

Estate & Succession Planning Corner

By *Lawrence I. Richman*

A Safe Harbor for Private Trust Companies



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Trusts are amazing. During the past hundred years alone they have proven their ability to change and respond to changes in circumstances. Trustee succession provisions were enhanced by the demands of 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 tax and cultural changes led to the revamping of how we viewed perpetuities periods—and the rule against perpetuities became no rule against perpetuities.

Today's changes in technology have caused a major rethinking of the traditional notions of trust *situs* and trust administration and have enabled families to think about simultaneously institutionalizing and personalizing the trustee position by using private trust companies. An impediment to doing so had been the relevant absence of a safe harbor ruling from the IRS on the tax issues.¹

On July 11, 2008, however, the IRS issued Notice 2008-63² (the "Notice") outlining proposed guidance in situations where a family-owned private trust company serves as the Trustee of trusts of which a specific family are grantors and/or beneficiaries. The IRS defines a private trust company as a trust company owned by a family either outright or through trusts and/or other entities.

Overview

The Notice deals with (1) the estate tax treatment of the grantors under Code Secs. 2036 and 2038, which are Code sections involving retained possession or enjoyment and retained control over a trust and (2)



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the estate tax treatment of the beneficiaries under Code Sec. 2041, which is the Code section dealing with whether the power of a beneficiary over a trust is so great that the beneficiary is deemed to have a taxable general power of appointment. The Notice also addresses the generation-skipping transfer tax issue under Code Sec. 2601 of whether an otherwise exempt trust's status would be affected by adopting the private trust company structure. Furthermore, the Notice addresses whether a gift is complete under Code Secs. 2501 and 2511 when an irrevocable transfer in trust is made to a grantor owned private trust company as Trustee. Finally, the Notice considers the income tax treatment of irrevocable trusts administered by a private trust company and whether grantor trust treatment could apply to such trusts under Code Sec. 671, 673, 674, 675 or 678.

By providing taxpayers with a path on how to avoid undesired estate, gift, generation-skipping and income tax consequences, the Notice focuses on the formalities (statutory or otherwise), processes and procedures of the private trust company. The underlying philosophical orientation of the Notice is that the tax consequences resulting from "the use of a private trust company... [be] not more restrictive than the consequences that could have been achieved by a taxpayer directly," while at the same time not enabling taxpayers through the use of a private trust company "to achieve tax consequences ... that could not have been achieved had the taxpayer acted directly."

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The Formalities

The Provisions of the Trust Agreement

The characteristics of the trusts considered by the Notice are as follows: (1) they are irrevocable trusts, (2) the trusts were established by family members for the benefit of the next and, possibly, succeeding generations, (3) the trustees of the trusts have discretionary authority to distribute income and/or principal to the primary beneficiary of the trust, (4) the primary

beneficiary has a testamentary power to appoint trust corpus to or for the benefit of family members (other than themselves) and/or charity, (5) the grantor or the primary beneficiary (if the grantor is not living) may appoint a successor Trustee other than themselves if the current Trustee resigns or becomes incapacitated and (6) the trust contains a traditional lives in being plus twenty-one years perpetuities provision.

Provisions that Apply to the Private Trust Company

The Notice juxtaposes two types of Private Trust Companies: a private trust company formed under the laws of a state that has enacted a private trust company statute (a "Statutory Trust Company") and a private trust company formed in a state without a statute governing private trust companies ("Nonstatutory Trust Company").

The state statute under which the Statutory Trust Company is established has the following provisions: (1) it requires the creation of a Discretionary Distribution Committee that has the exclusive authority to make all decisions regarding discretionary distributions from each

trust for which it serves as trustee; (2) it prohibits any member of the Discretionary Distribution Committee from participating in the activities of the Discretionary Distribution Committee with respect to any trust of which that committee member or his/her spouse is a grantor or beneficiary or which has a beneficiary that the committee member or his/her spouse has a legal obligation to support; (3) it provides that only officers and managers (as opposed to owners) of the private trust company may participate in personnel matters; (4) it prohibits a Statutory Trust Company either by state law or by its governing documents from overriding a more restrictive provision in the trust agreement; and finally (5) it prohibits any family member from entering into any express or implied reciprocal agreement regarding discretionary distributions from any trust for which a private trust company is serving as Trustee.

The characteristics of the Nonstatutory Trust Company parallel those of the Statutory Trust Company except that the governing law provisions are embed-

ded in the governing instruments of the Nonstatutory Trust Company instead of being mandated by statute. In order to prevent the Nonstatutory Trust Company from being tainted by an amendment to its governing instruments, the Notice states that the governing documents of the Nonstatutory Trust Company require the creation of an Amendment Committee, a majority of whose members must always be individuals who are neither family members nor persons related or subordinate (as defined in Code Sec. 672(c)) to any owners of the private trust company and that the Amendment Committee by majority vote is to have the sole authority to make any changes to (1) the Nonstatutory Trust Company's governing documents regarding the creation, function or membership of the Discretionary Distribution Committee or of the Amendment Committee itself, (2) the provisions granting exclusive authority over personnel matters to officers and managers and (3) the prohibition of reciprocal agreements between family members.

