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IRS Proposes Ruling on Private Trust Companies

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Introduction

The Internal Revenue Service (IRS) has proposed to issue a revenue ruling on private trust companies (PTCs) in Notice 2008-63, released on July 11 2008. The ruling would address whether family ownership and participation in the governance of a trust company serving as trustee of family trusts would trigger unintended and adverse transfer and income tax consequences. The proposed ruling would allow family members to participate in determining how and when distributions are made from a family trust, as long as certain firewall restrictions are adopted in decision-making. The proposed ruling also applies by analogy to other, more common kinds of collective family efforts to administer trusts, such as when family members serve as co-trustees or serve on distribution committees outside of a PTC. When the IRS finalizes its proposed revenue ruling, perhaps early next year, more wealthy families may be able to use

PTCs in their succession planning with fewer complications and less cumbersome procedures for engaging US family members in trust decisions. While the proposed ruling in its draft form has not yet addressed certain issues and suggests solutions that need further improvement, the proposal represents a step towards resolving US tax issues and provides a framework for further progress.

PTCs in Family Succession Planning

A PTC is typically an entity that: (i) is owned directly or indirectly by members of the same family (or several families); and (ii) serves as the sole trustee for the trusts held for that family. The PTC takes the form of a corporation or limited liability company. Its governance is structured like that of a corporation and it is formed in a jurisdiction (within or outside the United States) that will exempt it from all or most of the regulatory requirements imposed on trust companies that provide services to the public at large. Under such an exemption, the PTC is permitted to provide trustee services only to a group of related individuals and trusts.

While a PTC typically uses the corporate form of organization (ie, a board of directors), it often also includes a distribution committee and an investment committee, like a commercial trust company. Even though the voting power of the PTC is concentrated within the family, certain officer positions, boards or committees commonly include non-family members, chosen for their expertise in certain fields or to meet local jurisdictional requirements.

Non-family members may also be chosen to reduce the family's formal role in making distribution decisions in view of certain tax issues under US tax law. Many family PTCs have - over the last several years, in response to the threat posed by these taxes - excluded the family from making decisions on distributions and have relied entirely on outside advisers and professionals to make what were essentially personal and family decisions. It was believed that the IRS would insist on such restrictions because of a fear that PTCs would otherwise be used to avoid the tax rules that apply to distribution decisions by individual US family members.

This tax concern cast doubt on the use of PTCs at the same time that more and more wealthy families were seeing advantages in forming PTCs for reasons that had nothing to do with avoiding federal income, estate and gift taxes. The PTC offers a means, among other things, to:

- provide a more flexible compensation structure to attract higher-quality personnel for operations and investments;
- improve the methods used and expand the choices in selecting and managing investments;
- make better-informed distribution decisions;
- improve continuity and coordination in fulfilling fiduciary obligations;
- protect against risks associated with relying on individuals to serve as trustees; and
- protect individuals from personal liability who would otherwise be naturally reluctant to participate.

Factual Context of IRS Proposed Ruling

The proposed ruling deals with two illustrative fact patterns that differ only on whether tax-relevant restrictions are imposed on PTC distribution decisions by the local statutory law or the PTC's organizational documents. In both situations, the parents have three adult children, all of whom are married with children. The parents made gifts in separate trusts for the primary benefit of each of their children and grandchildren, and their children have similarly established separate trusts for their respective descendants. Each of these trusts:

- can distribute income or principal under a discretionary standard for the primary beneficiary during his or her lifetime;
- grants the primary beneficiary a broad but special power of appointment that is not subject to estate tax;
- allows the settlor (or, if deceased, the primary beneficiary) to fill a trustee vacancy by naming someone other than himself or herself; and
- becomes managed by the PTC as trustee when the original third-party bank trustee resigns.

Trusts later funded exclusively by one parent in 2008 are similar, except that: (i) one trust was established for each family branch and discretionary distributions can be sprinkled among those several beneficiaries; and (ii) the PTC was the original trustee. These 2008 trusts are especially pertinent to the IRS's proposed ruling on completed gifts, the generation-skipping transfer tax ruling dealing with post-1985 trusts and the income tax ruling on grantor trust status for trusts with sprinkling distribution powers.

