Resurrection of "De Facto Trustee" Concept—*Securities Exchange Commission v. Wyly,* 2014 WL 4792229 (S.D.N.Y. September 25, 2014)

Non-Tax Case Treating Effective Control of Trust by Settlors As Causing "Independent Trustee" Exception to Grantor Trust Rules Not to Apply; Possible Broader Implications

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Brief Synopsis

Long ago, the IRS has tried to make a "de facto trustee" argument, treating a settlor as holding the powers of the trustee if the settlor exercised persuasive control over the trustee. Courts (including a U.S. Supreme Court case) rejected that "de facto trustee" argument. *SEC v. Wyly* raises concerns for estate planning advisors by treating settlors as the de facto trustee of a trust (albeit in an extreme fact situation in which the trustees always followed the settlors' directions for over a decade).

SEC v. Wyly (Judge Scheindlin) is the determination of the "disgorgement" remedy in a securities law violation case by the billionaire Wyly brothers. The court based the amount of disgorgement largely on the amount of federal income taxes that the defendants avoided from the use of offshore trusts, after finding that the trusts were grantor trusts and that the defendants should have paid federal income taxes on all of the income from those trusts. The court determined in particular that the "independent trustee" exception in §674(c) did not apply even though the trustees were various Isle of Man professional management companies. Three close associates of the Wylys (the family attorney, the family office CFO, and the CFO of one of the Wyly entities) were trust protectors who had the power to replace the trustees. Throughout the trust administration, the Wylys expressed their requests to the trust protectors, who relayed them to the trustees, who always complied.

The SEC (not the IRS—this is not a tax case) argued that independent trustees *always* followed the wishes of the grantors regarding investment decisions (including some very questionable investments with close relatives, unsecured loans to relatives, and investments in real estate, artwork, jewelry, collectibles, furnishings used by family members). The court noted that the Tax Court had previously rejected this theory in *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238, which held that whether the independent trustee exception under §674(c) applies, turns on "a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes." (The Tax Court's rejection of the theory was grounded in the U.S. Supreme Court's decision in *U.S. v. Byrum,* an analogous determination that retained powers to cause gross estate inclusion under §2036(a)(2) must be "ascertainable and legally enforceable powers.") The court disagreed with that long-standing analysis, pointing to the substance over form doctrine, reasoning that the trustee always followed the grantors' directions, and observing that "tax law deals in economic realities, not legal abstractions."

Basic Facts

Billionaire bothers Charles Wyly and Sam Wyly transferred stock options in four publicly traded corporations to companies owned by offshore trusts (with various financial management firms from the Isle of Man as trustees) in exchange for deferred private annuities "in a tax-free kind of transaction." This raised securities law disclosure issues as to whether the Wylys had to disclose the ownership of and trading in those companies. The tax advisors advised that public SEC filings might lead the IRS to discover and investigate the tax effects of the transfers. If the Wylys controlled the stock in the offshore trusts, that could negate the desired tax-deferred nature of the transfers to the offshore trusts and result in the U.S. income taxation of those trusts. The SEC filings might be used by the IRS as evidence that the Wylys had some degree of control over the stock. As a result, the holdings and trades in the companies owned by the offshore trusts were not reported in SEC filings. Over the next ten years, the trusts and their

subsidiary companies exercised the options, separately acquired options and stock in the four companies, and sold the shares, without filing any disclosures.

After a six-week trial in the spring of 2014, a "jury found that the Wylys *always* had beneficial ownership over the options, warrants, and securities held by the [offshore] trusts" and found the Wylys liable on all counts alleged by the SEC. The court in August held a one-week bench trial to determine appropriate remedies. The SEC sought disgorgement of about $620 million. The court discussed that it had very broad discretion to determine the measure of and amount of appropriate disgorgement and decided to base the disgorgement amount primarily on the amount of income taxes that the Wylys avoided improperly by the offshore trust structure. This turned on whether the trusts were grantor trusts; if so, the Wylys should have been reporting the income from the trusts on their U.S. income tax returns.

There were two sets of trusts.

