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November 4, 2008

BY U.S. MAIL AND E-MAIL

Internal Revenue Service
Office of the Associate Chief Counsel
(Passthroughs and Special Industries), CC:PSI
Attn: Mary Berman, Room 5300
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Comments of The American College of Trust and Estate Counsel – Notice 2008-63

Dear Ms. Berman:

I am the President of The American College of Trust and Estate Counsel ("ACTEC"), a professional association of over 2,500 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching, and bar association activities. ACTEC fellows have extensive experience in rendering advice to taxpayers on matters of federal transfer taxes and estate planning, with a focus on estate and gift tax planning and compliance.

On July 11, 2008, the Internal Revenue Service and Treasury Department issued Notice 2008-63 (the "Notice"), which was a notice of a proposed revenue ruling regarding the income, estate, gift and generation-skipping transfer tax consequences in situations where family members create a private trust company to serve as the trustee of trusts having family members as grantors and beneficiaries. The Notice solicits comments, due November 4, 2008. This submission is the response of ACTEC to the request for comments.

The Notice is clearly intended to guide taxpayers in a user-friendly way with respect to private trust companies, which is very helpful. The income and transfer tax issues that arise with trustees generally, and in particular with private trust companies, are extremely complex and difficult, and we appreciate the amount of attention that the Service and Treasury are giving to this guidance. Comments by their nature tend to focus solely on problems, but we want to express our appreciation for the time and effort in this regard.

The principal author of the comments was Carol Harrington, whose telephone number is (312) 984-7794 and whose email address is charrington@mwe.com. Other contributors include Carlyn McCaffrey, Ron Aucutt, Dan Donohue, Mil Hatcher, and Don Kozusko. We request that any questions relating to our comments be addressed to Ms. Harrington.

We appreciate the ability to submit these written comments and would welcome the opportunity to offer any additional assistance that might be desired.

Sincerely,

W. Bjarne Johnson, President
American College of Trust and Estate Counsel

**AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL**

# COMMENTS ON PROPOSED REVENUE RULING ON THE TAX CONSEQUENCES OF THE USE OF PRIVATE TRUST COMPANIES[1]

On July 11, 2008, the Internal Revenue Service (the "Service") and the Treasury Department ("Treasury") issued Notice 2008-63 (the "Notice"), which was a notice of a proposed revenue ruling regarding the income, estate, gift and generation-skipping transfer tax ("GST tax") consequences in situations where family members create a private trust company ("PTC") to serve as the trustee of trusts having family members as grantors and beneficiaries. The Notice solicits comments, due November 4, 2008. This submission is the response of ACTEC to the request for comments.

The Notice states in general that the Service and Treasury intend that the final ruling will confirm certain tax consequences that are not more restrictive than the consequences that could have been achieved by a taxpayer directly, but without permitting a taxpayer to achieve tax consequences through the use of a PTC that could not have been achieved had the taxpayer acted directly. In this way, the choice of a trustee is tax neutral. This statement of principle is itself very helpful.

References to sections without more are to the Internal Revenue Code of 1986. References to regulations are to the Treasury regulations. In these comments, a related or subordinate party sometimes will be referred to as an "RSP." A person who is not an RSP with respect to another person will sometimes be referred to as an "independent person" or "IP" as to that other person.

## Summary of the Notice

The Notice describes two situations, Situation 1 and Situation 2. The Notice addresses the following issues if the PTC described in Situation 1 or Situation 2 is appointed and serves as the trustee of a trust:

- Will the value of the trust assets be included in a grantor's gross estate under Internal Revenue Code ("IRC") §§2036(a) or 2038(a)?
- Will the value of the trust assets be included in a beneficiary's gross estate under §2041?
- Will the grantor's transfer to that trust constitute a completed gift where the trust provides the trustee with the discretionary power to distribute income and/or principal to the grantor's child or descendants?

[1] ACTEC Fellows P. Daniel Donohue, Carol A. Harrington, Milford B. Hatcher, Donald D. Kozusko, and Carlyn S. McCaffrey drafted these comments. In addition, Ryan M. Harding contributed to the preparation of these comments.

- Does the appointment and service of a PTC as the trustee affect the exempt status of a trust that is otherwise exempt from the GST tax under §2601 or change the inclusion ratio of a trust?

- Is the grantor or any beneficiary treated as the owner of any portion of the trust under §§671-678?

The facts common to Situation 1 and 2 are as follows: A and B are husband and wife, C, D, and E are their children, each of whom is married and has children. References to "Family" includes A, B, their descendants, and spouses and former spouses of their descendants. A and B have established separate irrevocable trusts for each of their children and grandchildren. In addition C, D, and E each have established trusts for their respective descendants. Each child or grandchild of A and B is the primary beneficiary of the trust established for that child or grandchild. Each trust receives contributions only from the person who created the trust. All grantors and beneficiaries are U.S. persons and no trust is a foreign trust.

Each trust gives the trustee discretionary authority to distribute income and/or principal to the primary beneficiary ("PB") during his/her life. Each PB has a testamentary limited power of appointment among Family and qualified charities. Each trust provides that the grantor, or the PB if the grantor is not living, may appoint a successor trustee other than himself or herself if the current trustee either resigns or is not longer able to fulfill the duties of trustee. Each trust will terminate no later than 21 years after the death of the last to die of certain designated individuals living at the time of the creation of the trust.

<u>Situation 1</u>: The facts are as described above. All trusts are governed by the laws of State 1, which has enacted a PTC statute ("Statute"). The Statute provides that any PTC 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.

Discretionary distributions are defined as permissible distributions not mandated in the trust instrument or by applicable law. The Notice does not give any further information about the standards applicable to discretionary distributions, but one would assume that had the standards been ascertainable, as defined in §2041(b)(1)(A) relating to the health, education, support or maintenance of the beneficiary, the Notice would have so stated. Statute is assumed to contain several important provisions:

- Statute does not restrict who may serve on the DDC, but provides that no member of the DDC may participate in the activities of the DDC with regard to any trust to which the DDC member or his or her spouse is a grantor, or any trust of which the DDC member or his or her spouse is a beneficiary.

- Statute provides that a DDC member may not participate in the activities of the DDC with respect to any trust with a beneficiary to whom the DDC member or his or her spouse owes a legal obligation of support.

- Statute provides that 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).

- Statute provides that nothing in Statute or in the PTC's governing documents may override a more restrictive position in the trust instrument or trust for which PTC is acting as a trustee.

- Statute provides that no Family member may enter into any reciprocal agreement, express or implied, regarding discretionary distributions from any trust for which PTC is serving as a trustee.

The Notice assumes that Family formed a PTC under Statute and that the governing documents create the DDC that makes all discretionary distribution decisions. PTC's governing documents do not restrict who may serve on the DCC. Family owns all the stock in PTC either outright or through trusts or other entities. A, C, and D are officers and directors of PTC and also serve on the DDC. B and E own shares of PTC but neither is on the DDC and neither is an officer or director of PTC. E, however, is a manager and employee of PTC. X, a financial institution organized under the banking laws of State 1, has acted as the trustee of each of the trusts from their creation. No grantor of any of the trusts has a relationship with X other than as a customer or client of X.

After PTC was formed, X resigned as trustee of each of the trusts and PTC was appointed as successor trustee. In addition, A created and transferred property to three new irrevocable trusts (the "2008 Trusts"), one for the primary benefit of each of A's children and that child's descendants. The terms of each of the 2008 Trusts are the same as described above for the other trusts, except that these trusts provide that the trustee has discretionary authority to distribute income and principal to any one or more of the beneficiaries. Each of the 2008 Trusts receives contributions only from A, and PTC will serve as the trustee of each trust.

<u>Situation 2</u>: In Situation 2, the facts are the same as for Situation 1 except that the PTC is formed in State 2, which does not have a statute like Statute. PTC's governing documents provide that no member of the DDC may participate in the activities of the DDC with regard to any trust in which that DDC member or his or her spouse is a grantor or any trust of which that DDC member or his or her spouse is a beneficiary. In addition, the DDC member may not participate in the activities of the DDC with respect to any trust with a beneficiary to whom the DDC member or his or her spouse owes a legal obligation of support. Similar to Situation 1, PTC's governing documents provide that only officers and managers of the PTC may participate in decisions regarding personnel of the PTC and that nothing in PTC's governing instruments may override a more restrictive provision in the trust instrument. No Family member may enter into any reciprocal agreement express or implied regarding discretionary distributions from any trust for which PTC is serving as a trustee.

In Situation 2, PTC's governing documents also provide for the creation of an Amendment Committee, a majority of whose members must be individuals who are neither Family members nor persons related or subordinate (as described in §672(c)) to any shareholder of PTC. The governing documents further provide that the Amendment Committee, by no less than 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 of the Amendment Committee itself, or to the provisions delegating exclusive authority regarding personnel decisions to the officers and managers, and the prohibition of reciprocal agreements between Family members. These powers are vested exclusively in the Amendment Committee and the Notice assumes that this is not contrary to any applicable provision of the law of State 2 where the PTC is organized. A with F and G are the initial members of the Amendment Committee. F and G are not members of the Family, are not employed by PTC, and the Notice states that F and G are not otherwise related or subordinate to any Family member as defined in §672(c).

