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The IRS Issues Guidance on Private Trust Companies

Notice 2008-63 is a significant step forward in clarifying the tax issues involved in operating a private trust company, but there are still points that need clarification to make the Notice a better guide for taxpayers.

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Inter vivos irrevocable trusts are common in estate plans for wealthy individuals, used for both creditor protection and estate tax benefits. Determining who should act as trustee is a critical part of appropriately structuring such trusts, and choosing the right trustee depends on a number of factors. Using a family member—while comfortable—may raise tax issues, there may not be a family member with the appropriate level of expertise, and intra-family relationships are often difficult. Using an individual outside the family requires a relationship with someone who is not only trustworthy but also knowledgeable and willing to risk liability for his or her fiduciary decisions. Finally, using a corporate fiduciary may be unappealing due to cost or the types of investments held by the family. Given that none of these may be a perfect choice for a family of significant wealth, creating a private trust company (“PTC”), which has some elements of all these alternatives, has become an attractive option.

Private trust companies are not for everyone. They can be expensive to operate and require a commitment of capital. However, one needs only to look at the change in the minimum wealth to be included in the *Forbes* 400 over the last 25 years to understand why consideration of a PTC makes sense for an increasing number of families. *The New York Times* recently reported that in 1982, it took about \$159 million in today's dollars to make the *Forbes* 400 list, but today the minimum net worth to get on the list is \$1.3 billion.¹ And, there are 489 U.S. billionaires who did not make the list!² By no means does one need \$1 billion to form a PTC. But, if the number of billionaires has increased dramatically in 25 years, there are also substantially more families worth several hundreds of millions of dollars who will be interested in the advantages offered by a PTC.

Benefits of a private trust company

Some benefits of a PTC over using an individual trustee are that: (1) PTC board members are liable only for failing to exercise reasonable business judgment, while the company is liable for breach of fiduciary duty; (2) continuity in trusteeship is easier to maintain; and (3) formal policies and procedures governing decision-making should provide comfort to the family that risks are monitored and minimized and fiduciary responsibilities considered. Although the first point may appear to be a drawback because the beneficiaries' ability to recover against board members is limited, an individual with substantial net worth is more likely to agree to serve on a PTC board than to serve as individual trustee, thereby giving the family access to the resources and knowledge of capable advisors without exposing those advisors to personal financial risk.

By using a board rather than individuals, more people can be included on the board than would typically act individually, and there is no gap if one member of the board dies, resigns or becomes disabled. It is easier to remove a board member who is incompetent or for any other reason (that person is just not re-elected to the board) than it is to remove an individual trustee. At the same time, the family's trusted advisors do not have to be burdened by handling ongoing operational decisions.

There are also benefits of using a PTC over using a traditional corporate fiduciary. The family can be as involved or not in investment decisions, as they choose. By hiring qualified personnel within a PTC, the family can obtain the benefits of diversified financial services while continuing the family business or other alternative investments. Although the concept of a "directed trustee," such as authorized under Delaware law, may allow family control over investments, there are other trustee functions to be considered. (A comparison between a PTC and a "directed trustee" is beyond the scope of this article.) One may be able to negotiate fees with a corporate fiduciary, but costs of administration usually can be better controlled in a PTC because the family sets the PTC's budget and decides on costs. There is transparency in decision-making not only because the owner of the PTC and beneficiaries of the trusts under management have access to information about the policies and procedures, but also because the board members and employees, some of whom can be family members, establish those policies and procedures in the first place. Finally, family members can learn about family wealth by being involved in the process.

Nevertheless, the involvement of family members has been an issue for many families seeking to form a PTC because clear guidance was lacking from the IRS on the tax consequences of such involvement. Although the IRS issued a number of private letter rulings on PTCs from 2002 through 2005,³ those rulings appeared more restrictive than current law for individual grantors and beneficiaries who act as trustees. Therefore, advisors had the difficult task of deciding whether to recommend that such rulings be followed as a safe harbor or that different structures be used.

