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PRIVATE TRUST COMPANY GUIDANCE: SUMMARY OF NOTICE 2008-63

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Notice 2008-63, issued on July 11, 2008, includes the text of a proposed revenue ruling regarding the income, estate, gift, and generation-skipping transfer tax consequences of the appointment of a private trust company created by family members as the trustee of trusts of which the family members are grantors or beneficiaries. The notice indicates that the IRS intends the tax treatment of private trust companies to be no more permissive or restrictive than the results that would occur if a taxpayer were acting directly or using an individual or corporate trustee serving the public. The notice presents the proposed guidance in the form of two examples, Situation 1 and Situation 2, and this outline summarizes the facts and conclusions of Situation 1 and Situation 2. The notice provides an important framework for considering the tax implications of forming and operating a private trust company, but additional guidance is needed on certain issues to provide taxpayers with needed certainty.¹

Many of the technical considerations surrounding the use of private trust companies, such as banking laws and regulations, have limited applicability for the majority of clients. Most of the principles addressed in the notice, however, actually have much broader application to all trustees and the decisions they make, while still being relevant in the context of private trust companies. Regardless of whether a family is planning to create a private trust company, the rules either clarified or established by the final private trust company guidance likely will impact estate planning decisions for all clients.

¹ For a detailed discussion of these issues, see Carol A. Harrington and Ryan M. Harding, *Private Trust Companies Go Public: Looking Behind the Curtain*, 43rd Annual Heckerling Institute on Estate Planning, January 2009.

1. Summary of Notice 2008-63.

Facts

Husband and wife created separate irrevocable trusts for each of their children and grandchildren. The children also created irrevocable trusts for their respective descendants. Each child or grandchild is the primary beneficiary of the trust established for that child or grandchild. Each trust receives contributions only from the person who created the trust. All grantors and beneficiaries are U.S. persons, and no trust is a foreign trust.

Each trust instrument provides the trustee with discretionary authority to distribute income and/or principal to the primary beneficiary of the trust during the primary beneficiary's lifetime. Each primary beneficiary has a testamentary power of appointment exercisable in favor of one or more family members (other than the primary beneficiary) or one or more charitable organizations. Each trust also provides that the grantor, or the primary beneficiary if the grantor is not living, may appoint a successor trustee other than himself or herself if the current trustee either resigns or is no longer able to fulfill the duties of trustee. In addition, each trust will terminate no later than 21 years after the death of the last to die of certain designated individuals. The notice describes two situations, depending upon whether the applicable state has enacted a statute governing private trust companies.

Situation 1: The private trust company ("PTC") is formed under the laws of a state that has enacted a private trust company statute. All trusts are governed by the laws of the state. The private trust company statute provides as follows:

- (1) Any private trust company formed under the statute must create a discretionary distribution committee ("DDC") and delegate to the DDC the exclusive authority to make all decisions regarding discretionary distributions from each trust for which it serves as trustee. Discretionary distributions are defined as permissible distributions that are not mandated in the trust instrument or by applicable law.
- (2) Statute does not restrict who may serve on the DDC, but provides that no member of the DDC may participate in the activities of the DDC with regard to any trust of which that DDC member or his or her spouse is a grantor, or any trust of which that DDC member or his or her spouse is a beneficiary.

- (3) In addition, a DDC member may not participate in the activities of the DDC with respect to any trust with a beneficiary to whom that DDC member or his or her spouse owes a legal obligation of support.
- (4) Only officers and managers of the PTC may participate in decisions regarding the personnel of the PTC, including the hiring, discharge, promotion, and compensation of employees.
- (5) Neither the statute nor the PTC's governing documents may override a more restrictive provision in the trust instrument of a trust for which the PTC is acting as a trustee.
- (6) No family member may enter into any reciprocal agreement, express or implied, regarding discretionary distributions from any trust for which the PTC is serving as a trustee.

The family formed a corporation that is a PTC under the statute. The PTC is wholly-owned by the family. The PTC's governing documents create a DDC that will make all decisions with respect to discretionary distributions from all trusts for which it serves as trustee, consistent with the statute, but the governing documents do not restrict who may serve on the DDC. Some of the family members serve as officers and members of the board of directors of the PTC. These family members also serve on the DDC. One family member is a manager and employee of the PTC. Other family members own shares of the PTC but are not officers, directors or DDC members.