In Situation 2, A, C, and D are officers of PTC. A, C, D, F, and G serve on PTC's board of directors, and A, C, and D also serve on the DDC. B and E own shares of PTC, but neither is on the DDC and neither is an officer or director of PTC. E is a manager and an employee of PTC. All of the other facts are the same as in Situation 1.

## I. Analyzing Powers Held Through Entities Generally

There is little authority on the issue of how income or transfer tax rules apply in the context of control of entities. The only authority we are aware of on this point is Rifkind v. United States, 54 AFTR 2d 84-6453 (Cl. Ct. 1984) and Rev. Rul 72-552. In Rifkind, the decedent transferred property to a charitable trust during his life. The charitable trust required that all income be paid during the decedent's life to a charitable foundation created by the decedent. Until two years prior to his death, the decedent acted as one of three directors and also as an officer of the charitable foundation and, as a director, he had the power in conjunction with the other directors to designate which charitable beneficiaries would receive distributions from the foundation. The court found that the decedent had retained the right through acting as a director of the foundation to designate who may enjoy the income from the property transferred to the charitable trust, even though the decedent was not a trustee of the charitable trust. The Rifkind court concluded that the decedent, as one of three directors of the foundation, had retained the control of the disposition of the income from the trust, so that the trust was included in the gross estate of the decedent.

This result is consistent with Rev. Rul. 72-552, 1972-2 CB 525. In this revenue ruling, the decedent ("D") transferred property to a non-profit corporation of which D was a director and president until D's death. The by-laws authorized D, as president, and the vice president to direct the disposition of the corporation's funds for charitable purposes. At D's death, 90% of the corporation's funds had been transferred to it by D. The ruling held that D had the right in conjunction with others to designate who would possess or enjoy the property D transferred to it at D's death. The property D transferred to the corporation was included in D's gross estate under §2036.

The holdings in the Notice adopt this approach of looking through the PTC entity to the holders of its powers to analyze the transfer tax and income tax consequences of a PTC. We suggest that an explicit statement be included in the final guidance confirming this analysis generally for all tax purposes. For example, a PTC should be treated as an RSP only through an analysis of its decision-makers, and not through ownership or voting control except with respect to its effect on the decision-makers.

## II. Making Restrictions Irrevocable

### A. Situation 1: Statute Restrictions

No state at the moment has a law like Statute as described in Situation 1. The Notice essentially encourages states to enact a law like Statute if the state desires to facilitate the organization of PTCs under its laws. When and if states enact such a law, the assumptions and safe harbors of Situation 1 would become relevant. No state, however, is likely to act until the final guidance is issued, and there certainly will be a delay while any proposed legislation is crafted and makes its way through the system. In addition, only a few states may decide ultimately to enact such a statute. Thus, the option of creating a PTC following the guidelines of Situation 1 may not be available for some time, if at all, and for many taxpayers Situation 1 may be of very limited utility.

We are pleased to have this "blueprint" for a statute as part of the final guidance, but its limited current utility means that it is important for the final guidance to give examples of other methods that could be used immediately to achieve the "firewalls" that Statute provides.

### B. Situation 2: Restrictions in Entity Governing Documents

We know of no state that would allow the organization of a PTC subject to the condition that certain provisions of its governing documents only may be amended with the approval of persons who are not owners of any equity or debt interest in the entity. Thus the firewalls in Situation 2 may not be achievable as set forth in the Notice.

In Situation 2, the PTC's governing documents provide that the Amendment Committee has the sole authority to make changes to PTC's governing documents regarding the creation, function, or membership of the DDC or of the Amendment Committee itself, or to the provisions delegating exclusive authority regarding personnel decisions to the officers and managers, and the prohibition of reciprocal agreements between Family members.

Requiring Amendment Committee approval to change these provisions of a PTC's governing documents could be difficult to implement in fact and runs contrary to the general principles of corporate law. Owners of a corporation or limited liability company, including one formed as a PTC, have an inherent right to change the governing documents. This ability exists even if the controlling documents are silent. For example, a shareholder's agreement can be amended by unanimous consent of the shareholders even if its terms do not so provide. The final guidance should address the apparent conflict between the role of the Amendment Committee and the statutory and common law ability of the owners of an entity to amend governing documents, regardless of their current terms.

The role of the Amendment Committee in Situation 2 is to prevent Family members who are PTC's shareholders from amending the governing documents in such a way as to cause inclusion of any trust for which the PTC is acting as trustee in a Family member's

gross estate. See §§2036(a), 2038(a), 2041, 2511. The Amendment Committee provisions, however, may be more restrictive than necessary for transfer tax purposes.

The composition of the membership and voting of the Amendment Committee seems to have been prompted by a concern about amendment powers being held by groups of shareholders that include not only grantors or beneficiaries of trusts for which the PTC is acting as trustee, but those who are related or subordinate to them within the meaning of §672(c). If so, the Amendment Committee limitations appear to be broader than the limitations that would apply to an individual fiduciary serving under a trust who is not a grantor or beneficiary but is related to a grantor or beneficiary. In the transfer tax context, there are numerous opportunities for such RSPs to take part in trust administration and decision-making without risking negative tax consequences.

Even if the safe harbor of Rev. Rul. 95-58, discussed below, applies to limit the safe harbor for removal and replacement of trustees without adverse tax consequences, a family member (or other RSP) who is not a grantor or beneficiary and who does not owe a legal obligation of support to a beneficiary can be engaged in all of the following without transfer tax risk: (1) serving as the initial trustee, (2) being named as successor trustee except by a unilateral power of a grantor or beneficiary to change trustees as described in Rev. Rul. 95-58, and (3) holding a power to change trustees.

Further, such an RSP as to a grantor can hold a power to (i) amend the trust document as to administrative provisions, thus removing restrictions on trustees, (ii) change beneficial interests, as in the classic power of appointment, and (iii) appoint the trust funds to other trusts without restriction. For example, a grantor's spouse may hold a limited power to appoint a non-marital trust to other family members. No adverse transfer tax consequences result to the grantor if living or to any other family members from this power to appoint. If the spouse's power is testamentary, the trust would not be a grantor trust as to the grantor.

The independent majority requirement of the Amendment Committee parallels the "independent trustee" exception of §674(c) to avoid grantor trust treatment, which appears to be the purpose of the requirement. Accordingly, the final guidance should clarify that the independent majority requirement of the Amendment Committee has been prompted solely by grantor trust considerations, which would give further explanation for PTCs that administer trusts for which grantor trust income tax treatment is unimportant.

Moreover, even as to income taxes, the Amendment Committee provisions seem to violate the goal of not imposing on PTCs restrictions that are more restrictive than applicable to individual trustees. There is no grantor trust treatment in the individual trustee context if non-independent trustees may be but have not yet been appointed assuming that the grantor does not have a unilateral power to make such a change. Reg. §1.674(d)-2(a). The Notice goes further by approving only an approach that prevents any possibility of RSPs in the membership of the Amendment Committee (always requiring a majority of IPs as defined in §672(c)). In our view, the mere possibility of such a change should not be a problem, when it is not within the unilateral control of the grantor.

## C. Other Options

### 1. Irrevocable Trusts as Owners of the PTC

As we stated above, we believe that the limitations on amendment of PTC's governing documents in Situation 2 may not be binding under general state law principles regarding entities unless they are specifically authorized by statute. One practical solution to this potential issue is for the owner of the PTC to establish a new irrevocable trust specifically for the purpose of holding some or all of the PTC voting stock. The new trust's irrevocable provisions could prohibit the trustee from changing the tax-sensitive portions of the governing documents (as described in Situation 1 and Situation 2) in any way that would violate the tax rules with which they were designed to comply.

For example, the Amendment Committee concept effectively could be incorporated into an irrevocable trust by restricting the circumstances in which the trustee may approve an amendment and limiting the type of trustee who may consider the issue (e.g., only a trustee who is not an RSP within the meaning of §672(c) as to any grantor or beneficiary).

