NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT WITH RESPECT TO PROPOSED GUIDANCE ON FAMILY-OWNED TRUST COMPANIES

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

PROPOSED GUIDANCE ON FAMILY-OWNED TRUST COMPANIES[1]

The 2005-2006 Priority Guidance Plan, released in updated form by the Treasury's Office of Tax Policy and by the Internal Revenue Service (the "Service" and collectively the "Government")[2] on March 6, 2006, indicates that the Government intends to issue guidance regarding the estate, gift and generation-skipping transfer ("GST") tax consequences (collectively, "transfer taxes") of appointing a family-owned trust company (an "FTC") to serve as trustee of a trust for the benefit of family members (an "FTC Trust").[3] This report describes the type of guidance on this topic that we believe would be helpful to families who wish to use FTCs and would be consistent with existing transfer tax authority as to the attribution of trustee powers to the creators and beneficiaries of trusts. Because the use of an FTC presents similar questions under the so-called grantor trust rules of Subchapter J of the Code,[4] this report suggests that the guidance addresses both the income tax consequences under Subchapter J, as well as the transfer tax consequences, of using FTCs.

I. Introduction

FTCs are an increasingly common tool used by wealthy families to manage their assets held in trust. The potential advantages of appointing an FTC as a trustee of a family trust include (1) greater fiduciary continuity, (2) improved access to diversified, high-quality investment management, legal, accounting and tax planning service providers, (3) provision of a structure within which to engage individuals to

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[1] This report was prepared by the Committee on Estates and Trusts of the Tax Section of the New York State Bar Association. Its principal drafters were Elyse G. Kirschner, Carlyn S. McCaffrey and Jeffrey N. Schwartz. Helpful comments were received from Henry Christensen III, T. Randolph Harris and David Miller.

[2] 2005 TNT 152-18.

[3] The term "*family-owned trust company*" has no precise definition. We use it here to describe any entity, corporation, partnership, or limited liability company, that is owned by members of a family (or trusts for the benefit of those family members) and serves as a trustee of trusts created by a member or members of the family and/or of trusts held for the benefit of family members.

[4] Code sections 671 through 679. References to the "*Code*" refer to the Internal Revenue Code of 1986, as amended.

perform trust services without the risk to trust assets sometimes associated with giving individuals legal title to those assets, as trustees, (4) increased protection against liability for individuals involved in the decisions of the FTC,[5] and (5) more involvement by family members in the management of family wealth. Some states have recognized this increased interest in FTCs, and have enacted legislation that encourages the creation of FTCs in those states.[6]

Families who want to take advantage of these benefits have been concerned about the possibly adverse federal income and transfer tax consequences that could result from the use of FTCs as trustees of trusts for the benefit of family members. The Service has issued guidance to some of these families in the form of private letter rulings on a case-by-case basis.[7] This piecemeal approach is undesirable for at least three reasons. First, in each of these private rulings the Service was responding to a specific set of facts with which it was presented, facts that might not be applicable to all families who are interested in creating an FTC. Such families would benefit from more general and definitive guidance in the form of a published ruling or other form of notice on which taxpayers are entitled to rely that specifies exactly how FTCs and FTC Trusts should be structured in order to avoid negative income and transfer tax consequences for their

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[5] For example, an individual holding legal title to real property in her capacity as trustee may be held personally liable for injuries suffered by third parties in connection with that real property. Interposing an FTC and having the individual who would otherwise serve as trustee act as an officer or director of the FTC provides additional protection against these types of third party claims. It is also generally believed that individuals who make decisions with respect to trusts as officers or directors of corporate trustees have less exposure to potential liability to trust beneficiaries than they would have if they acted as trustees in their individual capacity. For example, the business judgment rule may protect directors of corporate trust companies from liability for their decisions other than those that are made in bad faith or those that are the product of gross negligence. *Otis & Co. v. Pennsylvania R. Co.*, 61 F. Supp. 905 (D.C. Pa. 1945). Nevertheless, it is clear that officers and directors of corporate trustees owe duties to the beneficiaries of the trusts administered by their corporations and that they cannot knowingly cause their corporations to commit a breach of trust without exposing themselves to potential direct liability to the trust beneficiaries, in addition to any potential liability they may have to their corporations for engaging in conduct that results in a claim against the corporation for a breach of trust. *William Fratcher, IV Scott on Trusts,* §326.3 (1989); *Beaubien v. Cambridge Consolidated, Ltd*, 652 So. 2d 936 (Fla. 5th DCA 1995). Thus, at a minimum, willful violations of tax laws or fiduciary responsibilities should expose such individuals to potential direct personal liability to trust beneficiaries.

[6] *See, e.g.*, Virginia Private Trust Company Act, Va. Code Ann. § 6.1-32.30:1 through § 6.1-32.30:7.

[7] S*ee, e.g.*, Private Letter Ruling 200548035 (August 2, 2005); Private Letter Ruling 200345006 (July 3, 2003); and Private Letter Ruling 200125038 (March 21, 2001).

grantors and beneficiaries. Second, because private letter rulings may not be cited as precedent,[8] they provide little comfort to families who do not wish to obtain private letter rulings of their own and who could have sizable assets at risk of taxation. Finally, the time required for the Service to review and respond to FTC private ruling requests, often involving very complicated series of trusts and trust company arrangements, is a poor use of the time by the Service's professionals.

II. Guiding Principles

There are only two tax-significant differences between using an independent trust company and an FTC.

The first one is clearly caused by a provision in the Code. Code section 672(c) includes the following individuals and entities within the definition of the term "related or subordinate party":

> "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; [and] a subordinate employee of a corporation in which the grantor is an executive. . . ." [9]

An independent trust company is unlikely to fit this definition. In contrast, this definition would cause many FTCs organized as corporations, and their employees, to be treated as related or subordinate to the grantor of a trust if the grantor's or the trust's stock holdings in the FTC are significant.

