PRIVATE TRUST AND PROTECTOR COMPANIES:

HOW MUCH FAMILY CONTROL?

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OCTOBER 2002

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When choosing trustees, wealthy U.S. families traditionally selected from among their own family members and those advisors or commercial trustees with whom they had a professional or business relationship over many years. In more recent years, however, many wealthy families have begun to employ family-controlled private trust companies and private protector companies in lieu of or in conjunction with those traditional fiduciary arrangements. This article will begin by briefly describing these "private" structures and some of the reasons for this shift away from relying on individuals and commercial fiduciaries.

This article then will review the tax milieu that affects how these private fiduciary companies must be structured in order to avoid a bad tax result for the trust grantor or beneficiaries under the income, gift or estate tax rules. Next, we will analyze the latest guidance from the Internal Revenue Service that applies these tax rules to such family-controlled companies. Finally, we will conclude with a discussion of whether the existing rules and authority provide an appropriate answer to a most critical issue in structuring a private fiduciary company: how much control over distributions will be, or should be, imputed to the trust grantors and beneficiaries because of family ownership of the fiduciary company, at the risk of causing unexpected and severe adverse tax consequences? This discussion will deal specifically with the application in this context of the power to remove and replace trustees, and most importantly, with the reciprocal trust doctrine.[1]

Private Trust and Protector Companies

As the term is used here, a private trust company ("PTC") is typically an entity that is owned entirely by members of the same family (or a few families) and that serves as the sole trustee for the trusts held for family members. The PTC often takes the form of a corporation, or of an LLC whose governance is structured like a corporation, and is formed in a jurisdiction that will exempt it from most of the regulatory requirements imposed on trust companies that provide services to the public at large. Under this exemption, the trust license of the PTC is "limited" and allows the PTC to provide trustee services only to a group of related individuals and trusts.

A PTC typically uses the corporate form of organization, with a board of directors (or perhaps a board of managers), but like a commercial trust company, also includes in its structure a distribution committee and an investment committee. The distribution committee consists of persons who make decisions regarding distributions from the trusts administered by the PTC, and the investment committee reviews and recommends how

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[1] While we deal specifically with private fiduciary companies, much of the analysis is pertinent as well for a structure in which the family simply participates in fiduciary decisions through a committee or other grouping of individuals without employing a specialized family entity.

the assets of the administered trusts are invested. Even though the voting power of the PTC is concentrated in the family, it is common for independent parties to be appointed to either the board of directors or one or more of the various committees of the PTC.

Before describing the private protector company ("PPC"), a brief description of a "protector" is in order. Although the term is most often used in an anthropomorphic sense, the "protector" can also be understood as referring to the process of (i) removing and replacing trustees, (ii) assisting the trustee in making particularly important decisions, and (iii) arranging for an organized, periodic review of the services being provided to a trust and its beneficiaries by the trustee, investment managers, and other providers. In addition, the protector may serve other functions, depending upon the trust documents and the needs of a particular family. For example, the protector can decide when to allocate investment authority to an advisor who is independent from the trustee (and who may also be providing personal investment advice to trust beneficiaries or grantors). At its best, the protector process also can provide a strategic perspective that enhances the operation of the trust and the relationships of the beneficiaries by anticipating ways to avoid issues in the future or improve trust governance over time. Unlike a business entity, a trust has special objectives and standards of performance beyond financial success, and these change over time, and may at times be difficult to identify with clarity and without controversy. A protector can focus at that strategic level and avoid being preoccupied with day-to-day administration.

As in a PTC, a PPC is an entity that is owned (or at least controlled) entirely by a family group (or groups) but serves as a trust's protector rather than as trustee. Like the PTC, the PPC is commonly a corporation, or a limited liability company structured like a corporation with a board of directors or perhaps a board of managers.[2] Like the PTC, one or more committees can be appointed by that board to perform the periodic review of certain issues, such as trustee policies regarding distributions or investment performance. Also similar to a PTC, a PPC typically includes independent parties serving as directors or members of various committees.

Why Create a Private Fiduciary Company?

The shift to private trust companies and protector companies has been motivated by reasons that have nothing to do with saving federal income, estate and gift taxes. Families create these companies in order to, among other purposes:

- recruit and retain quality staff;
- customize the resources available to the trustee, and allocate the desired level of those resources;
- improve the methods and expand the choices used in selecting and managing investments;
- make better informed distribution decisions;
- improve continuity and coordination in fulfilling fiduciary obligations;

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[2] The company could be formed as a non-profit corporation, without shareholders or stock, but with a self-perpetuating, family-dominated board of directors.

- protect against the risks associated with relying on individuals to serve as trustees, and to protect individuals from personal liability who would otherwise be naturally reluctant to participate; and, more generally,
- improve trust governance by obtaining the organizational and legal strengths of a corporate structure and governmental oversight of licensed fiduciaries, without sacrificing the benefits of the personal commitment and close family knowledge that families expect from an individual trustee.

Some seeds of the motivation toward increased use of private fiduciary companies were sown by the consolidation of the banking industry during the 1990s, which displaced large numbers of trust officers and other staff of corporate trust departments. The resulting displacement and turnover, and the deterioration of service levels in some institutions, led wealthy families to consider whether their desired level of service could be better met by, in effect, creating their own institution, using a "business plan" that was more tailored to their needs and desires.

During that process, families found that private fiduciary companies can indeed employ resources as a family considers more appropriate to its needs. Because private fiduciary companies do not have to meet the same standards of profitability and quarter-to-quarter performance that are now demanded of public companies by Wall Street, families found that they could operate the private trust company more like a "family business," and they could allocate more of its resources to a particular issue of importance to them, either in the short or long run. Private fiduciary companies are often able, for example, to provide a more flexible compensation structure (and thus attract higher quality personnel for particular positions). They can invest in capabilities that family members often find valuable and that commercial corporate fiduciaries cannot as readily provide, such as accounting, tax and investment management of multiple asset classes sourced from different third-party providers and in-house sources. Families may, for example, have particular reasons to hold illiquid positions in real estate, hedge funds, or closely held assets that cannot be managed well by a commercial trustee. Or a family may want to allocate certain investment opportunities to various trusts based on the particular circumstances of individual family members in a way that would be difficult, and expensive, for a commercial trustee to identify and manage as part of its regular investment process.

Finally, the trend toward private fiduciary companies has endured and strengthened because wealthy families have come to appreciate that private fiduciary companies afford a means to manage or even eliminate many of the risks associated with using individuals as trustees, and also to respond in a constructive way to the threat of personal liability to the individuals involved. From time to time, families have faced problems when an individual trustee changes in some way, such as by changing employment, moving to another jurisdiction, or becoming disabled, inattentive or frail. One also still hears from time to time of the errant individual trustee who absconds with assets of a trust. A private fiduciary company is itself obviously not subject to these failings. The company's directors, officers and staff may individually present such risks, of course, but the corporate structure of the private fiduciary company can more readily reduce that risk to a more manageable level than a "system" that starts off by relying on a single individual trustee. The PTC and PPC provide an established, orderly framework

within which to remove and replace individuals (i.e. directors, officers and employees) who become or threaten to become dysfunctional. Moreover, that same corporate structure makes it easier to implement procedures designed to improve quality control and provide checks and balances, such as double signing of checks and independent auditing (and a PTC is commonly subject to state or federal regulation). In contrast to the individual fiduciary, those characteristics of the PTC and the PPC reduce the risk of mistakes and make it easier to deal with the mistakes that slip through and with the occasional threat of litigation from a dissatisfied beneficiary. The corporate form also lends itself to liability protections that facilitate recruiting qualified outside board members and that give comfort to decision-makers when tough decisions must be made.

Speaking more generally, efficiency and quality of service can be enhanced by using a corporate form rather than one or more individuals serving as trustee because, in a company structure, all personnel (including directors, executives, outside consultants and experts, as well as administrative staff) can be more readily used to best advantage, using different skill sets for different tasks and objectives. This difference in the corporate form makes it easier to attract and retain appropriate individuals at each level. Delegation and division of responsibility are natural features of a corporate structure, but are still very recent and limited improvements in the law and practice of the individual trustee.