At common law, a grantor and all beneficiaries may agree to modify or terminate an irrevocable trust under some circumstances, and this scenario should be addressed in the final guidance when a PTC is owned by one or more irrevocable trusts as described above. In the context of transfer taxes, the regulations state that except as the regulation provides otherwise, "it is immaterial in what capacity the power [to alter, amend, revoke, or terminate] was exercisable by the [grantor] or . . . whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest." Reg. §2038-1(a)(3). However, the regulations specifically address the common law ability of a grantor and the beneficiaries to modify or terminate a trust by stating that §2038 does not apply if the grantor's power "could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law." Thus, the local law rights of a grantor to participate in modifying or revoking a trust are ignored under §2038.[2]

The Uniform Trust Code changes some of the limits regarding modification and termination rights as they existed at common law. However, we believe that the regulations under §2038 that provide that there is no inclusion also should apply to these Uniform Trust Code provisions as the regulation does not limit its application to case law. If Treasury desires instead to address the rights of grantors under the Uniform Trust Code differently, the final guidance (or other guidance) should state so clearly. The Uniform Trust Code allows the grantor to override any of its provisions

[2] While this provision in the §2038 regulations does not appear in the §2036 regulations, if the same local law rights would cause inclusion under §2036, the §2038 regulation on this point would be meaningless. For this reason, we think it is clear that there also is no inclusion under §2036 due to local law powers of the grantor to join with all beneficiaries to change or terminate a trust.

not specifically listed in Sec. 105 of the Uniform Trust Code. Because the list in Sec. 105 does not include the right of the grantor and beneficiaries to agree to modify or terminate a trust, a grantor can override those rights in the trust instrument. For this reason, putting taxpayers on notice is essential if Uniform Trust Code powers (if not superseded by the terms of the trust) will have adverse tax consequences. In fact, this issue should be resolved by guidance generally, as the issue is crucial outside of the PTC context as well as with respect to PTCs.

The issue of a grantor's power to agree with the beneficiaries to modify or terminate a trust is not addressed in the regulations under §676, but the rule should be the same as for transfer tax purposes, and the final guidance should confirm this result.

We believe that the final guidance should include an example where voting control of a PTC is held by one or more irrevocable trusts, the terms of which restrict the circumstances where the tax-sensitive provisions of the PTC's governing documents (as described in Situation 1 and Situation 2) may be amended. In this example, the applicable state law would not prohibit the amendment of the PTC's governing documents in any way and no Amendment Committee would be created. This would approve a method of implementing the restrictions imposed by Statute in Situation 1 and the Amendment Committee in Situation 2 that is currently achievable. Such an arrangement would add complexity, but it would be binding on the owners of the PTC and remain consistent with entity law principles.

### 2. PTC Governing Documents Require PTC to Cease as Trustee if the PTC Tax Sensitive Provisions are Amended

It would be helpful for the final guidance to approve a situation where the PTC's governing documents provide that if certain designated tax sensitive provisions of the PTC's governing documents are amended, the PTC would cease acting as trustee immediately before the amendment is effective. This would approve a practical way to eliminate the need for the Amendment Committee, while still maintaining the restrictions required in Situation 1 and Situation 2 without requiring the creation of a new irrevocable trust. One could argue that the power of the entity's owners to amend the by laws could allow them to amend the provision that causes the PTC to cease acting. However, any amendment can only apply prospectively, so that a provision that the PTC ceases acting immediately before any amendment to that provision should be effective.

### 3. New Trust Terms Require PTC to Cease as Trustee if the PTC Tax Sensitive Provisions are Amended

In some cases, it may be possible to structure the trusts for which a PTC will act as trustee to provide that if certain provisions of the PTC's governing documents are amended, the PTC, in its capacity as trustee, would no longer be able to make discretionary distribution decisions. For example, the terms of new trust documents could require a PTC while serving as trustee to maintain tax sensitive provisions of its governing documents, described in the Notice, with respect to the creation, function,

or membership of the DDC, the delegation of exclusive authority regarding personnel decisions to the officers and managers of the PTC, and the prohibition of reciprocal agreements between Family members. This suggestion, while effective, may not be feasible in the majority of situations where a PTC would act as trustee of existing irrevocable trusts. Nevertheless, these trust terms would alleviate the need for the Amendment Committee for some taxpayers, while still maintaining the restrictions required in Situation 1 and Situation 2. The final guidance should address this possible structure.

## III. Removal and Replacement of DDC Members

We believe that the Notice does not fully resolve the issues associated with the removal and replacement of DDC members and other PTC decision-makers by grantors and beneficiaries of trusts for which the PTC is acting as trustee. The assumption in Situation 1 and 2 that a grantor can be a member of the DDC but is prohibited from acting with respect to a trust does not solve this problem. A prohibition on a grantor from actually voting on DDC decisions does not cover the indirect control or influence that a grantor could have by threatening the DDC members with removal, or by actually continuing to remove DDC members until one is found that will do the grantor's bidding.

It is conceivable that Statute or the PTC's governing documents could attempt to avoid this issue by providing that grantors, beneficiaries or others are prohibited from removing and replacing any DDC member, or any person who directly or indirectly can remove and replace a DDC member, so as to influence decisions of the DDC. However, it is difficult for Treasury to enforce that prohibition or for a taxpayer to prove it was respected, because it requires the determination of the motive or purpose of any removal/replacement decision.

We believe four issues need clarification regarding the power to remove and replace DDC members. These issues need clarification not just in the context of PTCs, but also with respect to trustees generally:

1. Whether Rev. Rul 95-58 will be modified or retained in its present form with respect to a grantor of a trust, so that the only safe harbor available to a grantor is that the powers of a trustee will not be imputed to a grantor if the grantor may only replace the removed trustee or DDC member with a person who is not a related or subordinate person as defined in §672(c) with respect to the grantor.

2. Whether a more generous safe harbor will apply to a beneficiary who holds a unilateral power to remove and replace a trustee or DDC member.

3. Whether an indirect power to remove and replace a trustee or DDC member will impute the trustee's powers to the grantor unless the safe harbor of Rev. Rul. 95-58 applies (or to a beneficiary unless whatever safe harbor applicable is met). For example, if a grantor is the sole shareholder of the PTC, and can remove and replace directors, and the directors can remove and replace the DDC members, will the trustee's powers be imputed to the grantor/shareholder

if a removed DDC member can be replaced with a person who is related or subordinate to the grantor?

4. Whether a power to remove and replace held jointly with another person is treated the same as a power held unilaterally. Similarly, whether an indirect power held jointly will be treated the same as one held unilaterally.

We have not addressed the issue of whether a transfer to a trust is a completed gift in the context of imputed powers due to an ability to remove and replace the trustee as we have assumed that this issue will be treated consistently with the other transfer tax issues, discussed below.

**A. Background – Removal of Trustees**

The Notice makes no mention of Rev. Rul. 95-58. Rev. Rul. 95-58 revoked Rev. Rul. 79-353. In Rev. Rul. 79-353, the Service had ruled that the reservation by the grantor of the power to remove and replace a trustee at will and appoint another trustee is equivalent to the reservation of the trustee's powers. Thus, under Rev. Rul. 79-353, if the trustee's power to distribute income and principal was not limited by appropriate standards and the grantor had the power to both remove and replace the trustee, the trustee's powers attributable to the grantor could cause inclusion under §2036(a)(2) or 2038(a).

The Service's position in Rev. Rul. 79-353 was rejected by two cases, Estate of Vak, TC Memo 1991-503, rev'd, 973 F.2d 1409 (8th Cir. 1992), and Estate of Wall, 101 T.C. 300 (1993). The Service then issued Rev. Rul. 95-58, which revoked Rev. Rul 79-353 and which further provides that if the decedent possessed the power to remove the trustee and appoint an individual or corporate successor trustee, the decedent would not be treated as having retained a trustee's discretionary control over the trust income if the successor could not be related or subordinate to the decedent (within the meaning of §672(c)). Thus Rev. Rul. 95-58 provides a "safe harbor" for grantors of trusts under §§2036(a)(2) and 2038(a)(1).

The attribution of a trustee's powers to a person who could remove and replace the trustee is addressed in regulations under §§2036 and 2038 with respect to a grantor, under §§2041 and 2514 with respect to a beneficiary, and under §674, with respect to income tax issues for a grantor.

**B. Issue 1: §§2036, 2038 and Removal Power**

Issue 1 is whether the failure to address the issue of Rev. Rul. 95-58 in the Notice means that Treasury believes that this concept no longer should be applicable to the transfer tax area, as many practitioners believe should be the case. If that was intended, Rev. Rul. 95-58 should be modified with respect to the transfer tax area to create a more expansive safe harbor consistent with the final guidance on PTCs. If the safe harbor of Rev. Rul. 95-58 is left unchanged, Treasury should clarify how Rev. Rul. 95-58 applies in the PTC context, so that using a PTC does not allow a better result than currently allowed without a PTC. Otherwise, this result conflicts with the statement at the beginning of the Notice that a PTC should not allow a different result from what is possible without a PTC.

In both Situation 1 and Situation 2, no description is given of how DDC members are appointed, removed, or replaced. For example, assume that in both Situations, the grantor, A, can unilaterally remove and replace DDC members, and that there is no restriction on who A can name to replace a removed DDC member, so that A can replace a member with A's sister, S. This example does not fall within the safe harbor of Rev. Rul. 95-58. The final guidance should address whether the trustee's powers will be attributed to A because A can remove and replace a DDC member with a related party.

