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Estate & Succession Planning Corner

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The Private Trust Company–The Trustee Solution for the 21st Century?

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The Twentieth Century demonstrated the resilience and relevance of trusts. The issues that trust and tax practitioners handled reflected the tenor of the times: trustee succession provisions responded to two world wars, facility of payment provisions responded to a desire for less court supervision, spendthrift provisions grew in importance as the litigiousness of our society increased and, at the end of the century, tax and cultural changes led to the revamping of how we viewed perpetuities periods—and the rule against perpetuities became no rule against perpetuities.

The technological changes that marked the last two decades have upended the traditional notions of trust *situs* and trust administration. In a world in which the geographic distances between and among grantors, trustees, beneficiaries and the *situs* of trust administration can span the globe, technology allows constant and immediate real time personal communication. As a consequence of our global reach, our desire for immediacy and the personalization of our affairs, the private trust company is a family planning tool relevant to increasing numbers of families. A private trust company is a trust company that is family owned and provides investment and fiduciary services, customarily provided by institutional trustees. By combining a high level of personal service and an intimate knowledge of a particular family, private trust companies provide a level of service, responsiveness and professionalism that combine the best attributes of individual and corporate fiduciaries. The fact that a private trust company is seen as an answer to the trustee succession issues faced by families whose trusts now span generations, and that such a structure is seen as a way to diminish intergenerational conflict

by having a neutral third party as trustee, only augment the appeal of a private trust company.

Recent private letter rulings highlight the tax issues inherent in considering and structuring a private trust company. While the private letter rulings are lengthy and fact-specific,[1] the three private letter rulings issued in June, November and December 2005, detail successful private trust company conversions. The first issue to address with a private trust company is the matter of control. In LTR 200523003,[2] the private trust company was structured with two classes of stock that were identical in all respects, other than voting, with all voting shares held by an irrevocable trust established by Patriarch. The governing instruments of the private trust company provided that no more than half of the number of directors serving at any time may be related, or subordinate, to Patriarch as such terms are defined under Code Sec. 672(c) and that the Patriarch may not serve as a director. Powers regarding discretionary distributions were to be exercised by a Distribution Committee appointed by the board of directors, with no member of the distribution committee allowed who was, (1) a grantor or donor, or the spouse of a grantor or donor, of any trust of which the Trust Company is trustee, (2) a current or contingent beneficiary, or spouse of such beneficiary, of any trust of which the trust company is trustee or (3) related or subordinate to any grantor, donor or current beneficiary.

In LTR 200546055,[3] the Patriarch and his children were deceased, and the trusts at issue were for the benefit of the descendants of one of the Patriarch's children. The trust company bylaws provided that all discretionary decisions were to be made by trusts officers of the private trust company who were not family members, subject to review by the senior trust officer and the Discretionary Decisions Review Committee, which was to be a committee appointed by the board of directors. The board, in turn, was required to have at least one member who was not a grantor, donor, current or contingent beneficiary of an affected trust. In light of the family's ability to control the private trust company, no officer or director, or spouse of such officer or director, that is a member of the family could participate in any discretionary decision, nor could any officer or director, or spouse of such officer or director, participate in a discretionary decision involving a trust of which such person or such person's spouse was a grantor, donor or a current or contingent beneficiary. The facts in LTR 200548035[4] reflected an ownership and discretionary decision structure, similar to that in LTR 200546055.

The rulings requested encompass both income and estate tax issues. On the income tax side, the issues relate to the application of the grantor trust rules and whether the trusts, of which the private trust company is trustee, will be treated as separate taxpayers. Accordingly, the primary issues raised are whether the trust company is a related or subordinate party under Code Sec. 672(c), and whether the trust company is an independent trustee under Code Sec. 674(c) (and the related issue of whether under Code Sec. 674(a) the powers of the trust company to control beneficial enjoyment cause the trusts to be treated as grantor trusts). Separate issues are raised under Code Secs. 675(4), 677 and 678, depending upon the structure of the board and the discretionary distribution committee.

