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ARE YOUR POWER HOLDERS INDEPENDENT? DISSECTING INTERNAL REVENUE CODE SECTION 672

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In trust planning and administration, the presence of an independent fiduciary presents a wide variety of opportunities for flexibility for settlors and beneficiaries. For most clients, flexible trust administration and creditor protection are of primary importance. These results can be obtained without running afoul of undesirable transfer and income tax consequences if carefully planned for with the client during the initial trust design discussions.

The flexibility that we seek in the current environment derives from one or more of the following: (i) the driving (we might say frenzied) motivation for many clients, even the "merely wealthy," to create and fund irrevocable trusts based on a perception that the estate and gift tax exemption amounts may be reduced sometime in the future, (ii) the goal of being able to adapt those irrevocable trusts in accordance with tax law changes that may come, (iii) the desire for adaptation of dynasty trusts to fit the circumstances of the beneficiaries as they evolve, now that more trusts are not subject to the Rule Against Perpetuities and will last for generations, and/or (iv) the need for independent decisionmakers to protect the property held in spendthrift trusts, self-settled, or otherwise.

A fiduciary with the power to amend the trust, to authorize distributions driven by the family's overall tax and asset planning goals, to implement a decanting distribution,[1] or to grant or modify beneficiaries' powers of appointment are just a few purposes that can prove valuable to the trust beneficiaries as circumstances change with the passage of time. The strategic importance of an independent fiduciary has been discussed regularly from a variety of perspectives in this publication and elsewhere.[2] The fundamental question for many clients is often a difficult one to answer in practice: who is appropriate to serve as fiduciary for their intended beneficiaries, and how should the succession work?

We have found that most clients find great value in building flexibility into the trustee succession and fiduciary structure, and almost every client wants to retain as much control over who administers the trust as possible while avoiding undesirable transfer and income tax consequences. Nearly as many want to enable their surviving spouse, children, or others to do the same once the client has passed away to maintain effective mechanisms to oversee the trust administration. If the determination is made that an independent fiduciary is prudent, the drafting to require that independence is the easy part; filling the role appropriately can be far more challenging.

Often an institutional trustee is a perfectly acceptable solution to this issue, and barring unusual circumstances, a financial institution would be independent for all purposes. However, plenty of clients do not want to limit eligibility to financial institutions, or their personal circumstances or assets or intended role of the independent trustee cause an institutional fiduciary to not be the best choice. In these situations, clients consider individuals in their lives—friends, business associates, professional advisors, and relatives who are not intended to be trust beneficiaries. It is important that we are equipped to assist clients in working through the independence analysis as it applies to these individuals.

CONTEXT/BACKGROUND

ESTATE TAX INCLUSION

The general rule is that if a settlor retains powers under a trust instrument to control beneficial enjoyment beyond an ascertainable standard, the trust property will be included in his or her gross estate.[3] Similarly, when a beneficiary serves as trustee of a trust for his or her own benefit and his or her distribution powers are not limited to an ascertainable standard, the beneficiary is deemed to hold a general power of appointment over the property, causing estate tax inclusion.[4] We note that the Ohio Trust Code helps drafters avoid unintentional estate tax inclusion by providing default limitations to a trustee-beneficiary's distribution discretions.[5]

The question raised by the settlor then becomes: if I cannot make these decisions, is there a way to keep some measure of control over who can? Removal of a trustee and designation of the next successor trustee are the obvious levers for a settlor to retain or grant to a beneficiary. Unlimited removal and designation powers are treated as though the settlor or beneficiary (referred to in this article as an "interested party") held the trustee's powers.[6] While subject to Internal Revenue Service ("IRS") challenge for some time, it is now established that a settlor or beneficiary can have the power to remove a trustee without cause and designate a successor trustee, all without creating estate tax inclusion, so long as the successor trustee designated is not a related or subordinate party who is subservient to the interested party holding these powers within the meaning of Internal Revenue Code Section 672 (referred to in this article as "independent").[7]