Tax Milieu

Once a family has decided to create a private trust or protector company, the structuring of that company quickly leads into the Byzantine realm of the income, estate and gift taxation of trusts.[3] To explore this territory fruitfully, it should be divided into two distinct regions: trust creators and trust beneficiaries. The analysis relating to trust creators is primarily concerned with Internal Revenue Code Sections 674, 2036 and 2038, and for trust beneficiaries, Section 2041 and 2514.[4]

Transferors: Grantor Trust Status under the Income Tax

Section 674 generally provides that, after a transfer to a trust, if the transferor or a person without an interest in the trust can exercise discretion over the distribution of the trust income or principal, then the transferor is treated as owning the income tax items associated with that trust income or principal (called often, "grantor trust status").[5] There are numerous exceptions to this rule, the most important of which is the exercise of discretion by an independent trustee. For a trustee or group of trustees to qualify as independent, neither the transferor nor his or her spouse may serve as a trustee and no

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[3] This article will address only income, estate and gift taxes because the generation skipping taxes generally mirror the estate and gift tax provisions.

[4] There are, of course, other Code sections that would sometimes be pertinent to such an analysis, like Section 676, taxing a transferor's power to revoke, and Section 678 taxing powers held by persons other than transferors. However, this article will not address those sections because either the issue is straight-forward or the section is implicated infrequently.

All references to the "Code" mean the Internal Revenue Code of 1986, as it has been amended from time to time.

[5] Section 674(a).

more than half of the trustees may be related or subordinate to the transferor.[6] Other commonly used exceptions also depend upon the exercise of discretion, but:

- the exercise of the discretion requires the consent of a person whose interests are adversely affected by the exercise;[7]
- the standard for exercising the discretion is ascertainable and set forth in the trust instrument;[8]
- the discretion over principal distributions can be exercised with respect to a current income beneficiary if that beneficiary's share is accounted for separately and would be reduced by the distribution;[9] or
- the discretion over income distributions can be exercised with respect to a current income beneficiary so long as any accumulated income must be paid to the beneficiary or pursuant to a broad limited power of appointment in the beneficiary.[10]

If the power of a person to exercise discretion falls within any of the above exceptions, that power does not cause the trust creator to be treated as the owner of the tax items arising from the trust income or principal subject to the power, so the power does not cause the grantor or to be taxed on that ordinary income or capital gains of the trust.

Transferors: String Powers under the Estate Tax

As under the grantor trust rules, adverse tax consequences can result when a person transfers property into trust and retains certain rights in, or powers over, the trust property. The Code provisions causing those adverse consequences are primarily Sections 2036(a) and 2038.[11]

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[6] Section 674(c). The power to add beneficiaries vitiates this exception. Section 672(c) defines a person who is related or subordinate to a grantor to be any person who is not adverse and who is also:

- the grantor's spouse living with the grantor;
- the grantor's father, mother, descendant, or sibling;
- an employee of the grantor;
- a corporation in which the grantor (or the created trust) owns stock sufficient to be considered significant from the viewpoint of voting control;
- an employee of such a corporation; or
- a employee of a corporation where the grantor is an executive and that employee is subordinate to that executive.

[7] Section 674(a).

[8] Section 674(b)(5)(A). For decisions over income, the exception applies if the power is exercised by the trustee (who may not be the grantor or his or her live-in spouse) and the trustee's exercise needs no-one's consent. Section 674(d). If anyone has a power to add beneficiaries (other than simply later-born persons) to the trust, these exceptions do not apply.

[9] Section 674(b)(5)(B). The power to add beneficiaries also vitiates this exception.

[10] Section 674(b)(6)(A). The power to add beneficiaries vitiates this exception, as well.

[11] Section 2036(b) also involves the retention of the impermissible rights, namely, the right to vote shares in a closely-held corporation. Due to the limited scope of that provision, this article will not discuss Section 2036(b) independently of 2036(a) and 2038.

Section 2036(a)(1) provides that transferred property is included in a transferor's estate if the transferor upon his or her death was enjoying, or had the right to the income from, that property. This provision is construed to include transfers of property where that property or its income may be used to discharge the transferor's legal obligations.[12] Conversely, if the transferor retains a beneficial interest in the trust property, but trust property can be distributed to or for the transferor only under a non-ascertainable standard, such as "best interests" or "general welfare," then the transferor is not considered to possess the enjoyment of, or right to the income from, that property subject to taxation under Section 2036(a)(1).[13]

Additionally, Section 2036(a)(2) subjects to estate tax property that has been transferred in trust where the transferor controls who is to benefit from that property, whether or not the transferor can benefit personally from the power. Section 2036(a)(2) applies r egardless of whether the transferor must act in concert with others, for example as one of two co-trustees, and regardless of whether the transferor is acting in a fiduciary capacity.[14] However, if the discretion retained by a transferor is limited to distributions governed by an ascertainable standard, such as "health, maintenance, education or support," then the transferor is not considered to possess the ability to determine who benefits from the transferred property.[15]

Similar to Section 2036(a)(2), Section 2038 subjects to estate tax property that has been transferred in trust where the transferor retains the power to alter, amend, revoke or terminate the trust.[16] This applies regardless of whether the transferor must act in concert with others, for example as one of two co-trustees, and regardless of whether the transferor is acting in a fiduciary capacity.[17] The power in a trustee to accumulate or distribute income or principal of a trust that is exercisable pursuant to a non-ascertainable standard is considered a power to alter, amend, revoke or terminate.[18]

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[12] Treas. Reg. 20.2036-1(b)(2).

[13] The rationale for this exception is that distributions to the transferor under a non-ascertainable standard are not subject to review by a court. Therefore, the transferor has no rights which a court can enforce for him or her, and accordingly, he or she has no rights intended to be taxed under Section 2036(a)(1). *See, e.g. Jennings v. Smith, 161 F2d74* (2nd Cir. 1947), and *Leopold v. U.S.*, 510 F2d 607 (9th Cir. 1975).

[14] Treas. Reg. 20.2036-1(b)(3). *See, e.g. Rifkind v. U.S.* (trust assets included in gross estate of decedent, where sole income beneficiary of trust created by decedent was charitable foundation and decedent served on board of that foundation).

[15] The rationale for this exception is that because the transferor's discretionary powers are subject to review by a court and subject to reversal if improperly exercised, the transferor has not retained the level of control over transferred property intended to be subjected to tax under Section 2036(a)(2). *See, e.g. Jennings v. Smith, 161 F2d74* (2nd Cir. 1947), and *Leopold v. U.S.*, 510 F2d 607 (9th Cir. 1975). Cf. Treas. Reg. 25.2511-1(g)(2) as to "gifts" by trustees and 25.2511-2(b)(3) as to the standard for a completed gift.

[16] Section 2038(a)(1). The primary differences between Section 2036(a)(2) and Section 2038 are (1) the extent to which the property subject to a transferor's powers is includable in his or her estate, and (2) Section 2038 applies to a power that can change the manner and timing of enjoyment, even if the identity of the beneficiary is not changed. Treas. Reg. 20.2036-1(b)(3) and 20.2038-1(a)(3).

[17] Treas. Reg. 20.2038-1(a)(3). *See also*, *Rifkind, supra* note 14.

[18] Treas. Reg. 20.2038-1(a)(3), and s*ee, e.g. Pardee Est. v. Comr.*, 49 T.C.140 (1967), *acq.*, 1973-2 C.B.3.

Beneficiaries: General Powers of Appointment

For a beneficiary of a trust, one is usually concerned with preventing the beneficiary from ever possessing a general power of appointment under Code Sections 2041 or 2514. Sections 2041 or 2514 are mirror provisions.[19] Those provisions are designed to subject a general power of appointment to estate tax if a person dies while possessing such a power or to gift tax if a person possesses and then exercises, relinquishes or allows the lapse of such a power.[20] A general power is defined as the ability to direct property to oneself, one's creditors, one's estate, or the creditors of one's estate.[21] Except as noted below, in most cases, it is irrelevant if the exercise of that power requires the consent of any other person.