In 2005, the IRS announced that it would no longer issue private letter rulings on the topic as it was considering issuing a Revenue Ruling. The IRS requested comments on the types of provisions that should be covered by such a Ruling, and comments were provided by the author's firm as well as the New York State Bar Association, the American Institute of Certified Public Accountants, and several other law firms. Finally, on 7/11/08, the IRS issued Notice 2008-63⁴ (the "Notice"), setting forth a proposed Revenue Ruling on the structure of a PTC owned by family members which would (1) avoid inclusion of trusts of which a PTC was acting as trustee in the grantor's gross estate under Section 2036 or 2038, (2) avoid inclusion of such a trust in a beneficiary's gross estate under Section 2041, (3) not cause gifts to such trusts to be incomplete gifts under Section 2511, (4) not affect the generation-skipping transfer ("GST") tax-exempt status under Section 2601 or change the GST tax inclusion ratio of such trusts, and (5) avoid treatment of such trusts as grantor trusts under Section 671 through Section 678 as to the grantor or any beneficiary.

Although the Notice is an improvement over the position taken by the IRS in its private letter rulings on PTCs, there are points the IRS should clarify to make the Notice a better guide for taxpayers. This article describes the provisions of the Notice and focuses on the areas that require clarification.

Family background and trust provisions of the Notice

The family described in the Notice consists of a couple (the "Senior Generation"), their three children (the "Junior Generation"), the spouses of the Junior Generation (the "Spouses") and descendants of the Junior Generation (individually, a "Descendant" or, collectively, the "Descendants"). The Senior Generation, the Junior Generation, the Spouses, the Descendants and former spouses of the Junior Generation and the Descendants are referred to in the Notice, and in this article, as the "Family."

Under the facts of the Notice, the Senior Generation had previously created irrevocable trusts for the benefit of each member of the Junior Generation and the Descendants, and each member of the Junior Generation had previously established irrevocable trusts for the benefit of her own Descendants. The Notice does not specifically state when these trusts were created, but the PTC was formed in 2008 and replaced a financial institution which had acted as trustee since the inception of the trusts. The Notice concludes that the resignation of the existing trustee and appointment of the PTC is an administrative change that is not a modification under Reg. 26.2601-1(b)(4) that will cause a trust to lose its grandfathered GST tax-exempt status. This statement implies that the trusts were created before 9/25/85, but the Notice should state that to be clear about the GST tax consequences.

Each member of the Junior Generation or each Descendant is the primary beneficiary of the trust established for that person. The trust instruments give the trustee discretion to distribute income or principal to the primary beneficiary of the trust, and each primary beneficiary has a testamentary power of appointment in favor of any Family member (other than the primary beneficiary) and charities. The grantor (or primary beneficiary of a trust, if the grantor is not living) has the power under the trust instrument to appoint a successor trustee other than himself, if the trustee resigns or is unable to continue as trustee. As often provided under a traditional rule against perpetuities, the trusts terminate "21 years after the death of the last to die of certain designated individuals living at the time of the creation of the trust."

Subsequently, one member of the Senior Generation created three new trusts in 2008 for the benefit of each child and that child's descendants (the "2008 Trusts"), of which the PTC was named as initial trustee. The terms of the 2008 Trusts are the same as the earlier trusts except that the trustee of each 2008 Trust has discretion to distribute income and/or principal among any of the beneficiaries of each trust. The facts do not indicate whether the grantor of the 2008 Trusts allocated any of her GST exemption to such trusts, but the Notice concludes that there is no change in any trust's inclusion ratio under the GST tax provisions of the Code due to the PTC acting as trustee.

There are a couple of family facts that the IRS should revise to better illustrate the tax consequences.

