

# Trusts & Estates®

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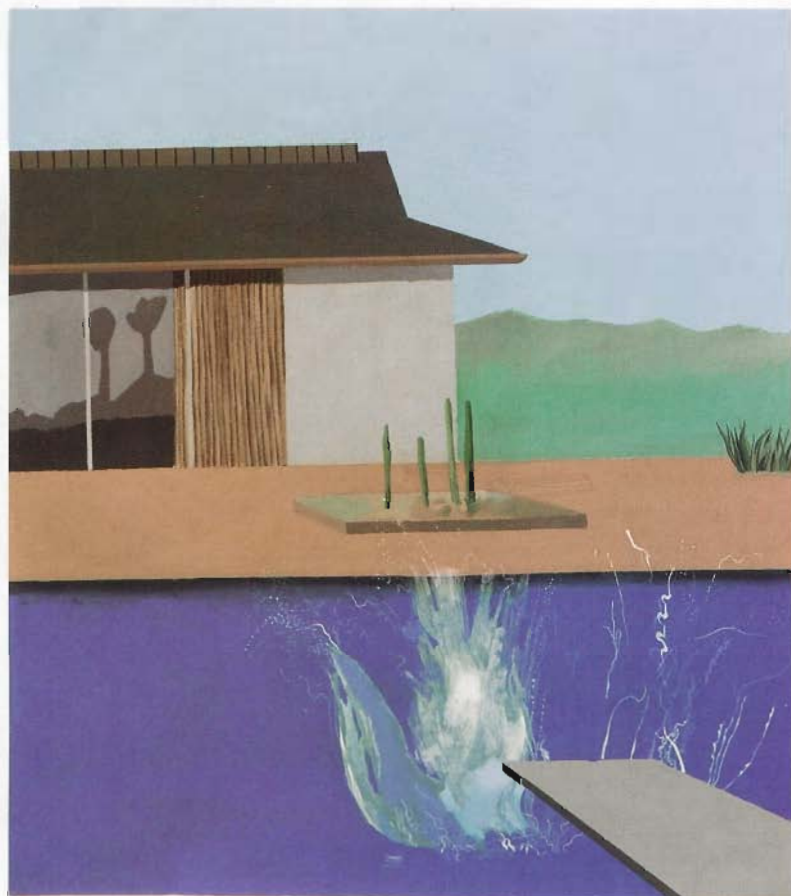
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“The Splash” by David Hockney sold at a recent auction for \$5.38 million, p. 6.

\*\*\*\*\*AUTO\*\*SCH 5-DIGIT 60601  
#60601DUNCAJ0067# 0708 TED1  
JOHN DUNCAN PRIM 22267  
DUNCAN ASSOCIATES PO107  
180 N LASALLE ST STE 3050  
CHICAGO IL 60601-2759





# PERSPECTIVES

## FIDUCIARY PROFESSIONALS

### Anticipated: Ruling on PTCs

The Internal Revenue Service has promised a revenue ruling on private trust companies serving as trustees of family trusts. Experts warn against making the standard more stringent for PTCs than for other types of trustees



By John P.C. Duncan, principal, and Michael R. Conway Jr., counsel, Duncan Associates Attorneys and Counselors, P.C., Chicago

In the past dozen years, spurred by the Prudent Investor Act and other major new trust laws, families with substantial trust assets (typically \$100 million and more) have turned in growing numbers<sup>1</sup> to organizing and chartering state trust companies to act as trustees of the referred to as private trust companies (PTCs).

Families use PTCs to solve a variety of family asset risk management, trustee and governance succession and regulatory issues, as well as to assure family oversight and participation in the implementation of multi-generational family strategic plans.

PTCs have been used for over 150 years and are the forerunners of some of our best-known trust institutions.<sup>2</sup> But one latter-day PTC led the Internal Revenue Service in 1998 and 2001 to issue private letter rulings<sup>3</sup> (PLRs) that seemed to limit a single family's ownership and board representation to 50 percent when family trusts with "tax-sensitive powers"<sup>4</sup> are involved.