Nonetheless, if the ability to appoint property to oneself is limited to an ascertainable standard, that power of appointment is not a general power.[22] Similarly, a power that would otherwise be a general power of appointment, but that is exercisable solely in conjunction with the creator of the power (*i.e.*, the creator of the trust) is not considered a general power of appointment.[23] So too, a power that is exercisable solely in conjunction with an "adverse party" is not considered a general power of appointment.[24]

Other Applicable Tax Doctrines

Even if one is satisfied that the basic tax rules discussed above do not pose a risk to a family's creation of a private trust or protector company, there are at least two tax concepts that must still be evaluated: *Attribution of Trustee Powers* and the *Reciprocal Trust Doctrine*.

Attribution of Trustee Powers

In regulations, the Service has taken the position that the reservation by a trust creator of the power to appoint himself or herself trustee is equivalent to the reservation of the powers of the trustee, which causes estate tax inclusion under Sections 2036 and 2038, in most cases.[25] By the 1970s, the Service had expanded that position, and claimed

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19 Adverse tax consequences of Sections 2041 and 2514 in fact can reach any person who possesses a general power of appointment, such as a trustee, even if that person is not designated as a beneficiary of the trust. However, because the tax principles can be readily applied to others, this article is concerned only with the tax consequences for trust beneficiaries.

20 Sections 2041(a)(2) and 2514(b).

21 Sections 2041(b)(1) and 2514(c). Examples of general powers of appointment are (1) the power to withdraw significant amounts of property from a trust; (2) a power exercisable during life by a descendant of the transferor to appoint trust property to "descendants" of the transferor; (3) the power, as Trustee, to make distributions to oneself for one's comfort or best interests, or (4) the power as Trustee, to make distributions to one's minor children for their support or maintenance.

22 Sections 2041(b)(1)(A) and 2514(c)(1).

23 Sections 2041(b)(1)(B) and 2514(c)(2)

24 Sections 2041(b)(1)(C) and 2514(c)(3). Who constitutes an "adverse party" is often not easy to determine, and should not be relied upon except in carefully considered circumstances.

25 Treas. Reg. 20.2036-1(b)(3) and 20.2038-1(a)(3); *see also*, Rev. Rul. 79-353.

that a trust creator who could, at will, remove and replace a corporate trustee with another corporate trustee also was deemed to possess the trustee's powers.[26] In justifying that position, the Service adopted the view that a person with the unfettered power to remove and replace corporate trustees could exercise that power over and over again until that person found a corporate trustee willing to follow his or her instructions.[27]

In the face of strong opposition from practitioners, the Service persisted in this position, brought the issue to court, and suffered repeated losses. In the *Estate of Wall*, the decedent had held the power to replace trustees of a discretionary trust with qualified corporate trustees.[28] The Service claimed that this power was sufficient to attribute the trustee's discretionary authority to the decedent, and so cause estate tax inclusion. The Tax Court rejected that position, describing it as a "quantum leap" that was supported "neither by cogent argument nor by cited cases . . . ."[29] The Tax Court reasoned that the mere threat of replacement would not make a trustee subservient to the decedent's wishes because the trustee is accountable to the beneficiaries, not to the grantor, and thus attribution of the trustees' powers to the decedent was inappropriate.[30]

Similarly, in the *Estate of Vak*, a trust grantor retained the power to replace trustees at will with a trustee that was not related or subordinate to him or her.[31] The Service claimed that this power was sufficient to give the grantor complete control over the trust because "he had the power to replace trustees with individuals who would do his bidding," and thus, according to the Service, the transfers to the trust were incomplete gifts because the trustee had discretion over principal distributions. Again, the court disagreed, reasoning that the grantor could appoint as replacement trustees only those persons who were independent of the grantor, and thus attribution of the trustees' powers was inappropriate.[32] Unlike in *Estate of Wall*, the Court's reasoning focused on the restriction that prevented the choice of related parties to be replacement trustees.

In response to those cases, the Service promulgated Revenue Ruling 95-58. That Revenue Ruling holds: where a decedent possesses the right to remove and replace trustees, the decedent will not be considered to possess the powers of the trustee if only persons or entities that are not related or subordinate (as defined in Code Section 672(c)) to the decedent may be appointed as replacements. Even though that Revenue Ruling provides no reasoning as to why the Service abandoned its broader position, nonetheless, that Ruling, until modified or revoked, is binding upon the Service under identical facts.[33] Moreover, even though that Ruling discusses the issue of attribution of fiduciary powers

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26 Rev. Rul. 79-353.

27 *See* Rev. Rul. 79-353, *citing Corning v. Commissioner*, 24 T.C. 907 (1955) (determining whether a trust was a grantor trust for income tax purposes).

28 *Estate of Wall*, 101 TC 300 (1987).

29 *Id.*, at 306, 311.

30 *Id.*, at 312-313.

31 *Estate of Vak*, 973 F2d 1409 (8th Cir. 1992).

32 *Id.*, at 1414.

33 It has been suggested that the rationale for the issuance of Revenue Ruling 95-58 was two-fold: (1) the Service wanted to limit any further negative court precedents and (2) the Commissioner at that time genuinely believed that the Service's position was erroneous.

to a "decedent," taxpayers and advisors have inferred that the same rule would apply in the context of living individuals for purposes of applying the federal gift tax and determining whether a gift was complete. Accordingly, Revenue Ruling 95-58 is considered to be the standard used by the Service to review the power to remove and replace trustees.

Reciprocal Trust Doctrine

The other doctrine that must be considered when a family creates a private trust or protector company is the Reciprocal Trust Doctrine (also sometimes called the "Reciprocal Transfer Doctrine"). The Reciprocal Trust Doctrine originated as a judicially created attempt to prevent trust creators from literally circumventing the estate and gift tax rules while still retaining for all practical purposes the beneficial enjoyment of the assets transferred in trust.[34] The seminal case that articulated that doctrine was *U.S. v. Grace*.[35]

Grace involved a husband who created a trust of which the husband was a co-trustee. The trust provided an income interest to the wife for life and principal distributions to her in the trustees' discretion. Within two weeks, the wife created an identical trust for her husband, of which the wife was a co-trustee. The husband died and the Service claimed that the value of the wife's trust was includable in the husband's gross estate.

In considering the procedural history of the case, the Supreme Court noted that the Court of Claims had been divided over the proper test for application of the Reciprocal Trust Doctrine.[36] According to the Supreme Court, the test that was applied by the Court of Claims was whether the similar trusts were created as consideration for one another, and the issue of consideration was an evidentiary one that depended upon the intent of the trust creators.[37] The Supreme Court disagreed.[38]

In formulating its own test, the Court began its analysis by noting that "emphasis on the subjective intent of the parties in creating trusts, particularly when those parties are members of the same family unit, creates substantial obstacles to the proper application of the federal estate tax laws." [39] Therefore, "the taxability of trust corpus does not hinge on a settlor's motives, but depends upon the nature and operative effect of the

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[34] *See Lehman v. Commissioner*, 109 F.2d 99 (2nd Cir. 1940), *cert. den.*, 310 U.S. 637 (1940).

[35] 395 U.S. 316 (1969).

[36] *Id.* at 321-322.

[37] The critical factor for the majority in the Court of Claims was whether the husband had established the trust of which his wife was the beneficiary in consideration of his wife establishing the trust of which he was the beneficiary. *U.S. v. Grace*, 393 F.2d 939 (Ct. Cl. 1968) (called here "Grace 1"). Even though that majority recognized that some other courts had inferred consideration from the establishment of substantially identical trusts close in time, the majority in the Court of Claims considered any such inference in Grace 1 to have been rebutted by the evidence in the case. *Grace*, 395 U.S. at 322. For the dissent in Grace 1, however, the subjective intent of the trust creators was irrelevant; once it was established that the trusts were interrelated, that was the end of the analysis of the Reciprocal Trust Doctrine. *See Grace*, 395 U.S. at 322.