In discussing the PTC governance, the Notice defines "discretionary distributions" as permissible distributions that "are not mandated in the trust instrument or by applicable law," but the Notice does not state whether distributions under the trust agreements have the same definition. Unfortunately, the Notice also never states whether distributions subject to an ascertainable standard but exercisable in the discretion of the trustee are "mandated" by the trust instrument or are "discretionary." The term "discretionary distributions," as used herein, has the meaning ascribed in the Notice, but it is used in quotes as a reminder that its definition is imprecise. Some consequences of the Notice's failure to properly address "discretionary distributions" which are subject to

an ascertainable standard are described further below in the discussion on the Discretionary Distribution Committee.

It is also unclear why the Notice deals only with trusts limited by something akin to a traditional rule against perpetuities. Since more and more jurisdictions have extended or abolished the rule against perpetuities and there is no apparent tax reason for this limitation, it is unclear how the Notice would apply to a trust not so limited by a traditional rule against perpetuities.

Finally, it is unclear why the Notice includes former spouses in the definition of "Family." Except in the limited situation where a former spouse has a legal obligation to support children or the other former spouse, there is no specific tax reason for prohibiting a former spouse from participating in distribution decisions. Former spouses are not included in the definition of a related party under Section 672, ⁵ nor would any of Sections 2036, 2038 or 2041 cause inclusion of a trust in a person's estate because a former spouse was acting as trustee. Although it might be unusual to include a former spouse on the board or a committee of a PTC and there are practical reasons for excluding a former spouse, there is no tax reason for doing so.

PTC operational facts in the Notice

The Notice covers (1) a PTC formed under the laws of a state that has enacted a PTC statute and (2) a PTC formed in a state that does not have a PTC statute but the PTC governing documents contain limitations that restrict the activities of grantors and beneficiaries. The provisions applicable to each situation are the same, but because there is no state that currently has a statute containing provisions such as those described in the Notice, this article will focus on a PTC formed in a state without such a statute.

The PTC in the Notice is formed as a corporation. The stock of the PTC is owned by two members of the Family—one a member of the Senior Generation and one a member of the Junior Generation. The shares are owned either outright or through trusts or other entities. A "Discretionary Distribution Committee" ("DDC") is formed to handle "discretionary distributions." There is no limitation on who can serve on the DDC but "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[,] . . . [or] with respect to any trust with a beneficiary to whom that DDC member or his or her spouse owes a legal obligation of support."

The PTC governing documents provide that (1) only officers and managers of the PTC can participate in decisions regarding personnel of the PTC (such as hiring, firing, promoting and compensation of employees), (2) the PTC governing documents may not override a more restrictive provision in the trust instrument of a trust for which the PTC acts as trustee, (3) no Family member may enter into any reciprocal agreement, express or implied, regarding "discretionary distributions" from any trust for which the PTC serves as trustee, and (4) an Amendment Committee is delegated the authority to modify the provisions of the PTC's governing documents described in the foregoing clauses 1 and 3 and the PTC's governing documents regarding the DDC and the Amendment Committee (these provisions are referred to as the "Tax Sensitive Provisions"), and such delegation is not contrary to state law.

The PTC's governing documents require that a majority of the members of the Amendment Committee are not Family members and are not a Related Party to an owner of the PTC. Members of the Senior Generation and Junior Generation serve on the board

and DDC and are officers, but the two persons who are shareholders of the PTC are not officers or directors and do not serve on the DDC. A majority of the board consists of the Family but includes two non-Family members who also serve on the Amendment Committee. One member of the Junior Generation is a manager and employee of the PTC.

Type of PTC entity used. Some states allow a PTC to be formed as either a corporation or a limited liability company ("LLC"). The Notice assumes the PTC is a corporation. There does not appear to be any tax reason for limiting the treatment in the Notice to a corporation (except potentially with respect to the Amendment Committee, described below). Therefore, the IRS should either expand the description of the facts to include LLCs or clarify that comparable rules will apply to other forms of entities.