Many families who had or were considering chartering PTCs were surprised to hear there might be tax pitfalls to having a PTC act as trustee of family trusts. Their family members already are involved in trust decisions as individual trustees, trust protectors and trust advisors and abide by the applicable tax rules. They found it difficult to understand why a move to a professionally managed, well-capitalized and usually state-regulated PTC, with policies and procedures to insure compliance with laws and fiduciary standards, could raise a specter of adverse tax consequences not present with individual trustees. Tax practitioners, too, were concerned (especially when the 1998 and 2001 PLRs were the only guidance available) that a family's PTC ownership or board representation exceeding 50 percent would risk adverse income, estate, gift and generation-skipping

transfer tax consequences.

The concerns led many families considering PTCs to seek clarifying PLRs. The Service obliged with a series of more flexible PLRs from 2001 through December 2005, substantially expanding the range of acceptable PTC structures.<sup>5</sup> In contrast to the structure approved in the first PLRs, the ratified PTCs involved extended families (but not individuals) owning as much as 100 percent of the PTCs and enjoying more than 50 percent board representation. The approved structures included an independent discretionary decisions committee as well as (in the final PTC approved) independent trust officers making distributions decisions and exercising all other tax-sensitive powers. Most of the PLRs, however, barred family members from serving even as non-voting members on such committees.

The IRS received so many requests for PLRs on the subject and found responding to them so time-consuming that it decided to stem the tide with a revenue ruling, expected sometime this year.<sup>6</sup> In its announcement promising a ruling, the Service declared only that it would issue guidance on the tax consequences of a PTC that serves as trustee of family trusts, indicated that it would not consider further filings for PLRs on the subject, and requested comments regarding its proposed (but as yet undrafted) revenue ruling.<sup>7</sup>

#### STRONG RESPONSE

The American Institution of Certified Public Accountants, the New York State Bar Association's Tax Section and several law firms (including ours) that represent families with private trust companies submitted detailed comments.<sup>8</sup> Commentators were faced with the unusual challenge of responding to a non-existent proposal. They were left to focus

on those structures the Service had approved with little explanation in PLRs and on informal comments IRS agents made during the discussions to obtain the approvals.

Despite needing to speculate about what the Service has in mind, there is remarkable consistency in the comments on material aspects and only slight variations among the guidelines recommended.

All urge the Service to avoid issuing a draconian rule that would prohibit family members from any involvement whatsoever in discretionary trust decisions as the only safe harbor from adverse tax consequences. The implication of such a rule would be to require family members to essentially "leave the building" when a decision is made and never even indirectly discuss any tax-sensitive topic with the decision makers.

That the Service is even considering a "leave the building" requirement appears to reflect a mistaken belief that families with PTCs micromanage trustees. Contrary to this widespread misimpression, most direct family member involvement in PTCs tends to be focused on providing information and policy guidance to trust decision makers, not acting as trust decision makers themselves. (See "Setting the Record Straight," p. 58).

Such a restrictive rule has never been required of any other type of trustee or trustee group and does not appear to be supported by legal precedent. It would be inconsistent with the proper roles of trustees,<sup>9</sup> and fails to reflect the beneficial role that PTCs play in tax compliance. The formality it would impose on communications between family settlors and beneficiaries and discretionary decision makers at a PTC

would impose significant burdens without any real benefit.