[38] *Id.*

[39] *Id.* at 323.

trust transfer."[40] The Court ultimately held that the value of Mrs. Grace's trust was included in Mr. Grace's gross estate for estate tax purposes. In doing so, the Court established the following test:

> Application of the reciprocal trust doctrine is not dependent upon a finding that each trust was created as a quid pro quo for the other. . . Nor do we think it necessary to prove the existence of a tax-avoidance motive. . . The reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.[41]

After *Grace*, the Reciprocal Trust Doctrine continued to generate substantial controversy. The first such controversy involved the question of whether transferors must have beneficial interests in the trusts at issue for the doctrine to be applied. In *Estate of Bischoff v. Commissioner*, the Tax Court held that reciprocal fiduciary powers were sufficient to trigger the doctrine.[42] In so holding, the Tax Court concluded that the Supreme Court's reference to "the same economic position . . . as life beneficiaries" was merely a reference to the facts before that court in that case, and should not be interpreted literally to require that transferors possess reciprocal beneficial interests.[43] In reaching that conclusion, the Tax Court noted that the purpose of the Reciprocal Trust Doctrine is simply to identify the "true" transferor of the property; once that transferor is determined, taxation of the trust property depends upon the operation of the tax code.[44]

After *Bischoff*, the Reciprocal Trust Doctrine has been expanded into other contexts and further refined. For example, in *Exchange Bank & Trust Co. of Fl. v. U.S.*, the doctrine was used again to apply the estate tax, but this time to reciprocal gifts made by husband and wife into custodial accounts for the benefit of their minor children.[45] Similarly, in *Sather v. Comm.*, the doctrine was applied to uncross inter-family gifts and

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[40] *Id.*

[41] *Id.* at 324. The Court buttressed its conclusion by reasoning that, as a practical matter, at the time the issue is in controversy, sometimes decades after the event, it is extremely difficult to adduce proof of subjective intent. The Court also reasoned that members of a family do not create trusts for one another as bargained-for consideration, because "consideration" typically does not exist in the family context. *Id.*

[42] 69 TC 32 (1977). *Bischoff* involved trusts created by a husband that benefited his grandchildren and that named his wife as trustee. Within days, the wife created, with identical assets, mirrored trusts that benefited the same grandchildren and that named the husband as Trustee. Neither the husband nor wife retained any beneficial interest in the trusts. The Tax Court ultimately held that the trusts were included in the respective estates of the husband and wife under Sections 2036(a)(2) or 2038(a)(1) because each of them possessed broad fiduciary powers over the property he or she transferred due to the reciprocal nature of the transfers. *Id.* at 48.

[43] *Id.* at 46. *Cf.*, *Estate of Green*, 68 F3d 151 (6th Cir. 1995), rejecting the Tax Court's position in *Bischoff*, and instead holding that fiduciary powers do not constitute the "economic benefit" needed to trigger the application of the reciprocal trust doctrine as expressed by the Supreme Court in *Grace*.

[44] *Bischoff*, 69 TC at 46.

[45] 694 F.2d 1261 (Ct. App. Fed. Cir. 1982).

deny the annual gift tax exclusion to the transferors in that case.[46] More important than the expansion of the doctrine into other areas, cases like *Exchange Bank* and *Sather* have refined the Reciprocal Trust Doctrine into a two-step analysis: (1) are the trusts or transfers inter-related,[47] and if so, (2) do the inter-related trusts or transfers leave the transferors in the same economic position as they would occupy if direct, rather than inter-related, transfers had occurred. In both *Exchange Bank* and *Sather*, the courts determined that the transferors were in the same economic position, that of passing assets to their children, by entering into the inter-related transactions as the transferors would have occupied had they made all of the transfers directly to their children. [48]

Despite the expansion of the Reciprocal Trust Doctrine, there do appear to be limits to that doctrine at this time. Specifically, there have been no cases or revenue rulings that stand for (or even address) the proposition that the Reciprocal Trust Doctrine should apply to persons who were not the transferors of the property at issue.

On one occasion, PLR 9235025, the Service addressed this issue and applied it to persons who were not transferors. PLR 9235025 involved two trusts, one created for each of two brothers by their father. Each trust provided for distributions that were not limited to ascertainable standards. The brothers served as co-trustees for each trust, but New York law prohibited a brother from making discretionary distributions to himself. The Service concluded that each brother possessed a general power of appointment over his trust because it could be "objectively inferred" that the brothers would exercise their respective powers on a reciprocal basis on behalf of the other.

However, the only authority cited by the Service for that position was the opinion of the New York Surrogate's Court in *Estate of Nathaniel Spear*,[49] and citation to that case

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[46] 251 F.3d 1168 (8th Cir. 2001). Sather involved multiple branches of a family where certain family members made gifts of stock in a family owned business both to their own children and to the children of their siblings. Those siblings in turn made mirrored gifts to the children of those other family members, and to the sibling's children as well. The Service uncrossed the gifts of the siblings so that a parent was considered to make the gifts to his or her children that were in fact made by the sibling. Thus, when the sibling's gifts, which were attributed to a parent, were added to the gifts that the parent in fact made to his or her children, the total gifts considered made by that parent far exceeded the annual exclusions available to the parent with respect to his or her children. *Id.* at 1174-1175.

[47] Courts have looked to the various factors when determining whether trusts or transfers are inter-related: similarity of trust terms; timing of the creation of the trusts; identity of trust assets; and whether the trusts are part of a pre-arranged plan of gifting. *See Est. of Green*, 68 F3d 151, 154-155 (Jones, N. *dissenting*).

[48] In *Exchange Bank,* had the transferor named himself (rather than his spouse) custodian over the property he transferred; in *Sather*, had he made the gifts directly to his children that were in fact made by his siblings. *Exchange Bank*, *supra* note 44, at 1268, and *Sather*, *supra* note 45, at 1175.

[49] 553 N.Y.S.2d 985 (Sur. 1990). *Spear* involved two trusts created by a grandparent, one for each grandchild, where the grandchildren were co-trustees of the two trusts. The ultimate issue raised by the facts in Spear was whether the two trusts qualified for the Gallo exception (a result favorable to the taxpayer, which would avoid a generation-skipping tax). The exception required that either a grandchild's trust be vested if he dies prior to termination or a grandchild have a general power of appointment over the assets in his trust. The Surrogate's Court specifically avoided ruling on the power of appointment issue: "although the court concurs that these

was inappropriate. The language relied upon by the Service is clearly dicta and has never been relied upon by any other court. Moreover, Spear was not truly an adversarial proceeding and was clearly result oriented: the Surrogate's Court wished to preserve a favorable tax result for the trusts at issue. If the power of appointment issue were to arise again but in a different context, it is very unlikely that a court would reach the conclusion expressed by the Surrogate's Court in *Spear* in its dicta.

Additionally, in more recent situations where one would have expected the Service to apply the Reciprocal Trust Doctrine to persons who are not the transferors, the Service declined to do so. For example, in PLR 9451049, a trust was created for each of two sisters. One sister's trust provided for distributions to her under an ascertainable standard but also provided that sister with a power to direct the trustees to distribute trust assets to any or all of the descendants of the trust creator. The power was exercisable during the sister's life but not in favor of the sister or persons whom the sister was obligated to support. The sisters planned to exercise their powers of appointment so that the property of the trusts was distributed to one another. The Service ruled that the exercise of such a power would constitute a taxable gift of a sister's lifetime interest in distributions for her under the ascertainable standard, but would not constitute the exercise or lapse of a general power of appointment. The Service also stated that "in appropriate circumstances, transfers similar in nature to those involved in this letter ruling could be viewed as reciprocal. . . . However, under the facts presented here, application of those principles is not warranted." Yet, it is hard to imagine a situation better than that in PLR 9451049 where the Service could claim that the Reciprocal Trust Doctrine applied to persons who were not the transferors of property.

In this way, the status of the Reciprocal Trust Doctrine can be summarized as follows. To apply that doctrine to two or more transfers in trust, (1) the transfers or trusts at issue must be inter-related, and (2) the transferors must be left in the same economic position as they would occupy if direct, rather than inter-related, transfers had occurred.[50] Additionally, that doctrine serves only to identify "true transferors" of property; it does not, at this time, sweep within its ambit those who are beneficiaries of trusts, but not transferors, and who hold reciprocal powers, whether as fiduciaries or as individuals.

