KOZUSKO HARRIS VETTER WAREH LLP

December 22, 2005

Via Email

Office of Chief Counsel
CC:PA:LPD:PR (RR-144464-04)
Room 5203
Internal Revenue Service
Ben Franklin Station
Washington, D.C. 20044

Attention: DeAnn K. Malone (Attorney, CC:PSI:B09)

Re: Comments on Family Trust Company Guidance

Dear Sirs:

We are writing in connection with the possibility of a forthcoming public ruling or revenue procedure concerning so-called family or private trust companies and, in particular, new guidance dealing with the possible attribution of trustee powers to grantors or beneficiaries by reason of their participation in distribution decisions as part of their office or position in the governance of a family-controlled trust company that serves as trustee of the family trusts. This attribution would be relevant for purposes of applying the grantor trust rules of Internal Revenue Code section 671-678 and estate and gift tax provisions such as Code sections 2036, 2038, 2041 and 2514.

<u>Introduction</u>

This letter focuses on the common situation in which the operative documents prohibit decision makers from acting on distribution decisions to or for their own personal benefit, regardless of the capacity in which they are acting, but do not prohibit participation in decisions on distributions to or for other family members, such as siblings and cousins. This type of prohibition has also been adopted by certain state trust company laws. For example, the statutory law of Virginia prohibits a trust company officer, director, employee or equity owner from participating in distribution decisions to or for the pecuniary benefit of the decision maker, but not from acting with respect to distributions affecting other family members. Va. Code Ann. § 6.1-32.30:7(B) (2003) (text in Appendix 1).

For purposes of this discussion, we refer to these distributions to or for other family members as “related party distributions” as distinct from “personal distributions” made to or for the benefit of the decision maker, and we are dealing here only with distributions that are made pursuant to a broad standard such as “best interests.” (These are sometimes referred to in the private letter rulings as “discretionary,” i.e., not distributions that are mandatory or made pursuant to an ascertainable standard). Also, no distinction is intended based on whether these family members, when participating in distribution decisions on behalf of the trust company, are acting as directors, managers, officers, members of a distribution committee, or any other agent or employee of the trust company.

Substantially all of the existing private letter rulings that address related party distributions have contained special facts in which the governing documents (either at the trust level or the trust company level or both) already prohibited family members acting on behalf of the trust company from participating in distribution decisions involving related party distributions as well as personal distributions. The private letter rulings conclude that such provisions were important in those cases because they prevented the "possibility of outside reciprocal agreements" that may "indirectly" give beneficiaries (or grantors) "effective control over the discretionary distributions" from the trusts at issue. E.g., PLR 200548035. As we understand it, the concern is that, for example, if family member X can decide upon discretionary distributions to family member Y, and Y can decide upon such distributions to X, then they can agree to follow each other's wishes in reciprocal fashion and each will obtain "effective control" over their own personal distributions.

Yet we are not aware of any guidance that requires a complete ban on any participation in related party distribution decisions, with the result that all family participation in all family distributions would be prohibited if a family trust company serves as trustee. While the existing guidance indicates that such a complete ban on family participation can lead to a favorable private letter ruling, there is no indication that this is the exclusive method. The rulings simply did not address other methods. We submit that other methods should be recognized as equally effective when dealing with the "possibility of outside reciprocal agreements" affecting distribution decisions on family trusts in which a family trust company is a trustee.

Conclusion

A complete ban on participation by family members in discretionary distribution decisions is, however, an overly broad solution to the perceived need to curb "reciprocal agreements" in family trust company governance. For the reasons discussed below, we believe that unless the pending new guidance leaves open a meaningful opportunity to adopt other methods for dealing with reciprocity issues, the guidance will not serve the purpose of facilitating taxpayer compliance and is likely to increase rather than reduce the need for private letter rulings. Therefore, we strongly suggest that any new guidance provide an avenue for seeking the approval of safe harbors other than a complete ban on family participation in distribution decisions.

