Private Trust Companies

A Handbook for Advisers

Consulting Editor **Todd D Mayo**

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1. Introduction

Despite the fact that private trust companies have been a feature of the offshore trusts and estates world for decades, only recently have private trust companies made inroads into the United States trusts and estates landscape. This chapter addresses non-commercial entities that service one or multiple branches of a family and that can be created under US state law without requiring a public trust company charter. These particular entities can be traced back to the turn of the 20th century, when jurisdictions such as South Dakota enacted specific statutes allowing for their creation with relative ease.[1] Due to a number of global factors, the number of US states enacting private trust company statutes has increased significantly over recent years, making it critical to understand the federal tax consequences when appointing such an entity as trustee of a family trust.

Unfortunately, the relative modernity of private trust companies in the United States means that the tax law addressing such entities is scarce and the use of such entities remains relatively untested. As of the date of this publication, the sole source of federal guidance for families and practitioners is a few private letter rulings and a proposed revenue ruling issued by the IRS through Notice 2008-63.[2]

This chapter discusses the potential estate, gift, generation skipping transfer and income tax consequences when using a private trust company as trustee of a family trust. Furthermore, the chapter will consider the ways in which the shares of a private trust company can be held, addressing tax and practical considerations. Finally, the chapter considers some of the financial regulatory considerations that families and practitioners should consider when establishing a private trust company.

1 See Al W King III and Pierce H McDowell III, "A Bellwether of Modern Trust Concepts: A Historical Review of South Dakota's Powerful Trust Laws", 62 *SD L Rev* 266, 276–77 (2017); see also Iris J Goodwin, "How the Rich Stay Rich: Using A Family Trust Company to Secure a Family Fortune", 40 *Seton Hall L Rev* 467, 516 (2010).

2 Notice 2008-63, 2008-31 IRB 261 (4 Aug 2008). Available at: www.irs.gov/pub/irs-irbs/irb08-31.pdf.

The reader should bear in mind that although a private trust company may look very similar in form and substance to a family office, the two are different entities serving different purposes. This chapter limits its scope solely to private trust companies and does not consider the tax consequences of using family offices. Furthermore, this chapter does not address a private trust company that offers its services on a commercial basis to more than one family. Lastly, because of the scarcity of law and the lack of final guidance on the subject, practitioners should be aware that the guidelines set forth below are very likely to change, particularly considering the extensive criticism levied at Notice 2008-63. Nevertheless, family members or practitioners who follow the guidelines set out below (even if these are fairly conservative) should feel comfortable using a private trust company as a trustee without incurring income or transfer tax liability to the grantor or beneficiaries of the trust.

2. Private letter rulings

Before Notice 2008-63, the law on taxation of private trust companies could only be found in a few private letter rulings (PLRs). Although such rulings cannot be relied upon by anyone other than the taxpayer requesting such ruling, they offer some guidance on how the IRS would treat such entities for tax purposes.[3]

In PLR 9841014,[4] the IRS considered whether a company acting as trustee was independent pursuant to Section 672(c) of the Internal Revenue Code ('the Code').[5] The voting shares of the company were owned 50% by one family unrelated to another family that held the other 50% through eleven trusts established by five related family members. The shares representing the 50% held through the eleven trusts would later be contributed to a voting trust for which the voting trustees were:

- one of the grantors;
- eleven beneficiaries of the trusts; and
- an unrelated party.

It was this second family that requested the private letter ruling.

The IRS ruled that the company was not related or subordinate to the grantors or beneficiaries because:

3 *Hanover Bank v Comm'r*, 369 US 672, 686–87 (1962).

4 PLR 9841014, 1998 PLR LEXIS 1305 (IRS 2 July 1998).

5 Section 672(c) is a significant provision in assessing the independence of a private trust company, as it sets forth what is considered a related or subordinate party, which is defined as the grantor's spouse, if living with the grantor; the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate party of a corporation in which the grantor is an executive. This section is relevant to a practitioner creating a private trust company because the persons exercising control over a private trust company may very likely be related or subordinate to the grantor. 26 USC § 672(c).

- none of the trusts individually owned more than 10% of the voting power of the company;
- the company's bylaws prohibited the participation of the grantors or beneficiaries in the exercise of discretionary powers; and
- one of the grantors or beneficiaries, acting alone, could control the decisions of the subject company, as trustee.

In PLR 200125038[6] (with PLR 9841014, 'the PLRs'), the IRS was asked (apparently by the same taxpayers) to rule on whether a company's appointment as sole trustee of the family trusts would:

- result in estate tax inclusion for the grantors or beneficiaries; or
- constitute a constructive addition to the trust that would affect the grandfathered status of the trusts for generation skipping transfer (GST) tax purposes.[7]

The IRS ruled that neither the appointment of the company as trustee, nor its exercise of discretionary powers over income distributions, would result in estate tax inclusion; nor would it affect the grandfathered status of the trust because the change was only administrative in nature.

The PLRs offered some guidelines on potential ways to preclude rendering a private trust company 'related or subordinate' to the grantor or causing estate tax inclusion to the grantors or beneficiaries. Identifying who will have the voting power over the private trust company is critical, as no grantor or beneficiary should own outright over 10% of the voting power. Additionally, the private trust company's governing documents should preclude its officers or directors from participating in any discretionary trustee decision for a trust in which such officer or director is a beneficiary, such as by being a grantor of the trust or a current or contingent beneficiary of the trust.