Related or subordinate status is significant under the Code only for purposes of the application of Code sections 672, 674 and 675, all of which are income tax provisions, and then only if the corporation or employee is also subservient to the grantor or to the grantor's wishes.[10] The Government, however, has concluded in one regulation and in two published rulings that in certain cases related or subordinate status, even without subservience, can be significant for purposes of the application of the rules governing charitable remainder unitrusts and can have transfer tax consequences.[11]

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[8] *See* Code section 6110(k)(3).

[9] A director of a corporation is not an "employee," as that term is used in Code section 672(c) in defining the term "related or subordinate party," merely because he is a director. *See* Rev. Rul. 66-160, 1966-1 C.B. 164.

[10] *See* Code sections 672(f), 674(c) and 675(3).

[11] *See* Treas. Reg. section 1.664-1(a)(7); Rev. Rul. 2004-64, 2004-27 I.R.B. 7; Rev. Rul. 95-58, 1995-2 C.B.191.

Two questions concerning the related or subordinate party issue should be answered in the guidance.

1. Is it possible to create a set of rules for an FTC that would ensure that the tax-sensitive powers[12] to be exercised by the FTC are made sufficiently independently from the grantor of the trust so that an FTC that is a "related or subordinate party" within the definition of Code section 672(c) would be treated as non-subservient for purposes of Code sections 672, 674 and 675 and, if so, what should those rules look like? If the FTC is non-subservient, then the Code imposed consequences of related or subordinate status would be avoided.

2. Is it possible to create a set of rules for an FTC that would ensure sufficient independence as to the exercise of its tax-sensitive powers to persuade the Government that an FTC that is a "related or subordinate party" within the definition of Code section 672(c) should be treated as non-related and non-subordinate in those situations where the Government has decided that non-related and non-subordinate status is significant and, if so, what should those rules look like?

The second difference between the use of independent trust companies and FTCs is less obvious. A number of income and transfer tax consequences are caused by the possession by a particular individual of a particular power. For example, if the grantor of a trust[13] possesses the power to change the beneficial enjoyment of trust property she, with certain exceptions, will be treated as the owner of the property held in the trust for federal income tax purposes.[14] And, if she possesses that power at death (or has released it within three years of her death), the trust property will be included in her gross estate for federal estate tax purposes.[15] When the trustee of a trust is an independent trust company, and, as trustee, possesses powers which, if held by an individual, would result in an income or transfer tax consequence to that individual, it is unlikely that those powers would be attributed to that individual. If, however, the trustee is an FTC and the individual, through ownership interest in the FTC or participation in its

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[12] By "*tax-sensitive power*" we mean any power exercisable over trust property which, if exercisable by the grantor or a beneficiary of a trust, would cause a tax consequences to the grantor, to such beneficiary or to the trust.

[13] The term "*grantor*" of a trust is defined in Treas. Reg. section 1.671-2(e) generally as any individual who made a gratuitous transfer to the trust.

[14] Code section 674(a).

[15] Code section 2038(a)(1).

governance, has some control over the FTC's exercise of its trustee powers, the Service could take the position that these powers should be attributed to the individual.

The question concerning the attribution of power issue that should be answered in the guidance follows the same theme as the questions asked in connection with the related and subordinate status issue above. Can a set of rules be established to ensure that the tax-sensitive powers exercisable by an FTC will not be attributed to the family members who through ownership interests and participation in its governance control it, and what should these rules look like?

We believe the first part of each of these questions should be answered affirmatively. We discuss below our recommendations for an appropriate set of guidelines to be used in establishing such rules.

We believe that the use of FTCs can serve legitimate family goals. While we recognize that the Government has an interest in preventing excessive control over FTCs by family members, the adoption by the Government of an overly restrictive set of requirements would discourage the use of FTCs and put them at a disadvantage relative to independent trust companies. To balance these concerns, we believe that the Government should establish a set of guidelines setting forth easy to follow, objective conditions under which FTC-held trustee powers will not be attributed to individual family members and that those conditions should be consistent with prior authority that deals with the attribution of trustee powers to non-trustees.

III. Statement of Applicable Law

Before considering a proposed set of guidelines, we review briefly the various tax-sensitive powers generally held by trustees that could be attributed to an FTC's family members and the existing authority that discuses the circumstances under which such powers may be attributed to another person.

A. <u>Estate Tax</u>

1. Relevant Code Provisions

a. Code Section 2036

Code section 2036(a) provides generally that the value of a decedent's gross estate includes the value of all property to the extent of any interest in the property that was gratuitously transferred by the decedent if the decedent retained for life possession or enjoyment of the transferred property or the right, exercisable alone or in conjunction with any other person, to determine who shall possess or enjoy the property's income.

Code section 2036(b) provides that the retention of the right to vote, directly or indirectly, shares of stock of a "controlled corporation" that the decedent

gratuitously transferred to a trust is a retention of the enjoyment of such stock for purposes of Code section 2036(a).[16]

b. Code Section 2037

The focus of Code section 2037 is on retained interests in or powers over trust principal rather than trust income. It provides that trust property gratuitously transferred by a decedent will be included in her gross estate if possession or enjoyment of the property by another can be obtained only by surviving the decedent, and the decedent has retained a reversion in the trust property, the value of which immediately before her death exceeds 5 percent of the value of the trust property. Code section 2037 is relevant to our inquiry because subsection (b) of the section provides that a power to dispose of a reversion is treated as a retained reversion.

c. Code Section 2038

Code section 2038(a)(1) applies to powers over income or principal. It provides generally that the value of a decedent's gross estate includes the value of all property to the extent of any interest which she gratuitously transferred to the trust if the enjoyment of such interest was subject at her death to any change through the exercise of a power by her alone or by her in conjunction with any other person to alter, amend, revoke, or terminate, or if she relinquished such a power during the three-year period ending on the date of her death.

d. Code Section 2041

Code section 2041 requires the inclusion of property in the gross estate of a decedent if she held a general power of appointment over it at the time of her death or if she relinquished such a power within three years of her death. It also reaches property that was subject to the decedent's general power of appointment if she released the power during her life in a transaction which is of such nature that, if it were a transfer of property owned by her the property would have been includible in her gross estate under any of Codes sections 2035[17] through 2038.