Discretionary Distribution Committee and Amendment Committee. The Notice's provisions regarding the delegation of authority to the DDC to make decisions on "discretionary distributions" and the use of an Amendment Committee to modify the Tax Sensitive Provisions appear motivated primarily by estate tax inclusion issues and the grantor trust rules. To understand these requirements, one needs to understand the Code provisions that will cause inclusion of a trust in a grantor's estate or cause a trust to be a grantor trust if the grantor acts as trustee of a trust individually or has the ability to control the trustee.

Of particular significance in the context of a PTC are the portions of the Regulations under Sections 2036 and 2038 which provide that a decedent is considered to hold the trustee's powers if the decedent as grantor reserved the unrestricted power to remove or discharge a trustee and appoint herself as trustee. ⁶ Rev. Rul. 95-58 ⁷ clarified these Regulations by concluding that a decedent would not be treated as holding a trustee's power to make distributions if the decedent could remove the trustee and appoint only a corporate trustee or an individual who is not a Related Party to the decedent. The IRS does not cite these provisions of the Regulations or Rev. Rul. 95-58 in the Notice, but does cite Reg. 20.2041-1(b)(1), which provides that a beneficiary of a trust has a general power of appointment if (1) the trustee has broad powers to make distributions to the beneficiary, and (2) the beneficiary can remove the trustee and appoint herself as trustee. Since the Regulations under Sections 2036 and 2038 and Rev. Rul. 95-58 cover situations in which a *grantor* has the power to remove the trustee, while Section 2041 covers situations in which a *beneficiary* has that power, the Notice should cover the former situations as well as the latter.

Section 674 is the most relevant income tax provision for determining grantor trust status in the context of a PTC. In general, a trust will be treated as a grantor trust under this section if the beneficial enjoyment is subject to a power of disposition which is exercisable by the grantor or a "nonadverse party" (defined in Section 672(b)) without the consent of any "adverse party" (defined in Section 672(a)). However, Section 674(c) provides that the grantor will not be treated as the owner of a trust which contains a discretionary power to distribute income or principal among beneficiaries if such power is held by a trustee or trustees, "none of whom is the grantor and no more than half of whom are related or subordinate to the grantor."

In determining whether the PTC is a Related Party to the grantor of any trust, the Notice concludes that it will apply "a 'look-through' test in which each employee of the PTC serving on the DDC, if any, is tested as if that employee was a trustee of the trust in his or her individual capacity." It is helpful that the Notice states that ownership of voting stock of the PTC is deemed not significant for purposes of Section 672(c).

By delegating the power to make decisions on “discretionary distributions” to the DDC and the authority to modify the Tax Sensitive Provisions to an Amendment Committee, the Notice presumably seeks to replicate provisions which would limit the powers of a grantor or beneficiary acting individually as a trustee. The Notice falls short in several respects.

Discretionary Distribution Committee. By providing that “discretionary distributions” are handled by the DDC and defining “discretionary distributions” vaguely (i.e., those that “are not mandated in the trust instrument or by applicable law”), the Notice does not indicate whether distributions which are in a trustee's discretion but limited by an ascertainable standard are handled by the DDC, the governing board, or employees. Even if distributions are limited by an ascertainable standard, if the grantor acts as trustee or has the power to remove and replace the trustee with himself or a Related Party to the grantor, the trust may be includable in that person's estate under Section 2036,⁸ and, depending on other terms of the trust, it may be a grantor trust for income tax purposes. To avoid inclusion of a trust in a grantor's estate and potentially grantor trust status, the Notice should provide that a person cannot participate in any distribution decisions involving trustee discretion from trusts created by that person, whether or not limited by an ascertainable standard.

The definition of “discretionary distributions” also should be clarified for beneficiaries. Certainly, a beneficiary can serve as individual trustee of a trust created by another person without causing the trust to be included in the beneficiary's estate under Section 2041 or a gift to occur under Section 2514 by making a distribution to another person, if the discretion is limited by an ascertainable standard.⁹ Therefore, beneficiaries should be able to serve on the DDC if the distribution standard is so limited.