In 2005 the IRS determined that it would no longer issue PLRs with respect to private trust companies, as it was considering issuing a revenue ruling.[8]

3. Notice 2008-63

The positions outlined in the PLRs formed the foundation for the IRS's position in its proposed revenue ruling issued through Notice 2008-63 on 4 August 2008 ('the Notice').[9] The Notice addressed the income and transfer tax consequences of family members creating a private trust company to serve as the sole trustee of trusts with family members as grantors and beneficiaries. In doing so, the Notice established safe harbours that are instructive for families and

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6 PLR 200125038, 2001 PLR LEXIS 526 (IRS 21 Mar 2001).
7 See 26 CFR § 26.2601-1(b)(1)(i), (iv) and (4)(i)(D).
8 See Rev Proc 2005-3, 2005-1 IRB 118 (3 Jan 2005). Available at: www.irs.gov/pub/irs-irbs/irb05-03.pdf.
9 2008-31 IRB 261.

practitioners seeking to establish a private trust company to serve as trustee of family trusts.

The Notice presents a factual example, in which a husband and wife with three children each establish separate irrevocable trusts for each of their children and grandchildren (with the respective child or grandchild being the primary beneficiary of his or her trust). Each trust only receives contributions from the person who created the trust, all grantors and beneficiaries are US persons,[10] and none of the trusts are considered foreign trusts.[11] Furthermore, the trusts provide the trustee with discretionary authority to distribute income or principal to the primary beneficiary of the trust during the beneficiary's lifetime. The trusts give the grantor (or the beneficiary if the grantor is not then living), the power to appoint a successor trustee other than himself or herself to act in the event that the current trustee resigns or is unable to act.[12]

Under the example's fact pattern, the family forms a private trust company owned partly outright and partly in trust. Some of the family members, including the grantor husband, serve as directors and officers of the private trust company and also serve as trustees of the separate irrevocable trusts. The private trust company's governing documents created a discretionary distribution committee (DDC) constituted by some of the members of the family, including the grantor. The governing documents included the following restrictions ('the Restrictions'):[13]

- A DDC member could not participate in DDC activities with regard to any trust for which that member or his or her spouse was a grantor or any trust of which that member or his or her spouse was a beneficiary, or with regard to a trust that had a beneficiary whom the member or his or her spouse had an obligation to support.
- Only officers and managers of the private trust company could make decisions regarding personnel, such as the hiring, discharge, promotion or compensation of the private trust company's employees.
- Nothing in the governing documents could override a more restrictive provision in the trust instrument.
- No family member could enter into any reciprocal agreement with

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10 A US person is generally defined as one who is a lawful permanent resident of the United States at any time during the calendar year or a person who is substantially present in the United States for a period of 183 days or more during a calendar year. Note, however, that under the Code, an individual can be substantially present in the United States without having actually been physically present in the United States for 183 days, so that the rules of the Code should be carefully considered. 26 USC § 7701(b)(1)(A), (3) and (4), 7701(a)(30).

11 A trust will generally be considered foreign for US federal tax purposes if it fails either of two tests, one of which is that a US court must be able to exercise primary supervision over the administration of the trust, and the other that one or more US persons have the authority to control all substantial decisions of the trust. Failing either of these tests (ie, if a trust requires a non-US person to consent to distribution payments) will cause the trust to be treated as foreign for US federal tax purposes. 26 USC § 7701(a)(30)(E) and (31)(B).

12 2008-31 IRB at 261.

13 *Ibid* at 262.

another family member, either expressly or implied, regarding discretionary distributions.

The governing documents of the private trust company also created an amendment committee with the sole authority to make any changes to the Restrictions and the DDC and in which no members of the family nor any of their related or subordinate parties could serve.[14]

4. Estate tax

The Notice considers various Code provisions under which the property of the trust for which the private trust company serves as trustee may be included in the grantor or beneficiary's estate.

4.1 Estate tax inclusion under Sections 2036 and 2038 of the Code

Under Section 2036(a), property transferred in trust will be included in the transferor's gross estate if the transferor made a lifetime transfer of property and retained:

- the possession or enjoyment of, or the right to the income from, the property; or
- the right, either alone or in conjunction with any person, to designate the persons who would possess or enjoy the property or the income therefrom

and such right was retained for:

- the transferor's life;
- any period not ascertainable without reference to the transferor's death; or
- any period that did not actually end before the transferor's death.[15]

Furthermore, this section will be triggered if such rights can be used to discharge the legal obligations of the transferor.[16]

Section 2036(a) tends to go hand in hand with Section 2038(a), which is triggered if the transferor makes a lifetime transfer of property and the transferor possesses, at death, a power to alter, amend, revoke or terminate the enjoyment of the transferred property, or if he or she relinquishes such power during the three-year period preceding the date of his or her death.[17] As the Notice makes

14 *Ibid*.

15 26 USC § 2036(a)(2); see Henry J Lischer Jr *et al*, Bloomberg/BNA Tax Mgmt. Portfolio 876-1st: Retained Powers (Sections 2036(a)(2) and 2038), Detailed Analysis II.D (2019) (The Four Requirements of § 2036(a)(2)).

16 26 CFR § 20.2036-1(b)(2).

17 26 USC § 2038(a)(1); see also 26 USC § 2035. Note that these provisions do not apply if the transfer was made pursuant to a *bona fide* sale for adequate and full consideration in money or money's worth.

clear, the discretionary authority to distribute or withhold income is considered a right to alter, amend, revoke or terminate a trust under Section 2038(a).

The Notice affirms that no estate tax inclusion to the transferor will result under Sections 2036(a) or 2038(a) if the state's private trust company statutes or the private trust company's governing documents provide for a DDC, and no family member serving on the DDC may participate in making decisions with regard to a discretionary distribution from any trust of which that person or his or her spouse is either a grantor or a beneficiary, or the beneficiary is a person to whom the family member or his or her spouse owes an obligation to support. In such case, the transferor does not retain, alone or in conjunction with another person, the rights described in Sections 2036(a) and 2038(a) through his or her participation in the private trust company.[18]

Note that either the state's private trust company statute or the private trust company's governing documents themselves must contain the Restrictions outlined in the fact pattern. To the extent that the state's private trust company statute does not provide for a DDC or include the Restrictions, not only will the private trust company's governing documents need to provide for a DDC and the Restrictions, but it will also need to establish an amendment committee that precludes the shareholders of the private trust company from amending the Restrictions.[19]