There is an important and non-intuitive distinction worth noting: for estate tax inclusion purposes, if the trust instrument is created including a list of individual successor trustees by name, those successors themselves do not need to be independent of the interested parties, so long as those successors do not actually act as the interested party's agent. But if the interested party controls the levers of the trustee succession, the independence requirement attaches.[8]

Notably, the IRS has stated that it will not issue private letter rulings on whether the use of a private trust company, owned in whole or in part by members of the family of the settlor or beneficiary, will cause the trust to be included in the gross estate of the settlor under Code Sections 2036 and 2038 or of the beneficiary under Code Section 2041.[9]

INCOME TAX ATTRIBUTION

The transfer tax efficiency of grantor trusts, where the settlor is treated as the owner of the trust property for federal income tax purposes only, is well documented. But transfer tax efficiency is not always the goal. Similarly, there are scenarios that could lead to a trust beneficiary being treated as the owner of part or all of the trust property for income tax purposes, and that may not always be the right result for the beneficiary in question.

The presence of an independent trustee can avoid unwanted grantor trust treatment. Unless the trustee is independent, a trustee's power to distribute income or principal among a group of beneficiaries, where no adverse party (defined below) participates in the distribution decision and the trustee's discretion is not limited to an ascertainable standard, causes grantor trust treatment.[10] The income tax treatment therefore is somewhat more transient: this context is driven by who the trustee is at any given time, not by who the trustee might be in the future or by the scope of control the settlor or the beneficiary possesses. The corollary to this is that a trustee could be independent at the time the trusteeship is accepted and then become non-independent, for example by accepting a position as the interested party's employee, so an element of monitoring is called for.[11]

For income tax planning purposes, it would also be wise to provide for at least the possibility of an independent fiduciary for any trust where the trustee's distribution discretions are not subject to an ascertainable standard. Even where grantor trust treatment is advisable at the outset but might later become undesirable, it may be prudent to carve out the ability for an independent trustee to be designated and serve for the duration of the trust. This allows for grantor trust treatment to be imposed under a different provision of subchapter J, and then released when desired, or vice versa.[12] When structured properly, the grantor trust treatment ends at the time of release without the identity of the trustee compromising the intended result.

EVALUATING AND MONITORING INDEPENDENCE

All roads, therefore, lead through Code Section 672. Following through the statute, it must first be determined if the power holder is an adverse party,[13] who is defined as a person who has a substantial current or future beneficial interest in the trust that would be adversely affected by his or her exercise or nonexercise of the power granted to him or her.[14] The holder of a general power of appointment is specifically contemplated to be adverse to the current beneficiaries.[15] Depending on the facts and circumstances, a limited beneficial interest may not make the beneficiary adverse but an interest could be adverse if contingent.[16] For example, a person who is entitled to receive distributions only from the trust income generally would not be not adverse as to powers affecting trust principal, nor would a remainder beneficiary ordinarily be adverse as to a current exercise of a power affecting income.[17] A fiduciary as such is not adverse as to distribution decisions simply because his or her fee derives from the value of the trust property and the value base would be reduced by a contemplated distribution.[18]

Overall, there is little guidance regarding what constitutes a "substantial" beneficial interest. We can speculate that the IRS actuarial tables are pertinent in the context of a survivorship contingency[19] and that multiple current discretionary beneficiaries are adverse to one another by default when there is no cap as to the amount of trust property that could be distributed to him or her.[20] In light of this open question, great care should be taken in evaluating a proposed fiduciary for independence if he or she has any sort of beneficial interest in the trust.

The next step is to determine whether the proposed trustee is a related or subordinate party as to the interested party. A related or subordinate party is a nonadverse party who is any of the following:[21] (i) the interested party's spouse, if living with the interested party; (ii) the interested party's parent, sibling (including half-siblings), or descendant; (iii) an employee of the interested party; (iv) a corporation or any employee of a corporation in which the stock holdings of the interested party and the trust are significant with regard to voting control (there is no further guidance on what this means); or (v) a subordinate employee of a corporation in which the interested party is an executive. A related or subordinated party is presumed to be subservient to the interested party, although the presumption can be rebutted, subject to a preponderance of the evidence standard.[22]