The requirement in the proposed PTC guidance that 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), does not solve this problem because A in both situations is stated to be an officer and director of PTC. (Also, in reality, DDC members often are not employees of the PTC, to avoid grantor trust issues, and instead are limited to directors who are not employees.)

Regulations under §2036 provide that "for example, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee" for purposes of §2036 Reg. §20.2036-1(b)(3). Similarly, Regulation §20.2038-1(a)(3) provides "for example, if the decedent had the unrestricted power to remove or discharge a trustee at any time and appoint himself trustee, the decedent is considered as having the powers of the trustee" for purposes of §2038.

One possibility is to modify Rev. Rul. 95-58 and create a more expansive safe harbor. Rev. Rul. 95-58 has been criticized for its narrow safe harbor and for importing an income tax rule into the transfer tax area. The regulations under §§2036 and 2038 reference only a power to replace the trustee with the grantor as causing imputation of the trustee's powers. This indicates that a power to replace the trustee with any person other than the grantor should not result in imputed powers to the grantor under those sections because the regulations could have taken the position that a power to replace a trustee with any person should cause inclusion under those sections, that example should have been included. Thus these regulations indicate that Rev. Rul. 95-58 is too narrow and should be revoked and replaced with a revenue ruling confirming that no imputation of the trustee's powers occurs for purposes of §§2036 or 2038 if the grantor can replace the trustee with any person as long as the grantor is prohibited from naming the himself or herself. If that is the resolution of this long standing issue, the PTC final guidance can so state.

If Rev. Rul. 95-58 is revoked or modified by the final PTC guidance, the income tax issues also must be addressed. The income tax regulations under §674 are somewhat different, in that two examples are given, one where the removal power "may" result in the independent trustee exception not applying, where the grantor can replace the trustee with anyone, including the grantor. The second example is a removal power that will not cause a loss of the independent trustee exception because only an independent trustee may be the replacement. Left unaddressed is a power to appoint any person other than the grantor, including persons who are related or subordinate to the grantor. However, like the regulations under §§2036 and 2038, it seems that if the exception was not to

apply in that case, the regulations could have easily said so. Instead, the ability to appoint the grantor as a replacement seems to be the significant part of the regulation, and the guidance could conclude that only that power should cause a loss of the independent trustee exception. Of course, if a related or subordinate party were actually appointed, the §674(c) exception might not apply thereafter, but the power to appoint a related or subordinate party without doing so does not seem especially significant.

If, however, Treasury is not willing to grant any safe harbor beyond that described in Rev. Rul. 95-58, then the PTC final guidance should address this issue and confirm this position, so that the result is consistent for the removal and replacement of trustees and DDC members.

## C. Issue 2: §2041 and Removal Power

Issue 2 is whether a more generous safe harbor will apply to a beneficiary who holds a unilateral power to remove and replace a trustee or DDC member that that applicable to a grantor in Rev. Rul. 95-58. Rev. Rul. 95-58 does not address a power held by a beneficiary to remove and replace a trustees.

Regulation §20.2041-1(b)(1) states that "[f]or example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment" for purposes of §2041. Similarly, Regulation §25.2514-1(b)(1) states that "[f]or example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment" for purposes of §2514.

The regulations under §§2041 and 2514 reference a power to replace with any person "including" the beneficiary as resulting in a power of appointment in the beneficiary. It is not clear that under §§2041 and 2514 a power to replace with any person other than the beneficiary will cause the power holder to be treated as having the trustee's powers. However, like the regulations under §§2036 and 2038, it seems that if the exception was not to apply in that case, the regulations could have easily said so. Instead, the ability to appoint the beneficiary as a replacement seems to be the significant part of the sentence, and the guidance could conclude that only that power should cause a loss of the independent trustee exception.

If Treasury does not choose to make that clear, Treasury should at least confirm a safe harbor like that in Rev. Rul. 95-58 to powers to remove and replace a trustee held by a beneficiary. The analysis applied by the courts in Wall and Vak is equally applicable in the context of powers that, if attributed to a beneficiary, would cause inclusion in the gross estate under §2041 or gift taxation under §2514.

The Tax Court in Wall stated that the power to replace a trustee would not compel the trustee to bend to the wishes of the power holder. If the speculation of coercion is not sufficient to cause attribution of trustee powers to the grantor under §§2036 and 2038, we can think of no reason that this principle would not apply in the context of a power held by a beneficiary to remove and replace a trustee as well. The courts' holdings that the threat of replacement does not have a sufficient coercive effect to attribute the trustee powers to the power holder is equally applicable to a beneficiary who holds the power to replace, because the effect of carrying out the threat is the same.

The only case law that addresses this issue is consistent with this analysis. The issue of removal of a trustee by a beneficiary arose before Rev. Rul. 95-58 was issued in First National Bank of Denver v. United States. In that case, the Tenth Circuit rejected the Service's assertion that a trust that gave the trustees power to distribute corpus to the decedent should be included in the decedent's estate under Code §2041 as a general power of appointment where the decedent who was the lifetime beneficiary also had the power to replace trustees. First National Bank of Denver v. United States, 648 F.2d 1286 (10th Cir. 1981). The court interpreted the trust as providing the decedent with a power only to change corporate trustees, which the court held did not cause the trust property to be included in the gross estate of the decedent under §2041. The Service also has adopted this analysis and applied the holding of Rev. Rul. 95-58 to beneficiary-held powers to remove and replace trustees in several private letter rulings. See, e.g., Letter Rulings 9607008, 9735023, 9746007, 200031008, 200229013 and 200533010.

For the above reasons, we believe that at the least Treasury should apply the analysis of the safe harbor of Rev. Rul. 95-58 in the context of a beneficiary's power to remove a trustee and appoint a successor trustee, and the PTC final guidance should make that clear.

### D. Issue 3: Indirect Removal Power

Issue 3 is whether an indirect power to remove and replace a trustee or DDC member will impute the trustee's powers to the grantor (or to a beneficiary) unless the safe harbor of Rev. Rul. 95-58 applies.

In addressing the right to remove and replace members of the DDC, the final guidance should address the indirect control that can exist with a corporation or other entity. The answer to this question will depend to some extent on how Issues 1 and 2 above are addressed. Treasury could require that Rev. Rul. 95-58 applies to an indirect power to remove and replace. For example, assume that A is the grantor of a trust and the sole voter of PTC stock, and as the sole voter, A can remove and replace the sole director of PTC, B, which sole director can remove and replace C, who is the sole DDC member.

There are several cases.

Case 1. The easy case is to assume that C can only be replaced with a person who is independent with respect to A. For example, assume that there is a statute like the one described in Situation 1 and that this statute requires that only persons who are IPs as to

A may replace a removed DDC member. In that case, A's power to remove and replace B cannot impute any of the DDC's powers to A because if A held B's power directly it would fall within the safe harbor of Rev. Rul. 95-58.

The more difficult cases arise where C can be replaced with an RSP as to A. If A could remove and replace C directly in this case, A's power would not fall within the safe harbor of Rev. Rul. 95-58. If A, however, can only remove and replace B, the issue is whether B's power to remove and replace C will be imputed to A.

Case 2. Assume that A can replace B only with an IP as to A. Following the logic of Rev. Rul. 95-58 would mean that B's power will not be imputed to A.

Case 3. Assume that A can replace B with a RSP as to A. The logic of Rev. Rul. 95-58 would input B's power to A, which would not fall within the safe harbor.

Case 4. Assume that B is a RSP when first appointed; in fact, assume that B is A's spouse. The answer to Case 2 and 3 would not change as to A. The imputation of B's power to A only occurs under Rev. Rul. 95-58 due to A's power to remove and replace B, not due to any prohibition in the first place as to who B can be.

Case 5. Assume that B is in fact a grantor or a beneficiary of other trusts of which PTC is the trustee. To eliminate any tax risk with respect to the layers of removal and replacement for both A and B, a statute like that described in Case 1 could provide that only persons who are IPs with respect to all grantors or beneficiaries can replace a removed DDC member. This seems to be a solution if Rev. Rul. 95-58 is applied serially to layers of removal and replacement powers.

Alternatively, Treasury could modify Rev. Rul. 95-58 or limit it to direct removal and replacement, so that there is only one level of imputed powers through a removal/replacement power.

**E. Issue 4: Jointly Held Removal Power**

Issue 4 is whether a power to remove and replace held jointly with another person is treated the same as a power held unilaterally, and if so, whether an indirect power held jointly will be treated the same as one held unilaterally.