4.2 Estate tax inclusion under Section 2041 of the Code

It is possible that a beneficiary who did not transfer any property to the trust will have such property included in his or her gross estate if he or she is considered to hold a general power of appointment under the provisions of Section 2041 of the Code.[20]

Under Section 2041(a)(2), property in trust will be includible in a beneficiary's gross estate if the beneficiary has the power to appoint the property to themselves, their creditors, their estate or the creditors of their estate (referred to as a general power of appointment) or if he or she relinquishes such a power in a manner that would bring it within the estate of a transferor under Sections 2035 to 2038, such as by, *inter alia*, relinquishing such power within the three-year period preceding the beneficiary's death or retaining the right, alone or in conjunction with another person, to use, possess or benefit from such property.[21] Notably, the fact that a beneficiary may hold such power in a fiduciary capacity, such as by serving on the board of directors of the private trust company, is not sufficient to prevent estate tax inclusion.[22]

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18 2008-31 IRB at 263. The Notice, of course, assumes that these restrictions will be properly observed.
19 *Ibid.*
20 26 USC § 2041.
21 26 USC § 2041(a)(2)-(3) and (b)(1).
22 2008-31 IRB at 264; *Est. of Lanigan v Comm'r*, 45 TC 247, 251 (1965).

In the private trust company example, it is possible for Section 2041(a)(2) to be triggered if the beneficiary of a trust can appoint assets to himself through the private trust company, either as an officer or director of the private trust company, or by influencing someone who is a related or subordinate party. Nevertheless, for the same reasons set out in Sections 2036 and 2038, namely, the inclusion of the Restrictions, the Notice finds that property in a trust for which a private trust company serves as trustee should not be included in a beneficiary's gross estate if the aforesaid Restrictions are included.[23]

4.3 Gift tax

The transfer of property to a trust of which the private trust company serves as trustee may create gift tax issues if it is determined that the transferor did not sufficiently part with dominion or control over the property, thereby rendering the transfer incomplete.[24] A gift will be deemed incomplete if the transferor has reserved the power, alone or in conjunction with any other person not having a substantial adverse interest to such power, to name new beneficiaries or change the interest of the beneficiaries, unless such power is limited to a fixed or ascertainable standard.[25] For the same reasons expressed in the prior sections, namely, the inclusion of the Restrictions, the Notice determined that transfers of property to a trust for which the private trust company is the trustee will be deemed completed gifts and subsequent distributions from the trust by a private trust company will not be deemed gifts, provided the aforesaid Restrictions are observed.[26]

4.4 GST tax considerations

An additional consideration when appointing a private trust company as trustee of a trust is whether such appointment will cause a trust that is exempt from the GST tax to no longer be exempt because:

- it is considered an addition of property to the trust or a modification of the trust that shifts the beneficial interest in a trust to a beneficiary that is in a lower generation; or
- the appointment extends the time of vesting of the trust beyond the time provided when the trust became irrevocable.[27]

Assuming that the Restrictions are provided for and observed, the Notice

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23 2008-31 IRB at 264.

24 26 USC § 2511; 26 CFR § 25.2511-2(b).

25 Distributions for the health, education, maintenance and support of the beneficiary have been deemed a sufficiently ascertainable standard that can be enforced by the courts. 26 CFR § 25.2511-2(c) and (e).

26 2008-31 IRB at 265.

27 26 CFR § 26.2601-1(b)(1)(iv) and (4)(i)(D). The ways in which a trust can be GST exempt are beyond the scope of this chapter, but a common way is if it was in existence and made irrevocable before 25 September 1985. 26 CFR § 26.2601-1(b)(1)(i).

concluded that the change in trustee to a private trust company is only administrative in nature and therefore will not cause the trust to lose the GST tax-exempt status because the change will not:

- subject the trust to estate and gift tax;
- shift beneficial ownership to a lower generation; or
- extend the time of vesting.[28]

4.5 Planning through the Notice

Currently, none of the private trust company statutes in the jurisdictions discussed in this book contain any of the Restrictions stipulated in the Notice. Florida, New Hampshire, South Dakota, Tennessee and Wyoming do contain tax-savings provisions in their trust statutes that could arguably achieve a similar restrictive effect. New Hampshire, for example, precludes a trustee who is also a beneficiary from:

- making a distribution of principal or income to him or herself except to provide for the trustee's health, education, maintenance and support;
- allocating receipts or expenses of the trust between principal and income unless the trustee is acting in a fiduciary capacity in which he or she does not have the power to shift the beneficial interests of the trust;
- making a distribution of principal or income to satisfy a legal support obligation; or
- removing or replacing a trustee in order to cause the foregoing powers to be exercised on the trustee's behalf.[29]

Nevertheless, the statutes do not appear to go far enough in protecting a grantor or beneficiary from taxation under the safe harbours of the Notice. For one, these statutes only refer to an individual trustee situation and it is therefore questionable whether the tax-savings provisions apply to a private trust company. Suppose, for example, that the private trust company's board of directors is constituted by the grantor, his spouse and his son. Is the grantor considered to be a trustee under the statute if he exercises the power to make discretionary distributions to himself through the trust company? Arguably not, at least according to the tax-savings provisions of a state like New Hampshire, particularly if he is in the board's minority. Supposing that the grantor is considered a trustee and refrains from acting, his spouse and son are related or

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28 2008-31 IRB at 265–66.