- One set, referred to as the "Bulldog Trusts," were created by the Wylys as settlors for the benefit of their wives and children and several charitable organizations, but no U.S. beneficiary could receive a distribution until two years after the settlor's death. Named trust protectors could add to or substitute the charitable organizations. (The delay in distributions until after the settlors' deaths was apparently in an attempt to avoid the treatment of the foreign trusts as grantor trusts under §679, which treats any foreign trust created by a U.S. person as a grantor trust to the extent that distributions could be made to U.S. beneficiaries; the delay argument to avoid §679 was removed in a 2010 amendment to §679.)
- The other set, referred to as the "Bessie Trusts," did not have the distribution delay provision. They were nominally funded by foreign individuals; for example the foreign settlor of some of these trusts contributed $1 and a note for $24,999 but the note was immediately forgiven. If a foreign person created the trust and the Wylys merely transferred assets to the trust for full consideration, §679 would not apply.

The trustees of all of the trusts were professional management companies located in the Isle of Man. In addition, there were three trust protectors of each trust, the Wylys' family attorney, the family office CFO, and the CFO of a Wyly-related entity. The trust protectors had the power to add or substitute charitable beneficiaries of the Bulldog Trusts and had the power to remove and replace trustees of all of the trusts.

After the trusts were created, the Wylys told the trust protectors what transactions they wanted the trusts to enter, the trust protectors discussed those recommendations with the trustees, and the trustees always followed those directions. There was no evidence of a single investment that ever originated with the independent trustees or that the trustees ever rejected *any* Wyly recommendation. There were several situations in which the Wylys directed the sales of certain assets, bypassing the trustees entirely.

ANALYSIS

1. *Substance Over Form.* The analysis as to whether the trusts were grantor trusts started with a review of the substance over form doctrine. As applied to trusts, the substance over form doctrine looks to, among other things, "whether the taxpayer's relationship to the transferred property differed materially before and after the trust's creation," and "whether the taxpayer respected restrictions imposed on the trust's operation as set forth in the trust

documents or by the law of trusts." The court concluded that the substance over form doctrine applies to the grantor trust provisions:

> The substance over form doctrine is applicable to the entire body of federal tax law, including the grantor trust provisions. Thus, even when a trust is not a "sham" – that is, where it has legitimate economic substance – it may still be taxable as a grantor trust because it satisfies an exception within the grantor trust provisions only in form. [citations omitted]

2. *Bessie Trusts Were Grantor Trusts.* The opinion is very unclear as to its reasons for finding that the Bessie Trusts were grantor trusts. The court did find that the purported foreign grantors made no gratuitous contributions to the trusts. They were merely nominal settlors. The court strongly doubted that they ever actually transferred even the very nominal $1 or $100 stated in the agreements. Therefore, the Wylys were the real settlors of the trusts. The court's entire analysis about why the Bessie Trusts were grantors is two sentences long. The second sentence states: "Because I conclude that the purported foreign grantors made no gratuitous contributions, 'the trusts at issue [are] clearly grantor trusts taxable to the domestic grantors.' [citing "Def. Resp. to U.S."—perhaps an admission by the defendants]. That would seem to result in a conclusion that §679 applied, but the heading of the section is titled "…Taxable Under Section 674", and footnote 218 says that because the court concludes that the Bessie Trusts (and Bulldog Trusts) "were grantor trusts under Section 674, I need not reach the issue of whether they were also grantor trusts under Section 679."
3. *Bulldog Trusts Were Grantor Trusts; §674 Analysis*.

    a. *Section 674 Statutory Provisions.* The general rule is that a trust is a grantor trust if the beneficial enjoyment is subject to a power of disposition exercisable by the grantor or a nonadverse party, without the approval of any adverse party. Therefore, the general rule is that most trusts are grantor trusts. There are various exceptions under §674(b)-(d).

    Section 674(c) is the independent trustee exception. A trust is not a grantor trust if the power of disposition over the trust is "solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor."