For this purpose a general power of appointment is a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the

[16] Code section 2036(b) defines a "controlled corporation" as a corporation in which the decedent owned (with the application of the constructive ownership rules of Code section 318) or had the right to vote, either alone or in conjunction with any other person, stock possessing at least twenty (20%) percent of the total combined voting power of all classes of stock of the corporation.

[17] Code section 2035 deals, generally, with the gratuitous transfer of property or release of powers within three years of a decedent's death.

creditors of the decedent's estate either unilaterally or with the consent of persons who do not have an economic interest adverse to the exercise of the power.

e. Code Section 2042

Code section 2042, in general, provides that a life insurance policy on the life of a decedent is included in her gross estate if she possessed at death any incidents of ownership over the policy, exercisable either alone or in conjunction with any other person.

2. The Role of Ascertainable Standards

If the power held by the decedent was limited by an objective, external and ascertainable standard, unless the power can be exercised to advantage economically the power holder, the power is not a tax-sensitive power for purposes of any of Code sections 2036 through 2038. Examples of such standards include a power to distribute trust income or principal for the "support, education and maintenance" of a trust beneficiary.[18]

Under Code section 2041, a power exercisable by a decedent which is limited by an ascertainable standard relating to her health, education, support, or maintenance is not treated as a general power of appointment and, therefore, has no estate tax significance.[19]

3. Regulations Attributing Powers Held by a Trustee to the Decedent

In general, a decedent will not be treated as holding a power under any of Code sections 2036 through 2038 or under Code sections 2041 and 2042 if the power is actually held by another.[20] This is so even if she is in a position to influence that person's decisions and actually exercises that influence.[21]

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[18] *See, e.g., Leopold v. United States*, 510 F.2d 617 (9th Cir. 1974); *Jennings v. Smith,* 161 F.2d 74 (2d Cir. 1947); *Estate of Wier v. Commissioner,* 17 T.C. 409 (1951), *acq.* 1952-1 C.B. 4.

[19] Code section 2041(b)(1)(A).

[20] Treas. Reg. section 20.2036-1(b)(3). All references in this report to "Treas. Reg. section " shall mean sections of the Treasury Regulations promulgated under the Code.

[21] *See Estate of Goodwyn v. Commissioner*, 32 T.C.M. 740 (1973), in which the Tax Court, relying on the Supreme Court's decision in *United States v. Byrum*, 408 U.S. 125 (1972), declined to include trust property in a grantor decedent's gross estate under Code section 2036(a)(2) despite the fact that, until his death, the trustees, who were his attorneys, followed his determinations as to how trust income was to be distributed.

If, however, a decedent reserved the unrestricted power to remove or discharge a trustee at any time and to appoint herself as trustee, the regulations will attribute the powers of the trustee to her.[22]

4. Authorities Dealing With Attribution of Powers

In Revenue Ruling 79-353, the Service took the position that a decedent who had held the power to replace a trustee (with a person other than the decedent) should be treated for purposes of Code section 2036 as holding the powers held by the trustee.[23] It was widely believed that the Service, given the opportunity, would apply the same principle under Code sections 2038, 2037, 2041 and 2042. The Service's position was rejected by the Tax Court in *Estate of Wall v. Commissioner*[24] and by the 8th Circuit in *Estate of Vak v. Commissioner*.[25] Shortly, thereafter, the Service modified this position in Revenue Ruling 95-58.[26]

In *Wall* the Tax Court based its conclusion that the will of the holder of a power to replace trustees could not be imposed on the trustees she appoints on its understanding of the fiduciary obligations that are imposed on trustees. The Tax Court observed that,

> a trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take regarding the beneficial enjoyment of any interest in the trust, or agreed with the settlor, prior to appointment, as to how fiduciary powers

[22] Treas. Reg. sections 20.2036-1(b)(3), 20.2038-1(a)(3), 20.2041-1(b)(1). Because the regulations under Code section 2036 provide that a retained power includes a power the exercise of which is subject to a contingency beyond the decedent's control even if that contingency did not occur before the decedent's death, a power exercisable by a decedent to appoint herself as trustee in the event the original trustee ceases to serve will result in the trustee's powers being attributed to her for purposes of Code section 2036 despite the fact that the original trustee is still serving as trustee at her death. *See Estate of Farrel v. United States*, 553 F.2d 637 (Ct. Cl. 1977).

[23] Rev. Rul. 79-353, 1979-2 C.B. 325. Rev. Rul. 81-51, 1981-1 C.B. 458 modified Rev. Rul. 79-353 by limiting its application to trusts created after October 29, 1979, if the trust was irrevocable on that date.

[24] *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993).

[25] *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992).

[26] Rev. Rul. 95-58, 1995-2 C.B. 191.

should be exercised over the distribution of income and principal.

In considering how these rules should apply to powers exercisable by FTCs, it should be kept in mind that the individual officers and directors who actually make decisions on behalf of an FTC have direct duties both to their trust companies and to the relevant trust beneficiaries. For example, an officer or director of an FTC would face potential direct liability to a trust beneficiary if she knowingly permitted the FTC to breach the FTC's own fiduciary duties to the trust beneficiaries, *e.g.*, participated in a decision by the FTC to acquiesce in the wishes of a grantor by taking action that the FTC would not otherwise take regarding the beneficial enjoyment of any interest in the trust.[27]

Revenue Ruling 95-58 concludes that a decedent/grantor's reservation of an unqualified power to remove a trustee and to appoint an individual or corporate successor trustee who is not related or subordinate to her within the meaning of § 672(c), is not considered a reservation of the trustee's discretionary powers of distribution over the property transferred by her to the trust. Accordingly, the trust corpus was not included in the decedent's gross estate under Code sections 2036 or 2038.

The fact pattern described in Revenue Ruling 2004-64[28] suggests that the Service may have concluded that a trustee power to reimburse the grantor of a trust which is treated as owned by her for income tax purposes for that portion of her taxes attributable to the trust's income could be a tax-sensitive power under Code section 2036 if the trustee were not independent within the section 672(c).