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The estate tax rulings requested are ones that ask the IRS to rule that neither the appointment of the private trust company nor its exercise of its discretionary distribution authority will result in estate tax inclusion under Code Secs. 2036, 2038 or 2041.

Provisions that limit or preclude grantors, beneficiaries or members of their family from participating in discretionary distribution decisions allow the IRS to conclude that the private trust company is not a related or subordinate party under Code Sec. 672(c), is independent and that its exercise of powers to control beneficial enjoyment will not cause grantors/donors of such trusts to be treated as owners of any portion of the trusts under Code Sec. 674(a).

While acknowledging that, as described above, and in the letter rulings, neither the terms of the trusts for which rulings are requested, nor the bylaws of the private trust company are such that a grantor could exercise in a nonfiduciary capacity the powers of administration listed in Code Sec. 675(4), the IRS considers the determination of whether such powers may be exercised in a nonfiduciary capacity (and whether the trust would be taxed as a grantor trust if found to be the case) to be a factual determination to be resolved at the time of the examination of a filed return.

Under none of the trusts for which rulings were sought was the trustee authorized to make distributions

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to the grantor, grantor's spouse or in discharge of the grantor's legal obligations. Accordingly, the IRS concluded in LTR 200546055 that a "living grantor's ownership interest in Trust Company or membership on its board of directors or any of its committees will not give the grantor an interest or power that would cause that grantor to be treated as an owner of any portion of the trusts under Section 677."

Similarly, the fact that no family member could participate in any discretionary distribution decision with respect to any trust of which he or she was a beneficiary was critical to ruling that the grantor trust provisions of Code Sec. 678 did not apply.

In reviewing the estate tax inclusion issues under Code Secs. 2036, 2038 and 2041, and in determining that the facts did not demonstrate the dominion and control that would warrant estate tax inclusion under those sections of the Code, the critical fact was that neither the grantor nor the beneficiaries of a trust could directly participate in both the initial decisions of the private trust company and any review of such decisions regarding discretionary distributions.

On March 29, 2006, the AICPA issued a *Letter and Comments on Planned Guidance for Estate, Gift, GST Tax Provisions of Using Private Trust Companies as Trustee*. The AICPA letter urged the IRS to rule when providing guidance with respect to family-owned private trust companies as follows: (1) that estate inclusion will not result "as long as adequate safeguards are in place to prevent the grantor or beneficiary from participating in decisions that, acting as an individual trustee, would have caused the trust assets to be included in his or her estate"; (2) that a safe harbor should apply "as long as the private trust company's bylaws prohibit a grantor or current beneficiary from participating in any discretionary distributions with respect to any trust of which they are a grantor or beneficiary while serving on the distribution committee"; and (3) that family members should be able to participate fully in the ownership and management of the private trust company, as long as their authority with respect to discretionary distributions is limited in the manner described in (1) and (2).

The focus of the AICPA is on estate inclusion under Code Secs. 2036, 2038 and 2041; income tax issues seem not to be discussed. The goal of having safe harbors is a good one, especially in such a fact intensive area like this one, where not only do trust provisions vary, but also there is no uniformity with respect to governing state law.

Pending a safe harbor ruling, families will need to structure their private trust company in a manner that specifically considers the grantor trust income tax rules and the estate tax inclusion rules. In doing so, families appear to have great flexibility on issues of ownership and investment, but are far more restricted in how discretionary distribution decisions may be made.

Endnotes

[1] The volume of documents required to be reviewed by the IRS coupled with the highly factual nature of the rulings probably is one reason why the IRS has advised taxpayers that its current position is not to issue private letter rulings regarding private trust company conversions. *See* Rev. Proc. 2006-3, IRB 2006-1, 122.

[2] LTR 200523003 (March 8, 2005).

[3] LTR 200546055 (August 2, 2005).

[4] LTR 200548035 (August 2, 2005).