    The court reasons that the only open question regarding the application of the independent trustee exception under §674(c) is whether the independent trustees were able to exercise their powers "solely" or "without the approval or consent of any other person."

    b. *Rejection of De Facto Trustee Argument and Estate of Goodwyn v. Commissioner.* The court acknowledged the 1976 case that rejected the IRS's "de facto trustee" argument—that the grantor in effect was the trustee in light of the actual operation of the trust. The court acknowledged the holding in Estate of *Goodwyn v. Commissioner* (T.C. Memo. 1976-238) that §674(c) refers to "an ascertainable and legally enforceable right, not merely the persuasive control which [the grantor] may exercise over an independent trustee who is receptive to his wishes." To this 38-

year old doctrine, which planners have assumed to be well established, the court responds "I disagree."

c. *Economic Realities Control*. The court reasons that the economic realities are that the Isle of Man trustees were acting at the direction of the Wylys, so the independent trustee exception of §674(c) did not apply. The court reached this conclusion with strong language that conceivably could be extended broadly to other contexts:

> I disagree. "Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that 'tax law deals in economic realities, not legal abstractions.'" [citing *PPL Corp. v. C.I.R.*, 133 S.Ct. 1897, 1905 (2013) (quoting *CIR v. Southwest Exploration Co.*, 350 U.S. 308, 315 (1956))] As Professor Danforth, the defendants' own expert, writes in his treatise, "[i]t would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person." The Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their every order, and that is exactly what the trustees did.
>
> The evidence amply shows that the IOM trustees followed every Wyly recommendation, whether it pertained to transactions in the Issuer securities; making unsecured loans to Wyly enterprises, or purchases of real estate, artwork, collectibles, and other personal items for the Wylys and their children. The trustees made no meaningful decisions about the trust income or corpus other than at the behest of the Wylys. On certain occasions, such as the establishment of the Bessie Trusts [with their nominal foreign grantors], the IOM trustees actively participated in fraudulent activity along with the Wylys. The Wylys freely directed the distribution of trust assets for personal purchases and personal use. Because the Wylys and their family members were beneficiaries, the IOM trustees were thus "distributing" income *for* a beneficiary at the direction of the grantors—the Wylys.

Planning Observations

1. *Significant Even Though Not a Tax Case*. This is not a tax case, so why should we be concerned about this case, even if the judge did seem to upset what planners had thought were established principles? This was a decision by the federal district court (and by a very respected federal district court judge); this judge would have reached the same conclusion if this had been a tax refund case arising from claims by the IRS rather than a case arising from SEC allegations. The IRS has not raised the "de facto trustee" argument (particularly in the context of §674(c)) for decades. In light of this federal district court opinion, however, the IRS may be more inclined to raise this argument in the future—and beyond just the §674(c) grantor trust context. Perhaps, though, this is just a "terrible facts make bad law" case that will not give rise to a growing use of future similar attacks by the IRS in tax cases.

2. *Rejection of De Facto Trustee Argument in Estate of Goodwyn.* In *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238, two attorneys served as the trustees of a trust, but at all times, with the acquiescence of the trustees, the grantor "made all decisions with respect to the purchase and sale of trust assets and the investment of any proceeds and determined the amounts, if any, to be distributed to the respective beneficiaries." The IRS argued in that case that based on the grantor's relationship to the trust management and administration, "he should be deemed to be a trustee, in fact, during his life." The Tax Court rejected that approach, noting that the U.S. Supreme Court (as well as a prior *Goodwyn* case) have held that an analogous provision in §2036(a)(2), requiring estate inclusion in a decedent's gross estate if the decedent retained the "right" to designate who

shall possess or enjoy property transferred by the decedent, applies only if the decedent held "an ascertainable and legally enforceable power" reserved in the trust instrument or by some other means (citing *United States v. Byrum*, 408 U.S. 125, 136037 (1972)). Based on that analysis, despite the terrible facts suggesting that the grantor in fact made all trust decisions, the Tax Court in *Goodwyn* concluded that the "power" of disposition for independent trustees in §674(c) refers to:

> A power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes. Such interpretation is also, we believe, indicated by the holding [in] the Byrum case.
>
> In this case, the trustees in question accepted the rights, duties and obligations granted them in the trust instruments. Regardless of the fact they had entrusted to the decedent the complete management and control of these trusts, this informal delegation did not discharge them from the legal responsibility they had as the trustees. As a matter of law, the trustees were liable and answerable for the decedent's acts on their behalf. See 2 Scott, Trusts 1388, 1391 (3rd ed., 1967); 3 Scott, Trusts 1794 (3rd ed., 1967).
>
> There is nothing in the record to show that the trustees could not have undertaken exclusive control of the trust res if they had elected to do so. Whatever power Goodwyn exercised over the trust assets, administration or distribution, he did so [in] the trustee's behalf and not in his own right.