Rev. Rul. 95-58 considers only unilateral powers. Assuming that Rev. Rul. 95-58 will continue to apply, that leaves open the question as to whether a comparable "safe harbor" for PTCs (and by analogy, for distribution committees acting outside a PTC) should require a shared power to meet the same standards for the independence of the replacement fiduciaries as the "safe harbor" provided by Rev. Rul 95-58. Given the necessary involvement of multiple parties, whether acting jointly at the same time or sequentially or both, the replacement "power" is significantly diluted when it is not a sole power to change a decision-maker. In the context of removal/replacement powers, treating a jointly held power to remove and replace the same as a unilateral power may be an unduly harsh result, given that the basis for Rev. Rul. 95-58 can be questioned. This

may be a reason to distinguish jointly held powers to remove and replace and other jointly held powers in a PTC.

Many estate planners believe that the definition of "related or subordinate" under the income tax rules should not be important in the transfer tax area, given that the income tax rules manage very different consequences. It seems difficult to justify that a power to choose a sibling rather than a close friend as a trustee justifies a tax bill of almost half of a trust's net worth.

Certainly a grantor or beneficiary should not be able to hold a unilateral right to change the decision-maker and avoid attribution simply because the power is exercised inside a PTC. How can the rules for succession inside a PTC be made tax neutral? We have considered the following hypothetical involving individual trustee succession as the proper starting point for the comparison:

Example 1: Indirect

The beneficiary (B) of a trust cannot serve as trustee of the trust (T) because of tax sensitive powers. The trustee can be changed by the protector (P) serving under the trust and the master adviser (M) under the trust can change the protector. The trust document would allow a "chain reaction" in which M changes P and P changes T in quick succession.

Under these circumstances we assume for purposes of this discussion that no "safe harbor" should allow B to serve as M and initiate such a chain reaction in which the new P chosen by B serving as M is related or subordinate to M and the new T chosen by P is related or subordinate to both B and P. We assume this even though P and T are fiduciaries and M/B cannot direct the conduct under the trust of P and T. P and T are in effect presumed to be compliant to the wishes of B.

Put another way, we assume in this part of the analysis that the safe harbor of Rev. Rul. 95-58 would require appointments in a sequential replacement power to meet the same standards as for a single unilateral power, precluding the naming of related or subordinate replacements after a removal, even though the "ability to control" through removal and replacement is diluted because it is shared by more than one party.

Example 2: Indirect and Shared

Assume that in Example 1 there are three parties at each level (three B's, three T's, and three P's and three M's) and each level requires majority consent to act. Many more people must now conspire for B1, B2 or B3 to accomplish control. Does it matter if B1, B2 or B3 have varying interests under the trust, or different interests under different trusts? In applying the "related or subordinate" language, does it matter if some of the new Ts are related or subordinate to the Ps that voted for them but not to all of the Bs?

As compared to Example 1, this complex example represents more closely the context of a PTC, which is owned by a family (level M) that elects a broad of directors (level P) that

in turn appoints a DDC (level T), and where every level could potentially have several parties involved.

It is clear that succession in PTCs and the relevance of the issues addressed by Rev. Rul 95-58 will become increasingly important as PTCs age and succession becomes a real world issue, and the analogous use of distribution committees outside the PTC becomes more common. No family has a limitless supply of "independent" parties to satisfy the demands of unduly restrictive tax rules for succession, and in any event, one could question whether the family's influence on the replacement will be in fact be less simply because the family must choose a close friend or professional advisor instead of a family member.

Analysis of Example 2:

If the income tax standard of "related or subordinate" as used in Rev. Rul. 95-58 to identify compliant parties were to be applied in constructing a safe harbor for PTCs where a beneficiary might have a power to vote directly or indirectly on the choice of DDC members and successors, the following details, among others, would need to be considered because of the multi-party context of PTCs:

There should be no application of this standard unless a beneficiary with a tax-sensitive power or a grantor is participating in both the removal and selection of a successor. In the individual fiduciary context, the concept of Rul. 95-58 and related rulings deals only with a power to change decision-makers when it is held by a grantor or beneficiary, not when it is held by someone else, even if that someone is related or subordinate to a grantor or beneficiary.

When it applies at all, the safe harbor restriction should preclude the selection of a replacement only if that candidate is related or subordinate to both the appointing party/parties and the beneficiary/beneficiaries in question. Otherwise the chain of compliant parties is broken. In Example 2, some of the Ts (the DDC) voted on by the board of Ps (board of directors) may be related to the Ps but not to the Bs (beneficiaries) and vice versa. A replacement candidate should not be disqualified if not related or subordinate to majority of the beneficiaries in question and also to the minimum number of voting parties needed to approve the candidate. In many instances of family PTCs this will be a distinction without a difference but it would make a difference if the family PTC involves cousins in its governance and not just parent/descendant and sibling relationships.

The restriction should not preclude from voting in the chain (as Ms, or Ps) any of the Bs (beneficiaries) or any related or subordinate parties to the Bs as long as these tainted parties represent a minority of those voting. This "independent majority/tainted minority" distinction is drawn from §674 which applies the independent trustee exception in subsection (c) along the same lines. This rule on beneficiary participation is different from the restrictions that determine whether a power of appointment held by a beneficiary is a general power of appointment; shared control does make such a power non-general unless it is shared with an adverse party or the creator of the power. Here the

beneficiary is not the actual holder of a power of appointment, but instead would be voting on whether to remove and replace fiduciary decision-makers with a new third-party. The tax issue concerns whether voting to change a fiduciary should be grounds for attributing the fiduciary's powers to the beneficiary if the beneficiary's vote is one among many, and does not control at all. To be consistent with the independent majority rule in §674(c), we believe that there should be no attribution. Whether grantors should be allowed to participate in the selection chain is another question, which might be considered differently if we consistently look to §674(c ) as the standard for independence.

As this above demonstrates, the "related or subordinate" concept of Rev. Rul. 95-58 could be applied to shared powers, whether jointly or sequentially exercised, only with great difficulty and could lead to mind-numbing complexity and unworkable rules.

A more realistic approach would be to adopt a different concept from Rul. 95-58 which emphasizes the connection between the power to remove and the power to name the successor. The critical feature is whether there is an ability to change control. A safe harbor could be constructed for PTCs that relies on an inability to change control, whether or not related or subordinate parties are chosen as successors. It could also be a much simpler safe harbor than one focusing on the type of successors selected. The different approach seems warranted if the concerns implied by Rev. Rul. 95-58 were extended beyond unilateral powers to shared powers.

Example 3: Change of Control

A PTC formed as a corporation provides in its governing documents that all directors and DDC members serve three year terms, and during the term, a director or DDC member may be removed by the shareholders/directors respectively but not if a special change of control results. A "special change of control" means a membership change by removal over the course of three years of more than half of those serving in the body in question, counting those changes in which a grantor or beneficiary of a tax sensitive trust participated in the vote for removal and the vote for filling the vacancy, or voted for the election of those persons who made those decisions. Further, the PTC provides that the terms of no more than two-thirds of the directors or DDC members may be scheduled to expire in any one year.

Analysis of Example 3:

As shown in Wall, and Rev. Rul. 79- 353, the genesis of Rev. Rul. 95-58 rests in powers that permit unlimited use, such as repeatedly changing trustees whenever a trustee fails to comply with the grantor or beneficiaries wishes. The governing provisions in Example 3 make it extraordinarily difficult if not impossible far a shareholder to influence the DDC in similar fashion, or for even a single director or group of directors to do so, because of the prohibition against removals that cause a change of control and because of the staggered regular election terms.

This approach is workable because it allows for a discreet use of a removal power, which is necessary to resolve inadequate performance caused by conflict, inattentive members, lack of diligence, lapses in mental incapacity, and other changes in family circumstances or member performance. It also allows for a replacement to fill the vacancy caused by the removal without needing to find “outsiders.”

The provision for three-year terms and staggering the terms of the members of the directors and DDC (if they serve fixed terms) is to limit the opportunity to use regularly scheduled frequent elections to make changes.

Conclusion

In view of the severity of the potentially adverse tax results, more explicit guidance is needed as to whether the succession process for the DDC is affected by the concerns addressed by the unilateral power to remove and replace decision-makers as in Rev. Rul 95-58, which is not mentioned in the Notice.

Even if Rev. Rul. 95-58 is not modified as recommended above, the guidance in the proposed ruling should make it clear that there is no intention to extend this debate beyond a unilateral power to replace a decision-maker. The Notice should provide that a shared power to remove and replace decision-makers does not lead to attribution of tax sensitive powers to a holder of the shared replacement power if that person cannot personally name himself or herself to the position that can exercise the tax sensitive power. For example, a person who is a beneficiary of a trust managed by the PTC should be free to serve on the board of directors of the PTC even though that board appoints members to the DDC, including through a power to remove and replace existing members of the DDC. It should be enough that this beneficiary is prohibited from voting to exercise a tax sensitive power while actually serving on the DDC; the proposed ruling should eliminate any tax risk that the votes of others on the DDC will be attributed to the beneficiary simply because the beneficiary is part of a customary governance process by which others are named to the DDC through multiple members of the board of directors and the persons selected might be related or subordinate parties. A narrow exception could be created for a PTC structure that is not, in substance, truly multi-party (not shared) and resembles the context of Rev. Rul 95-58 very closely. This safe harbor could preclude a single owner of a PTC (who was also a relevant grantor or beneficiary) from naming himself or herself, or a party related or subordinate to him or her, to serve as a single director/or manager who then in turn could remove DDC members at will at any time and name parties related or subordinate to either the PTC owner or the director /manager.

