of a beneficiary from being able to attach the trust assets.

## Taxes and Filing Requirements

### British Virgin Islands

In the British Virgin Islands there are no capital gains taxes, capital transfer taxes, inheritance taxes, or sales taxes (VAT). There are property taxes and stamp duties on certain transactions. According to the BCA 2004, all dividends, interest, rents, royalties, compensations, and other amounts paid by a company, and capital gains realized on any shares, debt obligations, or other securities of a company are exempt from all provisions of the Income Tax Ordinance. In addition, no estate, inheritance, succession, or gift tax is payable on any shares, debt obligations, or other securities of a company. Finally, notwithstanding any provision of the Stamp Act, all instruments relating to transfers of property to or by a company, all instruments relating to transactions of shares, debt obligations, or other securities of a company, and all instruments relating to other transactions of the business of a company are exempt from the payment of stamp duty. Trust income is exempt from tax if the trust (1) is created by or on behalf of a nonresident person, (2) owns no land in the BVI, and (3) does not carry on business in the BVI.

### United States of America

**Income Tax Reporting.** Trusts must file a Form 1041, "U.S. Income Tax Return for Estates and Trusts," for each taxable year in which the trust either has at least \$600 in U.S. taxable income or has a U.S. situs and a nonresident alien as a beneficiary. A "grantor trust" as defined in IRC §§ 671-79, wherein the grantor/settlor also is the trustee, does not file a Form 1041, because the

grantor is required to report all income on the grantor's income tax return. When the trustee is a third party, a grantor trust does file a Form 1041 as an information return, along with a "grantor letter" identifying the specific items of income, deductions, and credits that the grantor should report on his or her income tax return. As a practical matter, however, if the trust has a foreign trustee and holds few or no U.S. assets, the filing of the Form 1041 infor-



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mational return is problematic.

Because their tax structures are so different, most offshore jurisdictions have little or nothing to report to the Internal Revenue Service (IRS), and there is the potential that huge amounts of offshore income, particularly for trust accounts, go unreported by U.S. persons (IRC § 7701(a)(30) defines a "United States person") who are settlors of such trusts, despite the fact that the income is fully subject to taxation. To address this issue, the U.S. Congress adopted IRC § 6048, and the IRS developed Form 3520, an informational return providing data on which the IRS can base conclusions regarding the actual taxable income of U.S. persons. IRC § 6048 and IRS Notice 97-43 require every U.S. person who creates or makes a transfer to a foreign trust to file Form 3520 for each event. The penalties for noncompliance with the

filing obligations are substantial. Under the IRC, the failure timely to file Form 3520 when required under IRC § 6048 subjects the responsible party to a penalty of up to 35% of the gross reportable amount. IRC § 6677.

Form 3520 must also be filed by every U.S. person who receives distributions from a foreign trust, regardless of who might have been the settlor of the trust. A distribution from a foreign trust includes any gratuitous transfer of money or property from a foreign trust, whether or not the trust is owned by another person and whether or not the transferee is a beneficiary. This reporting requirement is directed toward combating tax abuse and avoidance achieved through the use of foreign trusts in tax havens, but the reporting requirement applies with equal force to the receipt of distributions from any foreign trust. Furthermore, the fact that a U.S. person has reported such income on his or her income tax return does not obviate the penalty for failure to file the Form 3520.

The trustee of a foreign trust that either has a U.S. settlor or makes any gratuitous distribution to a U.S. person must provide information for, and sign and file, Form 3520-A each year. If the trust is established by a non-U.S. person and no distributions are made to any U.S. persons, the trustee has no responsibility to file Form 3520-A. The IRS plans to revise Form 3520-A to allow foreign trusts to use the form to satisfy their annual reporting requirements. Under Notice 97-34, until the revised Form 3520-A is available, the trustee is required to (1) file the unrevised Form 3520-A, (2) write "FOREIGN GRANTOR TRUST" at the top of the form, (3) complete the identifying information on the form as if the foreign trust were the U.S. settlor required to complete the form, (4) sign the form, (5) attach a Foreign Grantor Trust Information Sheet to the form, (6) send a Foreign Grantor Trust Owner statement to each U.S. settlor of the trust, and (7) send a copy of the Foreign Grantor Trust Beneficiary statement to each U.S. person who received a distribution from the trust during the tax year. Under IRC § 6048 and Notice 97-34, a U.S. person who is the



settlor of a foreign trust is responsible for ensuring that the trustee files IRS Form 3520-A. The U.S. settlor is subject to a penalty of 5% of the gross reportable amount in the event of noncompliance, as well as additional penalties for noncompliance. The filing deadline for Form 3520-A is March 15 for the calendar year preceding the filing date.