The PTC shares are owned entirely by the family (ie, by the parents and one child) and various family trusts. One parent and two children, who own no PTC shares outright, are officers and directors of the PTC and serve on its discretionary distributions committee. The third child, who does own shares, is an employee and manager of the PTC.

Firewall Restrictions on the PTC

In the first situation under the proposed ruling, certain firewall restrictions are imposed by state statute. In the second situation, these restrictions are imposed by the PTC's organizational documents. These firewall restrictions on the PTC require that: (i) a discretionary distributions committee be organized and operated to determine all discretionary distributions by the PTC (ie, all distributions that are not required by the trust document or applicable law); and (ii) no member of the discretionary distributions committee participate in such distribution decisions for trusts of which that member or their spouse is a settlor or beneficiary, or owes an obligation of support to a beneficiary of the trust.

The composition of the membership of the discretionary distributions committee is not restricted. However, the firewall restriction on participation in distribution decisions prevents a family member who is a trust beneficiary from deciding upon distributions to himself or herself, or upon distributions to certain other beneficiaries from the same trust. This restriction can have a broad disqualifying effect for trusts that have multiple beneficiaries (eg, discretionary trusts or trusts of long duration, or with contingent remainders), and there is no guidance on how to apply this restriction to a trust that permits the addition or removal of beneficiaries or appointment to other trusts.

These restrictions limit who may decide upon distributions and are often referred to as 'recusal restrictions'. They are complemented by supporting restrictions on the PTC that state that:

- any more restrictive provision in the trust document cannot be overridden by the governing PTC statute or organizational documents;

- express or implied reciprocal agreements between family members regarding discretionary distribution decisions by the PTC are prohibited; and
- only officers and managers of the PTC may participate in employment decisions relating to PTC personnel.

The second situation under the proposed ruling differs in that the recusal and supporting restrictions are imposed by the PTC's organizational documents, rather than governing statutory law. Thus the PTC structure provides that none of these firewall restrictions can be waived or changed except by a special amendment committee. This committee must act by a majority of its members, who must be individuals who are not: (i) related or subordinate to any shareholder of the PTC (as defined in the Internal Revenue Code); or (ii) family members (broadly including the parents and each child and other descendant of the parents, and spouses and former spouses of any of these persons).

Proposed Ruling on the Issues

The issues raised by the proposed ruling involve the estate and gift tax (or 'transfer tax'), generation-skipping transfer tax and grantor trust status of the trust under the income tax rules. In each of these issues the question is whether certain tax results that are presumably adverse and unintended will apply if the PTC serves as trustee of the trusts. On every issue the proposed ruling would hold that having the PTC serving as trustee does not, on its own, cause the threatened bad tax result because of the firewall restrictions described above, so that:

- the value of the trust assets will not be included in the settlor's gross estate under estate tax rules concerning retained control;
- the value of the trust assets will not be included in a beneficiary's gross estate under estate tax rules concerning powers of appointment;
- gifts will be complete for gift tax purposes;
- a trust that is exempt from generation-skipping transfer tax under the effective date rule will not lose its grandfathered status. Nor will a

trust to which generation-skipping transfer tax exemption has been allocated lose that exemption; and

- neither the settlor nor any beneficiary will be treated as the owner of the trust for income tax purposes under the grantor trust rules (for further details please see "Taxation of Offshore Trusts and Impact of New Lower Tax Rates").

The proposed ruling states that estate tax inclusion will not apply: (i) in the event of the death of the PTC shareholders by reason of shareholding, or the death of an officer, director, employer, manager or discretionary distributions committee member by reason of that service; or (ii) by reason of the PTC serving as the trustee. It is also stated that the result would not change if the PTC were owned solely by one family member.