Existing Guidance as to Private Fiduciary Companies

In view of the above discussion of the rules and doctrines governing income, estate and gift taxation of trust creators and beneficiaries, one can well anticipate that the application of those rules and doctrines to the context of a private trust or protector company is quite complex. Unfortunately, there is very little specific authority available

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reciprocal powers are the equivalent of a general power of appointment, there is another basis for determining that the [trusts] satisfy the Gallo amendment." *Id.* at 986. The court disposed of the Gallo issue by employing its equity powers to rewrite the trusts so that a grandchild was given an express general power of appointment over his trust in the event of premature death. *Id.* at 986.

50 The primary unresolved issue is whether the "same" economic position must be beneficial interests retained by the transferor, or is it enough that the transferors accomplished the same economic result through the interrelated transfers as they could if direct transfers had been used. Given the interpretation of the economic benefit requirement by courts other than the 6th Circuit, it seems that the Tax Court's position in *Bischoff* will likely prevail.

to provide guidance in structuring private fiduciary companies, and the authority that is available is limited in usefulness.

As suggested above, some guidance from the Service does exist that involves private fiduciary companies: PLRs 200125038 and 200229013. It is worthwhile to review those letter rulings briefly.

PLR 200125038, which is the follow-up to PLR 9842007, involved a PTC of which the voting stock was owned by 50% by one family.[51] That 50% of the stock was owned by eleven trusts created by siblings of that family.[52] The Service had already ruled in PLR 9842007 that the PTC was not a related or subordinate party to any of the trust creators within the meaning of Section 672(c). In issuing that ruling, the Service relied on the fact that, from among these 11 trusts that held the stock of the PTC, no trust or group of trusts created by one grantor could control more than 10% of the PTC's voting stock, and that none of the grantors or beneficiaries, acting alone, could control a decision of the PTC.

In the follow-up ruling, PLR 200125038, the Service addressed that same PTC except that now the beneficiaries of the 11 trusts were more directly involved in controlling the voting power of the PTC. Prior to this second ruling, the voting stock of the PTC had been transferred by the 11 trusts to a voting trust, under which the voting trustees were the 11 grandchildren-beneficiaries of the 11 trusts. In this later ruling, the Service concluded, among other things, that the trust grantors and beneficiaries did not face an estate tax problem by virtue of the family's collective voting power in the PTC. More specifically, the Service ruled that the PTC's position as trustee of the 11 trusts and its discretion over trust distributions did not cause any portion of the trusts to be included in the gross estates of any of the grantors (siblings A – E) under 2036 or 2038 or in any of the gross estates of the trust beneficiaries. In so ruling, the Service provides no rationale or reasoning, nor does the Service highlight determinative facts.

PLR 200229013 involved a similar but simpler structure -- in which the family collectively held the entire voting power over the PTC. The PTC was wholly owned by a corporation, which in turn was owned by three members of a family, A, B and C. The PTC was the sole trustee of three trusts, one held for each of A, B and C and their respective descendants. Why the favorable result? Despite the family's collective control

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[51] The other 50% was owned by a second family.

[52] The creators and stock ownership of each trust can be summarized as follows:

Trust Creator	Trust #	% of Voting Stock owned by a Trust	Aggregate % of Voting Ownership by Branch
Sibling A	1-3	3.37	10
Sibling B	9-10	5	10
Sibling C	6-8	3.37	10
Sibling D	11	10	10
Sibling E	4-5	5	10

over the PTC, all distributions were controlled by an independent committee (i.e., not related or subordinate to the family members who were the grantors and beneficiaries). Specifically, the bylaws of the PTC provided that a sub-committee of the board of directors would make decisions r egarding trust distributions. The by-laws also provided that the members of that sub-committee could not be a beneficiary of any trust of which the PTC served as a trustee, an employee of the PTC, or a related or subordinate party with respect to any trust grantor or any beneficiary. Among other things, the Service ruled that A, B or C would not possess a general power of appointment over their respective trusts. In reaching this conclusion, the Service relied upon the fact that, even though A, B and C were the sole shareholders of the corporation owning the PTC, and thus could elect the directors of the PTC, the by-laws prevented a person who was related or subordinate to any trust grantor or beneficiary from serving as a member of the distribution sub-committee.

The usefulness of these rulings to the practitioner is limited due to the highly factual nature of those rulings and the very limited explanation set forth in the rulings themselves. As noted above, in PLR 200229013, the bylaws restricted a trust grantor or beneficiary from serving on or appointing a related or subordinate party[53] to a sub-committee that exercised power over trust distributions. These bylaw provisions are the functional equivalent of the provisions now used in many trust documents to protect from the risk of adverse transfer tax consequences. These clauses restrict the ability to make distributions by imposing an ascertainable standard when a person who is also a beneficiary possesses the power to remove and replace a trustee with related or subordinate parties.[54] Because of the by-law provisions, that ruling provides little guidance to the practitioner outside of its specific factual context. The client's advisor must therefore revert back to applying the general principles discussed above in this article, particularly the doctrine of attribution of fiduciary power, in order to analyze a client's planned structure. This analysis may in turn lead to the need to apply for a private letter ruling.[55]

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[53] As defined in Section 672(c).

[54] The following is an example of such a clause:

> A Trustee may make discretionary distributions of income or principal to himself or herself or a Powerholder only for the support of the recipient and not for the recipient's best interests. A Trustee may not make discretionary distributions of income or principal that would discharge the legal obligation of himself or herself or a Powerholder. A Trustee may not exercise any incident of ownership on an insurance policy insuring his or her own life or the life of a Powerholder. In determining whether the power of a particular Trustee is so restricted, the term "Powerholder" means any person acting in any capacity, whether alone or with others, who possesses the power under this Document to remove and replace that particular Trustee with a Trustee that is related or subordinate (by applying Section 672(c) of the Code) to that person.

[55] In view of the value of the assets typically involved in these settings, and the corresponding amount of the tax bill if the structure of the private fiduciary company triggers an estate tax, the client and client's counsel may decide to seek a letter ruling whenever the planned structure does not fall neatly within the general principles discussed above.

Similarly, in PLR 200125038, the Service provided no analysis but it is fair to assume that the favorable result was grounded on a somewhat similar bylaw provision to that in PLR 200229013.[56] The bylaws of the trust company prohibited a director or officer from participating in decisions regarding discretionary distributions from a trust if that officer, director or spouse of the officer or director was a (1) grantor of that trust, (2) a beneficiary (whether vested or contingent) of that trust, or (3) a descendant of "F" so long as any descendant of F (whether the director or director herself, or any other descendant of F) was a beneficiary of that trust (whether vested or contingent). F was the common parent of the creators of all the trusts at issue. Again, these bylaw provisions are the functional equivalent of the protective language referred to above that is often found in trust documents, and were presumably critical to the favorable result in that ruling. It is also important to recognize that the bylaw provision in this ruling was even more protective than the bylaw in PLR 200229013. Note that the restriction in (3) above is an anti-reciprocity provision. It serves to preclude the application of the Reciprocal Trust Doctrine, since no descendant of F (or spouse of a descendant of F) could participate in discretionary distribution decisions for any other descendant of F. This restriction precludes even the possibility of collusion or interrelated conduct, so control over distributions through reciprocal "back scratching" cannot be at issue.[57] Thus, like PLR 200229013, the usefulness of PLR 200125038 is limited to substantially identical factual situations.

The Question Not Asked: Can a Family Member Participate in Naming a Related Party to Make Discretionary Distributions?

Certainly, letter rulings are not precedent that can be relied upon by other taxpayers and thus all such rulings might be considered confined to their facts. But the limited scope of the two rulings above is noteworthy because they did not address the following fact pattern that would be particularly relevant to structuring a private fiduciary company. Assume that the structure allows a trust beneficiary, acting in

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[56] At first glance, it appears to be significant that the Service held in PLR 9841014, its prior ruling, that the trust company at issue was not related or subordinate to the trust grantors. However, one may infer that such a legal conclusion was not relevant to the transfer tax analysis because in 200229013, there is no mention of whether the trust company was related or subordinate to the trust beneficiaries or grantors. Instead, one should note that in PLRs 200229013 and 200125038 the Service is focusing on which parties in fact control distribution decisions, which to these authors is the core tax issue. Rightly so, the Service has not taken the position that the private fiduciary company itself must be unrelated and non-subordinate to the family in order to avoid a bad tax result.