In short, to trigger Code Section 672 and all of its transfer and income tax consequences, a trustee must be (i) nonadverse, (ii) related or subordinate, *and* (iii) subservient. Subservience, without more, will not cause problematic tax implications, so long as the subservience is not so complete that it constitutes actual control by the interested party or his or her agents.[23] These could be the interested party's lawyer, professional advisor, or business associate, presuming there is not an employment relationship. Similarly, it is entirely possible that a client's sibling might be an acceptable candidate to serve as an independent trustee based on the sibling's professional and/or personal qualifications, so long as the interested party and his or her advisory team evaluate the subservience element rigorously within the context of the interested party's relationship with the sibling and with regard to the sibling's plan for administering the trust pursuant to his or her overriding legal obligations to the trust beneficiaries.

CO-TRUSTEES, TRUST DIRECTORS, AND BIFURCATED AUTHORITY

In our opinion, flexible planning opportunities in this area multiply when we consider allocating different types of fiduciary duties among different actors, by providing in the trust instrument that sensitive powers that trigger our estate and income tax concerns are exercisable only by an independent fiduciary, and others (such as distributions subject to an ascertainable standard and investment management decisions) can be exercised by any person serving as trustee.[24] In these cases we rely on the general maxim that the legal rights, interests, and duties of the various actors derive from local law.[25] It has been held that a settlor who reserved the power to add a co-trustee, without explicitly excluding himself from eligibility, nevertheless did not cause estate tax inclusion based on state law trust interpretation conventions that allowed the Court to conclude that the settlor truly intended to exclude himself.[26] The Ohio Trust Code, like that of many other states, is clear that trustees may be subject to direction by third parties, and when properly applied, all fiduciary power, discretion, and liability so granted lies with the directing third party, shielding the trustee serving subject to that direction authority.[27]

On that basis, we are confident that a trust instrument can effectively bifurcate the trustee's powers between a fiduciary who is independent and one who need not be, and so long as that differentiation is drafted and implemented properly, it will carry federal transfer and income tax effects. The independent fiduciary should hold tax- and creditor-sensitive discretions and any other powers the settlor wishes. A non-independent fiduciary, meanwhile, could have authority pertaining to day-to-day trust administration, including investment management authority and the power to make distributions within an ascertainable standard. Operationally, the trust could require both an independent and non-independent fiduciary at all times, or it could provide for an independent fiduciary to serve only as needed or when called upon. These limitations could be further tailored in accordance with client's estate plan goals for the overall administration of the trust.

The evaluation of independence for these co-fiduciaries follows the analysis outlined above for trustees. As a practical matter, the restrictions for independence may be easier for a client to tolerate when the role is more limited and their spouse or children can retain a significant amount of operational control over the day-to-day operation of the trust.

CONCLUSION

Practitioners must take care when evaluating the need for independent fiduciaries and the evaluation of candidates for independence, as this drives a variety of transfer and income tax consequences for settlors and/or beneficiaries. Practitioners would also be wise to become well acquainted with Code Section 672 and its complexities as well as local law to construct a plan to grant decision-making authority to the appropriate person(s) without generating undesirable tax consequences for the settlor or the beneficiaries. Bifurcating fiduciary duties between independent and non-independent parties can also be a powerful tool in this context. Finally, monitoring ongoing compliance is essential, as a person's relationship to a settlor or a beneficiary may change with time, and this could inadvertently reintroduce transfer and income tax consequences thought to be avoided.

ENDNOTES:

[1]Particularly within the more robust "absolute power" standard authorized pursuant to R.C. 5808.18(A).

[2]*See*, *e.g.*, Saccogna, *Trustee Succession and the Use of Multiple Fiduciaries: Critical Elements of the Estate Planning Process*, 27 PLJO 137, 27 No. 3 Ohio Prob. L.J. NL 16 (Jan./Feb. 2017); Ross, *Drafting Grantor Trust Powers with an Exit Strategy*, 27 Probate & Property 34 (Mar./Apr. 2013); Harriman and Simon, *2020 Year-End Estate Planning: Planning in a Time of Uncertainty*, wealthmanagement.com (Dec. 2020).