29 NH Rev Stat Ann § 564-A:3(IV)(a)(1) (2007 & Supp 2019); see also NH Rev Stat Ann § 564-B:8-814(d) (2007 & Supp 2019); Fla Stat Ann § 736.0814(2) (West 2017 & Supp 2019). Note that although South Dakota, Tennessee and Wyoming do have a tax savings statute, the statutes do not restrict the beneficiary trustee from shifting beneficial interests through allocations of receipts or expenses or replacing the trustee to cause a distribution to the trustee or the discharge of a legal obligation. SD Codified Laws § 55-4-38 (2012 & Supp 2019); Tenn Code Ann § 35-15-814(d) (West 2009 & Supp 2019); Wyo Stat Ann § 4-10-814(b) (West 2007 & Supp 2019).

subordinate under Section 672(c) of the Code and could make the decision to pay principal or income to him or her, which act fails the safe harbours of the Notice. Moreover, it is unclear whether the safe harbours actually require the creation of a DDC or if statutory tax-savings provisions alone, such as those contemplated by the Restrictions, will suffice. A conservative reading of the Notice would indicate that a DDC is required, despite the fact that this requirement is more stringent than the requirements imposed on a trustee acting in his or her individual capacity.

Therefore, it is strongly recommended that the governing documents of the private trust company contain the Restrictions discussed in the Notice in order to ensure that the trust property is not taxed to the grantor or included in the grantor or beneficiaries' estates. In the event the private trust company is created in a state without a tax-savings statute, the governing documents should also create an amendment committee possessing the sole authority to make changes to the Restrictions in the private trust company's governing documents. Such committee should be constituted by a majority of individuals who are neither family members nor persons related or subordinate to any shareholder of the private trust company pursuant to Section 672(c) of the Code, and any amendments should only be enacted through a majority vote of the committee.

5. Income tax

5.1 Grantor trust rules

In addition to addressing the transfer tax consequences of a private trust company, the Notice addressed the income tax repercussions of a private trust company serving as trustee of family trusts. Unlike the transfer tax issues addressed by the Notice, income tax considerations deserve a more fact-specific analysis. The ultimate question under the Notice for income tax purposes is whether a grantor or beneficiary will be treated as the owner of any portion of the trust for which a private trust company serves as trustee under the grantor trust rules of Sections 671 to 678 of the Code (the 'grantor trust rules') because the powers of the private trust company are attributed to the grantor or beneficiary under the grantor trust rules.

The Notice divides the income tax analysis into two main categories, the first dealing with all grantor trust rules exclusive of Sections 672 and 674 and the second, more complex category, specifically dealing with Sections 672 and 674. The Notice then provides certain guidelines based on the factual example outlined in the preceding estate tax section, in which either the private trust company statutes of a state or the private trust company's governing documents provide for a DDC, amendment committee and certain prophylactic restrictions.

5.2 Grantor trust rules exclusive of Sections 672 and 674 of the Code

Under certain circumstances described in the grantor trust rules, the grantor of a trust or other person[30] may be treated as the owner of all or a portion of a trust for US federal income tax purposes.[31] This means that any income or gains earned or realised by the trust will be attributable and taxable to such individual (irrespective of whether such individual actually 'controls' the property held in trust or receives the same). In the private trust company context, the grantor trust rules are relevant because the appointment of a private trust company to a trust may result in the powers held by the private trust company or its officers being attributed to the grantor or other beneficiaries.

Section 675 of the Code and applicable treasury regulations provide that the grantor is treated as the owner of any portion of a trust if, under the terms of the trust agreement or circumstances attendant to its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust.[32]

Section 677(a)(1) of the Code provides that the grantor shall be treated as the owner of any portion of a trust (whether or not he or she is treated as such owner under Section 674), whose income, in the discretion of the grantor or a non-adverse party, or both, may be distributed to the grantor or the grantor's spouse without the approval or consent of any adverse party.[33]

Section 678(a) of the Code provides that a person other than the grantor is treated as the owner of any portion of a trust with respect to which such person has a power, exercisable solely by that person, to vest the principal or the income of such trust to that person.[34] This section is relevant in the context of beneficiaries of a trust who do not settle the trust, but who may be treated as grantors by virtue of the powers they hold, either individually or through the private trust company.

The Notice clarifies that a private trust company can serve as trustee of a trust without causing the grantor or beneficiary of such trust to be considered the owner for income tax purposes under Section 673, 676, 677 or 678, provided the Restrictions outlined in the factual example are integrated into the governing documents of the private trust company and are thereafter observed.[35] Note, however, that in the case of the administrative powers of Section 675,[36] the

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30 26 USC § 678.
31 26 USC § 671.
32 26 USC § 675.
33 26 USC § 677(a)(1).
34 26 USC § 678(a)(1). Note that this power does not apply if a grantor or other transferor is otherwise treated as the owner of the trust.
35 2008-31 IRB at 268. See Christopher C Weeg, "The Private Trust Company: A DIY For The Über Wealthy", 52 *Real Prop, Tr & Est L J* 121, 148–49 (2017) (discussing grantor trust treatment).
36 Such powers include the power by the grantor to (i) deal with or dispose of the *corpus* or income of the trust for less than adequate consideration, (ii) borrow from the *corpus* or income without adequate interest or security, (iii) borrow from the *corpus* and income of the trust without adequate interest and security, and not repay the loan before the end of the taxable year. 26 USC § 675(1)-(3).

Notice highlights that whether the grantor trust rules are triggered is based on a question of fact that can only be determined after the relevant income tax returns are examined by the IRS. Therefore, a degree of uncertainty will remain with respect to these sections, making it critical that care is taken that the grantor or his or her spouse not exert undue influence on a trustee, even if informally.[37]

5.3 Power to control beneficial enjoyment – Sections 672 and 674 of the Code

Section 672(a) of the Code defines the term 'adverse party' as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power (including a general power of appointment) that he or she possesses respecting the trust.[38] Section 672(b) of the Code defines the term 'non-adverse party' as any person who is not an adverse party.[39]

Section 674(a) of the Code provides, in general, that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the principal or the income therefrom is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party.[40] For purposes of this section, a related or subordinate party is presumed to be subservient to the grantor in respect of the exercise or non-exercise of the powers conferred on the grantor unless such party is shown not to be subservient by a preponderance of the evidence.

