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TALES FROM THE DARK SIDE: DRAFTING ISSUES FROM THE FIDUCIARY PERSPECTIVE

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Introduction

The following materials come from the author's observations since leaving private practice to join the fiduciary side of the trusts and estates profession. The issues addressed are all matters that the author has encountered, both good and not so good.

Most of the suggestions in these materials assume that the trust in question is designed to last a very long time, either to the end of any applicable *Rule Against Perpetuities* period, or indefinitely, where no such rule applies, thus increasing the likelihood that during the term of the trust, circumstances, including both beneficiary personal circumstances and governing law, will change, and in ways not foreseen at the time the trust instrument was written. Moreover, the assumption here is that it is desirable to provide flexibility *without* necessity of court involvement, thus avoiding potentially significant delay, expense, and public disclosure of facts that are usually better left within the family.[1] While one occasionally still encounters situations where heavy oversight by a court is necessary or desirable, the trend in this country is clearly away from such oversight, with a view toward allowing all parties interested in a trust to address their issues by agreement, where possible, rather than by court order.

Many of the sample provisions in these materials bestow very broad discretion upon trustees, so, as discussed in more detail below, it is of critical importance that trustees be given adequate guidance as to how the settlor intends for such powers to be exercised.

Acknowledgements

The author wishes to thank his colleagues, Steve Akers, Mark Parthemer and Vanesa Hernandez for their thorough review of, and additions to these materials.

Uniform Trust Code

Many references are made in these materials to the Uniform Trust Code ("UTC"). Some version of the UTC has been enacted in more than half of the states and the District of Columbia,[2] other versions are under consideration in several other states, and still other states that have declined to enact a version of the UTC have nevertheless borrowed from the UTC.[3] Many UTC provisions make good "go-by" provisions for drafting in

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[1] *See, e.g.* the comment to UNIF. TRUST CODE § 111 (2005), stating that "resolution of disputes by nonjudicial means is encouraged."

[2] As of 2016, 33 states and the District of Columbia have enacted a version of the UTC.

[3] *See, e.g.*, The Revised Georgia Trust Code of 2010, GA. L. 2010, p. 579, Codified at Title 53, Chapter 12 of the Official Code of Georgia Annotated (hereinafter O.C.G.A.), which is a comprehensive rewrite of Georgia's trust statutes, and 760 ILL. COMP. STAT. 5/16.1, which is a "virtual representation" statute based

non-UTC jurisdictions, or for drafting in UTC jurisdictions in contemplation of a change of situs and governing law to a non-UTC jurisdiction.

Reliance on State Law

The UTC and the statutes of many non-UTC jurisdictions include many helpful provisions that are discussed below, but drafters may want to include certain provisions in trust agreements nevertheless, rather than relying upon state law, for two reasons.

First, as discussed more fully below, it is possible to improve upon some provisions of state law in the drafting process. For example, these materials include sample "virtual representation" provisions that are similar to, but broader than, the provisions of the UTC.

Second, there is always a possibility that the situs, principal place of administration, and law governing administration of the trust may change in the future, after which the default provisions of the newly governing state law may be less favorable, or simply different, than those under the laws that initially governed the trust.

Note, however, that when including provisions in a document that otherwise may be governed by the default provisions of governing state law, it may be advisable to specify whether the intent is that the document provision replaces the state law provision, such that only the document provision applies, or that the document provision is in addition to the state law provision.

State Specific Sources

These materials refer to many provisions of the law of *Georgia*,[4] which is *not* a UTC jurisdiction, and to the law of *Virginia*,[5] which *is* a UTC jurisdiction; although, like all versions of the UTC enacted by states, there are some differences between the Virginia version and the uniform act. The author claims no specialized experience in any particular state, but has attempted to cite to the laws of certain jurisdictions as examples of alternative statutory provisions that may be applicable.

I. Amendments and Codicils: Just Say "No"; A Plea from the Poor Fiduciary

Much of this material is devoted to the ability to make changes and adjustments along the way to deal with changing circumstances. Obviously, in the case of wills and revocable trusts, such changes can be made any time, as long as the testator or settlor is still living and possesses sufficient capacity. In that regard, the author humbly asks, nay, *begs on bended knee*, an indulgence:

upon the UTC provisions regarding both nonjudicial settlement agreements and virtual representation discussed below.