If further restrictions are believed to be necessary to immunize the succession process from tax risk, the safe harbor should be constructed around the concept of preventing a change of control during a certain defined period of time, as in Example 3, rather than around the concept of restrictions on “related or subordinate” replacements, as in Example 2. The approach in Example 3 focuses on allowing removal in discreet cases while preventing it from being used as an instrument of control for self-interested purposes by grantors and beneficiaries in tax sensitive circumstances. By not relying on

the definition of an RSP, this approach also can be applied in the same way to PTCs formed as corporations and as limited liability companies without being affected by the §672(c) reference to employees of corporations.

However, a clear rule, even if not ideal, is better than uncertainty. Thus in our view the final guidance should address how jointly held powers to remove/replace will be treated, whether or not they are treated the same as other jointly held powers. In addition, jointly held powers to remove and replace that are indirect, as discussed in Issue 3 above should also be addressed.

### F. Application of Different Standards if a DDC Member Dies or Resigns

It would be helpful if the final guidance clarifies that Rev. Rul. 95-58 does not apply to situations where the DDC member resigns or retires, but only to situations where the DDC member is removed and replaced by the same person.

## IV. DDC Recusal Issues

### A. Restriction on Participation by Spouses of Grantors and Beneficiaries

In both Situation 1 and Situation 2, the Notice prohibits an individual from participating in DDC decisions for a trust of which his or her spouse is a grantor or a beneficiary.

Unlike under §672(e), there is no automatic attribution between spouses as to transfer taxes. For example, under §2041 the grantor's spouse could hold a special power of appointment over the grantor's trust without triggering an estate tax at either death as long as the power is not exercisable in favor of the spouse, the spouse's estate or creditors, or to discharge the spouse's legal obligation of support. The recusal restriction applicable to spouses should be necessary only to prevent grantor trust status.

A spouse of a grantor or beneficiary should have the same right to be a decision-maker in a PTC as a spouse who serves as an individual trustee of a family trust (or less commonly, as a fiduciary member of a distribution committee without a PTC). The final guidance should clarify that the recusal of spouses is necessary only for income tax purposes, and not necessary for transfer tax purposes, as the income tax consequences of acting on the DDC may be manageable, neutral, or even desirable.

### B. No Definition of "Beneficiary" and No Description of Fiduciary Standards

Statute in Situation 1 provides that no DDC member may participate in the DDC decisions (i.e. must be recused) with regard to (1) any trust of which that DDC member or his or her spouse is a "beneficiary" or (2) any trust with a beneficiary to whom that DDC member or his or her spouse owes a legal obligation of support. (Statute also prohibits the trust's grantor or grantor's spouse from participating in DDC decisions as to that trust.) Analyzing the gift tax issues in the Notice is complicated by the lack of any explanation of what is meant by "beneficiary" of a trust.

For example, assume that in Situation 1, A created C Trust for his child, C, where the trustee has discretion to pay income or principal among C and C's descendants while C or any descendant of C is living, and on the death of the last to die of C and all of C's descendants, C Trust will be distributed per stirpes to A's then living descendants. Assume that C, D and E are A's living children, and that C has one child, GC1. In Situation 1, A, C, and D are members of the DDC. C clearly is a beneficiary of C Trust, so C cannot participate in any DDC decisions with respect to C Trust. A cannot participate because A is the grantor. Is D a "beneficiary" of C Trust? D is not a current beneficiary but has a remainder interest, contingent on the death of C and all of C's descendants before D. The issue is whether under Statute, D may participate in DDC decisions for C Trust?

This issue is important because the gift tax regulations provide that a remainder beneficiary who causes trust principal to be paid to another is making a transfer subject to gift tax. Reg. §25.2514-3(e), Ex. 4. However, the regulations contain a safe harbor for a trustee-remainderman who makes a distribution to another if made pursuant to a fiduciary power limited by "a reasonably fixed or ascertainable standard set forth in the trust instrument." Reg. §25.2511-1(g)(2). This safe harbor uses a broader standard than that applicable under §2514 where the trustee has a power to appoint to himself or herself. This gift tax issue arises whenever a person acts as trustee and either is (1) a possible remainder beneficiary, or (2) a current beneficiary, and as trustee has a power to pay to others that is not limited by a reasonably fixed or ascertainable standard set forth in the trust instrument.

By not defining "beneficiary" and by not describing the discretionary standards, the conclusion in the Notice that distributions from a trust will not be deemed a gift by any DDC member is not necessarily correct. For example, if D is allowed to participate in DDC decisions for C Trust, and the standards are not fixed or ascertainable within the meaning of Reg. §25.2511-1(g)(2), D's power does not fall within the safe harbor. This does not necessarily mean that a payment is subject to gift tax, as the regulation does not directly state this, but the risk exists that this could be the result. If the Notice intends to expand on the safe harbor in Reg. §25.2511-1(g)(2), the Notice should explicitly so state, and make it clear that this applies to trustees acting directly as well as DDC members. How Treasury addresses this issue should determine how Statute defines who must be recused from DDC decisions. This is discussed further in IV, C, below.

### C. Restriction on Participation by a Beneficiary for Distributions to Others from the Same Trust

In the Notice, the recusal restrictions (in the Statute or PTC governing documents) with respect to the DDC would preclude participation by a beneficiary in deciding whether to make distributions to others from the same trust. However, tax rules do not require a beneficiary serving as an individual trustee to be completely restricted from participating in decisions regarding distributions in this case.

This firewall will avoid any gift by the beneficiary (subject to our comments in IV, B, above), and also will avoid estate tax inclusion, regardless of the standards for the trustee's discretion. However, a total ban on beneficiary participation is not required, because there

are at least three sets of circumstances where a distribution decision does not constitute a gift by the beneficiary-trustee:

(1) If the distribution is made to others by the beneficiary acting as an individual trustee pursuant to a fixed or ascertainable standard set forth in the instrument, there is no gift. Reg. §25.2511-1(g)(2). If a beneficiary has a power to pay to himself or herself, and the power is limited by an ascertainable standard relating to the health, education, support or maintenance of the beneficiary, a payment to another beneficiary or the death of the beneficiary is not the lapse of a taxable general power of appointment. Reg. §25.2514-1(c)(2).

(2) There is no gift if the distribution decision requires adverse party consent. Reg. §25.2514-3(b) applies the adverse party exception to trustee distribution decisions in the same way as for powers of appointment.

(3) There may be no gift even if the safe harbor under Reg. §25.2511-1(g)(2) does not apply when a beneficiary exercises discretion to make payments to others where the trust is clearly adequate to continue to make any likely payment to that beneficiary. The beneficiary's exercise of a power to benefit others is a gift if it is a transfer of all or part of the beneficiary's own interest. Reg. §25.2514-1(b)(2) (power of appointment) and 25.2514-3(e)(Ex. 3); PLR 8535020; PLR 9451049. However, where the interest transferred is the possibility of receiving income or principal in the trustee's discretion in the future, one can argue that no gift should occur unless the payment to others materially reduced the value of the funds remaining to satisfy any entitlement of the beneficiary under the trust. If the remaining funds are clearly sufficient to continue to make any likely payments to the beneficiary, then one can argue that nothing has been given away. This argument is more than a debate over valuation. Instead the question is whether anything at all has been transferred from the beneficiary-trustee when trust assets are distributed to others if the remaining funds are plainly adequate. Gift characterization to date has been limited to cases where the remaining funds are clearly not adequate or a de facto transfer of a fixed interest has been made. E.g., PLR 8535020 and PLR 9451049 (trusts terminated in favor of a non-beneficiary); Reg. §25.2514-1(b)(2) (fixed income interest).

Conclusion

The final ruling should drop this part of the recusal and include caveats as to the circumstances that could lead to a gift. As an alternative to this recommendation, the following recusal provision could be used in the ruling to address these issues in a manner consistent with the treatment of distribution decisions by individual trustees:

"Discretionary distributions are defined as permissible distributions that are not mandated in the trust instrument or by applicable law, [and in this case may be made for the best interests and welfare of all current beneficiaries.] PTC's governing documents do not restrict who may serve on the DDC, but provide that no member of the DDC may participate in the activities of the DDC with regard to any trust of which that DDC member is a grantor [deletion], or any trust of which that DDC member [deletion] is a beneficiary, [except that the beneficiary may participate if a proposed distribution is to be made

pursuant to an ascertainable standard relating to that beneficiary's health, education, support or maintenance, or only with the consent of an adverse party, or if the proposed distribution would not have the same effect in substance as a transfer of all or part of the beneficiary's interest in the trust.] In addition, the governing documents provide that 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 [deletion] owes a legal obligation of support." ["Beneficiary" includes only those persons who currently could receive trust assets under any possible exercise of the trustee's discretion.]