Further, the Notice indicates that the PTC governing documents prohibit the Family from entering into reciprocal agreements regarding “discretionary distributions” from any trust for which the PTC is serving as trustee. This is certainly intended to be consistent with current concepts regarding reciprocal trusts.¹⁰ However, trusts can be considered “reciprocal” and included in a grantor's estate, regardless of whether the distributions from such trusts are limited by an ascertainable standard. Instead, grantors should be prohibited from participating in any distribution decisions, not just “discretionary distributions.”

The Notice does not adequately address removal and replacement of members of the DDC. As described above, to avoid estate inclusion for a grantor, the grantor cannot remove and replace an existing trustee with a person who is a Related Party to the remover, nor can a beneficiary—unless distributions are limited by an ascertainable standard—hold the power to remove. Although the Notice provides that for PTCs, no grantor or beneficiary can participate in “discretionary distribution” decisions to herself, her spouse or persons dependent upon her for support, there are no other limitations on who can serve on the DDC. The Notice should also limit either the manner in which DDC members are elected or the persons who can serve on such committee. For example, the PTC governing documents could provide that the DDC is elected by the nonfamily members who serve on the board or that, if family members elect the members of the DDC, the family members do not have the power to remove the DDC members.

Finally, Family members are prohibited in the Notice from “participating in the activities of the DDC” rather than “participating in the discretionary distribution decisions of the DDC.” By using the word “activities,” the question is whether the IRS has something broader in mind, such as not participating in discussions or not attending meetings at which a discussion occurs. The use of the term “activities” is too vague and could lead to inadvertent violations. The IRS should clarify this reference.

Amendment Committee. It is almost certain that no state law allows delegation of authority to modify the governing documents of a PTC to persons who are not the owners of the PTC or board members. Although most states allow the board of directors of a corporation to have the authority to amend the bylaws, the shareholders can change that; but the operating agreement of an LLC can be modified only by the members. Unless the IRS provides alternative ways to control the Tax Sensitive Provisions other than by an irrevocable delegation under state law, the Notice's requirement of the delegation of authority to the Amendment Committee could be practically unattainable.

One alternative is for the PTC owners to agree in the PTC governing documents not to change the Tax Sensitive Provisions in a manner that is inconsistent with those limitations except by unanimous agreement; the trust agreements could support this requirement if they contain provisions that are intended to reach the same tax results. Another option for a corporate PTC is for the bylaws to require that persons other than family members and Related Parties ("Third Parties") be included on the board and the governing documents provide that either (1) directors who are family members and Related Parties to the PTC owners cannot vote on changes to the Tax Sensitive Provisions, or (2) any such changes may be adopted only if the Third Parties constitute a majority of the board members who vote in favor of such changes. Of course, for a PTC formed as an LLC, this option would be unavailable.

A third alternative, which would apply to either a corporation or an LLC, is for all living grantors and current adult beneficiaries to adopt the Tax Sensitive Provisions as part of a written agreement related to the operations of the PTC, the provisions of which would be incorporated into the PTC governing documents. Such agreement could be changed only by unanimous consent of the living grantors and adult beneficiaries of the trust and, if it is changed, the negative tax consequences are triggered.

An alternative to an Amendment Committee is for the PTC owners to be someone other than the family. For example, the grandmother could create an irrevocable trust for the benefit of her descendants, of which a person who is not a family member is the trustee. This trust would own the PTC (an "Owner Trust"). As long as the trustee of the Owner Trust could never be a family member or, if the family members could remove the trustee, they could replace him only with a corporate trustee or a person who was not a Related Party to any family members, a separate Amendment Committee would be unnecessary because, by definition, the family would not control changes to the Tax Sensitive Provisions. Moreover, the trustee of the Owner Trust could be a Related Party to a family member if the family was not concerned about the grantor trust provisions of the Code (e.g., the grantor was deceased or the trust was a grantor trust in any event) or as long as no member of the family had the power to remove and replace the trustee of the Owner Trust with another Related Party.