We do not agree that family trust companies are being used to shield efforts by family decision makers to engage in reciprocal agreements or other conduct. We do not believe that the shared powers provided in the governance structure of a typical family trust company, serving as trustee of various family trusts of different stripes and sizes over long periods of time, provides a fruitful ground for improper reciprocal conduct in fact, any more than the usual cooperative relationship between trustees and beneficiaries in any group of family trusts. We do not agree with the proposition that the reciprocal trust doctrine can be used as a matter of law to trigger estate tax upon the mere potential for collaboration or family politicking in the exercise of powers. Similarly, we do not agree that a shared (not unilateral) power to remove and replace a fiduciary with a related party is grounds for attribution of the fiduciary's powers, or that taxable reciprocity can be conclusively found simply from the sharing of a power to remove and replace a fiduciary. See D. Kozusko and M. Padgett "Private Trust and Protector Companies: How Much Family Control?"43 Tax Man. Memo. No. 22 (Nov. 4, 2002). We believe that most trusts in a family trust company context would not be considered interrelated under the reciprocal trust doctrine. See P. Van Horn, "Revisiting the Reciprocal Trust Doctrine," 30 Tax Man. Estates Gifts and Trusts Journal Memo. No. 4 (Avoiding Interrelatedness). For purposes of this discussion, however, we will concede that there is a reciprocity "problem" in family trust companies that warrants attention.

Comparison to Standards Governing Individual Family Trustees

The "family" trust company that adopts a complete ban becomes in effect a "quasi-family" trust company because only non-family members can act on trustee decisions concerning distributions to family members. If such a complete ban is necessary to avoid tax issues, then using a family-controlled trust company as a trustee actually restricts the authority of the family to participate in distribution decisions as compared to an individual family member serving as trustee.

When an individual family member is trustee, the trust documents (or state law) typically prevent that individual from participating in distribution decisions only if a personal financial benefit to that person is involved; distribution decisions for other family members are not off limits. Indeed, without adverse tax consequences, a trustee can decide upon distributions to the trustee's own spouse or child, circumstances in which there is a natural tendency to assume close collaboration and a degree of joint decision-making.

Furthermore, in those more modern trust documents where trustees can be removed and replaced at the choice of the grantor or beneficiary, and thus where the family seeks to avoid tax issues by complying with the standards in Rev. Rul. 95-58, 1995-2 CB 191, there is still no wholesale ban on participating in distribution decisions that are being made to anyone in the extended family. If the guidance in Rev. Rul. 95-58 is followed, a new trustee could be named as a matter of right by the beneficiary and that new trustee could still act on discretionary distributions to that beneficiary without adverse tax results, even if the new trustee is the beneficiary's uncle or aunt, cousin, issue of a cousin, niece or nephew, or spouse of any number of different family members. The new trustee could not act on discretionary distributions to the beneficiary if the trustee were "related or subordinate" to the beneficiary, but the definition of a related or subordinate party in section 672(c) is not all encompassing. Moreover, Rev. Rul. 95-58 deals only with the unilateral power of a beneficiary (or grantor) to personally replace the trustee with such a related party. One's spouse can hold the power to remove and replace the trustee with a related family member, even a trustee related to the beneficiary's spouse or the beneficiary within the definition of section 672(c), all without violating the standards laid down by Rev. Rul. 95-58.

These more flexible standards for individual trustees not only put the family trust company at a disadvantage but are also instructive on the question of what constitutes appropriate limits for attributing taxable powers under the estate and gift tax law. The standards of

Rev. Rul. 95-58 are considered sufficient protection against collusion with, or undue control over, the trustee, presumably because it was determined that estate and gift taxation should not be based on the raw presumption that a new trustee will violate a fiduciary duty and do the bidding of the person who appointed the trustee. A practical opportunity to ignore legal limitations and duties does not create the equivalent of taxable ownership and control. In comparison to these standards for individual trustees, a complete ban in the family trust company setting would take the family entirely out of the trustee's role of deciding upon distributions, and if such a ban is required to avoid tax issues, it suggests a deep and unyielding distrust of family trust companies, and the need for a special remedy.

Why? As compared to individual family trustees governed by the standards in Rev. Rul. 95-58, there is no unilateral power in the typical family trust company that permits a beneficiary or grantor to replace a sole decision-maker. Thus what we have referred to as the reciprocity "problem" in family trust companies is based on a much more attenuated connection between the grantor/beneficiary and the decision-maker than is addressed by the standards in Rev. Rul. 95-58. The problem arises not from proof of an actual "outside reciprocal agreement" but, as indicated in the private letter rulings, from concern over the mere potential for such agreements or reciprocal understandings (or possibly even fear of mere close collaboration). Accordingly, the pattern of the private rulings suggests that prophylactic curbs are necessary to preclude reciprocity that would be somehow inherent in the trust company vehicle if family members were allowed to decide upon distributions for other family members.