Following the resignation of a corporate trustee, the PTC was appointed as successor trustee of three irrevocable trusts. In addition, the husband created three additional irrevocable trusts (the "2008 Trusts"), one for the primary benefit of each of his three children and each child's descendants. Unlike the other irrevocable trusts described above, the 2008 Trusts provide that the trustee has discretionary authority to distribute income and/or principal to any one or more beneficiaries during the beneficiary's life. Each 2008 Trust receives contributions only from the husband. PTC is designated to serve as the initial trustee of each of the 2008 trusts.

Situation 2: The PTC was formed in a state without a statute governing private trust companies, but the PTC's governing documents include provisions similar to the six items [(1) to (6)] outlined above with respect to Situation 1. In addition, the PTC's governing documents also provide for 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 to any

shareholder of PTC. The Amendment Committee, by majority vote, has the sole authority to make any changes to PTC's governing documents regarding the creation, function, or membership of the DDC or Amendment Committee, the provisions delegating exclusive authority regarding personnel decisions to the officers and managers, and the prohibition of reciprocal agreements between family members.

The initial three members of the Amendment Committee are the husband and two non-family members. The two non-family members are not employed by the PTC and are not otherwise related or subordinate to any family member. Like Situation 1 above, some of the family members serve as officers and members of the board of directors of the PTC. These family members also serve on the DDC. Other family members own shares of the PTC but are not officers, directors or DDC members. One family member is a manager and employee of PTC.

Like Situation 1 above, following the resignation of a corporate trustee, the PTC was named as the successor trustee of each trust. In addition, the husband created three additional irrevocable trusts (the "2008 Trusts") for the primary benefit of each of his three children and each child's descendants. The 2008 Trusts are similar to the trusts described above in Section 1, except that these trusts provide that the trustee has discretionary authority to distribute income and/or principal to any one or more beneficiaries during the beneficiary's life. The husband named the PTC as the initial trustee of each of the 2008 Trusts.

Conclusion 1: Trust Assets Not Included in Grantor's Gross Estate Under Sections 2036(a) or 2038(a).

Situation 1: The notice concludes that the value of the trust assets will not be included in any gross estate of a family member under § 2036(a) or § 2038(a), for the following reasons:

- (1) All distribution decisions are to be made by the DDC, and no family member serving on the DDC may participate in making discretionary distribution decisions with respect to any trust of which that person or his or her spouse is either a grantor or a beneficiary or with respect to any trust of which the beneficiary is a person to whom the family member owes an obligation of support.
- (2) Under the statute, no PTC shareholder may change the provisions governing the DDC. As a result, no family member, either alone or with any other person, has any right or power described in § 2036(a) or § 2038(a) with respect to a trust solely by reason of PTC's service as trustee

or by reason of the family member's ownership of or relationship with the PTC. Further, family members may not insert themselves into the position of holding such a power.

As a result, the notice concludes that the trust assets would not be included in the gross estate of any family member by reason of PTC's service as trustee or that person's service as an officer, director, or member of the DDC. Further, the notice concludes that no portion of the value of the trust will be includible in the gross estate of the family members who serve as shareholders and/or a manager or employee of the PTC.

Situation 2: Unlike Situation 1, the state in Situation 2 does not have a statute restricting the ability of the private trust company's shareholders to change the applicable provisions governing the DDC. The family members in Situation 2 who are PTC shareholders may amend the PTC's governing documents. However, only the Amendment Committee may amend the provisions with regard to the DDC and the Amendment Committee, with regard to the authority to make personnel decisions, and with regard to the prohibition on reciprocal agreements. Accordingly, no family member is deemed to have a power to change the governing provisions regarding the DDC that would result in the inclusion of any part of the trust in the family member's gross estate. As a result, the notice concludes that no portion of the trust should be includible in the grantor's gross estate under § 2036(a) or § 2038(a) by reason of PTC's service as trustee, the grantor's interest in the PTC, or a grantor's service as an officer, director, manager, employee, or as a member of the DDC or the Amendment Committee.

Conclusion 2: Trust Assets Not Included in Beneficiary's Gross Estate Under Section 2041.

Situation 1: Under State 1's statute, the PTC's powers to make discretionary distributions are delegated exclusively to the DDC, and no beneficiary who is a DDC member is permitted to participate in discretionary distribution decisions with respect to a trust in which that beneficiary has a beneficial interest, including a trust whose beneficiary is a person to whom the beneficiary owes an obligation of support. Also, family members are prohibited from entering into reciprocal arrangements designed to affect distribution decisions. The family members serving as officers, directors, and members of PTC's DDC do not have the unrestricted power to distribute trust assets to themselves as contemplated by § 2041. In addition, no beneficiary will be deemed to have a general power of appointment by acting as a shareholder or participating in the daily activities of the PTC.