An exception in Section 674(c) provides that Section 674(a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor, to:

- distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or
- pay out principal to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).[41]

The Notice clarifies that mere ownership of the voting stock by the grantor is not 'significant' due to the existence of a DDC and will not cause members of the DDC to be considered related or subordinate to the grantor by virtue of this

37 See Alan V Ytterverg and James P Weller, "Managing Family Wealth Through a Private Trust Company", 36 *ACTEC L J* 623, 633–34 (2010).

38 26 USC § 672(a).

39 26 USC § 672(b).

40 26 USC § 674(a).

41 26 USC § 674(c).

fact alone.[42] Whether a grantor will be treated as the owner of a trust or any portion thereof under Section 674 depends upon:

- the identity and powers of the trustee; and
- the proportion of the members of the DDC with authority to act who are related or subordinate to the grantor as that term is defined in Section 672(c).

For purposes of determining whether a private trust company is 'related or subordinate' to the grantor, the Notice applies a look-through test in which each employee of the private trust company serving on the DDC, if any, is tested as if that employee was a trustee of the trust in his or her individual capacity.[43]

Non-family members employed by the private trust company are considered related or subordinate to a grantor who:

- owns the voting stock of the private trust company; or
- is a director or officer of the private trust company.[44]

If a non-family member serves on the DDC and is employed by the private trust company, then such individual will be treated as a related or subordinate party to any grantor owning the voting stock of a private trust company or acting as an officer or manager of such.[45]

5.4 Planning through the Notice

Pursuant to the Notice, income tax inclusion to the grantor may be avoided if the governing documents of the private trust company:

- require the formation of a DDC that will make all decisions regarding discretionary distributions of the trust; and
- prohibit an individual serving on a DDC from participating in decisions regarding distributions from any trust of which such individual or such individual's spouse is either a grantor or beneficiary or the beneficiary is a person to whom the individual owes an obligation of support.[46]

The DDC should act through a majority of its members who are not family members or related or subordinate to any shareholder of the private trust company (as is the case if a DDC member is also an employee of the private trust company). The governing documents should also include provisions for an amendment committee constituted by individuals who are not family members or related or

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42 2008-31 IRB at 268.
43 *Ibid* at 267.
44 26 USC § 672(c)(2).
45 See 2008-31 IRB at 267.
46 See 2008-31 IRB at 268.

subordinate to the family with the sole authority to make any changes to the Restrictions outlined in the estate tax section and the terms of the DDC.

It is important to note that the Notice does not establish a clear safe harbour that will avoid triggering certain provisions of the grantor trust rules. Therefore, the most conservative approach that a family or practitioner can take in order to be fully compliant with the Notice is to form a DDC independent of the grantor and over which the grantor is not able to exercise control either directly as a member or indirectly through related subordinate parties, with regard to decisions related to discretionary distributions from a trust in which the grantor, his or her spouse or an individual to whom the grantor owes a legal obligation to support is a beneficiary.[47] In addition, the grantor and his or her related or subordinate parties should abstain from participating in meetings during which sensitive distribution decisions with respect to the grantor are made.[48] Finally, for purposes of avoiding grantor trust attribution, the grantor should carefully consider whether to hold any position as a director or officer of the private trust company, unless the governing documents provide sufficient safeguards that would prevent him or her from making decisions that could trigger income tax inclusion under the grantor trust rules.

6. Subsequent history and criticism of the Notice

As of the date of this publication, the IRS has yet to issue final guidance regarding the federal income and transfer tax consequences of using a private trust company as a fiduciary of family trusts, despite the Notice having been issued over a decade ago and the IRS clarifying that no further PLRs will be issued regarding the matter. This has left practitioners establishing a private trust company in the United States with uncertainty, particularly as the use of private trust companies in the private client world increases.

Although the Notice provides taxpayers with some guidance on the tax consequences of using a private trust company, numerous commentators on the proposed revenue ruling have pointed out areas of ambiguity or overreach by the Notice and have requested that the IRS implement various changes to the final revenue ruling ('the Final Ruling') whenever it is ultimately issued.

6.1 Expanding definitions and factual scenarios

Commentators have recommended that the Final Ruling fill gaps contained in the definitions and examples provided by the Notice, such as through an expansion of the factual circumstances outlined in order to avoid inadvertently excluding any structures that a prospective private trust company may use.[49] For

47 Ytterverg and Weller, "Managing Family Wealth", *supra*, at 637.

48 See Private Trust Company (PTC) as Trustee of Family Trusts – Estate Tax Consequences Under Retained Life Estate Rule, RIA Est Plan Analysis § 43,325.1 at 3 (2019).

example, further clarity should be provided on whether the definition of a private trust company includes an entity that services just one family or multiple families.

Various commentators have also noted that the Notice does not appear to encompass regulated private trust companies, despite the fact that these pose a much lower risk of being manipulated by a grantor or beneficiary because they are under the oversight of regulatory agencies of a state. Commentators to the Notice have therefore requested that the Final Ruling include a third situation involving regulated private trust companies and appropriate safe harbours for such.[50]

6.2 Inconsistent rules

Commentators have noted that some of the proposed safe harbours restrict family members from participating in the private trust company "in a way that is inconsistent with the IRS's professed purpose of only barring family members from taking action with respect to specific trusts through the private trust company that they could not take directly".[51] In fact, the Notice precludes family members acting through the private trust company from participating in distribution decisions even when these are limited to an ascertainable standard, and despite the fact that such family members would not be similarly restricted if they were acting in an individual capacity.

6.3 Restrictions on the DDC

Commentators have asked for clarification regarding the mechanism for the appointment, removal and replacement of members of the DDC because the Notice does not indicate who (if anyone) actually has the authority to fill any vacancies or remove and replace members of the DDC.[52]

In addition, the IRS should clarify "that a distribution decision [of the DDC] subject to an ascertainable standard is not a discretionary decision, that discretionary decisions are broader than merely distribution decisions, and that the DDC structure is appropriate for all of these decisions".[53]

Commentators also reflected that certain restrictions in the Notice are overly broad, such as restricting the grantor's or beneficiary's spouse from participating on the DDC or preventing an interested DDC member from

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49 See McGuire Woods LLP, Comments on Notice 2008-63 on transfer tax consequences when PTCs serve as trustees, at 2, Bloomberg BNA TaxCore (10 Nov 2008). Available at: www.mcguirewoods.com/news-resources/publications/taxation/Notice2008-63.pdf.