T.C. Memo. 1976-238.

3. *Goodwyn and Byrum Broadly Relied on By Planners.* Planners for years have been comfortable naming close relatives of grantors or beneficiaries as trustees without fear that a court would later determine that the grantor or beneficiary should be treated as holding the powers of the trustee because of the close relationship, even if the grantor or beneficiary had a significant amount of persuasive influence with the trustee. This reliance has been grounded, in substantial part, on cases like *Goodwyn*¸ as well as the *Byrum* Supreme Court case—cases that have looked to who held the "ascertainable and legally enforceable power."

   The U.S. Supreme Court made this position clear in *United States v. Byrum* with strong language that planners have relied on:

> In our view, and for the purposes of this case, O'Malley [United States v. O'Malley, 383 U.S. 627 (1966)] adds nothing to the statute itself. The facts in that case were clearly within the ambit of what is not §2036(a)(2). That section requires that the settlor must have "retained for his life … the *right* … to designate the persons who shall possess or enjoy the property or the income therefrom." O'Malley was covered precisely by the statute for two reasons: (1) there the settlor had reserved a legal right, set forth in the trust instrument; and (2) this right expressly authorized the settlor, "in conjunction" with others, to accumulate income and thereby "to designate" the persons to enjoy it.
>
> It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in O'Malley. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

United States v. Byrum, 408 U.S. 125 (1972).

The Tax Court relied on *Byrum* to reach the conclusion in a prior *Goodwyn* case that the settlor's actual administration of the trust, despite the fact that he was not the trustee, did not result in the settlor being treated as holding the powers of the trustee to cause the trust assets to be included in the settlor's gross estate under §2036(a)(2):

> In the course of the trial of this case, and in his briefs, respondent made no secret of the fact that support for respondent's position was to come from the decision of the U.S. Supreme Court in the case of United States v. Byrum then pending on writ of certiorari from the U.S. Circuit Court of Appeals for the Sixth Circuit. The Supreme Court has since rendered its decision in that case. By that decision, the Supreme Court has rejected the position of the respondent in the instant case that the de facto exercise of control over the management and investment of the trust res is within the ambit of section 2036.
>
> … [Quotations from Byrum case omitted]
>
> The right or power upon which the tax is predicated must thus be a legal right reserved in the trust instrument, or at least by some form of agreement between the trustees and the settlor. Admittedly, such a right did not exist in the case of the … Trusts. To hold otherwise would not only be contrary to the reasoning of the Supreme Court in the Byrum case but would present the insuperable problem of determining to what degree compliance on the part of unrelated trustees with the wishes of the grantor would be sufficient to constitute requisite control over the trust res within the meaning of section 2036.
>
> It would indeed be an unusual situation for a grantor to appoint trustees, whether corporate or otherwise, in the expectation that such trustees would, where given a choice, act contrary to the wishes and intent of the grantor. Notwithstanding that [the third party trustees] permitted the decedent full discretion in the management of these trusts, as a matter of law the trustees were responsible and answerable for the decedent's acts on their behalf. See 2 Scott, Trusts 1388 (3d ed., 1967); 3 Scott, Trusts 1794 (3d ed. 1967). Had they so elected, [the third party trustees] could have taken control of the trust res at any time.

Estate of Goodwyn v. Commissioner, T.C. Memo. 1973-153.