A needlessly restrictive rule is what the commentators hope the IRS won't do. What we hope the revenue ruling will do, however, is fully answer federal tax issues that have been raised by the PLRs and the IRS agents' informal comments involving family members' roles in a PTC. These issues arise under three categories: income taxes, estate and gift taxes, and generation-skipping

**Even though PLRs accepted firewalls, the IRS' position now seems to be absolutely no family involvement.**

transfer (GST) taxes. Specifically:

- Will a family member involved with a PTC be treated as the owner of a family trust for income tax purposes under IRC Sections 671 through 677 (as to a grantor) or Section 678 (as to a beneficiary)?
- Will such a family member be treated as an owner of a family trust for estate tax purposes under IRC Sections 2036 through 2038 and 2042 (as to a grantor) and 2041 (as to a beneficiary)?
- Will a GST-grandfathered or GST-exempt trust lose such status when the PTC is appointed trustee or co-trustee of a family trust?

#### **LEAVE THE BUILDING?**

Based on the PLRs already issued, most, if not all, adverse tax consequences to family trusts can be avoided through the use of adequate

safeguards or firewalls in one or more of the PTC's organizational documents, policies, procedures and trust instruments. These firewall provisions bar certain family members, grantors or beneficiaries of a family trust or their related or subordinate parties from participating in certain tax-sensitive powers regarding the family trusts.

But even though the IRS has accepted the use of firewall provisions in its PLRs, the Service's unofficial position now seems to be that absolutely no family involvement in PTC's tax-sensitive trust decisions should be allowed.

All of the commentators believe that this position is too conservative and restrictive.

Instead of imputing wrongdoing to mere interaction between settlors or beneficiaries and trust decision makers, the IRS should adopt a flexible rule that would police actual behaviors. After all, such communications are a long-standing and accepted feature of trust administration, one that has been enshrined in modern trust statutes such as the Uniform Prudent Investors Act and the Uniform Trust Code.<sup>10</sup> These laws recognize that trustees can and do follow the law and perform their fiduciary duties even when they receive input from obviously partial settlors and beneficiaries.

The commentators argue that family members should be allowed involvement to the same extent that individual fiduciaries who are family members are permitted by current law to be involved in trust decisions and administration for both related and unrelated trusts. In other words, a family member generally should be permitted to participate in all trust decisions and administration

decisions other than decisions that affect or relate to tax-sensitive powers with respect to his own trusts.

The rule commentators prefer would provide that adverse tax consequences would be avoided if the PTC's governance structure (including its bylaws and shareholders or operating agreement) reasonably restricted family members from participating in the exercise of tax-sensitive powers. So, for example, a grantor of a family trust would be prohibited from participating in discretionary distribution decisions from such a trust. Of course, a family member could not actually make a decision or participate in voting for a decision for a trust related to that family member.

While the exact nature and extent of the suggested restrictions vary among the commentators, all generally agree that firewall provisions need not and should not be more restrictive than those placed on trustees who serve as individual trustees. Consequently, they concede that a "tainted" family member should be expressly prohibited from directly participating in or voting for the exercise of tax-sensitive powers.<sup>11</sup> As also is the case for non-independent, individual trustees, all actual "reciprocal" decision making should be barred.<sup>12</sup> But the commentators urged the Service not to prohibit family members from voting on non-tax-sensitive powers. Conversely, they urged that family members who are untainted with respect to a particular trust should not be prohibited from participating in that trust's decision making.

## FIREWALLS

What should these firewalls look like? Arguably, the provisions we and the other commentators propose are actually more restrictive than current authority requires. Included among

each commentator's firewalls were the following:

(1) *To prevent the direct or indirect exercise of a tax-sensitive power*—A committee should be established to make all discretionary decisions related to tax-sensitive powers (a "discretionary decisions committee") and to provide that (a) no grantor of any family trust may act on such committee with respect to such trust; (b) no beneficiary of any family trust may act on such committee regarding discretionary decisions related to such beneficiary or to anyone whom the beneficiary has a legal obligation to support; (c) no member of such committee shall participate in any decision with respect to any distributions to any person whom such member is legally obligated to support; and (d) no more than one-half of the members of such committee, with respect to any family trust, shall consist of related or subordinate parties to the grantor of such a trust.