50 See Arnold & Porter LLP, Comments on Notice 2008-63 on transfer tax consequences when PTCs serve as trustees, at 3–4, Bloomberg BNA TaxCore (10 Nov 2008); McGuire Woods LLP, Comments on Notice 2008-63, *ibid*.

51 See John PC Duncan and Michael R Conway Jr, "Breaking the PTC Logjam", 147 *Tr & Est* 22, 24 (Sept 2008) (discussing key provisions of the proposed revenue ruling on private trust companies).

52 See Sullivan & Cromwell LLP, Comments on Notice 2008-63 on transfer tax consequences when PTCs serve as trustees, at 2–4, Bloomberg BNA TaxCore (10 Nov 2008).

53 Duncan and Conway, *supra*, at 24.

participating in meetings at which a discretionary distribution is to be considered.[54] These restrictions technically disqualify the entire family from participating in any type of distribution decisions because most family trusts tend to provide for distributions to various family members and the contingent remainder beneficiaries are often members of the same family.

6.4 Removal of officers and other personnel decisions

Commentators have noted that the Notice would prohibit family members who are not officers or managers from making private trust company-related personnel decisions.[55] The Notice does not provide a rationale for this position and such a restriction would be overbroad because it would include family members who are not grantors or beneficiaries (or related or subordinate parties to such) from making personnel decisions. The limitation on making personnel decisions should only extend to family members who are settlors or beneficiaries of trusts for which the private trust company serves as trustee and in which such individuals are interested.[56]

7. Taxation of the private trust company as a corporate entity

Although a single-family private trust company is generally not expected to generate much, if any, profit, it will still be required to report any taxable income (ie, trustee fees) and liabilities on an annual basis to the IRS.[57] Typically, private trust companies are formed and taxed as corporations, such as through a limited liability company.[58] For tax years beginning after 31 December 2017, corporations are taxed by the United States at a flat 21% rate on taxable income.[59] Corporations must report their taxable income and liabilities on Form 1120, US Corporation Income Tax Return, which must be filed with the IRS by 15 April if the corporation reports on a calendar year basis or by the fifteenth day of the fourth month after the closing of the fiscal year, if the corporation reports on a fiscal year basis.[60] An automatic six-month extension is available by

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54 See Kozusko Harris Vetter Wareh LLP, Comments on Notice 2008-63 on transfer tax consequences when PTCs serve as trustees, at 2–5, Bloomberg BNA TaxCore (10 Nov 2008); Florida Bar Tax & Real Property, Probate and Trust Law sections, Comments on Notice 2008-63 on transfer tax consequences when PTCs serve as trustees, at 2–5, Bloomberg BNA TaxCore (10 Nov 2008).

55 See Caplin & Drysdale Chartered, Comments on Notice 2008-63 on transfer tax consequences when PTCs serve as trustees, at 1–2, Bloomberg BNA TaxCore (10 Nov 2008).

56 Duncan & Conway, *supra* at 26.

57 The private trust company must also comply with any state income tax laws, although generally, states with private trust company statutes such as Alaska, Florida, New Hampshire, Nevada, South Dakota and Wyoming do not impose an income tax. Portfolio 869-1st: State Income Taxation of Trusts, Detailed Analysis, A. Introduction. Note, however, that New Hampshire does tax interest and dividends and has a business profits tax and a business enterprise tax. New Hampshire Revised Statutes, RSA 77:3, Who Taxable; RSA 77-A, Business Profits Tax; RSA 77-E, Business Enterprise Tax.

58 Although it is not unforeseeable that a private trust company may be formed and taxed as a partnership or corporation, doing so through such entities would present complex practical, tax and regulatory issues that are beyond the scope of this chapter.

59 26 USC § 11.

60 26 USC § 6072(a). See generally Portfolio 750-2nd: Corporate Overview, Detailed Analysis, A. Corporate Income Taxes Generally.

request if the corporation submits Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and other Returns, before the filing due date and provided the corporation's total tax liability is submitted by the original filing due date (ie, 15 April).[61]

8. Shareholder considerations

A critical consideration for family members and practitioners during the initial planning stage is how the shares of the private trust company should be owned. This decision may depend on the family's particular set of circumstances, including various tax considerations (ie, US and non-US grantors and beneficiaries) and family dynamics. The usual forms of ownership include:

- direct ownership, whereby the private trust company is owned by an individual or multiple family members; and
- through a trust or foundation.

8.1 Direct ownership

Individual ownership of the private trust company can be desirable for the sake of simplicity. In this case, the shares of the private trust company would be owned by one or more family members, and would be transferred during life or at death by a shareholder. Although simple, direct ownership can present various disadvantages for the shareholder. For one, the value of the shares of the private trust company may be includible in the shareholder's gross estate upon his or her death.[62] Additionally, foreign shareholders owning 25% or more of a private trust company will be subject to reporting to the IRS by the private trust company for certain types of transactions (such as the payment of trustee fees) with related parties, which definition includes trusts for which the shareholder is a grantor, trustee or beneficiary.[63]

Direct shareholding may also result in such shares being subject to a probate proceeding, which may present a number of complications. Probate presents an opportunity for family members to contest a shareholder's disposition of the private trust company's shares. Should the shareholder die intestate, then the shares of the private trust company may end up being owned by individuals who:

- should not own such shares in order to prevent taxation;
- are not part of the family's inner circle or decision-making process; or
- may have interests adverse to the beneficiaries of the trusts.

