

Executive Summary of Notice 2008-63

Rana H. Salti

On July 11, 2008, the Internal Revenue Service issued Notice 2008-63, which includes the text of a proposed revenue ruling regarding private trust companies. The notice addresses the income, estate, gift and generation-skipping transfer tax consequences of the appointment of a private trust company created by family members as the trustee of trusts of which the family members are grantors or beneficiaries.

This notice has been anticipated anxiously since the IRS announced on January 3, 2005 that it would no longer consider private letter ruling requests regarding the tax implications of the appointment of private trust companies as trustees of family trusts until the IRS issued additional guidance.

The IRS specifically states that the tax consequences of using a private trust company should be no more restrictive than the tax consequences of using individual or institutional trustees.

Facts

Husband and wife created separate irrevocable trusts for each of their children and grandchildren. The children also created irrevocable trusts for their respective descendants. Each child or grandchild is the primary beneficiary of the trust established for that child or grandchild. Each trust provides the trustee with discretionary authority to distribute income and/or principal to the primary beneficiary of the trust during the primary beneficiary's lifetime. Each primary beneficiary has a testamentary power of appointment exercisable in favor of one or more family members or charitable organizations. The grantor or, if the grantor is not living, the primary beneficiary, may appoint a successor trustee other than himself or herself if there is a vacancy in the office of trustee. In addition, each trust will terminate no later than 21 years after the death of the last to die of certain designated individuals. The notice describes two situations, depending upon whether the applicable state has enacted a statute governing private trust companies.

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

- (1) Any private trust company formed under the statute must create a discretionary distribution committee ("DDC") and delegate to the DDC

the exclusive authority to make all decisions regarding discretionary distributions from each trust for which it serves as trustee.

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

The family formed a PTC consistent with the statute. The PTC is wholly-owned by the family. The PTC's governing documents do not restrict who may serve on the DDC. Some of the family members serve as officers and members of the board of directors of the PTC. These family members also serve on the DDC. One family member is a manager and employee of the PTC. Other family members own shares of the PTC but are not officers, directors or DDC members. One family member is a manager and employee of PTC. Following the resignation of a corporate trustee, the PTC was appointed as successor trustee of three irrevocable trusts. In addition, the husband created three additional irrevocable trusts (the "2008 Trusts") for the primary benefit of each of his three children and each child's descendants. Unlike the other irrevocable trusts described above, the 2008 Trusts provide that the trustee has discretionary authority to distribute income and/or principal to any one or more beneficiaries during the beneficiary's life. The husband named the PTC as the initial trustee of the trusts.

Situation 2: The PTC was formed in a state without a statute governing private trust companies, but the PTC's governing documents include provisions similar to the six items [(1) to (6)]

outlined above with respect to Situation 1. In addition, the PTC's governing documents also provide for the creation of an Amendment Committee, a majority of whose members must always be individuals who are neither family members nor persons related or subordinate to any shareholder of PTC. The Amendment Committee, by majority vote, has the sole authority to make any changes to PTC's governing documents regarding the creation, function, or membership of the DDC or Amendment Committee, the provisions delegating exclusive authority regarding personnel decisions to the officers and managers, and the prohibition of reciprocal agreements. The initial three members of the Amendment Committee are the husband and two non-family members. The two non-family members are not employed by the PTC and are not otherwise related or subordinate to any family member. Like Situation 1 above, some of the family members serve as officers and members of the board of directors of the PTC. These family members also serve on the DDC. Other family members own shares of the PTC but are not officers, directors or DDC members. One family member is a manager and employee of PTC.

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

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

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

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

member's ownership of or relationship with the PTC. Further, family members may not insert themselves into the roles of having any such powers.

As a result, the trust assets will not be included in the gross estate of any family member by reason of that person's service as an officer, director, member of the DDC, shareholder or employee of the PTC.

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

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

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

Situation 2: PTC's governing documents preclude a beneficiary from having the power as a member of the DDC to affect the beneficial enjoyment of property as described in § 2041. In addition, family members are prohibited from entering into reciprocal arrangements. As in Situation 1, the family members serving as officers, directors, and members of PTC's DDC do not have the unrestricted power to distribute trust assets to themselves as contemplated by § 2041. In addition, no beneficiary will be deemed to have a general power of appointment by

participating in the daily activities of the PTC. For reasons discussed in Conclusion 1 above, a beneficiary will not be deemed to have a general power of appointment under § 2041 as a result of the beneficiary's service on the Amendment Committee.

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

Situations 1 and 2: In both Situations 1 and 2, no member of the DDC may participate in the activities of the DDC with regard to any trust of which that DDC member or his spouse is a grantor or any trust of which that DDC member or his or her spouse is a beneficiary. In addition, family members are prohibiting from entering into reciprocal agreements. The husband, as grantor of the 2008 Trusts, does not have the power to change the interests of the beneficiaries of the 2008 Trusts. Also, the husband is not considered to hold a power exercisable by him in conjunction with any other person not having a substantial adverse interest in the disposition of the transferred property or the property's income merely because of the husband's membership on the DDC. Thus, the husband's transfers to the 2008 Trusts will be deemed completed gifts. Also, because no member of the DDC may participate in the activities of the DDC with regard to any trust to which that DDC member or his spouse is a grantor or any trust of which that DDC member or his or her spouse is a beneficiary, distributions of income and principal from a trust of which the PTC is the trustee will not be deemed to be a gift by any member of the DDC.

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

Situations 1 and 2: In both Situations 1 and 2, the change in trustee will not subject the value of the trust corpus to tax under Chapter 11 or 12, and the modification is an administrative change that does not shift a beneficial interest in a trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification. In addition, each trust will terminate no later than 21 years after the death of the last to die of certain designated individuals. As a result, appointing the PTC as trustee of the trusts does not affect the inclusion ratio of a trust subject to Chapter 13.

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

Situations 1 and 2: The provisions governing the DDC and, with respect to Situation 1, the state statute render the identity of the trustee irrelevant to the determination of whether any person is treated as an owner of a trust under §§ 675, 677, or 678. The circumstances regarding the operation of the PTC, the DDC, and the family trusts for which the PTC is acting as trustee will determine whether any grantor will be treated as the owner of any portion of the trusts under § 675, and this determination will be a question of fact. Accordingly, the appointment and service

of the trustee does not affect whether the grantor or any other person will be treated as the owner of a trust, and none of the grantors or beneficiaries of the family trusts for which the PTC is acting as trustee will be treated as an owner of the trusts under §§ 673, 675, 676, 677, or 678 solely by reason of their ownership or management of, or employment by, the PTC. Whether a grantor is treated as an owner of any portion of a trust under § 674 will depend upon the particular powers of the trustee and the proportion of the DDC members with authority to act with regard to that trust who are related or subordinate to the grantor. The ownership of voting stock of PTC is deemed to be not significant under § 672(c).

Comments to Notice.

Comments to the notice were due by November 4, 2008. Several professional organizations and law firms prepared comments to the notice.

IRS Circular 230 Disclosure: Any discussion of U.S. tax matters contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed by the Internal Revenue Service.

Rana H. Salti,
Counsel and Trust Officer
Kinship Trust Company LLC
rana.salti@kinshiptrustco.com