5. Authorities Dealing With Reciprocal Powers

The "Reciprocal Trust Doctrine" is a judicially-created doctrine intended to deal with potential transfer tax abuses that could arise when two individuals create trusts for the benefit of each other. When the doctrine applies in its original form, the settlors of the reciprocal trusts are uncrossed so that each one is treated for estate tax purposes as if she had created the trust that was actually created by the other.

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[27] *See* William F. Fratcher, IV Scott on Trusts, §326.3 (1989). As observed in Scott on Trusts, the potential exposure of an officer or director to a direct claim by a trust beneficiary against the officer or director in her individual capacity is likely to be greatest when the corporate trustee is thinly capitalized. Regardless of capitalization, officers and directors also may be held personally liable to their corporations for conduct that results in a claim against the corporation for a breach of trust.

[28] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

The seminal case in this area is *United States v. Grace*.[29] It focused on two trusts, one created by Joseph Grace and the other by his wife, Janet Grace. Joseph created a trust (the Joseph Grace Trust) which was required to pay income to his wife Janet for her life. Two weeks later, Janet executed the Janet Grace Trust, the terms of which were virtually identical to the Joseph Grace Trust except that Joseph, rather than Janet, had the right to receive trust income for life. The Supreme Court applied the reciprocal trust doctrine to conclude that Joseph was the settlor, for estate tax purposes, of the trust created by Janet with the result that the assets of the Janet Grace Trust were included in his gross estate. The Court articulated a two part-test to be applied in possible reciprocal trust cases. If (1) the trusts are interrelated[30] and (2) the trust arrangements leave each settlor in approximately the same economic position as she would have been in had she created the trust that named herself as the life beneficiary, the trusts will be treated as reciprocal trusts and the actual settlor of each trust will be treated for estate tax purposes as the creator of the other trust.

The Service, with some success, has extended the reciprocal trust doctrine beyond its original scope to include situations that do not involve the mutual economic value concept seemingly applied by the Supreme Court in *Grace.*[31] The mutual economic benefit concept requires that, after the trusts are uncrossed, each settlor has an actual economic interest in the trust of which she is being treated as the grantor. In *Estate of Bischoff v. Commissioner*, for example,[32] the Tax Court uncrossed eight trusts, four created by Bruno Bischoff for his four grandchildren and the other four by his wife Bertha for the same four grandchildren. Although neither had an economic interest in the trusts created by the other, each had been named trustee of such trusts and held powers over trust property that would have been sufficient to result in gross estate inclusion under Code sections 2036(a)(2) and 2038(a)(1) if he or she had been the settlor.

In a private letter ruling issued in 1994, the Service extended the reciprocal trust doctrine to reciprocal powers conferred on two individuals by a third party. In Letter Ruling 9235025[33] the Service concluded that a decedent had held a

[29] *United States v. Grace*, 395 U.S. 316 (1969).

[30] The Supreme Court in *Grace* did not defined "interrelatedness," but the facts of the case show that both trusts had substantially identical terms, were created at the same time and were part of the same design.

[31] *See, e.g.,* Estate *of Bischoff v. Commissioner*, 69 T.C. 32 (1977) and *Exchange Bank & Trust Co. of Florida v. United States*, 694 F.2d 1261 (Ct. App. Fed. Cir. 1982). *But see Estate of Green v. U.S.*, 68 F.3d 151 (6th Cir. 1995), in which the court reached a contrary result.

[32] *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977).

[33] Private Letter Ruling 9235025 (May 29, 1992).

general power of appointment over a trust of which he was a beneficiary because his brother had the power, as trustee, to make unlimited principal distributions to him and he held the same power over a trust of which the brother was beneficiary and it could be "objectively inferred that the decedent and [his brother] would exercise their respective distributive powers on a reciprocal basis."

The Service's conclusion in Letter Ruling 9235025 has not been followed in any subsequent private letter rulings dealing with reciprocal powers. Letter Ruling 9451049,[34] for example, concludes that two sisters, each of whom had the power to appoint trust property held in a trust for her benefit to the other sister, did not hold general powers of appointment. The ruling observes that, under appropriate circumstances, the reciprocal trust doctrine set forth in *Estate of Grace* could apply to a similar situation, but without further explanation, concluded that its application was not warranted in this case. In several more recent private letter rulings, without reference to the *Estate of Grace* doctrine of reciprocity, the Service has concluded that individuals who hold the power to appoint trust property to each other do not hold general powers of appointment.[35]

B. Gift Tax

1. Relevant Code Provisions

a. Code Sections 2501 and 2511

Code sections 2501 and 2511 provide that the gift tax will apply to all transfers by gift whether direct or indirect, and in trust or otherwise. Treas. Reg. section 25.2511-2 significantly limits the scope of these provisions by providing that the gift tax will not apply to "incomplete gifts" and by defining incomplete gifts to include any gift with respect to which the donor has reserved the power to name new beneficiaries or change the interests of beneficiaries exercisable either alone or with others who do not have a substantial interest adverse to the exercise of the power.[36] When a gift is initially incomplete, it becomes complete at the time that the donor's retained power is exercised, lapses or is released. Because a gift is incomplete only if the power to direct an alternate

[34] Private Letter Ruling 9451049 (September 22, 1994).

[35] Private Letter Ruling 200612002 (November 23, 2005); Private Letter Ruling 200502014 (September 17, 2004).

[36] The power to change the time of enjoyment of transferred property is not sufficient to cause a gift to be incomplete although such a power is sufficient to cause the application of Code section 2038 at the death of the donor. *See Lober v. United States*, 346 U.S. 335 (1953).

disposition is within the donor's control, a power exercisable only on the occurrence of a condition not within her control will not cause a gift to be incomplete.[37]

b. Code Section 2514

The term "general power of appointment" has the same meaning for gift tax purposes as it does under the estate tax. Code section 2514(b) provides that the exercise or release of a general power of appointment is treated as a transfer of property by the individual possessing the power for gift tax purposes. Treas. Reg. section 25.2514-1(b)(1) provides that a beneficiary who has the power to remove the trustee and appoint herself as trustee is treated as holding those powers of distribution that the trustee holds. If those powers include the power to make a distribution to the beneficiary, that power will be a general power of appointment.