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61 26 USC § 6081(b); 26 CFR § 1.6081-3. See generally Portfolio 750-2nd: Corporate Overview, Detailed Analysis, A. Corporate Income Taxes Generally.

62 Although practitioners should bear in mind that a private trust company is not likely to be profitable, so that the value of such shares may be *de minimis*.

63 See 26 USC §§ 6038A, 267(b); Form 5472, Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business. Form 5472 available at: www.irs.gov/pub/irs-pdf/i5472.pdf. The aforementioned reporting is required even if the corporation is treated as a disregarded entity for US federal income tax purposes. See 26 CFR § 301.7701-2(c)(2)(vi).

Proceeding with probate is an even greater issue for a shareholder who is not a US resident, as that entails a probate proceeding in the United States that is ancillary to the shareholder's estate administration in his or her country of residence or domicile. Furthermore, probate may be an issue for the privacy-minded family, as all probate records are a matter of public record. Therefore, practitioners should advise on – and family members should carefully weigh – the decision of making family members direct shareholders of the private trust company, despite the allure of simplicity.

8.2 Use of a trust or foundation

The alternative to direct ownership is to use a trust or foundation. One possibility is for the same trust for which the private trust company serves as shareholder to own the private trust company's shares. This is a simple approach, but one that is circular and potentially problematic. Furthermore, the common law and state trust statutes tend to preclude a trustee from investing in its own shares unless specifically permitted by the trust instrument. Adequate provisions will therefore have to be included in the trust instrument in order to address such shareholding.

Another possibility is to use a special or single purpose trust that will hold the private trust company's shares, but which otherwise does not conduct any other activity or have ascertainable beneficiaries. Such a vehicle ensures that the shares of the private trust company are outside of the gross estates of the grantors and beneficiaries, while also providing a degree of multi-generational longevity under the terms of the trust that is not affected by the death of any one family member. The trustees of the special purpose trust could be the family members, an institution or an individual who is not related or subordinate to the family. Upon the end of the trust term, the trustee can determine to whom the shares can be distributed.[64]

Regardless of which approach is adopted, the shareholder will receive the private trust company's shares in exchange for an equity contribution, which amount will differ depending upon the state in which the private trust company is incorporated. Furthermore, if the shares are to be held in trust, practitioners should consider whether any part of an individual's US federal gift or GST tax exemption should be allocated to the trust.[65]

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64 When drafting, the practitioner should bear in mind that trust state statutes may prevent a special purpose trust from having ascertainable beneficiaries, as a trust with ascertainable beneficiaries is not a special purpose trust any longer. See, eg, NH Rev Sta Ann § 564-B:4-409 (2007 & Supp 2019); Tenn Code Ann § 35-15-409 (West 2009 & Supp 2019).

65 This may not be an issue because the private trust company is not likely to have income or inherent value and in the case of a special purpose trust, there may not be ascertainable beneficiaries to whom distributions can be made.

9. Regulatory considerations

Any entity with a US nexus providing investment advice regarding securities must consider whether such entity needs to register as an investment adviser with the US Securities and Exchange Commission (SEC) or other relevant state regulatory agency.[66] Although a private trust company's main purpose is to serve as trustee of family trusts, the private trust company may find itself subject to the US Investment Advisers Act of 1940 (as amended, 'the Advisers Act')[67] through the various functions the private trust company may perform for a family or trust.

For example, many trust instruments provide the trustee with the discretionary authority to make investments on behalf of the trust, such as through the purchase of stocks, bonds and other securities. If the private trust company receives compensation for its functions as trustee, then exercising such powers may naturally constitute providing investment advice to the trust through the private trust company's managing of the trust fund and accounts. Should the private trust company be required to register as an 'investment adviser' with the SEC, then it would be subject to the Advisers Act and under the jurisdiction of the SEC.[68]

There are exemptions or exceptions that may be available to a private trust company such that it may not be required to register as an investment adviser with the SEC. The first step is to determine whether the private trust company meets the definition of an investment adviser and if so, what if any exclusions or exemptions are available to mitigate full registration.

9.1 Family office exclusion

In 2011, the SEC adopted Rule 202(a)(11)(G)-1 under the Advisers Act which defines the term 'family office' for purposes of excluding such entities from the definition of 'investment adviser' (the 'family office exclusion').[69] As we have discussed, a private trust company may not necessarily be a family office, in the sense in which such term is commonly used in the industry, and may serve different functions from a family office (although it could act as such). The federal securities laws do not make such a distinction so that the family office exclusion can equally apply to a private trust company.

Under the family office exclusion, a family office is excluded from the definition of 'investment adviser' if it:

- has no clients other than family clients;

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66 17 CFR Part 275. Generally, and subject to a set of exceptions, an investment adviser is defined as any person who, for compensation, engages in the business of directly or indirectly advising others on the value of securities or the advisability of investing in, purchasing or selling securities. 15 USC § 80b–2(a)(11).

67 Codified as 15 USC 80b-1–80b-21.

68 See SEC Staff of Inv Adviser Reg Off, Div of Inv Mgmt, Regulation of Investment Advisers by the US Securities and Exchange Commission at 7 (Mar 2013). Available at: www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

69 17 CFR § 275.202(a)(11)(G)-1.

- is wholly owned by family clients and is exclusively controlled by family members or family entities; and
- does not hold itself out to the public as an investment adviser.[70]

The definition of what is considered a 'family client' under the first and second requirement is quite broad, and includes, but is not limited to:

- all current family members[71] and former family members;[72]
- key employees and certain former key employees of the private trust company;[73]
- non-profit organisations or charitable foundations or trusts funded exclusively by family clients; and
- trusts for the sole benefit of one or more family client and the estates of such.[74]

The private trust company therefore has certain flexibility in the clients it can service including the trusts for multiple branches of the family or employees, but in all cases it is only applicable to one family and not available to a multi-family private trust company.