The "reciprocity problem" thus depends upon an argument that a power shared by a family group (either to decide on distributions, or to name other family members to do so) will provide a manipulative grantor or beneficiary within the group with the opportunity to maneuver for reciprocal benefits by skewing decisions for the benefit of others in order to gain favor with those other family members, so that there will be some positive payback if and whenever those other family members are called upon to make decisions as to trusts that involve the manipulative grantor or beneficiary personally. See D. Kozusko and M. Padgett "Private Trust and Protector Companies: How Much Family Control?" 43 Tax Man. Memo. No. 22 (Nov. 4, 2002). In a phrase, the concerns seems to be that vote-trading will naturally arise, either explicitly or by vague implication, and that at least some trust companies may even be formed to facilitate that conduct. If, however, a complete ban on family participation is considered the only solution to this presumed abuse, then it suggests that family members in a trust company cannot be trusted -- or at least that they are more likely to make fiduciary decisions for illegitimate ulterior motives (i.e., trading votes) than individual family trustees. We hope that this is not the intended rule and rationale, but in any event, we are not aware of any evidence of past practice that could even begin to justify such a fundamental mistrust of family trust companies.

Using a broad prohibition against family participation as the sole remedy for the perceived potential for reciprocal back scratching would also be at odds with the limits of the reciprocal trust doctrine and with other estate and gift tax provisions. The reciprocal trust doctrine has not been applied by the courts to reciprocal powers or interests held by non-transferors, and the most recent private letter ruling on the question (PLR 9451049) indicates that the doctrine would not be readily extended to that context. See Kozusko and

Padgett at p. 8; P. Van Horn, "Revisiting the Reciprocal Trust Doctrine," 30 Tax Man. Estates Gifts and Trusts Journal Memo. No. 4 (Reciprocal Powers Without Any Transfer) (July-August 2005). There is no indication, therefore, that a large grouping of family trusts would be scrutinized upon the death of a family member to determine whether the individual family trustees or members of a family distribution committee, none of whom are transferors but some of whom are beneficiaries, could potentially engage in reciprocal back scratching over trusts that are related to each other only by reason of the family relationships. Furthermore, in a context that is closely analogous to a family trust company, the attribution of incidents of ownership of a life insurance policy held by a family company are <u>not</u> attributed to the family shareholders under Code section 2042. There is no presumption that reciprocal conduct is demonstrable when multiple family members can control a company by acting together. The control over the life insurance owned by the company is attributed only if and to a stockholder who owns more than 50% of the voting control, and the stockholdings of other family members are not attributed or aggregated for this purpose. Reg. section 20.2042-1(c)(6). Accordingly, to require broad preventative prohibitions to curb presumed abusive reciprocal conduct by fiduciaries in family trust companies would create an unwarranted and inconsistent intrusion into the governance of family trusts.

<u>Complete Ban on Family Participation as Sole Safe Harbor</u>

We also expect that if a complete ban on family participation were to be the only "safe harbor" provided by any new guidance on family trust companies, this would not satisfy the needs of taxpayers for workable guidance and would increase rather than decrease the need for private letter rulings outside the safe harbor. Of course, adopting such a broad ban on family participation is an acceptable solution for some family trust companies, as demonstrated by the private ruling requests themselves. The number of ruling requests made to date, however, represents only a small fraction of the number of taxpayers with family trust companies acting as trustees. (For example, the single state of South Dakota is by itself home to over 20 private trust companies, and those trust companies presumably serve a much greater number of taxpayers than 20.) Accordingly, limiting new guidance to the method used in the existing rulings apparently does not address many, if not most, of the trust companies already in existence.

Creating a safe harbor based only on the facts present in the existing rulings will likely prompt even more attention to the other cases that fall outside this pattern, since safe harbors naturally cause concern for those who do not so qualify. Yet, the motivation to use other approaches will continue and indeed grow as the interest in family trust companies increases, since many families will seek to avoid engaging outside decision makers for the sole purpose of managing distributions to their children and grandchildren, nieces and nephews, cousins and in-laws.