4 Where the author lived for 43 years and practiced law for 18 years.

5 Where the author currently resides.

Please, please, please resist the urge to engage in *significant* modification of wills and revocable trusts by codicil or amendment, as opposed to simply writing a new will or restating a revocable trust in its entirety. Rarely, if ever, is a codicil or amendment a better choice than a complete restatement, especially given the ease with which new documents can be produced in our modern, technological age. Long gone are the days when producing an entirely new will, rather than a codicil, required some overworked secretary to re-type dozens of pages of text on an Underwood manual typewriter.

If codicils and amendments *are* to be used, they should be limited to changes that are relatively minor ***and uncontroversial***. If the changes in any way adversely affect any beneficial interest in the original document, or require more than one or two pages, serious consideration should be given to a complete rewrite. To be sure, the author's interest in this subject is somewhat selfish,[6] since administering a document that includes multiple and substantial modifications can be quite cumbersome. However, it is worth noting that frequent and substantial modification of wills and trusts by codicil or amendment also gives rise to a significant risk of error, disclosure of information or evidence of a change of heart that otherwise would be better kept secret and, of course, the ever-present risk of fiduciary exasperation.

A. Appendix: A Codicil Too Far

By way of demonstration, the Appendix to these materials is a copy of a will, as amended by two (2) codicils. ***Please note:*** The copies of the pages have been reduced to itty-bitty size so that 16 pages of the will are shown on a single page of the Appendix. This is not a misprint, and you are not supposed to be able to read the provisions of the will. The purpose of the Appendix is merely to demonstrate, graphically, how much of the original will was changed by the first codicil, and how much of the first codicil was further changed by a second codicil.[7] It should be noted that this will was originally written in 2002, well within the modern technological era, so the extensive changes by codicil cannot be justified by deference to a bedraggled secretary.

Note that the original will consisted of *seventeen* pages, *four* of which (nearly 25 percent) were eliminated by the later codicils. The first codicil consists of *eleven* pages demonstrating rather substantial modification of the will. Moreover, more than *half* the first codicil was eliminated or changed by the second codicil, which consisted of *seventeen* pages of text (as many pages as the entire original will), demonstrating even more substantial modification than the first codicil. In the author's humble opinion, each of these modifications was well beyond anything that should be dealt with by mere codicil. Moreover, the changed provisions mostly deal with who gets what (rather than mere administrative

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[6] After all, remember that this discussion is presented from the *fiduciary's* point of view.

[7] Even if you could read the print, information that might identify the testator or the testator's family has also been redacted. Pages consisting only of signatures and notary blocks have also been omitted.

provisions), and changes to *who* gets *what* no doubt tend to cause the most litigation.

It is understandable that clients who wish to update their planning often prefer a codicil or amendment to a complete rewrite, since they do not wish to read, let alone pay for, an entirely rewritten instrument. However, it has been the author's experience, as well as the experience of many other practitioners with whom the author has spoken, that extensive amendments can actually require more (billable) time than simply starting over with the practitioner's current "form" document and tailoring it to the client's current wishes, especially where the original instrument was prepared by another attorney or is several years old. Presumably, most practitioners are familiar with the terms of their own forms, and therefore do not need to scrutinize the terms of those documents for each client to the same extent as would be necessary for a document prepared by another lawyer.

In any event, extensive amendment by codicil can present many "traps" for both the attorney and the client, as demonstrated by two Georgia decisions.

B. *Honeycutt v. Honeycutt*

In *Honeycutt v. Honeycutt*,[8] the testator's original will left his residuary estate to his wife, if she survived, otherwise equally to his three children. Following the testator's divorce, he executed a codicil in which he made specific bequests of $500 to each of his children and then stated that his (pre-divorce) will otherwise "shall remain in full force and effect," but without any specific reference to the residuary bequest to the ex-wife. After testator died, the ex-wife offered the will and codicil for probate, claiming entitlement to the entire residue after the $1,500 of specific bequests to the children. The children argued that since the will predated the divorce and did not contemplate divorce, the ex-wife is treated as predeceased and the children were entitled to the residue,[9] because the language of the codicil did not expressly republish the pre-divorce will. The ex-wife argued that the "shall remain in full force and effect" language validly re-published the will as a post-divorce will. The Georgia Supreme Court agreed with the ex-wife and held that she was entitled to the residue. This is probably what the testator intended, since there would be no point to the specific bequests to the children if they were to receive the entire residue anyway.