2. The Role of Ascertainable Standards

If a donor's retained power over transferred property is exercisable in a fiduciary capacity and is limited by a fixed or ascertainable standard, the retained power will not be sufficient to cause the gift to be treated as incomplete.[38] Similarly, if a beneficiary holds a power exercisable in her favor that is limited by an ascertainable standard relating to her health, education, support or maintenance, the power will not be a general power of appointment.[39]

3. Authorities Dealing With Attribution of Powers

Although the principle behind Revenue Rulings 79-353 and 95-58, that an individual who has the power to remove a trustee and replace that trustee with another person who is related or subordinate to her should be treated as holding the powers that such trustee holds, seems equally applicable to the gift tax, the principle has not been consistently applied to the gift tax. In Letter Ruling 199909016,[40] for example, the Service concluded that a beneficiary's power to remove and replace a trustee with any other person (including a related or subordinate person) was not a general power of appointment even though such trustee had an unlimited power to make trust distributions to the beneficiary so long as "there is no express or implied understanding between the

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[37] Private Letter Ruling 9109027 (November 30, 1990).

[38] Treas. Reg. section 25.2511-2(g).

[39] Code section 2514(c)(1); Treas. Reg. section 25.2514-1(c)(2).

[40] Private Letter Ruling 199909016 (November 30, 1999).

successor trustee and the [beneficiary] that the trustee will exercise the discretionary powers other than independently of the [beneficiary] . . . ."[41]

4. Authorities Dealing With Reciprocal Powers

The principle behind the *Bischoff* case, that interrelated transfers to trusts over which reciprocal powers are retained should be uncrossed for purposes of determining whether a transferor has retained a power under Code sections 2036 or 2038 should be equally applicable in the gift tax context for purposes of determining whether a gift is complete. In Letter Ruling 8029001[42] the Service reached this conclusion.

C. Generation-Skipping Transfer Tax

The use of an FTC will have significance for GST tax purposes if the FTC causes the FTC Trust's grantor to be attributed powers that result in her gift to the FTC Trust being treated as incomplete, or that result in the inclusion of trust property in her gross estate. In addition, the use of an FTC will have significance under the GST tax rules if an attribution of powers to a beneficiary would result in the beneficiary being treated as holding a general power of appointment.

When these powers are attributed to the grantor, the imposition of the GST tax on the grantor could be postponed[43] or the estate tax inclusion period rule could be invoked, which would have the effect of postponing the date on which the grantor could allocate GST tax exemption to her transfers to the trust.[44]

When these powers are attributed to a beneficiary, the exercise or lapse of these powers (or the death of the beneficiary at a time when such powers are attributed to her) could cause a shift in the identity of the trust's transferor for GST tax purposes from

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[41] The fact that the beneficiary could replace a removed trustee with herself did not create a general power of appointment because under Florida law, the law applicable to the trust, a beneficiary who holds a distribution power exercisable in her favor under a trust instrument cannot exercise such power except to provide for her health, education, maintenance or support.

[42] Private Letter Ruling 8029001 (February 12, 1980).

[43] Code section 2612(c). A direct skip does not occur until the transferor makes a transfer subject to the estate tax or the gift tax.

[44] Code section 2642(f) prohibits the allocation of GST exemption to a transfer to a trust during any period in which, if the transferor died, the trust property would be included in her gross estate under any provision other than Code section 2635 (dealing with certain transfers made within three years of death).

the original transferor to the beneficiary.[45] Furthermore, attribution of these powers to a beneficiary assigned to the generation of the transferor's grandchildren (or more remote descendants), could cause the occurrence of a taxable distribution.[46]

In addition, if these powers are attributed to the grantor or to a beneficiary of a trust that is protected from GST tax because it was an irrevocable trust on September 25, 1995 or because sufficient GST tax exemption has been attributed to it, the Service could conclude that such attribution should be treated as a trust modification which could cause the trust to lose its protected status.[47]

D. Income Tax

1. Relevant Code Provisions

a. In General

Code section 671 treats the grantor, and in some cases, the beneficiary, of a trust as the owner of the trust's property for income tax purposes under a variety of circumstances described in Code sections 673 through 679. When a trust's property is treated as owned by another, it is generally referred to as a "grantor" trust. For purposes of this discussion, the relevant provisions are those that cause grantor trust status because the grantor or her spouse holds a distribution power, because a majority of the trustees who hold a distribution power are related or subordinate parties who are subservient to the wishes of the grantor, because the grantor has borrowed funds from the trust in a transaction approved by trustees who are related or subordinate trustees subservient to the wishes of the grantor or because a beneficiary has the unilateral right to withdraw property from the trust. Each of these provisions is discussed more fully below.

b. Code Section 674

Code section 674(a) provides that the grantor of a trust will be treated as the owner of any portion of the trust in respect of which the beneficial enjoyment of the corpus or the income of the trust is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. Code section 674(c) creates an important exception to this broad rule. It provides that Code section 674(a) will 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

[45] Treas. Reg. section 26.2652-1(a) Examples 3 and 5.

[46] Treas. Reg. section 26.2612-1(c)(1).

[47] Treas. Reg. section 26.2601-(b)(4).

grantor, and no more than one-half (1/2) of whom are related or subordinate parties[48] who are subservient to the wishes of the grantor (1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for or within a class of beneficiaries; or (2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). Because under Code section 672(e) a grantor is treated as holding powers held by her spouse, for the Code section 674(c) exception to apply, none of the trustees who hold the power of disposition can be the grantor's spouse.

c. Code Section 675(3)

Code section 675(3) treats a trust as a grantor trust if the grantor or the grantor's spouse has directly or indirectly borrowed trust funds and has not completely repaid the loan by the beginning of the year unless the loan was made with adequate interest and adequate security and was made by trustees who are not related or subordinate trustees subservient to the grantor, in the case of a loan to the grantor, or to the spouse, in the case of a loan to the spouse.

d. Code Section 678

Code section 678(a) provides, in general, that a person who is not the grantor of a trust will be treated as the "owner" of any portion of the trust with respect to which (1) she has a power exercisable solely by herself to take corpus or the income from the trust, or (2) she has previously partially released or otherwise modified such a power and, after the release or modification, retains such control as would subject a grantor of a trust to treatment as the owner of the trust. In order to prevent double grantor trust status from occurring, the Code section 678 rule does not apply to a power over income if the grantor is treated as the owner of the trust under Code sections 671 to 677.[49]

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[48] Code section 672(c)(2) defines "related or subordinate party" as any nonadverse party who is any one of the following: (1) the grantor's spouse, father, mother, descendant, or sibling; (2) an employee of the grantor; a corporation or any employee of a corporation in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control; and (3) a subordinate employee of a corporation in which the grantor is an executive.