Furthermore, this issue involves more than family trust companies. If a public ruling or procedure is forthcoming, this will also raise concerns with other trust structures that do not use a private trust company but would appear to raise similar issues, most notably trusts that employ a family distribution committee. These relatively inexpensive structures for joint family participation are likely to become even more common as the Uniform Trust

Code becomes more widespread in its adoption and use, because that model statute, already enacted in some 15 states, now makes it clear that such committees can make distribution decisions in a fiduciary capacity to the exclusion of the trustee. If the complete ban on family participation becomes a requirement of all family trust companies in order to avoid tax issues, it must necessarily apply to family participation in committee form as well, which would render these committees useless because they are created for the sole purpose of allowing family members to make distribution decisions.

A new guidance policy that depends heavily on a complete ban on family participation in distribution decisions would also make it extremely difficult to fashion a workable test to identify the “family” or otherwise tainted participants.

(1) How would the guidance treat a multi-family trust company formed by a collaboration of several families? Would each natural family be presumed to be ready to engage in “reciprocal outside agreements” with all other members of all other families? If yes, then where does the line of attribution stop, since it has been suggested in other contexts that continuing reattribution would carry us all back to Adam and Eve?

(2) Is everyone connected to the trusts too tainted, so only outsiders who have no connection at all can act on distribution decisions? If not, where does the “family” definition stop as to each trust in question if the definition in section 672(c) is not the answer? Does the number of trusts and beneficiaries matter? What if there are 20 decision-makers and 400 beneficiaries? Who scratches whose back? When and where is the conscious parallel behavior going to occur?

(3) If a person is tainted solely by reason of having some personal stake in trust company decisions, that answer is impractical. How much connection to a trust in the pool of trusts will disqualify a participant? Suppose a good candidate to serve as an “independent” decision-maker on the distribution committee is not a family member and not a primary discretionary beneficiary but is a law partner of one? And the family pays the law firm $500,000 a year in fees? Or the candidate is the father of a remote contingency beneficiary? Or a director of a charitable foundation to which the family has contributed, or a foundation which could be the sole appointee of a power of appointment that controls over ten million dollars in trust?

(4) Assuming hypothetically that the candidate is not tainted when named to the distribution committee, what is the result if circumstances change and the person becomes tainted? And then resigns two years later - - is this the release of a power? In a population where 50% of marriages end in divorce and the rest in death, how does the concept of “family” collusion apply to divorced and surviving spouses as well as living spouses? Is a divorce the release of a taxable power? At all four or five generations in a large family?

(5) How would the new attribution rule be revised over time if it is originally fashioned outside the legislative and regulatory process? Will the changes come with grandfather protection for pre-existing arrangements? How is a taxable power being identified in this process on a basis other than broad speculation about the possibility of potential collusion or reciprocal favoritism?

As these questions indicate, we believe that workable guidance cannot be constructed on such a foundation when a 50% estate tax on trust principal is at stake, and fiduciaries and advisors can be held personally liable for failure to recognize and avoid such a tax liability. We recommend against a safe harbor that amounts to a complete ban on family participation in distribution decisions. But if such a ban were to be adopted as a safe harbor, we recommend that a process be provided for approving other additional methods as safe harbors in the future.

Alternative Methods

Alternative restrictions are available for dealing with the "possibility of outside reciprocal agreements" that may "indirectly" give "effective control over the discretionary distributions" from the trusts at issue. Thus, it would be best if future guidance did not effectively foreclose the use of these other methods by limiting the safe harbor to the complete ban used in the existing rulings. One such alternative that should be accorded the same safe harbor status is an explicit prohibition against outside reciprocal agreements, and further, against vote trading in less explicit terms. (See the italicized language in Appendix 2 for an example of such language.)

This is a direct solution. We submit that family members who form trust companies would respect this restriction, since it explicitly declares that vote trading and similar reciprocal conduct in its various forms is not permitted. Family members would understand that violating this prohibition risks serious adverse consequences including taxation and claims for breach of fiduciary duty from disaffected family members.