[57] There appears to be a second difference as well. The by-laws in PLR 200125038 do not protect a beneficiary who has the power (exercisable only in conjunction with other beneficiaries who served as trustees of the voting trust in that ruling) to remove and replace a director or officer, not with himself or herself or any other descendant of F, but with a party that is otherwise related or subordinate to himself or herself, when that director or officer could participate in discretionary distributions from that beneficiary's trust. However, this is a difference without substance. Each person who would qualify as a related or subordinate party under Section 672(c) to such a beneficiary was already restricted from participating as a director or officer of the trust company due to the by-law provisions. The only person who could potentially serve as an officer or director of that trust company and who could be considered related or subordinate to such a beneficiary would be an employee of that beneficiary or an employee of a corporation where that beneficiary was an executive, both highly unlikely possibilities.

conjunction with other family members, to name the person who can decide upon discretionary distributions and that the beneficiary can name someone who is related or subordinate to that beneficiary.[58] In other words, assume that the structures in the PLRs described above did not contain the restrictive bylaw provisions. This kind of structure would often be preferred by families who seek to create private fiduciary companies. In their desire to preserve maximum flexibility, families often wish to reserve the ability to appoint related or subordinate persons (like siblings and other related parties) to offices where discretion over trust distributions is exercised, because those persons best understand the family situation. Yet these letter rulings indicate that families are not structuring private fiduciary companies in this way.

If families are not following their preference for flexibility, it must be due to the fear that the Service will seek to attribute a fiduciary's discretionary powers to family members based solely on the fact that those members may, as a group, remove and replace that fiduciary.[59] Under this analysis, the Reciprocal Trust Doctrine would be applied in its broadest possible fashion, and also applied in combination with the Attribution of Trustee Powers under Revenue Ruling 95-58. This analysis would presume that the "family" (however defined) will act in concert to remove and appoint related or subordinate parties as the fiduciaries who decide upon discretionary distributions and who will "do the bidding" of each family member as to his or her trust.

The chain of reasoning that could produce this bad tax result can be illustrated as follows:

(1) <u>Related Party Can Name Related Party as Trustee</u>. The Attribution of Trustee Powers under Revenue Ruling 95-58 focuses on whether a trust creator (or, by extension, a beneficiary) holds a power to change trustees (the "Powerholder") and select a related or subordinate party ("Related Party") as a replacement trustee. Thus, there is no attribution under this rule if someone else is the Powerholder, even if that someone else is a Related Party. <u>Example</u>: B can remove the trustee of a trust for the benefit of S and substitute a trustee that is a Related Party. B is the brother of S. There should not be attribution of the trustee's powers to S, since B holds the removal power and not S. It does not matter that S may have great influence over B, as long as there is no nominee arrangement by which B will take directions from S.

(2) <u>Same Power is Held Jointly with Trust Creator/Beneficiary</u>. Suppose, however, that the power cannot be exercised without the consent of the trust creator/beneficiary. This "negative control" still should not cause attribution to the

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[58] The above situation would arise in a PTC where a sub-committee, elected by directors, exercises discretionary distribution authority over trust assets. This situation would also arise in a PPC, where family members serve on the board of directors or may elect members of the board of the PPC, and where the PPC serving as the protector can remove and appoint, as trustees, persons who are related or subordinate to members of the board of directors or those who may elect members of the board.

[59] For purposes of the discussion here and on the following pages, the reader should assume that the removal power at issue may be exercised without precondition, that the pool of replacement fiduciaries includes related or subordinate parties, and that distributions from a beneficiary/family member's trust can be made to him or her for his or her under a non-ascertainable standard.

creator/beneficiary under Revenue Ruling 95-58. Example: Same as Ex.1 but B cannot act without the consent of S. No attribution.

(3) Reciprocal Transferors with Powers to Name Trustees. Is the result different if the Powerholder in the first trust is also the trust creator/beneficiary of a second "mirror" trust, and vice versa? Example: S and B are siblings. S is the Powerholder for a trust funded by B and can change the trustee to a party that is related or subordinate to B, and B has a similar power over a trust funded by S. Result? Depending on the facts, the Reciprocal Trust Doctrine could justify the conclusion that B (rather than S) should be treated as the Powerholder of the trust funded by B, thus exposing B to estate tax on the trust assets under Revenue Ruling 95-58 by attribution of the trustee's powers. The same reasoning would apply to S as to the trust funded by S. This is a simple combination of the application of the Reciprocal Trust Doctrine and the Attribution of Trustee Powers under Revenue Ruling 95-58. (It does assume, contrary to *Estate of Green*, that the Reciprocal Trust Doctrine applies even if the transferors are not also beneficiaries, consistent with the holding in *Bischoff* and later cases.)

(4) "Crossed" Powers to Name Trustees But Not Reciprocal Transferors. Is the result different if the Powerholders are beneficiaries of what appear to be similar trusts, but the trusts were funded by someone else? Example: B and S are siblings, and S is the Powerholder for a trust funded by B as described above in Ex. 3, and B has a similar power over a second trust. But S did not fund the second trust and is merely a beneficiary of that trust. Result? To apply reciprocity here would be an extension of the doctrine because B and S are not both transferors. This would be even clearer if neither B nor S were transferors, e.g., both trusts were established many years ago by different grandparents of B and S.

(5) Joint Power to Name Trustees Held by Group of Beneficiaries. If several trusts are administered by the different trustees, but each trustee can be replaced with a trustee that is a Related Party as to one or more of the beneficiaries of that trust, should it lead to a bad estate or gift tax result if the removal and selection of trustees can be done by a committee where a majority of the committee members are beneficiaries and the committee acts by majority vote? It should lead to a bad tax result only if the power to change trustees is considered to be equivalent to the reciprocal power in Ex. 3 rather than the joint power in Ex. 2, on the reasoning that the Reciprocal Trust Doctrine somehow should override the fact that the power to change trustees is held jointly by several people who cannot act alone. The Reciprocal Trust Doctrine would have to be used to expand the rule on the Attribution of Trustee Powers. This result would apply attribution even though the removal power was not exercisable by one person without restriction. This step would be based on the potential for reciprocal conduct, not on demonstrated reciprocal conduct as in Ex. 3. The Service has presumed collusion between a Powerholder and a trustee in all cases (and has not sustained that position in court, even as to related party trustees). This step would now seek also to presume collusion between joint holders of the power.[60]

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[60] This example presents the same issues as the private fiduciary company. As noted above, for purposes of Sections 2036, 2038 and 2041, it is immaterial in what capacity the power was exercisable by the decedent. Thus, the status of the fiduciary company is not the issue, and the

This potential combination of "rules" is not so threatening because the analysis is viewed as valid. It is so troublesome because its effect would be so severe if the argument succeeded. Simply put, the transfer tax cost for a family that sets up a private fiduciary company in this manner and loses this issue would be huge.[61] Because of this threat, most if not all taxpayers in this setting would seek to avoid the risk that the Service (1) will treat taxpayers, who are members of the same family and who serve as directors of a private fiduciary company, as colluding with one another in removing and replacing fiduciaries that can exercise discretion over trust distributions, (2) then attribute to each such family member the discretionary authority of those fiduciaries, and therefore (3) subject the assets in such a family member's trust to transfer taxation.

The Right Answer: No Attribution

Should the possibility of collusion among family members who share the power to replace the fiduciaries in these private companies cause the fiduciary powers to be attributed to those family members?[62] The question suggests that "no" is the correct answer. But to see why this answer is correct, one should analyze the question in two contexts. The first context would be a situation where non-transferor family members serve as directors of a private fiduciary company, but only certain of those family members possess beneficial interests in the administered trusts (the "Non-Reciprocal Beneficial Interests"). The second context (the "Reciprocal Beneficial Interests") would be a situation in which the private fiduciary company administers multiple trusts, one for each member of a family, and each family-member serves as a director of that company (each such family-member called a "beneficiary-director").[63]

1. Non-Reciprocal Beneficial Interests

In the context that we have labeled the Non-Reciprocal Beneficial Interests, there would be no economic motivation for reciprocity between family-member directors, because some of them do not have beneficial interests in the administered trusts. Even if

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issue arises even if there is no private fiduciary company. Put another way, the fact that the PTC or the PPC may not be a related or subordinate party as to the particular trust creator/beneficiary is not the real issue, because the entity acts only through individuals. The real focus should be on what individual or group of individuals holds the actual power to decide upon distributions and whether any trust creator or beneficiary (that is, the potential taxpayer, whether acting as a PTC or PPC director, committee member, etc.) can remove and replace those individuals who control distributions with parties related or subordinate to the creator/beneficiary.