(2) *To prevent any tax issues that may arise from the ability to remove and appoint members of the discretionary decision committee*—If a grantor or a beneficiary of a family trust participates in the removal and the replacement of a member of such committee, the replacement member must not be related or subordinate to such a participant.

(3) *To avoid any reciprocal arrangement*—No grantor, beneficiary or member of the discretionary decisions committee should enter into any outside reciprocal agreements that may effect any tax-sensitive decisions of any family trust.

(4) *To prevent any tax issues that may arise with the ability to alter the firewall provisions of the PTC*—No grantor of any family trust should be allowed to possess more than 50 percent of the total combined voting power of the PTC or more than 50 percent of the

total value of the ownership interest of the PTC (unless the bylaws or other governing or controlling documents expressly and irrevocably provide that the PTC shall cease to serve as trustee of family trusts if the firewall provisions are eliminated by amendment).

## IMPACT

These firewalls, the only ones included by most commentators, would make a PTC's restrictions largely indistinguishable for tax purposes from those applicable to a group of individual fiduciaries. The New York State Bar Association Tax Section also suggests mild ownership restrictions and possibly selected cross-attributing of actions among family members,<sup>13</sup> which we and the other commentators do not favor.

The consensus firewalls should be adequate to satisfy all applicable federal tax requirements for the exercise of tax-sensitive powers within the family trust context:

(1) *Income tax*—Because these firewall provisions would bar any grantor from holding an ownership interest in the PTC that is "significant from the viewpoint of voting control,"<sup>14</sup> the appointment of a properly structured PTC should not result in grantor trust treatment of any family trust for income tax purposes if the family trust was not already taxable as such. These firewall provisions also prohibit any one grantor from directly or indirectly having the power to direct or cause the direction of the PTC's management and policies.

In addition, even if related or subordinate party rules were applied to individual members serving on the discretionary decisions committee, the proposed firewall provisions conservatively bar the inadvertent grantor trust

treatment of a family trust for income tax purposes by placing control of these decisions in the hands of independent parties or untainted family members.

(2) *Estate tax*—The appointment of a properly structured PTC, in and of itself, should not result in the inclusion of the value of any family trust in the estate of a grantor or beneficiary for estate tax purposes. That's because no

individual family member would be able through the PTC to control the use and enjoyment of trust property of a related trust. As a general matter, the proposed firewalls prohibit any grantor or beneficiary from controlling the PTC board, and, secondarily, bar individual family members from participating in a tax-sensitive decision concerning a trust that is related to that family member.

(3) *Gift tax*—Because the proposed firewall provisions would bar any grantor or individual from exercising any tax-sensitive power, such as a power to revest the beneficial title to the property in the grantor or the power to name new beneficiaries, the appointment of the PTC as trustee would not make a gift to a family trust incomplete. Moreover, because grantors and beneficiaries are prohibited

## Setting the Record Straight

It's ironic that the Internal Revenue Service seems to assume that private trust companies (PTCs) are a vehicle for family members to become overly involved in trust distributions and other tax-sensitive trust powers. Certainly, at wealth management and family office conferences, people with no real experience with PTCs sometimes speculate out loud that PTCs are prized for this reason.

But our experience (and we are very involved in forming PTCs) is that most families want them to control risks—which includes ensuring strict compliance with tax laws. They also want to make sure that trustees are professional and permanent.

In practice, almost all direct family member involvement in PTCs regarding trusts tends to be focused on inputs, not outputs—that is on providing information and policy guidance to actual trust decision makers, not on acting as trust decision makers themselves. This is even more true when it comes to distributions. Family members usually don't want their relatives to make decisions about their distributions requests; and they'd like to avoid the messy business of constantly judging how much money their relatives should be receiving. In fact, family members invariably fight having relatives even see information about their distribution requests, personal needs and financial circumstances, all of which are needed for distribution decisions.

Moreover, family tax law compliance is assured, not hampered, by interposing a PTC's management between trusts and their donors and beneficiaries. This structure can benefit a family not only with respect to family trusts but also with family investment partnerships, private annuity trusts, and charitable trusts and foundations.