**Other Reporting.** A provision of the Bank Secrecy Act, 5 U.S.C. § 522a(e), 31 U.S.C. § 5314, 5 U.S.C. § 301, requires each U.S. person with a financial interest in, or signature or other authority over, any financial accounts (including bank, securities, or other types of financial accounts) in a foreign country to report that relationship each calendar year if the aggregate value of the accounts exceeds \$10,000 at any time during the year. Merely being the beneficiary of a VISTA trust (with no assets other than the BVI corporation) does not trigger the requirement; however, having signatory authority over bank accounts either of the BVI corporation or of a non-U.S. subsidiary of the BVI corporation when the aggregate value of all accounts exceeds \$10,000 during a calendar year would trigger the filing requirement.

Civil and criminal penalties, including, in certain circumstances, a fine of not more than \$500,000 and imprisonment of not more than five years, are provided for failure to file or for filing a false or fraudulent report. 31 U.S.C. § 5322(a) & (b); 18 U.S.C. § 1001. The Foreign Bank Account Report (F-BAR) is required to be made by filing Form TD F 90-22.1 with the U.S. Treasury on or before June 30 of the succeeding year. No extensions are permitted for late filing.

**Conclusions—U.S. Taxes.** Generally, no immediate income tax avoidance is available if the trust is a grantor trust under the IRC (U.S. grantor trust) or if gratuitous distributions are made to a U.S. person. On the other hand, even if the VISTA trust is a U.S. grantor trust, (1) unless and until the income is paid by the BVI corporation as a dividend to the VISTA trust, the U.S. grantor has no income to report, and (2) until the VISTA trust actually makes a distribution to a U.S. beneficiary, the

beneficiary has nothing to report.

In addition, no gift, estate, or generation-skipping tax avoidance is available, because the general rules of the IRC still apply to U.S. persons regardless of the fact that the trust is a foreign trust; however, the trust will be able to take advantage of the asset holding and limited control provided by the VISTA trust. In those cases in which a settlor wants to avoid the issues that arose in the Hershey case, the additional costs of the VISTA trust will be justified.

Furthermore, even if the trust is settled by a U.S. person, all of the planning opportunities of a regular so-called intentionally defective grantor trust (IDGT) are available to a VISTA trust, including the trust's establishment as a dynasty trust. This may be of particular interest if the settlor is more interested in creating opportunities for the individual beneficiaries to earn a living rather than allowing them to live as trust fund beneficiaries. It is even more useful if the intent is to benefit a particular locality, à la Hershey.

### Conclusion

Like Milton S. Hershey, many settlers choose to use trusts as vehicles for business succession. Traditionally, offshore trusts have not been so used. The principal reasons for this are twofold. On the one hand, most offshore trustees are not likely to accept the risk of oversight in a business in which they have little knowledge. On the other hand, most business owners are wary of giving active control of the company to a foreign third-party trustee and are wary of the level of oversight and the duties required of the trustee under the prudent investor rule.

VISTA 2003 has transformed this area of trust law so that the concerns of both the family enterprise and the trustees are met. VISTA 2003 gives business owners control by prohibiting the trustee from being appointed as a director of the company and permits "Office of Director Rules" specifying how the trustee must exercise its voting powers regarding the appointment, removal, and remuneration of directors. In addition, VISTA 2003 both discharges the trustee from any liability should the

VISTA shares lose value and removes the trustee's monitoring and intervention obligations. A trust containing these provisions could not be created with any degree of certainty in the United States, or in any other jurisdiction recognizing trusts, because of the fact that the prudent investor rule has been adopted in some form in every jurisdiction.

The VISTA trust is the only sure and certain option

- when there are factors more important to the settlor than maximizing profit or reducing investment risk (such as keeping a business in a particular location or providing employment opportunities rather than paying dividends),
- when the settlor wishes to remain in control of the underlying company without directly owning any shares,
- when the settlor wishes to keep the control of the underlying assets in the hands of his chosen successors, and out of the hands of all or some of his heirs,
- when a trustee's involvement in an underlying company's affairs (payment *vel non* of dividends, risk management, and so on) is undesirable, or
- when the underlying assets involve risk factors that might make its retention by a non-VISTA trustee questionable. ■

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