[49] Code section 678(b); Treas. Reg. section 1.678(b)-1. Although the exception appears to apply to beneficiary powers over income and not over principal, on several occasions the Service has applied it to powers over both income and principal. *See* Private Letter Ruling 200603040 (October 24, 2005); Private Letter Ruling 9309023 (December 3, 1992); Private Letter Ruling 9141027 (July 11, 1991).

2. The Role of Ascertainable Standards

a. Under Code Section 674

A power held by trustees or others to distribute corpus to beneficiaries will not cause the trust to be treated as a grantor trust no matter who holds the power so long as its exercise is limited by a reasonably definite standard which is set forth in the instrument.[50]

The exception with respect to distributions of income is different. A power to distribute trust income limited by an ascertainable standard will cause the trust to be treated as a grantor trust unless the power is exercisable by trustees, none of whom is either the grantor or a spouse living with her.[51]

b. Under Code Section 678

A power held by an individual as trustee to use trust income or principal to discharge a support obligation of hers will not cause her to be treated as owner of the trust unless she actually exercise the power.[52] It is unclear whether a power to use trust property for the power holder's support, if limited by an ascertainable standard, would be subject to Code section 678.

3. Authorities Dealing With Attribution of Powers

Revenue Ruling 79-353's decision to treat an individual who had the power to replace trustees as if she held the power of the trustees was based on a Tax Court income tax decision that pre-dated the 1954 Code and the statutory grantor trust rules. In *Corning v. Commissioner*[53] the Tax Court concluded under the so-called *Clifford* rules[54] that the grantor of a trust retained sufficient power over a trust to justify taxing him on trust income when he retained the power to replace one corporate trustee with another. The trustee in *Corning* had the power to change the beneficial interests of the trust beneficiaries.

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[50] Code section 674(b)(5); Treas. Reg. section 1.674(b)-1(b)(5).

[51] Code section 674(d); Treas. Reg. section 1.674(b)-1(b)(7).

[52] Code section 678(c); Treas. Reg. section 1.678(c)-1. Curiously although this power has no income tax significance, it would cause the power holder to be treated as holding a general power of appointment under Code sections 2041 and 2514.

[53] *Corning v. Commissioner*, 24 T.C. 907 (1955) *aff'd per curiam* 239 F. 2d 646 (6th Cir. 1956).

[54] See *Helvering v. Clifford*, 309 U.S. 331 (1940).

The Treasury regulations issued under the grantor trust rules have effectively overruled the *Corning* decision. Treas. Reg. section 1.674(d)-2 provides that a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c).

4. Authorities Dealing With Reciprocal Powers

The principle behind the *Grace* and *Bischoff* cases, that interrelated transfers to trusts in or over which reciprocal interests or powers are retained should be uncrossed for purposes of determining whether a transferor has retained a power or interest under the grantor trust rules should be equally applicable in the income tax context for purposes of determining who the grantor of a trust is. In *Krause v. Commissioner*[55] and in Letter Ruling 8813039 the Service and the Tax Court so concluded.

IV. Proposed Rules

We propose that the Government issue guidance that describes the circumstances under which the owners of an FTC, its directors, committee members, employees, or other individuals who have the power to direct the exercise by an FTC of its trustee powers will be not be treated as holding the FTC's "Tax-Sensitive Powers." By Tax-Sensitive Power we mean any power over a trust that, if held directly by an individual, would cause trust property to be included in her gross estate, would cause a gift made by her to be incomplete for gift tax purposes or would cause her to be treated as the owner of the trust under the grantor trust rules of Subchapter J.

In general, the guidance should provide that if the by-laws[56] of an FTC prohibit a grantor or a beneficiary[57] of an FTC Trust from participating, directly or indirectly, in the exercise of a Tax-Sensitive Power, such power will not be attributed to the grantor or beneficiary. A similar provision should apply to individuals whose lives are insured under life insurance policies owned by the trust and to individuals whose possession of powers would result in the treatment of the trust as a grantor trust under Code section 674 or 675. Such individuals could, however, participate without any

[55] *Krause v. Commissioner,* 57 T.C. 890 (1972), *aff'd* 497 F.2d 1109 (6th cir. 1974).

[56] Although we refer to an FTC's governing document as its "by-laws," we recognize that families establishing FTCs might wish to select entities other than corporations, such as limited liability companies. If a different form of entity is selected, such entity might be governed by instruments other than by-laws.

[57] For this purpose, we include within the definition of "*beneficiary*" any person whose support or other obligations can be satisfied by a distribution of trust property.

adverse tax consequences in many other types of decisions made by the FTC, such as investment[58] and other administrative decisions.

These proposed general governance rules are similar to the existing income and transfer tax rules that provide boundaries within which individual and institutional trustees have operated for some time. If the Government incorporates these proposed governance rules into its guidance, it will go a long way towards codifying equal tax treatment for trusts, grantors and beneficiaries, regardless of the type of trustee in control.

Even with these general governance rules in place, however, one more question must be faced. Should the powers exercisable by the FTC nevertheless be attributed to the family members who own the FTC because of their inherent power, as owners, to change the governance structure by changing the entity's by-laws or other governing instrument or to otherwise exert influence over the operations of the FTC? For example, if an FTC is wholly owned by the grantor of a trust of which it is serving as trustee, any provision in its organizational documents prohibiting the grantor from participating in the exercise of Tax-Sensitive Powers could easily be changed by the grantor as its sole shareholder.