4. *Possible Extension of Wyly Analysis to Other Contexts.* The analysis in *Wyly* could be extended beyond just the independent exception to the grantor trust rules in §674(c). The same reasoning might be used to treat a grantor as being deemed to hold the powers of the trustee to make distributions beyond a "determinable external standard" that might cause inclusion of trust assets in the grantor's gross estate under §§2036(a)(2) or 2038. That precise argument was rejected by the Supreme Court in *Byrum* and by the Tax Court in the earlier *Goodwyn* case (involving the same estate) as well as other cases. It might also conceivably be extended to a §2041 analysis. If a son is named as trustee of the credit shelter trust with his mother as a discretionary beneficiary, and if the mother is an "overbearing mama" who calls all the shots in the family, might the IRS argue that the mother is treated as holding the powers of the trustee to trigger §2041? Planners have not worried about those concerns in the past in selecting trustees.

   While the specific facts of *Wyly* involved settlors acting through trust protectors, the fact that trust protectors were involved is not central to the court's decision. The court's arguments would be just as strong, and even stronger, if there had been no trust protectors and the settlors had exerted their "persuasive" influence directly on the trustees.

   The IRS has on rare occasion made the de facto trustee argument, especially in offshore trust cases. *E.g., Weigl v. Commissioner,* 84 T.C. 1192 (1985) (treating offshore trustee

as a mere nominal trustee); Pvt. Ltr. Rul. 9043074. Perhaps this case simply highlights that if grantors egregiously control every trust decision and are allowed to act for the trust with the trustee's consent, the IRS will treat the grantors as trustees.

5. *IRS Has Restricted Its Argument that the Persuasive Control of Being Able to Remove and Replace Trustees Causes the Person Holding the Removal Power to Hold the Trustee Powers.* The IRS kept losing its argument that trustee removal powers should cause trustee powers to be attributed to the grantor or beneficiary who held the removal power. *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992); *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993). The IRS eventually in Revenue Ruling 95-58, 1995-2 C.B. 1, conceded that trustee removal powers would not cause the remover to be treated as holding the trustee powers as long as the remover had to appoint a successor who was not a related or subordinate party. (Various private letter rulings have extended the logic of Rev. Rul. 95-58 to concluded that removal powers by beneficiaries will not trigger estate inclusion in the beneficiary's estate under §2041 if the removed trustee must be replaced with an independent trustee. *E.g.,* Ltr. Rul. 201432005.)

   This history regarding removal powers and the ultimate concession by the IRS in Rev. Rul. 95-58 is a further indication of the extent to which the courts and even the IRS stipulate that legally enforceable powers control, not the power to persuade (or brow beat) a trustee with the constant threat of removal hanging over the trustee's head. In *Wyly*, the settlors exercised their power by asking the trust protectors to relay their wishes the trustee, who knew that the trust protectors held the removal powers over the trustees. If the settlors had instead held the removal powers directly rather than through trust protectors, Rev. Rul. 95-58 assures that this persuasive/brow beating influence could not have resulted in the settlors being treated as if the held the trustee's powers under §2036(a)(2) as long as they had to replace the trustee with another independent trustee.

6. *Planning—Pay Attention to Actual Administration of Trusts*. Trustees should have a process for making investment and distribution decisions, and should *document* their reasons for decisions that they make. Seeking the input of the settlors or beneficiaries of a trust is not a problem (and indeed is often encouraged). The *Wyly* opinion noted the testimony of one of the defendants' attorneys that the trustees followed the settlors' recommendations "when it came to the four securities that were in companies that the Wylys were more familiar with than anyone in the world." (Footnote 73). Even so, trustees should document their reasons for decisions on behalf of the trust—particularly distribution decisions. (Indeed, an occasional "no" to requests by the settlor or a beneficiary may help evidence the trustee's independence.) The *Wyly* court emphasized that the trustees *never* said no, but *always* followed the Wylys' directions.

7. *Trust Protectors With Broad Grantor-Like Powers.* There is a growing trend toward naming trust protectors with very broad powers, including the broad ability to amend trusts, change beneficial interests, veto or direct distributions, modify powers of appointment, change trustees, or terminate the trust—all in the name of providing flexibility to address changing circumstances, particularly for long-term trusts. The *Wyly* case points out how that could backfire if a pattern of "string-pulling" by the settlors occurs in practice with respect to the exercise of those incredibly broad powers. Planners will not stop using trust protectors in the future in light of *Wyly* but should be aware of potential tax risks that can arise if the broad trust protector powers are abused by overbearing settlors.