If the private trust company will be held by a special purpose trust, as discussed above, then careful consideration must be given to ensuring that the second family office exclusion requirement is met, namely, that the private trust company be owned or exclusively controlled by the family.[75] Because special purpose trusts usually do not have ascertainable beneficiaries,[76] the family is likely not considered to actually own the private trust company, meaning that the element of control is critical. This can be achieved if family members serve as trustees of the special purpose trust or have overriding powers over the trustee either through an office of protector or otherwise.[77]

If the above requirements are met, the family office will be excluded from SEC registration as well as state registration under federal pre-emption laws.[78]

70 17 CFR § 275.202(a)(11)(G)-1(b).

71 'Family member' is defined as the lineal descendant of a common ancestor (which includes adopted, step and foster children) within 10 generations of the youngest generation of family members, and the spouses or spousal equivalents of such lineal descendant. 17 CFR § 275.202(a)(11)(G)-1(d)(6) and (9).

72 'Former family member' is defined as a spouse, spousal equivalent or stepchild that is no longer a family member due to divorce or a similar event. 17 CFR § 275.202(a)(11)(G)-1(d)(7).

73 The family office exclusion defines a key employee as any natural person who is an executive officer, director, trustee or general partner of the family office and any employee of the family office who (i) regularly participates in the investment activities of the family office and (ii) has been performing such functions for at least 12 months, and includes employees who only perform clerical, secretarial or administrative functions. 17 CFR § 275.202(a)(11)(G)-1(d)(8).

74 17 CFR § 275.202(a)(11)(G)-1(d)(4).

75 Careful consideration must be given to the planning and designing of a private trust company that does not cause any adverse tax implications while meeting the control requirement.

76 26 USC § 11.

77 For further guidance, see SEC Staff Responses to Questions about the Family Office Rule (23 Mar 2018), available at: www.sec.gov/divisions/investment/guidance/familyofficefaq.htm.

78 15 USC § 80B-3a(b)(1)(B).

The exclusion is self-effecting, meaning that no affirmative filings are required by the private trust company with the SEC.

9.2 Domestic bank exclusion

Despite the added administrative cost, a private trust company may wish to become regulated so that it qualifies as a bank as defined by the Advisers Act, which is excepted from the definition of investment adviser under the Advisers Act.[79]

A regulated private trust company may qualify as a bank under this definition because it is generally supervised as a banking institution by a state's banking regulatory agency under the state's private trust company statutes. This is the case, for example, in New Hampshire, in which regulated private trust companies must obtain a bank charter and are subject to periodic examinations and filing requirements. The careful practitioner, however, will consider the state's private trust company statute before concluding that the private trust company qualifies for the bank exclusion.

9.3 Other considerations

Note that if a private trust company also provides advice with respect to 'commodity interests',[80] the private trust company must also consider whether it needs to be registered as a commodity pool operator (CPO) or a commodity trading adviser (CTA) with the US Commodity Futures Trading Commission (CFTC). The CFTC has recently adopted rules, effectively codifying two previously issued no-action letters, which provide for self-effecting exemptions from registration as a CPO or a CTA for family offices.[81] The CFTC exemptive rules generally follow the SEC family office rules.[82]

10. Conclusion

Although the private trust company has established itself as a flexible tool for addressing the needs of high net worth individuals and families in the United States, it has also created a need for greater certainty surrounding the US federal tax treatment of such entities. While individual states are racing to enact and improve their private trust company statutes, the IRS has yet to provide final guidance that can be relied upon by families and practitioners when creating

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79 15 USC § 80b-2(a)(11).

80 These are typically futures, forwards and swaps regulated by Commodity Futures Trading Commission. 17 CFR § 1.3(1)-(4) (definition of commodity interest).

81 See generally Registration and Compliance Requirements for Commodity Pool Operators (CPOs) and Commodity Trading Advisors: Family Offices and Exempt CPOs, 84 FR 67355, available at www.cftc.gov/sites/default/files/2019/12/2019-26162a.pdf (25 Nov 2019).

82 *Ibid* at 67358–59, available at www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/12-37.pdf; and CFTC Div of Swap Dealer & Intermediary Oversight, CFTC Letter No 14-143 (No-Action), No Action Relief from Registration as Commodity Trading Advisors for Family Offices (5 Nov 2014), available at www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/14-143.pdf.

private trust company structures. Therefore, great care regarding the tax and securities law considerations referenced in this chapter must be observed when deciding to proceed with a private trust company-centric structure. In the meantime, families and practitioners are advised to adopt the conservative approach outlined by the IRS in Notice 2008-63 which, despite not being final, offers certain safe harbours that should provide taxpayers with some confidence that their structure will withstand potential challenges.

The material in this chapter is the opinion of the authors and is not an official publication of Cadwalader, Wickersham & Taft LLP.

Private Trust Companies

A Handbook for Advisers

Private Trust Companies: A Handbook for Advisers

Ultra-wealthy families have incorporated private trust companies into their wealth structures with increasing frequency over recent decades. Private trust companies can offer greater control over the administration of the family's trusts and can provide greater flexibility in the management of the trust's assets. For many families, a private trust company is a natural complement to the family office, enabling it to include fiduciary services among the services that it provides to its members. Reflecting the rising popularity of private trust companies, more jurisdictions have enacted legislation allowing them.

This handbook is a comprehensive resource for lawyers, accountants, family office executives and any others who advise ultra-wealthy families on private trust companies. Featuring chapters written by leading practitioners from firms including McDermott Will & Emery, Bedell Cristin and Holland & Knight among others, it fully explores the legal, regulatory and practical dimensions of forming and operating a private trust company.

A series of chapters examines the relevant law in prime jurisdictions including Bermuda, the British Virgin Islands, the Cayman Islands, Hong Kong, Jersey and key US states. Other chapters focus on organisational and operational issues, such as designing a private trust company's ownership structure, implementing proper internal controls, outsourcing services and working with professional advisers. Important matters like coordinating with the family office, communicating with family, protecting privacy and handling disputes involving private trust companies are also covered.

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