Situation 2: PTC's governing documents preclude a beneficiary from having the power as a member of the DDC to affect the beneficial enjoyment of property as described in § 2041, and

family members are prohibited from entering into reciprocal arrangements to affect distribution decisions. As in Situation 1, the family members serving as officers, directors, and members of PTC's DDC do not have the unrestricted power to distribute trust assets to themselves as contemplated by § 2041. In addition, no beneficiary will be deemed to have a general power of appointment by participating in the daily activities of the PTC. For reasons discussed in Conclusion 1 above, a beneficiary will not be deemed to have a general power of appointment under § 2041 as a result of the beneficiary's service on the Amendment Committee.

Conclusion 3: Grantor's Transfer to Trusts Constitute Completed Gifts.

Situations 1 and 2: In both Situations 1 and 2, no member of the DDC may participate in the activities of the DDC with regard to any trust of which that DDC member or his spouse is a grantor, or any trust of which that DDC member or his or her spouse is a beneficiary. In addition, family members are prohibited from entering into reciprocal agreements to affect distribution decisions. The husband, as grantor of the 2008 Trusts, does not have the power to change the interests of the beneficiaries of the 2008 Trusts, nor will he be considered to hold a power exercisable by him in conjunction with any other person not having a substantial adverse interest in the disposition of the transferred property or the property's income merely because of the husband's membership on the DDC. Accordingly, the notice states that the husband's transfers to the 2008 Trusts will be deemed completed gifts. Also, because the provisions of the DDC prohibit any beneficiary who is a member of the DDC from participating in decisions with regard to any trust in which the beneficiary has a beneficial interest, distributions of income and principal from a trust of which the PTC is the trustee will not be deemed to be a gift by any member of the DDC.

Conclusion 4: GST Status of Trust Should Not Be Affected.

Situations 1 and 2: In both Situations 1 and 2, the notice concludes that the change in trustee will not subject the value of the trust corpus to tax under Chapter 11 or 12. The modification is deemed to be an administrative change that does not shift a beneficial interest in a trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification. In addition, each trust will terminate no later than 21 years after the death of the last to die of certain designated individuals, and accordingly, the appointment of PTC alone will not extend the time for vesting of any beneficial interest in a trust for which the PTC acts as trustee beyond the date provided for in the original trust. The notice states that appointing the PTC as trustee of the trusts does not affect the inclusion ratio of a trust subject to Chapter 13.

Conclusion 5: Grantor or Beneficiary Should Not Be Treated as Owner of Trust.

Situations 1 and 2: The notice states that the provisions governing the DDC and the state statute (with respect to Situation 1) render the identity of the trustee irrelevant to the determination of whether any person is treated as an owner of a trust under §§ 675, 677, or 678. The circumstances regarding the operation of the PTC, the DDC, and the family trusts for which the PTC is acting as trustee will determine whether any grantor will be treated as the owner of any portion of the trusts under § 675, which is a question of fact. Accordingly, the notice states that the appointment and service of the trustee does not affect whether the grantor or any other person will be treated as the owner of a trust, and none of the grantors or beneficiaries of the family trusts for which the PTC is acting as trustee will be treated as an owner of the trusts under §§ 673, 675, 676, 677, or 678 solely by reason of their ownership or management of, or employment by, the PTC. The notice states that the identity of the trustee is relevant with regard to whether the grantor will be treated as the owner of a trust under § 674.

The notice states that the general rule is that powers must be subject to the approval or consent of an adverse party as defined in § 672(a) in order to avoid treating the grantor as the owner of a trust for income tax purposes. The notice considers the two clauses of § 672(c)(2). With respect to the first clause of § 672(c), the notice states that voting control of the PTC has been made irrelevant as it applies to the power to make distributions due to the provisions of the statute or the presence of the Amendment Committee. Accordingly, the notice concludes that the ownership of voting stock of PTC is deemed to be not significant under § 672(c).

With respect to the second clause of § 672(c), the notice states that in order to determine whether a PTC as trustee is related or subordinate, one must consider the members of the DDC who are authorized to act with regard to that particular trust (as if those DDC members individually were the trustees). The notice explains that this look-through is necessary to ensure that a grantor cannot achieve income tax results indirectly by using a PTC as trustee that could not be achieved with an individual trustee. The notice concludes that whether a grantor is treated as an owner of any portion of a trust under § 674 depends upon the particular powers of the trustee and the proportion of the members of the DDC with authority to act with regard to that trust who are related or subordinate to the grantor applying a “look-through” test in which each employee of the PTC serving on the DDC, if any, is tested as if that employee was an individual trustee, rather than as a member of a committee existing within and functioning on behalf of the PTC.

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