We believe that, in order to prevent circumvention of governing instrument restrictions by the owners of an FTC, who will generally always have the power to change the by-laws of their entities, the trust agreement under which the FTC is serving or the instrument appointing it as trustee should prohibit the FTC from exercising any Tax-Sensitive Powers if the FTC's by-laws dealing with the exercise of Tax-Sensitive Powers by a grantor or beneficiary are changed.

To the extent that the proposed general governance rules, and the further inability of an FTC to exercise Tax-Sensitive Powers without those general governance rules being in place, are for any reason deemed insufficient to provide an appropriate degree of separation between an FTC and a grantor or beneficiary who holds a significant ownership interest in the FTC, the guidance should provide an objective test for determining an appropriate level of ownership.

A. Types of "Tax-Sensitive Powers"

After providing a general definition of "Tax-Sensitive Powers," the guidance should provide examples of such powers. This list should include the following powers:

[58] *Cf.*, *U.S. v. Byrum,* 408 U.S. 125 (1972).

1. Powers Held by the Grantor

When held by the grantor of a trust, the following powers could result in the assets of the trust being included in the grantor's gross estate pursuant to sections 2036 through 2038 of the Code:

- The power to determine the timing of distributions of trust assets or the identity of the recipient of such distributions, unless such powers are limited by an ascertainable standard.

- The power to vote the shares of a closely-held corporation.

When held by a grantor, the power to make decisions with respect to life insurance policies on the grantor's life held in the trust could result in the inclusion of trust assets in the gross estate under Code section 2042.

When held by the grantor the power to participate in decisions to make discretionary distributions of trust income and principal without the consent of an adverse party could result in treatment of the trust as a grantor trust pursuant to Code section 674(a).

The powers described in this section are collectively referred to as "Grantor Tax-Sensitive Powers."

2. Powers Held by Beneficiaries

When held by a beneficiary of a trust, the following powers could result in the beneficiary being treated as having a general power of appointment over trust assets for purposes of section 2041 and section 2514 of the Code or being treated as having made a taxable gift when such power is exercised:

- The power to direct the payment of trust assets to the beneficiary, except when limited by an ascertainable standard relating to the beneficiary's health, education, maintenance and support.

- The power to participate in decisions to distribute trust assets to other beneficiaries, except when limited by an ascertainable standard, if such distributions decrease the beneficiary's interest in the trust.

- The power to direct the payment of trust assets so as to discharge the beneficiary's legal obligations (including support obligations to others).

If the beneficiary of a trust has the unilateral power to make distributions of trust income and principal to herself, the trust may be treated as owned by the

beneficiary pursuant to Code section 678. This type of Tax-Sensitive Power in the hands of such beneficiary could result in unintended income tax liability for the beneficiary.

The powers described in this section are collectively referred to as "Beneficiary Tax-Sensitive Powers."

3. Powers Held by Others

When held by a person who is related or subordinate to the grantor, discretionary distribution powers may result in grantor trust status for a trust under Code section 674 if a majority of the trustees holding the powers are related or subordinate to the grantor and subservient to the grantor's wishes. Similarly, if such persons can participate in decisions to lend funds to the grantor and such a power is exercised, grantor trust status may result under Code section 675(3).

The powers described in this section are collectively referred to as "Related Party Tax-Sensitive Powers."

4. Committees

The guidance should require that an FTC's by-laws establish one or more committees whose purpose would be to control all Tax-Sensitive Powers to be exercised by the FTC. This will make it possible for the FTC to isolate the Tax-Sensitive Powers and prevent the grantor and the beneficiaries from participating in decisions regarding such powers. The by-laws governing the administration of these committees should prohibit the grantor of a trust from participating in any decisions by a committee that are Grantor Tax-Sensitive Powers, should prohibit a beneficiary from participating in any decisions by a committee that are Beneficiary Sensitive Powers, and should prohibit any person who is a related or subordinate party to the grantor from participating in discretionary distributions decisions unless there are an equal number of committee members who are not related or subordinate parties.

B. <u>Indirect Exercise of Tax-Sensitive Powers</u>

The general rule described above prohibiting direct participation by grantors and beneficiaries in the exercise of Tax-Sensitive Powers over an FTC Trust should be expanded to cover indirect participation in the exercise of such powers. Grantors and beneficiaries can indirectly participate in the exercise of such powers if they have unchecked powers to participate in the removal and replacement of members of the FTC's committees that hold Tax-Sensitive Powers or to amend the FTC's by-laws.

As discussed above, the Service has taken the position, in Revenue Ruling 95-58, that a grantor with the unqualified power to remove a trustee who had unlimited discretion over trust distributions, and to appoint a successor trustee will not be deemed to hold such discretionary distribution power if the replacement trustee cannot be related or subordinate to the grantor, within the meaning of Code section 672(c). Estate planning attorneys often avoid the application of Revenue Ruling 95-58 by including in their trust

instruments provisions that prevent the replacement trustees selected by a trust's grantor and/or beneficiaries from exercising Tax-Sensitive Powers if such replacement trustees are related or subordinate to such grantor and/or beneficiaries.

The Service could rationally conclude that the same principle should apply to the power to remove or replace members of an FTC's committees that hold Tax-Sensitive Powers. If a grantor or a beneficiary is permitted to participate in decisions to remove members of such a committee and appoint persons who are related or subordinate to her, she could be deemed to participate indirectly in the exercise of the Tax-Sensitive Powers in which the removed member was permitted to participate. If the FTC held Grantor or Beneficiary Tax-Sensitive Powers, this would result in the assets being included in the grantor's gross estate under Code section 2036 or section 2038 or the beneficiary's gross estate under Code section 2041, even though the grantor or the beneficiary was prohibited from direct participation in all decisions by the FTC regarding the exercise of all other Tax-Sensitive Powers.

In order to avoid confusion on this issue, the guidance should require the FTC's by-laws to provide that, if a grantor or a beneficiary participates in any decision to remove and replace any member of a committee of an FTC that holds Tax-Sensitive Powers, the replacement for the removed member must be a person who is not related or subordinate to the grantor or beneficiary within the meaning of Code section 672(c).