In the revised paragraph, the restriction on spouses has been deleted, although this would need to be adjusted for the income tax part of the ruling.

## V. Further Clarifications Requested

### A. Reciprocal ("Mirror") Powers

We use the term "mirror" powers to refer to powers that parallel each other but were not created by the power holders, so that it is clear that the reciprocal trust doctrine does not apply. For example, Jack is the trustee of a trust that benefits Jill and has powers that would cause estate tax inclusion if Jill were trustee, and Jill is the trustee of a trust that benefits Jack with the same terms. Where these mirror powers were created by their by their mother, the reciprocal transfer doctrine does not apply. It has been suggested (as in PLR 9235025) that the mirror powers invite cross-trading of votes to achieve a result that could not be achieved directly and thus mirror powers should be treated like reciprocal transfers and taxed accordingly, even without any evidence of vote trading or any exercise of the powers. The Service has concluded to the contrary in more recent private letter rulings that powers held by persons who were not the transferors who created the powers are not treated as reciprocal transfers. PLR 9451049; PLR 200748008 (and four related rulings, 200748011 to 13 and 200748016).

The Notice concludes that there is no adverse transfer tax or income tax effect due to mirror powers, so long as there is an express prohibition in the PTC structure against reciprocal agreements, express or implied, regarding discretionary distributions. This indicates that no reciprocal transfer doctrine will apply. An explicit statement would be helpful, as family-owned trust companies may administer multiple trusts that have mirror powers. The trusts are often established at different times, so the powers are not interrelated when created; and the transferors may even be deceased or otherwise not involved in PTC decisions; e.g., three siblings sit on a distribution committee, together with other family members, for trusts established by their deceased parents.

It would be helpful to taxpayers for the Notice to reaffirm the results of the private letters rulings cited above by including the same principles in the text of the published ruling proposed by the Notice, stating that the reciprocal transfer doctrine does not apply to powers held by persons who are not the transferors who created the powers.

In addition, the Notice relies on an express prohibition in the PTC structure against vote-trading. To achieve tax neutrality for trusts that are administered by family co-trustees or

distribution committees rather than PTCs, the Notice should specify that the same result would be reached if the vote-trading prohibition were supplied by governing trust law or other means such as a trust document provision.

Finally, it would be helpful if the final guidance illustrated or explained what was intended by the prohibition of "implied" reciprocal agreements.

## B. Additional Grantor Trust Issue

The Notice concludes that in both Situations 1 and 2 no grantor or beneficiary of the trust would be deemed to be an owner under §§673, 676, 677 or 678. The Notice points out that under §677(b), the grantor would be deemed to be the owner of the trust to the extent the trust income is actually used to discharge a support obligation of the grantor, but that this would be true regardless of the identity of the trustee.

The Notice points out that the identity of the trustee is relevant with regard as to whether the grantor is treated as the owner under §674. In Situations 1 and 2, the standards are not described, so §674 could apply.

The general rule is that certain powers held by a trustee must be subject to the approval or consent of an adverse party as defined in §672(a) to avoid treatment as a grantor trust. The Statute in Situation 1, or the governing instruments in Situation 2, would prohibit a DDC member from acting as to each trust where the DDC member has an interest, so there would be no adverse party with the power to grant approval or consent. The Notice points out that two clauses of §672(c)(2) are relevant in analyzing Situation 1 and Situation 2.

The first is the clause of §672(c) that defines a related or subordinate party to include a corporation or any employee of a corporation in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control. The Notice holds, however, that voting control of PTC is irrelevant as it applies to a power to make distributions due to the provisions of Statute, or the Amendment Committee structure, with regard to the DDC and by the delegation of all PTC personnel decisions to the officers and managers of PTC. Under these circumstances, the Notice concludes that the ownership of voting stock of PTC (even the sole ownership of all of the voting stock) should not be deemed to be "significant" under §672(c) for this purpose. Voting control is concluded to be relevant only if it gives the grantor power over distributions made in the discretion of the corporate trustee or power over the employees of the corporate trustee who make discretionary distributions. The Notice concludes that adequate safeguards protect against the exercise of such powers. This analysis in the Notice does not address the indirect control issue raised above regarding the power of the shareholder to remove the directors, who can remove the officers or managers of the PTC.

The Notice points out that the second relevant clause of §672(c) defines a related or subordinate party as including a subordinate employee of a corporation in which the grantor is an executive. The Notice states that the determination of whether or not PTC as trustee is related or subordinate for purposes of §672(c) must be made by looking at the members of the DDC who are authorized to act with regard to particular trusts, as if those

DDC members individually were the trustees, and that this look-through is necessary to insure that a grantor cannot achieve income tax results indirectly that could not be achieved with an individual trustee or trustees. Subordinate employees of a corporation in which the grantor is an executive will still be deemed to be subordinate to the grantor under §672(c). Thus, a non-Family member serving on the DDC who is an employee of PTC will be related and subordinate to A, C, D, and E but not to B (who is not an officer or manager of PTC). However, for purposes of this test the ownership of the voting stock in PTC is deemed to be not significant. The Notice states that these conclusions would not change even if the discretionary distributions are made pursuant to a reasonably definite external standard or even if a single Family member were the sole owner of PTC.

If the trust terms are such that the trust may be a grantor trust under §674 if the DDC members are all subordinate parties, the trust will be a grantor trust with respect to any grantor who is an officer, manager or is in any other executive position at PTC. It would be helpful to give an example of a DDC that consists of individuals who are not employees, such as where the DDC consist of only independent directors of PTC. As directors they can receive compensation for serving on the DDC and yet are not employees, and thus not subordinate parties under §672(c).

The income tax analysis in the Notice considers an employee of the PTC (organized as a corporation) to be a related or subordinate party to a grantor or beneficiary who serves as an officer and director, which would cause the use of a corporate PTC to expand further the category of related or subordinate parties. However, if the PTC is organized as a partnership or limited liability company instead, §672(c) does not apply for employees where the grantor is an executive. The final guidance should include an example involving §672(c) and a PTC organized as a partnership or limited liability company.

The Notice should address issues regarding the independent trustee exception under §674(d), Rev. Rul. 95-58 and Reg. §1.674(d)-2(a), as discussed in III above, regarding removal and replacement of the DDC members.

### C. **Recusal Provisions for Amendments**

Underlying the rationale of the Notice is a concern that a grantor or beneficiary of a trust for which the PTC is acting as trustee could vote on an amendment to the PTC's governing documents under the normal legal governance processes of the entity and indirectly exert control over discretionary decisions made by the PTC, thereby causing inclusion in the individual's gross estate or taxation under the grantor trust rules. As an alternative to the Amendment Committee structure requiring control by independent parties, a more narrow recusal provision that would preclude such persons from voting on tax-sensitive amendments would cover this point, even assuming that voting as one among many on such an amendment constitutes the equivalent of unilaterally holding the power to change the governing documents.

For example, the final guidance could contain a recusal provision, such as the following, to replace the Amendment Committee structure: "A person who is not permitted to participate in voting on a proposed action of the DDC or take part in (insert other relevant provisions)

may not vote on an amendment to remove that restriction." While this provision is likely to be broader than strictly necessary, it is believed that the need for amendments will be infrequent, and this recusal provision is still much more workable than the requirement of a standing independent Amendment Committee. Also, a recusal provision avoids the implication that a fully independent majority (i.e., persons who are not related or subordinate within the meaning of §672(c)) is needed to approve any tax-sensitive amendment to the PTC governing documents, an implication that is inconsistent with providing parallel treatment for PTCs and individual fiduciaries. This requirement would still have to be made

**D. Only Officers and Directors Participate in Personnel Decisions**

The proposed ruling limits participation in PTC personnel decisions (including the hiring, discharge, promotion and compensation of PTC employees) to officers and managers of the PTC.

The initial concern with this limitation is that it does not differentiate between decisions regarding personnel who are officers or managers of the PTC and other subordinate personnel. Under general corporate law, the board of directors is responsible for hiring, discharging, promoting, and determining the compensation of officers. Furthermore, a significant number of limited liability companies use a board structure analogous to a corporate board of directors and then have the board name officers and determine their compensation. A substantial number of other limited liability companies are member-managed, as opposed to manager-managed, and the members directly have the power to retain or dismiss the manager or managers and to determine the compensation of each manager. Therefore, this restriction should be limited to personnel who are not officers or managers of the PTC, and cannot apply to member managed LLCs.