Certainly, as compared to a complete ban on family participation, the solution lacks the involvement of an independent fiduciary, and thus appears to be weaker. But such an independent fiduciary is not universally required for policing and restricting individual trustees, as we have discussed above in connection with Rev. Rul. 95-58. As in any self-reporting tax system, there is always a measure of trust involved; for example, even when Rev. Rul 95-58 requires the appointment and participation of an independent trustee, we trust that the person will not be chosen pursuant to a pre-arranged plan by which the new trustee agrees to follow the direction of the appointing beneficiary; and we tolerate (and expect) the appointment of friends, advisors and associates, not just independent commercial trust companies, and we recognize that these persons may have financial ties to the family that could affect their judgment. This system is considered sufficient because we expect fiduciaries to honor the restrictions imposed on them, and they are subject to challenge under the tax and trust rules if they do not. That principle should apply here as well. It should be sufficient to impose an explicit prohibition against vote trading and other reciprocal conduct.

If, however, this alternative is not considered sufficiently strong to qualify as a safe harbor, it could be strengthened, so that we still have available a more workable safe harbor than the complete ban on family participation in distribution decisions by family trust companies. It would be entirely consistent with regulatory standards in other areas of the tax law involving interrelated transfers to impose the following additional restriction to establish a safe harbor: a family member may not participate in making a distribution decision to or for a second family member if the second family member had cast the deciding vote on a distribution to the first family member (the current decision-maker) within the prior two years (a 24 month period). Pursuant to this alternative approach, if the family trust company followed this procedure, it would be presumed that the distribution decisions were not interrelated, i.e., one was not made in exchange for the other. Absent proof that clearly establishes an "outside reciprocal agreement," there would be no interrelationship and thus no possible application of the reciprocal trust doctrine, and no risk of taxation on that ground.

We believe this restriction would be workable for family trust companies and still address the reciprocity problem. It would be workable for families because we are dealing only with restrictions on discretionary distributions, as noted earlier (see page 1 above). Also, this rule should not apply to every discretionary distribution, but only larger ones. Because of the protection for "5 and 5" powers provided by Code section 2041(b)(2), we believe 5% of the trust value is the appropriate threshold. The adoption of a safe harbor based on this two-year rule could specify that it does not apply (i.e., no disqualification is needed to invoke the favorable presumption) if the distribution decision is not being made by a grantor of either of the two trusts in question, and if either the earlier distribution or the current proposed distribution did not exceed 5% of the then value of the trust assets (an amount over which the beneficiary could have a withdrawal power without creating a taxable general power of appointment as to the entire trust). Furthermore, because this is a safe harbor and not an absolute rule, a distribution inside the two-year period should not be conclusive evidence of reciprocity but instead should trigger a presumption that could be rebutted if, and only if, substantial evidence is presented to show there was clearly no connection between the two distributions. Thus if special circumstances arise and the trust company could not comply with the disqualification rule for some unusual reason, the family should still be permitted to make the distribution without adverse tax consequences if it can clearly establish that the two distribution decisions were not reciprocal (e.g., the need for the second distribution was completely unforeseeable).

This standard should also adequately address the reciprocity problem. The two-year period has come to be accepted as the test for identifying interrelated transfers in income tax regulations that deal with comparable difficulties of proof of economic benefit and reciprocal dealings. In these other contexts, there is at least as much, and probably much more reason, to suspect reciprocity or to doubt whether self-reporting is an adequate system by itself. Generally speaking, transfers from a non-U.S. individual to a U.S. person in the form of a gift are traced back to a foreign trust and presumed to be a disguised trust distribution (i.e.. the non-U.S. individual is considered an intermediary) if the purported gift occurs within 24 months before or after the non-U.S. individual received property from the foreign trust in a gratuitous transfer (and if certain other circumstances are present). This presumption is rebuttable. Reg. section 1.643(h)-1. Disguised sales of property between a partner and a partnership when property is contributed to the partnership and payments are made in the form of a distribution to a partner are similarly controlled by a two-year period that links the two transfers and creates a rebuttable presumption. Outside the two-year period the presumption is reversed. In either case, the presumption can be rebutted by clear evidence to the contrary. Reg. section 1.707-3.

In Closing

We recommend against a safe harbor that amounts to a complete ban on family participation in distribution decisions. But if such a ban were to be adopted as a safe harbor, we recommend that a process be provided for approving other additional methods as safe harbors in the future. We are available to further explain our proposed safe harbor and to discuss any aspect of this matter.