Estate Tax Rulings

The Notice provides that with respect to estate tax inclusion under Code Sec. 2036(a) or 2038(a) neither the terms of the irrevocable trust nor the governance of the private trust company (if as described in the Notice) will alone result in trust assets being included in the estate of the grantor. This is because all discretionary distribution decisions are to be made by the Discretionary Distribution Committee and the restrictions on the grantor's participation in such matters (and the fact that the grantor cannot alter the make-up of the committee) prevent the application of these estate inclusion sections of the Code.

Similarly, the Notice concludes that neither the appointment nor the administration of the private trust company in the manner described will cause a beneficiary of the irrevocable trust to possess a taxable general power of appointment under Code Sec. 2041. Again, it is the existence and power of the Discretionary Distribution Committee coupled with the stated prohibition upon family members from entering into reciprocal arrangements that cause a beneficiary not to be deemed to have a taxable general power of appointment under Code Sec. 2041.

Gift Tax Ruling

When a grantor establishes a new irrevocable trust having terms identical to those described above,

naming a private trust company as the initial trustee neither causes the transfer to be deemed an incomplete gift under Code Sec. 2511 nor does it cause any distribution from the trust to be considered a gift by any Discretionary Distribution Committee member. This is because the grantor does not have the power to change the interests of the beneficiaries thereby making the gifts to the irrevocable trust completed gifts when made.

Generation-Skipping Transfer Tax Ruling

The Notice provides that under the generation-skipping transfer tax rules the appointment of a private trust company does not affect the exempt status of that trust if it is otherwise exempt or change its inclusion ratio, because the modification of an existing trust instrument caused by the administrative change to a new private trust company trustee does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person(s) who held the beneficial interest before the modification and because the appointment of the private trust company does not affect the perpetuities period of the trust.

Grantor Trust/Income Tax Rulings

The grantor trust rules cover a myriad of factual as well as legal circumstances. Regarding Code Sec. 673 concerning reversionary interests, Code Sec. 676 concerning the power to revoke, Code Sec. 677 income for the benefit of the grantor and Code Sec. 678 where a person other than the grantor is subject to income tax on account of a power of withdrawal, the Notice provides that grantor trust treatment does not apply under the irrevocable trust facts stated in the Notice.

The grantor trust rules under Code Sec. 674 regarding the power to control beneficial enjoyment and Code Sec. 675 regarding administrative powers are fact driven and under Code Sec. 674 can trigger application of the grantor trust rules, if the Trustee is deemed a related or subordinate party under Code Sec. 672(c). That section, in addition to defining certain family members as related, also considers as subordinate "any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control."

Because the Notice avoids outlining how the private trust company's ownership should be structured or who should own the private trust company (going so far as to say it may be 100-percent owned by a single grantor), the Notice explicitly states that "the ownership of voting stock of PTC [Private Trust Company] (even the sole ownership of all of that voting stock) should not be deemed to be 'significant' under Section 672(c) for this purpose." By effectively rewriting the language of Code Sec. 672(c) as it applies to the powers to control beneficial enjoyment under Code Sec. 674 the Notice is concluding that the power of the Discretionary Distribution Committee nullifies any power over distributions that could occur on account of the grantor's ownership and control of the private trust company.

The Notice, however, does not rewrite that portion of Code Sec. 672(c), which labels as a subordinate party "a subordinate employee of a corporation in which the grantor is an executive." The subordinate party language is relevant because Code Sec. 674(c) causes the taxation of the trust to the grantor unless the powers described therein are held by a trustee, none of whom is the grantor and no more than half of whom are related or subordinate to the grantor. Under the facts as posited in the Notice, it is possible that more than half the members of the Discretionary Distribution Committee may be nonadverse parties who are related or subordinate. "One must look at the members of the DDC [Discretionary Distribution Committee] who are authorized to act with regard to that particular trust (as if those DDC members individually were the trustees). This partial look-through is necessary to ensure that a grantor cannot achieve income tax results indirectly through a PTC trustee that could not be achieved with an individual trustee or trustees. A subordinate employee of a corporation in which the grantor is an executive will still be deemed to be subordinate to the grantor under Section 672(c)." Accordingly, the Notice holds that

whether any grantor is treated as the owner of a trust under Code Sec. 674 depends upon the powers of the trustee under the trust instrument and upon the composition of the Discretionary Distribution Committee. Specifically, if the grantor is an executive of the private trust company and more than half the members of the Discretionary Distribution Committee are subordinate employees of the private trust company, then depending upon the trust provisions grantor trust treatment could result.

The Notice provides no holding regarding Code Sec. 675 stating that the treatment of the grantor as the owner of the trust on account of the existence of certain administrative powers under the trust is a question of fact.

Conclusion

As it is a proposed revenue ruling, the IRS and Treasury Department request comments to the Notice by November 4, 2008. Specifically requested are comments on "whether additional guidance is necessary where trust assets include stock in a controlled corporation or life insurance and whether the creation of similar special committees for tax sensitive issues relating to such assets would be helpful." Implicit in the IRS's query is the approach and answer it appears to seek.

While the Notice is not yet a formal revenue ruling, it does provide taxpayers with sufficient detail to have comfort that if the government specified form for private trust companies as Trustees of irrevocable discretionary trusts is followed, certain tax results should occur. We may not have the safe harbor yet, but it's definitely in sight.

ENDNOTES

¹ See, e.g., LTR 200523003 (Mar. 8, 2005), LTR 200546055 (Aug. 2, 2005) and LTR 200548035 (Aug. 2, 2005).

² Notice 2008-63, IRB 2008-31, 261.

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