C. Deemed Exercise of Tax-Sensitive Powers Through Reciprocal Arrangements

As discussed above, the Service has taken the position, and that position has been upheld by the Tax Court, that when one individual, A, has a dispositive power exercisable over a trust created by another individual, B, and B has a similar power over a trust created by A, A will be deemed to hold the power actually held by B, and vice versa.[59]

In several of its private letter rulings regarding FTCs,[60] the Service has been concerned with the possibility of abuse in the FTC context through similar reciprocal arrangements. If A can participate in decisions regarding Tax-Sensitive Powers (or the removal and subsequent appointment of related committee members or the amendment of the FTC's by-laws) with respect to B and B's family, and B can participate in such decisions with respect to A and A's family, it is possible for A and B to work together to ensure that each follows the wishes of the other regarding decisions each could not otherwise make directly. This would give A and B effective control over, for

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[59] *See Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977).

[60] *See, e.g.,* Private Letter Ruling 200548035 (August 2, 2005); Private Letter Ruling 200345006 (July 3, 2003).

example, distributions to or for the benefit of themselves, and serve as an end-run around all of the limitations previously discussed in this report.

In order to prevent abuse through such reciprocal arrangements, the guidance should set forth the following rules. First, an FTC's by-laws should prevent a grantor of a trust who serves on a committee of the FTC that holds Grantor Tax-Sensitive Powers from participating in the exercise of Grantor Tax-Sensitive Powers over not only the trust of which she is a grantor, but also over any trusts as to which any other member of the committee is the grantor. Second, an FTC's by-laws should provide that no individual who is a discretionary beneficiary of a trust may participate in a decision regarding the exercise of Beneficiary Tax-Sensitive Powers over the trust or over any other trust a grantor or beneficiary of which is a member of a committee of the FTC that holds Beneficiary Tax-Sensitive Powers.

D. Residual Concerns Regarding Ownership

As mentioned above, to eliminate any issues that might be associated with the ability of a grantor or beneficiary to participate in a decision to alter the by-laws of an FTC, the relevant trust agreement or instrument appointing the FTC should prohibit an FTC whose by-laws do not contain the foregoing limitations from exercising Tax-Sensitive Powers.

To the extent that the foregoing governance rules are for any reason deemed insufficient to provide an appropriate degree of separation between an FTC and a grantor or beneficiary who holds a significant ownership interest in the FTC, the guidance should provide an objective test for determining an appropriate level of ownership. For example, based upon the definition of a "controlled entity" in Treas. Reg. section 25.2701-2(b)(5), the guidance could provide that the powers of an FTC subject to the governance rules described above would in all circumstances not be attributed to a grantor or beneficiary who did not "control" the FTC by (i) in the case of a corporation, holding at least 50 percent of the total voting power in the corporation, (ii) in the case of any partnership, holding at least 50 percent of either the capital interests or the profits interests in the partnership, and (iii) in the case of a limited partnership, holding any equity interest as a general partner.[61]

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[61] Treas. Reg. § 25.2701-2(b)(5) does not provide a rule for determining the control of a limited liability company. For most tax purposes, limited liability companies are treated as partnerships rather than as corporations. From the standpoint of determining control, however, the partnership model, which generally treats a general partner as being in control of a limited partnership, will not always be appropriate. In the case, for example, of a limited liability company whose manager is elected by members holding a majority of the profits interest, actual control is likely to rest in the members rather than in the manager. The reverse may be true when the manager cannot be removed by the members or can be removed for cause. We recommend that the Government update Treas. Reg.

We further note that, if some form of ownership test is determined to be required, careful consideration will need to be given to the application of ownership attribution rules. As a general matter, given the basic underlying concern regarding an owner's or beneficiary's ability to exercise control over an FTC, we believe that it would be appropriate to attribute ownership through corporations and partnerships that are, in turn, "controlled" by the grantor or beneficiary. It might also be appropriate to attribute ownership by a grantor's or beneficiary's spouse to the grantor or beneficiary. At the same time, in light of the other governance safeguards mentioned above, and the degree of control that grantors and beneficiaries may otherwise appropriately exercise with respect to trust structures under current law, we do not believe it would be appropriate to include more extensive ownership attribution rules, such as the family and trust attribution rules applicable under other provisions of the Code. Indeed, the application of such attribution rules would likely result in the treatment of most FTC's as controlled by the grantors and beneficiaries of the trusts of which they are trustees.

V. Summary of Proposals

In summary, we suggest that the following definitions and rules be incorporated into the guidance to be issued by the Government:

- The by-laws of the FTC should prohibit (1) the grantor of a trust of which it is serving as trustee from participating in any Grantor Tax-Sensitive Powers, (2) any beneficiary of such a trust from participating in the exercise of a Beneficiary Tax-Sensitive Power and (3) any person who is a related or subordinate party to the grantor of such trust from participating in any decisions by any committee regarding the exercise of a Related Party Tax-Sensitive Power unless there are an equal number of members of such committee who are not related or subordinate parties as to the grantor.

- The by-laws of the FTC should provide that, if a grantor or a beneficiary of an FTC Trust participates in the removal and replacement of a member of a committee that holds Tax-Sensitive Powers, the replacement member must not be related or subordinate to such participant.

- To avoid reciprocal arrangements, the FTC's by-laws should prohibit grantors and beneficiaries from participating in committee decisions exercising Tax-Sensitive Powers over any trusts as to which any other member of such committee is the grantor or a beneficiary.

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§ 25.2701-2(b)(5) to address limited liability companies as part of any FTC guidance project.

- To eliminate any issues that might be associated with the ability to alter the by-laws of an FTC, the relevant trust instrument or instrument appointing the FTC should provide that the FTC will cease to serve as trustee of the FTC Trust or cease to possess any "Tax-Sensitive Powers" over the FTC Trust if the safeguards discussed in the three previous points are eliminated via by-law amendment. Alternatively, the instrument appointing the FTC as trustee should contain this limitation.

- If deemed necessary, the guidance could also include objective ownership tests.