The proposed ruling is less helpful on the issue of who pays income tax on trust income because of certain qualifications and exceptions that depend on the PTC structure and its operation. This aspect of the proposed ruling would particularly affect a US family member serving as an officer or director of a PTC if that person had also funded a trust of which the PTC was the trustee. The income tax part of the proposed ruling involves subtle issues and proposes more limits on PTC decision-making bodies. The income tax question is whether the grantor trust rules will attribute trust income to the settlor if the PTC structure involves decision making by a 'related or subordinate' party, as defined by the Internal Revenue Code. PTCs would be subject to the grantor trust rules in a tax-neutral way. The ruling would then conclude that nothing in the firewalled PTC triggered the grantor trust rules, with one important exception – a need to test whether powers at the discretionary distributions committee level are exercised by a 'related or subordinate' party that is 'subservient' to the grantor (as defined in the Internal Revenue Code), as if the committee members were individual trustees. Whether the proposed ruling deals adequately with the membership composition of the discretionary distributions committee on this point is open to question. The proposed ruling concludes with the favourable conviction that family ownership of PTC voting shares does not by itself cause parties inside the PTC to be related or subordinate, reasoning that the firewall restrictions preclude shareholders from having 'significant' and 'relevant' voting control.

Application by Analogy to Other Kinds of Family Trust Administration

The proposed ruling is a positive step towards reducing the fears of an even more expansive adverse tax treatment of family collaboration that, in the past, led some tax advisers to recommend much more comprehensive bans on family participation in distribution decisions. Moreover, the ruling intends that the same analysis should apply outside of the PTC, so the choice of a structure will be tax neutral.

This means that family collaboration in the form of other arrangements involving group or mirror powers, such as distribution committees or multiple co-trustees involving family members who are beneficiaries, should also be tax neutral with respect to the transfer tax. The critical facts of the proposed ruling involve a distribution committee. The PTC structure surrounds this committee in the facts of the ruling, but the positive aspects of the tax analysis that focus on the workings of the committee could stand on their own and achieve the same favourable result in the situation where the PTC structure is not present. If the proposed ruling is finalized and clarified, family members who are beneficiaries of trusts funded by others should be able to serve as trustees or members of a distribution committee and make decisions on each other's trust distributions, without fear of being taxed as if they could make distributions to themselves, as long as they are prohibited from trading votes by the documents or applicable governing law.

Revisions are Needed

While encouraging, the proposed ruling warrants attention on several points before finalization.

Recusal firewalls

The proposed recusal firewalls prevent a family member from deciding on distributions from a trust of which that person or the person's spouse is the settlor or a beneficiary. This restriction is broader than would apply to distribution decisions by individual trustees who are also trust beneficiaries, because it prevents a beneficiary from deciding on distributions that benefit only other persons. Thus the proposed ruling does not accomplish its stated purpose of applying the same standards (no more or less restrictive) to PTC decision making as would apply to family members making those decisions directly as co-trustees or members of a distribution committee formed under the trust document. The final ruling should clarify or change the recusal restrictions on participation by spouses of settlors and beneficiaries and by a beneficiary on distributions to others.

Discretionary distributions committee members

The proposed ruling has at least one significant gap in reassurance on transfer tax issues because it fails to deal with succession inside the PTC. The power to remove and replace members of the discretionary distributions committee, or to replace directors who can change the discretionary distributions committee, is not expressly considered. Thus, the risk of taxation due to indirect influence on discretionary distributions committee succession is not foreclosed by the proposed ruling.

Related or subordinate employees

The proposed ruling as regards income tax issues imposes some potentially troublesome limits on the composition of the discretionary distributions committee. The proposed ruling finds that certain employees would be 'related or subordinate' (as defined in the Internal Revenue Code), for income tax purposes. The IRS has previously issued rulings attributing taxable powers under the transfer tax using the same 'related or subordinate' standard for restricting the power to replace trust decision makers. This may complicate the succession process for the discretionary distributions committee that would be needed to avoid transfer tax issues. More explicit guidance would be helpful in any event.

Comment

The proposed ruling represents a step towards providing practical rules that allow family decision making over family trusts without undue complexity and tax risk. Assuming certain weaknesses in the proposed ruling are repaired with workable solutions and certain firewall restrictions are narrowed, it will become much easier to resolve tax issues arising from a family's collective management of its trusts through private trust companies, family committees and similar governance methods and means.[1]

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Endnotes

(1) For further discussion on this topic, please see Don Kozusko's article, "Recent Tax Guidance on Private Trust Companies, Family Co-Trustees and Distributions Committees: Notice 2008-63", available at www.wealthstrategiesjournal.com/articles/2008/09/recent-tax-guidance-on-private.html.