Sincerely,

Don Kozusko

Appendix 1: Virginia Code

§ 6.1-32.30:7. Limitation on powers

A. In the exercise of any power held by a private trust company in its capacity as a fiduciary, the private trust company shall have a duty not to exercise any power in such a way as to deprive the estate, trust or other entity for which it acts as a fiduciary of an otherwise available tax exemption, deduction or credit for tax purposes or deprive a donor of trust assets of a tax exemption, deduction or credit or operate to impose a tax upon a donor or other person as owner of any portion of the estate, trust or otherwise.

B. Without limitation to subsection A, no family member who is a stockholder or member or who otherwise holds an equity interest in, or is serving as a director, officer, manager, or employee of, a private trust company shall participate in or otherwise have a voice in any discretionary decision by the private trust company to distribute income or principal of any trust in order to discharge a legal obligation of the family member or for the family member's pecuniary benefit, unless:

1. The exercise of the discretion is limited by an ascertainable standard relating to the health, education, support, or maintenance of that family member;

2. The distribution is necessary for that family member's support, health or education; or

3. The instrument governing the administration of that trust clearly so provides.

C. "*Tax*" includes, but is not limited to, federal, state or local income, gift, estate, generation-skipping transfer, or inheritance tax.

Appendix 2: Sample Bylaw Provision

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Section ___. Restrictions on Discretionary Decision Makers: Notwithstanding any other provision of the Bylaws of the company, the following rules restrict the officers and Managing Directors who may participate in making decisions on behalf of the company concerning discretionary distributions and the exercise of the incidents of ownership of life insurance:

(a) Those who participate in deciding whether and to what extent the company should make a discretionary distribution with respect to a trust cannot include any of the persons described in (1) through (5) below:

(1) a donor of the trust;

(2) a beneficiary who could be a recipient of the distribution in question;

(3) a beneficiary whose vested interest would be reduced in value by the distribution in question;

(4) a spouse of a donor or such a beneficiary; or

(5) a person who is treated under these rules as controlled by a donor or by such a beneficiary.

(b) No officer or Managing Director may participate in deciding whether the company should make a discretionary distribution if the distribution could discharge a legal obligation of that officer or Managing Director, or of his or her spouse, or of a person who is treated under these rules as controlling the officer or Managing Director.

(c) No officer or Managing Director may participate in a decision of the company that exercises an incident of ownership on an insurance policy that insures the life of that officer or Managing Director or the life of a person who is treated under these rules as controlling that officer or Managing Director.

(d) *An officer or Managing Director shall not enter into any agreement, understanding, arrangement or engage in any pattern of conduct by which a vote, decision, action or failure to act is, and is intended to be, offered or provided in exchange for certain conduct or inaction of another officer or Managing Director; this prohibition applies whenever an officer or Managing Director, whether alone or with others, may make decisions regarding the exercise of trustee or other fiduciary powers or may appoint persons who may make such decisions.*

Section ____. Certain Rules and Definitions for Applying Restrictions: In applying the provisions of this Article XII:

(a) The provisions of this Article ____ are not intended to restrict decisions regarding investments, and thus, a discretionary decision refers to the exercise or non-exercise of a discretionary power, other than an investment decision;

(b) An officer or Managing Director is treated as "controlled by" any person who has the power, acting alone and without the consent of any other, (i) to dictate the decision of that officer or Managing Director or (ii) to remove and replace that officer or Managing Director with himself or herself or with a person that is related or subordinate to him or her; it is irrelevant in what capacity that person is acting in exercising that power or in what position that officer or Director is serving;

(c) A person shall be considered "related or subordinate" to another person by applying the provisions of Section 672(c) of the Internal Revenue Code of 1986, as amended;

(d) A decision regarding the following shall be considered to be a decision regarding discretionary distributions: allocation of receipts or disbursements between income and principal unless that allocation is subject to a fiduciary standard; "adjusting" between income or principal; or making or terminating an election of "total return" or "unitrust" or like power;

(e) ***

(f) ***

(g) *Whenever an officer or Managing Director may not participate in a decision, this prohibits making the decision, voting on the decision and trying to influence those who do so, regardless of the manner in which those behaviors takes place.*

Section ____. Operation of Disqualification Rules: The provisions of this Section ___ are intended to explain who may make certain decisions of the company when certain persons become disqualified ***