[61] In some cases, the tax cost of this distribution structure would be particularly difficult for the family to accept because the trusts being administered by the private fiduciary company are not often needed as a source of discretionary distributions, so the tax would have been levied by reason of a distribution power that is intended to be used only in the event of a special, unexpected need.

[62] Again, assume that the removal power at issue may be exercised without precondition, that the pool of replacement fiduciaries includes related or subordinate parties, and that distributions from a beneficiary/family member's trust can be made to him or her under a non-ascertainable standard.

[63] Note that if there was only one trust for multiple beneficiary-directors, those beneficiary-directors might be considered to be adverse parties as to one another, which could prevent adverse tax consequences due to the exception to general powers of appointment for joint powers held by adverse parties.

the directors colluded, not all of them could "get their backs scratched." Therefore, any effort by the Service to attribute to each of them personally the powers of the fiduciary company would have to rely heavily upon the fact that the directors were related to one another; that is, it is assumed they will act reciprocally because they are in the same family. Such a position would be equivalent to adopting a *de facto* family attribution rule.

This *de facto* family attribution rule cannot be justified. First, there is no basis in the tax code for family attribution of fiduciary powers. Such a rule would require authorization by Congress.[64] Congress has not taken any legislative action under the transfer tax system to attribute any similar powers based on family relationships. This is not surprising because it would contravene basic principles of the system. For example, under the transfer tax system, a power of appointment (which can more easily be used to control beneficial enjoyment than a power to change trustees) is <u>not</u> attributed from one family member to another for purposes of imposing estate taxes or delaying the completion of a gift based on a retained power. The approach is quite different under the grantor trust rules for income tax purposes. In that context, all powers are explicitly attributed from one spouse to another, and certain powers held by related parties are in effect treated as if held by the grantor.[65] In contrast, the entire estate and gift tax system is constructed on the principle that ownership by an individual family member is not attributed to another family member and, indeed, taxes are imposed when ownership is transferred between them.[66]

Additionally, *de facto* family attribution of fiduciary powers cannot be justified because it would create an irrefutable presumption that family members collude simply because they are related to one another.[67] Common experience, however, teaches us that persons do not collude, or even cooperate, simply because they are related. As noted above, the Service does not assume collusion between an independent fiduciary and grantors/beneficiaries. Presumably this distinction rests on the set of assumptions that an independent fiduciary is more concerned about the risk of fiduciary liability than a family fiduciary, and is less subject to coercion and less inclined to be accommodating than a related person. Whatever validity these assumptions may have in individual cases, they are a weak rationale by which to impose a transfer tax. Transfer taxes are imposed on the basis of ownership and control, and there is no body of evidence or

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[64] *Compare* Sections 2036(b), 2701 and 2704 where Congress enacted special rules for family owned entities, using attribution rules, in order to curb perceived abuses. Contrast family attribution in the context of valuing minority ownership in a family business: the Service long argued for family attribution, but ultimately abandoned that position because there was no justification in the Code and the position contravened the hypothetical willing buyer-willing seller concept. *See* Rev. Rul. 93-12, *revoking* Rev. Rul. 81-253. The proposals to enact statutes to adopt family attribution in valuing minority interests have failed in Congress.

[65] *See* Sections 672(e), 674, 675 and 677.

[66] The tax is not a wealth tax on the family as a unit, but is a transfer tax; transfers between individual family members are considered to be just as economically significant as if made between unrelated parties, unlike related party transfers under many rules of the income tax. *See, e.g.*, Sections 267 and 704(e).

[67] This presupposes that the proper definition of "family" for this purpose (and related entities) is self-evident, even though such terms are defined differently for purposes of various attribution rules under the Code. *See, e.g.*, Section 318 and Section 2704.

experience that establishes a consistent practice of collusion among family members just because they are family members. Remember that we would be assuming that groups of beneficiaries and grantors can act together to control fiduciaries simply because those fiduciaries are related to them, and upon that reasoning, we would impose a transfer tax equal to half the value of the trust property. Common experience does not support this radical step.

In these times, the risk of fiduciary liability is a very real concern for all fiduciaries, including family fiduciaries. As families grow larger and more geographically diverse, the familial connection between a trust beneficiary and family member fiduciaries becomes weaker. In fact, suits by trust beneficiaries against those fiduciaries are occurring more often, and even those family fiduciaries who are not much concerned about being sued by a family member they know well, like a sibling, are still concerned about family members they do not yet know, such as future nephews or nieces.

Moreover, a family member fiduciary is not inherently more vulnerable to coercion and influence than an independent individual. Independent fiduciaries in this context may depend upon other relationships with a grantor or beneficiary for their financial livelihood. Therefore, those "independent" individuals may be often inclined to please, and not to make unpopular decisions. At the same time the familial relationship can provide a family member fiduciary with some independence to make a difficult or unpopular decision. Therefore, there is no justification for, on the one hand, assuming no collusion among an independent person and grantors/beneficiaries, while, on the other hand, assuming collusion among family members, and using that distinction as a basis for determining whether there will be a transfer tax on the trust. In fact, whether a fiduciary "does the bidding" of a grantor/beneficiary would most likely depend not upon whether a family relationship exists, but instead upon how respected the fiduciary is by the grantor/beneficiary and on the nature of the issue at hand. For these reasons, creation by the Service of *de facto* family attribution would be unjustified and the adoption of any such rule, whatever its merits and however limited its scope, should be left to the legislature.

2. Reciprocal Beneficial Interests

Next, we should consider the context when each family member who is a director of the fiduciary company is also a trust beneficiary. If the Service were to attribute powers in this second context (what we have called Reciprocal Beneficial Interests),[68] that position would, as we have suggested above, require an extension of the Reciprocal Trust Doctrine, combined with a full adoption and expansion of the Attribution of Fiduciary Powers Doctrine. The Service's argument would be as follows: beneficiary-directors will collude in decisions regarding removal and replacement of fiduciaries for one another's trusts because, by doing so, a beneficiary-director will be able to remove and replace unilaterally the fiduciaries for his or her own trust and thus will be able to control the

[68] Again, assume that the removal power at issue may be exercised without precondition, that the pool of replacement fiduciaries includes related or subordinate parties, and that distributions from a beneficiary/family member's trust can be made to him or her under a non-ascertainable standard.

exercise of those fiduciaries' discretionary powers over trust distributions to himself or herself.