[3]I.R.C. § 2036(a)(2); *Jennings v. Smith*, 161 F.2d 74 (C.C.A. 2d Cir. 1947).

[4]Treas. Reg. § 20.2041-1(b)(1).

[5]R.C. § 5808.14(B).

[6]Treas. Reg. §§ 20.2036-1(b)(3), 20.2041-1(b)(1).

[7]Rev. Rul. 95-58 (as to powers retained by settlor); *see*, *e.g.*, *First Nat. Bank of Denver v. U.S.*, 648 F.2d 1286 (10th Cir. 1981) (as to powers granted to beneficiary). While not made explicit, this line of authority also gives many practitioners comfort in drafting trusts that permit a settlor or beneficiary to remove and replace independent trustees repeatedly over time, where at one time, that ongoing ability was thought to constitute sufficient control as to risk estate tax inclusion. *See generally* Tax Mgmt. Tax Prac. Ser. (BNA) *Estates & Trusts- Income, Estates and Gift Taxation* at ¶ 6230.07.

[8]For more on this discrepancy, *see* 820-4th Tax Mgmt. (BNA) Estates, Gifts, and Trusts, *Administrative Powers Over Trusts*, at V.B.1.

[9]Rev. Proc. 2021-3.

[10]I.R.C. § 674(c), (d). The impact of a foreign settlor or beneficiary on the application of the grantor trust rules is outside the scope of this article.

[11]In the estate tax context, we speculate that an individual who is independent when designated as trustee, and later becomes not independent, arguably should not create estate tax inclusion, but care should be taken if this scenario arises.

[12]While outside the scope of the present discussion, extreme care should be taken if a client wishes to consider "toggling" grantor trust status. *See* IRS Notice 2007-73.

[13]I.R.C. § 672(a).

[14]I.R.C. § 672(a); Treas. Reg. § 1.672(a)-1.

[15]Treas. Reg. § 1.672(a)-1.

[16]Treas. Reg. § 1.672(a)-1.

[17]Treas. Reg. § 1.672(a)-1.?

[18]Treas. Reg. § 1.672(a)-1.

[19]*Chase Nat. Bank v. C.I.R.*, 225 F.2d 621 (8th Cir. 1955).

[20]*Phipps v. Commissioner of Internal Revenue*, 137 F.2d 141 (C.C.A. 2d Cir. 1943).

[21]I.R.C. § 672(c); Rev. Rul. 58-19 (as to half-siblings). No attribution rules apply.

[22]I.R.C. § 672(c); Treas. Reg. § 1.672(c)-1. Commentary points to legislative history suggesting that effective rebuttal would have to show that the trustee was not acting "in accordance with the grantor's wishes." 819-2nd Tax Mgmt. (BNA) Estates, Gifts, and Trusts, *Grantor Trusts (Sections 671-679)* at IV.A.2.

[23]*See*, *e.g.*, *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238 (trustees' delegation of nearly all administrative duties did not equate to subservience because of trustees' overriding fiduciary duties to trust beneficiaries); *S.E.C. v. Wyly*, 56 F. Supp. 3d 394 (S.D. N.Y. 2014) (finding that trustees' following settlor's directions, through trust protectors holding power of removal and replacement of trustees, constituted subservience).

[24]With regard to grantor trust treatment in the context of distribution decisions by multiple fiduciaries, we note that I.R.C. § 674(c) specifically contemplates non-independent decisionmakers participating in group distribution decisions, providing that grantor trust treatment will not result so long as at least one-half of the acting fiduciaries are independent. In our practice, we prefer to allocate sensitive decisions to independent fiduciaries entirely, but this

particular rule is more forgiving.

[25]*Peoples Trust Co. of Bergen County v. U.S.*, 412 F.2d 1156 (3d Cir. 1969).

[26]*Durst v. U.S.*, 559 F.2d 910 (3d Cir. 1977), recommendation regarding acquiescence, AOD-1976-256, 1976 WL 39459 (I.R.S. AOD 1976).

[27]R.C. 5815.25(c). Nearly every state has implemented directed trusts by statute with many variations among them.

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