The reason for the restriction appears to be that because these personnel are subordinate only to the officers and managers, the shareholders' (or LLC members') voting power can be deemed to be not significant for §672(c). However, it is confusing, because the restriction does not prevent a shareholder or LLC member, even a 100% equity owner of the PTC, from serving as an officer or manager responsible for personnel decisions. Nor is a family member of such an equity holder barred from so serving. Therefore, if Treasury's concern is undue influence over subservient employees, the restriction ostensibly would not effectively address that concern.

In addition, to the extent that a particular officer, manager, or other employee is not on the DDC or the Amendment Committee, there would appear to be no reason for the restriction in regard to that officer, manager, or other employee. Even if the officer, manager, or other employee is on the DDC or the Amendment Committee, the proposed ruling otherwise addresses such situations. In regard to the Amendment Committee, a majority of the members must always be individuals who are neither Family members nor persons related or subordinate (within the meaning of Code Section 672(c)) to any equity holder of the PTC. In regard to the DDC, the fact that one or more members of the DDC are related or subordinate persons (as defined in Code Section 672(c)) could

result in classification of the respective trust as a grantor trust, as the proposed ruling already warns.

## E. Separate DDCs for Separate Trusts

In both Situation 1 and Situation 2, a single DDC makes the discretionary distribution decisions for each trust for which the PTC is acting as trustee. In many cases, however, families forming PTCs may wish to adopt a structure that uses separate DDCs for separate trusts. This is particularly common for PTCs serving as trustee of trusts for multiple branches of the same extended family. Nothing in the Notice suggests that a PTC could not have more than one DDC or that different DDCs comprised of different members could not act for separate trusts. In fact, such a structure would parallel the organization of many corporate trustees serving the general public and would enhance the flexibility and utility of PTCs. The same result could be achieved by having a separate PTC for each trust, but this would be expensive and cumbersome.

We suggest that the final guidance include an additional Situation confirming the tax consequences of a PTC with different DDCs operating for two or more separate trusts. The facts of the new Situation could be the same as in Situation 1 except that PTC has two DDCs. A, C, and D serve on DDC #1, and B, D, and E serve on DDC #2.

## F. Voting Shares of Stock of a Controlled Corporation

Pursuant to §2036(b), a transferor's retention of the right to vote, either directly or indirectly, shares of stock of a controlled corporation gratuitously transferred to a trust is considered a retention of the enjoyment of the transferred property causing inclusion of the assets in the transferor's gross estate. For this purpose, a corporation is a "controlled corporation" if, at any time after the transfer of the property and during the three-year period ending on the transferor's death, the transferor owned (with the application of the §318 rules) or had the right to vote (either alone or with others) stock possessing at least 20% of the total voting power of all classes of stock of the corporation. §2036(b)(2).

In some cases, trusts for which a PTC may serve as trustee could own shares of stock of a controlled corporation that have been transferred to those trusts for less than full and adequate consideration by one or more individuals who own the PTC, serve on the PTC's board of directors or other committees, are officers, managers, or employees of the PTC, or are otherwise involved in the operation of the PTC. The final guidance, therefore, should address the voting of shares of stock of a controlled corporation by a transferor in three capacities: 1) directly as an officer, manager, or employee of a PTC, 2) directly as a member of the board of directors or other committee of a PTC, and 3) indirectly as a shareholder or member of the board of directors of a PTC.

The final guidance should approve a model PTC's governing documents that provide a bright line prohibition against a transferor directly participating in the voting of shares of stock of a controlled corporation that he or she gratuitously transferred to a trust for which the PTC is acting as trustee. This restriction should apply to the transferor's actions as an officer, manager, or employee of the PTC, as well as his or her decisions as

a member of the PTC board of directors or any other PTC committee having the power to vote the shares. For purposes of this analysis, it seems likely that Treasury would follow the regulations under §2036(a), which provide that it is immaterial whether the transferor holds the power to vote alone or only in conjunction with another person or persons, as would be the case if the transferor were acting on the PTC board of directors or other committee. Reg. §20.2036-1(b)(3). The proposed regulations under §2036(b) currently so provide. Prop. Reg. §20.2036-2(c).

The final guidance also should address whether a PTC's governing documents must prohibit a transferor from participating in the voting of shares of stock of a controlled corporation through the transferor's ownership of the PTC through the power to remove and replace members of the board of directors or as a member of the board of directors with the ability to remove and replace the decision-makers who would vote the shares. The proposed regulations provide for inclusion under §2036(b) to apply if the transferor has indirectly retained voting power, regardless of the corporate formalities. Prop. Reg. §20.2036-2(c).

The final guidance should clarify that §2036(b) does not apply due to a removal/replacement power if the transferor's ability to replace removed members of the PTC board of directors or other decision-makers who would vote the shares is limited to individuals who are not RSPs as to the transferor. This conclusion, however, assumes that Rev. Rul. 95-58 applies to §2036(b), which should be clarified.

### G. <u>Incidents of Ownership of Life Insurance Policies</u>

Section 2042(2) provides that the amount of proceeds payable from life insurance policies will be included in the decedent's gross estate if he or she possessed at death any of the incidents of ownership, exercisable either alone or in conjunction with any other person, over the policy. A PTC may serve as trustee of a trust owning one or more life insurance policies on the life of a Family member who is an owner, member of the PTC board of directors or other committee, or an officer, a manager, or an employee of the PTC. Consequently, the final guidance should cover the ownership of life insurance on the life or lives of one or more Family members by a trust for which the PTC is acting as trustee.

"A decedent is considered to have an 'incident of ownership' in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust." Reg. §20.2042-1(c)(4). The final guidance should approve governing documents of a PTC that prohibit an insured under any policy owned by a trust for which the PTC is acting as trustee from exercising either alone or with others (e.g., as a member of the board of directors or any other committee or as an officer, a manager, or an employee of the PTC) any incidents of ownership over the policy.

Such a precaution, however, does not address the potential indirect exercise of incidents of ownership by an insured who is an owner of the PTC (through the removal and replacement of members of the board of directors) or as a member of the board of directors with the ability to remove and replace the decision-makers who would exercise the incidents of ownership. The safe harbor of Rev. Rul. 95-58 does not apply to §2042, but the final guidance should clarify that if Rev, Rul. 95-58 is applicable to PTCs, it reasoning also applies to §2042 issues.

### H. Legal Obligation of Support for Grantors and Beneficiaries

In Situation 1, Statute provides that a DDC member may not participate in the activities of the DDC with respect to any trust with a beneficiary to whom the DDC member or his or her spouse owes a legal obligation of support. This provision of Statute is overly restrictive with respect to a DDC member who is not the grantor and not effective with respect to a DDC member who is the grantor. The Statute instead should provide that a DDC member who is not the grantor is prohibited from participating in any decision of the DDC to use trust funds to discharge a legal obligation of support of that DDC member, and that no DDC member may use trust funds to discharge a legal obligation of the trust's grantor unless the trust terms specifically and unequivocally provide that the grantor's legal obligations are to be paid from the trust. See Reg. §§20.2036-1(b)(2) and 20.2041-1(c)(1).

### I. Amendment Committee Membership Standards

In Situation 2, the Notice states that the PTC's governing documents provide that a majority of the Amendment Committee must be individuals who are neither Family members nor person who are RSPs as to any shareholder of PTC. However, later in that paragraph, the Notice states that F, G and A are the initial members of the Amendment Committee and that F and G are not Family members and are not RSPs as to any Family member. F and G either should be stated to be not RSPs as to any shareholder, as the governing documents require, or the description of the governing documents should be changed to require a majority to be not RSPs as to any Family member.

### J. Application of the Rule Against Perpetuities

In the Notice, each trust for which PTC is acting as trustee is subject to the rule against perpetuities and will "terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time of the creation of the trust." Many states have adopted statutes eliminating the rule against perpetuities, and the final guidance should confirm that the tax consequences of a PTC do not change if the PTC is acting as the trustee of a trust not subject to the rule against perpetuities.

## VI. Future Private Letter Ruling Policy

We appreciate the willingness of Treasury to issue guidance that will allow taxpayers to create PTCs without necessarily applying for private letter rulings, and we believe that the final guidance can accomplish this. However, we also believe that it is unlikely that all taxpayers will want to fit within the confines of the guidance. We urge the Service to

continue to be willing to rule on PTC structures after the guidance is final, so that taxpayers whose structures are not within the guidance can have certainty.

We also understand that the task of issuing private letter rulings with respect to particular existing trusts can be time consuming and burdensome for the Service. If the Service is not willing to rule with respect to any particular trust, we hope that the Service would be willing to rule on PTC structures in a general way. For example, we hope that the Service would be willing to rule that the PTC described in a private letter ruling request can act as trustee of any trust, or of any trust with ascertainable standards, or that it can act without adverse transfer tax consequences, but depending on who acts on the DDC, or who the co-trustees are, may result in grantor trust status if none of the exceptions under §674(b) apply, and so forth. We believe that this could allow for needed flexibility without undue burden on the Service.