This position is also without merit. Such an interpretation of the Reciprocal Trust Doctrine extends that doctrine beyond its original purposes. As many of the cases applying the *Grace* decision have concluded, the purpose of the Reciprocal Trust Doctrine is to identify the true transferor of property, so that the tax code can be applied to the reality of a particular situation.[69] It is not a giant step to infer that collusion represents reality when two transferors who have controlled the terms of their contemporaneous transfers have in fact produced "mirror image" results. It is a much greater step (even beyond the "quantum leap" that the court refused to take in *Estate of Wall)* to presume ongoing collusion in the context at issue here as to each family member's distributions. The family simply shares a power to name a group of fiduciaries who will then make decisions over the years as to how to apply under changing circumstances the terms of multiple sets of legal documents that usually were created, at least in part, many years earlier and at different times and typically by many different transferors.[70]

Put another way, the presumption of collusion among family members in this context is particularly troublesome because applying the Reciprocal Trust Doctrine to cover family-member beneficiary-directors as described above would require only one precondition: that these persons share a power of removal and replacement. None of the other signs of collusive behavior that are naturally present in the traditional cases of transferors would be required. If this is enough to justify treating powers as reciprocal, then the Reciprocal Trust Doctrine has been transformed into a kind of intellectual kudzu. It can thrive almost anywhere and has no natural limits. It assumes a particular reality, that beneficiary-directors are colluding and acting as one another's stooge. Even if beneficiary-directors in fact are not colluding, nevertheless, application of the Reciprocal Trust Doctrine would automatically yield a legal determination that each beneficiary-director unilaterally could exercise that shared power. Thus, so extending the Reciprocal Trust Doctrine could create circumstances for tax purposes (without any possibility of rebuttal) that do not exist. The Reciprocal Trust Doctrine was designed to reveal reality, not to create "realities" that are sometimes true and sometimes false. For

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[69] *Bischoff*, 69 TC at 46. *See also*, *Sather* at 1174-1175. It is critical to recall that the reality of a situation involving transferors is determined by the analysis of a number of factual issues. Those issues include whether the transfers at issue occurred close-in-time, whether the transferors are related or closely connected to one another, whether the assets transferred are substantially identical, and whether the transferors for all practical purposes stand in the same position(as a beneficiary, trustee or simply as a donor parent) both before and after the transfers. A combination of these factors leads to the application of the Reciprocal Trust Doctrine; no one of these factors is determinative, and the taxpayer has the opportunity to disprove all of them.

[70] Note that the only "collusive" behavior here is forming the fiduciary company. Thus, the analysis here for directors who are beneficiaries would usually also apply to directors who are transferors; in that case, we would be assuming that the trusts were not formed by transferors who evidenced collusive conduct by funding the trusts at the same time with "mirror" provisions. Instead, collusion would be an issue simply because the transferors together participated in the trust company.

all these reasons, the doctrine should not be extended as a rule of taxation to beneficiary-directors in the context of private fiduciary companies.[71]

Not only should the Service fail to so extend the Reciprocal Trust Doctrine, the Service should also fail in applying the Attribution of Fiduciary Powers Doctrine to beneficiary-directors who may, acting only in conjunction with others, remove and replace fiduciaries. Taken in a view most favorable to the Service, the doctrine of Attribution of Fiduciary Powers is premised upon the idea that, if a person has the unqualified power to remove a fiduciary, and to replace that fiduciary with someone who is related or subordinate (by applying the principles of Section 672(c)), then that powerholder in reality can exercise the powers of the fiduciary.[72] The crucial condition is that the person can remove and replace the fiduciary without qualification, in other words, unilaterally, or at any time and for any reason. Even under the view adopted by the Service (which has not been endorsed by the courts, as discussed above), the power must be unilateral.

This unilateral characteristic is not present in the private fiduciary company. In a private trust company where beneficiary-directors select members of a distribution committee, for example, or in a private protector company where beneficiary-directors select trustees, the power to remove and replace those members or trustees is not "unqualified" or exercisable by one of beneficiary-director unilaterally. Instead, it is subject to the real limitation that beneficiary-directors must agree to exercise that power; it may not be necessary that all of those beneficiary-directors agree, but at least some of them must be convinced to exercise the power. The only way to reach the conclusion that a beneficiary-director can unilaterally remove and replace a fiduciary is to assume that the beneficiary-directors are colluding and the other beneficiary-directors will act as his or her stooge – without qualification or exception. As shown above, this assumption is unrealistic. Therefore, because beneficiary-directors in a typical private fiduciary company cannot unilaterally remove and replace fiduciaries, the powers of those fiduciaries over trust distributions should not be attributed to the beneficiary-directors simply because they are related to one another.[73]

Additionally, the standards suggested by the Service to attribute fiduciary powers, such as in Revenue Ruling 95-58, are being used out of their legitimate domain. Those standards, which are articulated in Section 672(c), were not designed to determine whether a person has sufficient dominion over trust assets to subject those assets to transfer taxation. Instead, those standards were designed to determine who should pay the income tax on income generated by trust assets, and thus, most importantly, at what marginal rate, the trust's or the grantor's. Using Section 672(c) to determine transfer taxation is using the standards of that section for a task for which they are not suited. Introducing this alien species into the estate and gift system disrupts the logical balance

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71 If beneficiary-directors are in fact colluding, the Service can prove this reality, just as the Service proves the reality of step transactions or nominee arrangements.

72 *See* Rev. Rul. 95-58. Of course, that revenue ruling is concerned with a grantor who retained such a power, but most practitioners assume that its reasoning would apply equally in the context of beneficiaries as well, during life or at death.

73 Again, if the Service wishes to apply tax provisions based upon the collusion of beneficiary-directors, the Service should have to prove that collusion.

of the system. For example, nowhere in the grantor trust rules (Sections 671- 679) is a release of a power subject to taxation, but clearly under Chapters 11 (estate) and 12 (gift) of the Code, releases are intended to be taxed. Moreover, the grantor trust rules generally cannot function to cause a tax where a tax would otherwise not be due. Only when a trust's assets generate income items will there be an income tax due; the grantor trust rules only determine who pays the tax and thus, at what rate. However, the gift and estate tax rules concern themselves with whether a tax on assets will or will not be due at all - - a very different question with more serious consequences. The purposes of the two sets of r ules (income vs. transfer taxation) are very different. A tool designed for one set of rules should not be used to apply the other set of rules.

This misplaced use of tax concepts would lead not only to bad law, but to serious difficulties in application. There are very practical defects in a rule that would attribute fiduciary powers to family members based on the mere possibility of collusion. How closely-related would parties need to be for the assumption to arise that they act in collusion? Would a father and son-in-law be sufficient? Does the size of the family matter? Should we assume that 20 family members will act in concert? How about 200? What happens when this attribution of fiduciary powers ceases because the justification has disappeared? For example, what happens when the company directors are no longer sufficiently related to assume collusion? For a beneficiary-director, that would be a lapse of a general power if the rule were adopted. Note, however, that the "lapse" of the attributed power could be beyond the control of that beneficiary-director, triggered by events such as the resignation of the son-in-law director or his divorce from the beneficiary-director's daughter. This sweeping attribution rule thus would create significant practical problems that are unnecessary – if parties are colluding, the Service can prove that.

Conclusion: Cautionary Advice Pending Further Guidance

Despite the above analysis, it is likely that most, if not all, families will try to structure their affairs to avoid having to face the issue. Given the amount of assets usually involved when private fiduciaries are created, families will continue to sacrifice maximum flexibility in exchange for certainty that taxation of those assets will be avoided until there is more useful guidance on the issue. Therefore, families are still faced with the question: what positions in our private fiduciary company should be filled only by independent parties?[74]

In a PTC, to avoid this risk of transfer taxation, the structure should provide for independent parties to occupy all offices where discretion over trust distributions is not limited to an ascertainable standard. This may mean that a distribution committee that deals with purely discretionary distribution standards must consist entirely of independent persons since the "family" is selecting those persons under the PTC structure. Alternatively, if distribution decisions are exercised by the board of directors

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[74] This discussion has addressed the tax issues, but it should be remembered that the private fiduciary company structure must also comply with the restrictions on the trustee selection process that are imposed by the language of the trust documents in question, or those documents must be modified accordingly. See, for example, PLR 9842007 in which the trust documents required at least one independent trustee.

of a PTC, then only those board members who are not related or subordinate parties should be permitted to make distribution decisions under a non-ascertainable standard. In a PPC, when its sole function is to remove and replace trustees that have discretionary power over distributions, family members can be allowed to participate without restriction as members of the PPC's board of directors. When replacing trustees, however, candidates for trustee positions should be limited to independent parties (that is, to parties who are not related or subordinate to the board members who are beneficiaries or grantors).

Accordingly, given the current state of the law and the need to avoid any material risk of transfer taxation, beneficiary-directors and other family members will often be limited, by an abundance of prudence, to participating in decisions over investments and purely administrative issues. If this creates unnecessary constraints in making distributions, hopefully those obstacles can be avoided by the use of powers of appointment under the operative trust documents. This conclusion illustrates that families will be needlessly prevented from employing private fiduciary companies to best advantage, at least until the Service articulates a more reasoned approach to the question of potential joint action by families.