Whatever outsiders might think, the top three tax reasons

for a family to form a PTC are, in order:

(1) limiting state taxation of trusts by making the tax *situs* of some or all family trusts the PTC's charter state's;

(2) using the PTC's professional and independent management, policies and procedures to assure compliance with federal tax limitations on how and by whom family-created and funded entities, such as trusts, partnerships and foundations, are managed; and

(3) appropriately transferring to family trusts legitimate trust administration expenses (not including investment management) incurred by the family office that previously were charged to individual family members.

There are many non-tax-related purposes in creating a PTC that can help families be more responsive to the IRS' goals, including to:

- provide a permanent solution for trustee succession;
- improve fiduciary risk management by using the PTC's built-in corporate hierarchical structure with capital committees, professional executives and policies and procedures meeting the same regulatory and fiduciary standards that are generally applicable to commercial trust companies;
- obtain the benefits of regulatory supervision of trustees by a state banking department; and
- hire and retain executives and directors (from both within and outside the family), without asking them to assume a trustee's level of personal risk.

Obviously we think there are many other, non-tax reasons for families to create PTCs. But we hope that better familiarity with the prime motivators helps assuage some of the IRS' anxiety.

— John P.C. Duncan and Michael R. Conway Jr.

by these firewall provisions from participating in tax-sensitive decisions over a related trust, they cannot be deemed to hold a general power over any trust that could be deemed to be released for gift tax purposes.

(4) *GST tax*—Where family members are barred from exercising tax-sensitive powers, the appointment of a PTC as trustee of a family trust is clearly an administrative change and should not be considered a shift of beneficial interest.

### PTC REALITY

Firewalls that send families out of the building would interfere with the legitimate, non-tax-driven purposes of a structure primarily created to provide quality services to families and assure the protection and enhancement of their assets over generations.

Moreover, firewall provisions that go substantially beyond what seems necessary to assure compliance with tax rules and beyond the tax rules applicable to individual fiduciaries would do little to discourage inappropriate reciprocal agreements or intentional misconduct. In fact, even an over-the-top rule that barred substantial family ownership or prohibited family participation in a PTC would likely have little impact on intentional misconduct. Individuals intent on ignoring tax rules by entering into express or implied (undoubtedly secret) reciprocal agreements probably would try to do so regardless of tax rules or firewalls.

Conversely, firewalls that work in concert with PTC structures and legitimate purposes would enhance tax law compliance management while not unduly limiting the value of the PTC to families for meeting their non-tax objectives. ■

### Endnotes

1. Accurate data on the number of private trust companies (PTCs) being created annually is unavailable. Our own experience and discussions with state regulators suggests formations have doubled every year since the late 1990s, at least for regulated PTCs. Based on our expectation of doing at least 12 this year, our guess is that nationwide perhaps two to three times that number of regulated PTCs will be chartered in 2006. It is impossible to know how many unregulated PTCs are formed each year.
2. Morgan Guaranty Trust Company (through two of its components), The Northern Trust Company and US Trust Company all started as PTCs, but the latest generation emerged only in the mid-1990s. John P.C. Duncan, "The Private Trust Company: It Has Come of Age," *Trust & Estates*, August 2003.
3. Private Letter Rulings 9841014 and 9842007 (July 2, 1998) and 200125038 (March 21, 2001).
4. "By 'tax-sensitive power' we mean any power exercisable over trust property which, if exercisable the grantor or a beneficiary of a trust, would cause a tax consequence to the grantor, such beneficiary or the trust." New York State Bar Association Tax Section Report No. III, p. 5, FN 12 (May 30, 2006) (NYSBA Report).
5. These PLRs have involved about six separate private trust companies. The authors' firm has acted as trust company counsel to a majority of the companies.
6. This revenue ruling was originally promised by the end of 2005.
7. Treasury's Office of Tax Policy and Internal Revenue Service, 2005-2006 Priority Guidance Plan, 2005 TNT 152-18 (updated, March 6, 2006).
8. Duncan Associates Attorneys and Counselors, P.C., Comment, April 18, 2006; Kozusko Harris Vetter Wareh, LLP, Dec. 22, 2005; Levin & Schreder, Ltd., Jan. 30, 2006; McGuire Woods, LLP, Feb. 27, 2006; The American Institute of Certified Public Accountants (AICPA), Comment, March 29, 2006; and New York State Bar Association,