Aside from allowing the PTC to comply with state law with respect to amendment of the governing instruments, using such a trust would be beneficial for several reasons. The PTC shares would not become subject to the claims of the owner's creditors or a former spouse or subject to disposition at the death of the owner to someone who is not a family member. Because a perpetual GST tax-exempt trust could be used, the family could ensure that the value of the PTC would not be includable in the estate of an owner and thereby subject to estate tax. Of course, trustee succession for that trust would have to be addressed, but that determination should be more manageable than trustee succession for all the family's assets.

Personnel decisions. The Notice is particularly confusing with respect to employees of the PTC. It provides that only officers and managers of the PTC have authority over personnel decisions (including hiring, discharge, promotion and compensation of

employees), apparently to limit control over employees who make distribution decisions. However, the Notice never indicates that employees have any involvement in such decisions. If employees do not have authority with respect to distribution decisions or do not serve on the DDC, control over employees is irrelevant for estate tax purposes; if they do have such authority, then the family members who are officers and managers have a potential estate tax inclusion problem by having possible control over distributions.

Furthermore, this limitation does not seem to accomplish the intended result for income tax purposes. In ruling on the grantor trust issue, the Notice states that control over employees of the PTC is significant under Section 672(c)(2) if the employees make "discretionary distribution decisions on behalf of the corporation." While that is certainly true, the Notice does not state that employees of the PTC are so involved. The facts in the Notice should provide either that employees are not involved in "discretionary distribution" decisions (whether limited by an ascertainable standard or not) or that grantors who want to avoid grantor trust treatment are not involved in personnel decisions.

Conclusion

The Notice is a significant step forward in clarifying the tax issues involved in operating a private trust company. However, the Notice needs work to be consistent with current tax law applicable to individual grantors and beneficiaries acting as trustee and to avoid taxpayer confusion.

PRACTICE NOTES

To avoid inclusion of a trust in a grantor's estate and potentially grantor trust status, the Notice should provide that a person cannot participate in any distribution decisions involving trustee discretion from trusts created by that person, whether or not limited by an ascertainable standard.

[1](#)

Arango and Creswell, "End of an Era on Wall Street: Goodbye to All That," New York Times (10/4/08).

[2](#)

Prey, "Poor Billionaires," The Forbes 400 (10/6/08).

[3](#)

See Ltr. Rul. 200229013, Ltr. Rul. 200345006, Ltr. Ruls. 200406040-44, Ltr. Ruls. 200410014-15, Ltr. Ruls. 200523003-04, Ltr. Ruls. 200546052-55, and Ltr. Rul. 200548035 .

[4](#)

2008-31 IRB 261.

[5](#)

References in the Notice and herein to "Related Party" mean a related or subordinate party as defined in Section 672(c). That includes any of the following: (1) the grantor's spouse (if living with the grantor), parents, descendants, and siblings; (2) an employee of the grantor; (3) "a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; [and (4)] a subordinate employee of a corporation in which the grantor is an executive."

[6](#)

Regs. 20.2036-1(b)(3) and 20.2038-1(a)(3) .

[7](#)

1995-2 CB 191.

[8](#)

Rev. Rul. 95-58, 1995-2 CB 191; Reg. 20.2036-1(b)(3).

[9](#)

Regs. 20.2041-1(b)(1), 20.2041-1(c)(2), and 25.2514-1(c).

[10](#)

Grace, 23 AFTR 2d 69-1954, 395 US 316, 23 L Ed 2d 332, 69-1 USTC ¶12609, 1969-2 CB 173 (1969); Estate of Bischoff, 69 TC 32 (1977).

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