(NYSBA) Report, May 30, 2006 (all to be published).

9. See, for example, Uniform Prudent Investor Act (1994), Section 2(c) and (d); Uniform Trust Code (2005), Section 813; Restatement (Second) Trusts (1959), Section 173; Wisconsin Statutes Section 701.12 (2006).
10. *Ibid.*
11. By "tainted" family member, we mean a family member who is either the grantor or a beneficiary of a family trust or who is deemed to hold a tax sensitive power with respect to that trust.
12. By "reciprocal" decision making, we mean the express or implied agreement (by two of more individuals acting in decision making capacities with respect to each other's trusts) to exercise their discretion in accordance with the other's wishes.
13. NYSBA Comment, note 8.
14. IRC 672(c)(2).



*Captivating Contemporaries:* Lucian Freud's portrait of the London photographer "John Deakin" sold at the Sotheby's "Contemporary Art Auction" in London on June 21 for \$3.115 million.

*Elizabeth Morgan Schurig is a partner at Giordani, Schurig, Beckett & Tackett, LLP, in Austin, Texas.*

*Amy P. Jetel is an associate at Giordani, Schurig, Beckett & Tackett, LLP in Austin, Texas.*

*Carolyn M. Beckett is a partner at Giordani, Schurig, Beckett & Tackett, LLP in Austin, Texas.*

## PERSPECTIVES FIDUCIARY PROFESSIONS

### **48 Reverse Focardi**

By Stephen K. Vetter

Did the Tax Court make a mistake with its decision in *Focardi v. Commissioner*? Author Stephen K. Vetter says it may have, and explains why the U.S. Court of Appeals for the Eleventh Circuit should reverse.

*Stephen K. Vetter is a partner at Kozusko Harris Vetter Wareh LLP in Washington. He specializes in taxation, closely held businesses and exempt organizations.*

### **54 Anticipated: Ruling on PTCs**

By John P.C. Duncan and Michael R. Conway, Jr.

While no one knows exactly what the Internal Revenue Service's expected ruling on private trust companies will say, those that submitted comments urged the Service to avoid issuing a draconian rule that would prohibit all family members, even the untainted ones, from any involvement whatsoever in discretionary trust decisions as the only safe harbor from adverse tax consequences. Authors John P.C. Duncan and Michael R. Conway, Jr., PTC advocates, share what commentators submitted to the Service and some of

the guidelines they recommended.

*John P.C. Duncan is the founder of, and principal at Duncan Associates Attorneys and Counselors, P.C. in Chicago. He specializes in representing private and public trust companies, family offices, investment advisors and private investment funds.*

*Michael R. Conway, Jr. is counsel to Duncan Associates Attorneys and Counselors, P.C. in Chicago. He concentrates his representation on fiduciaries, family offices and high-net-worth individuals.*

### **60 Scandal in Paradise**

By Alexander A. Bove, Jr.

Alexander A. Bove, Jr., says *Broken Trust* by Samuel P. King and Randall W. Roth is a page-turner that no one in the wealth management industry will want to miss. It's the expose of how the largest trust in America was looted for decades by fiduciaries and how this thievery was finally stopped.

*Alexander A. Bove, Jr. is a partner at The Law Firm of Bove & Langa, PC, Boston. He is the author of many trusts-and-estates books and journal articles, including The Complete Book of Wills, Estates & Trusts.*

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