C. *Dyess v. Brewton*

In *Dyess v. Brewton*,[10] the decedent executed a will in *March* 2000, then executed a new will in *May* 2000, expressly revoking the March will. Twenty months later, the testator executed a codicil, including express republication language, referring to the *March* will, both by date and by reference to the

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[8] *Honeycutt v. Honeycutt*, 284 Ga. 42, 663 S.E.2d 232 (2008).

[9] O.C.G.A. § 53-4-49 provides that divorce does not result in revocation of a will that does not expressly contemplate divorce, but it does result in the spouse being treated as having predeceased the testator for all purposes of the will.

[10] *Dyess v. Brewton*, 284 Ga. 583, 669 S.E.2d 145 (2008).

witnesses, but the codicil did not revoke, or otherwise mention, the *May* will. The original of the codicil was found with the original of the *May* will, and the attorney stated in an affidavit that the reference to the *March* will was merely scrivener's error, because the testator intended to modify the *May* will. Those who fared better under the *March* will argued that it had been revived, and those who fared better under the *May* will argued that the *May* will still controlled. The Georgia Supreme Court held that the *May* will should stand and that the *March* will had not been revived. Again, this was probably consistent with the testator's intention.

D. Observations

Both *Honeycutt* and *Dyess* probably reached the right result in the end, but not until after extensive litigation to resolve issues that simply *would not have arisen* had the testators in each case simply executed new wills, rather than attempting to use codicils to modify existing wills. Moreover, it bears noting that while *Dyess* does not discuss what claims, if any, were brought against the attorney for his drafting error, the attorney was no doubt in a very awkward position. Certainly, the attorney's fees that were incurred by the parties in litigating these cases more than offset any cost savings resulting from the testators' use of codicils, rather than new wills.

II. Avoiding Challenge – *In Terrorem* Provisions

A. Will of Wolgith – An Oldie, But a Goodie

"No contest" provisions can be very helpful in those states that honor such provisions, to prevent disgruntled relatives from litigating in an effort to sidestep the testator's or settlor's wishes. Moreover, such provisions have a long and honorable history. The following provision, from the *Will of Wolgith*, is an example of an *in terrorem* provision that dates back to 1046:

> beryaui þe hic nu biqueþen habbe. a Godes ywitnesse; beryaued he worþe þises erthliche mergþes and ashiregi hine se almigti drigten. þe alle shepþe yshop. and ywrogte. vram alre halegene ymennesse. on domesday. and sy he bytagt Satane þane diefle. and alle his awargede yueren into helle grunde. and þer aquelmi mid Godes wiþsaken bute ysuyke and mine irfnumen neuer ne asuenche þisses is to ywitnesse Edward king and manie oþre.

For those hopelessly ignorant among you who do not happen to read Old English, the following translation of this provision is offered:

> He that bereaves my will, which by God's permission I have now made, let him be bereaved of these earthly joys; and may the Almighty Lord -- cut him off from all holy men's communion in Doomsday; and be he delivered to Satan, the Devil and all his cursed companions to hell's bottom, and there be

> tortured, with those whom God has cast off or forsaken, without intermission, and never trouble my heirs.[11]

Can the reader improve upon that?

B. Avoiding Overkill with *In Terrorem* Provisions

The usual goal of "no-contest" provisions is to prevent a *caveat* to a will by a legal heir who would take more from the estate under rules of intestacy than under the terms of the will. Likewise, in the case of an *inter-vivos* trust, there may be concerns that the validity of the trust, or some aspect of the trust, may be challenged to bring about a result that is contrary to the testator's or settlor's wishes. Therefore, the provision serves as a disincentive to challenge the validity of the document, because an unsuccessful challenge will result in the challenger receiving nothing at all, rather than the benefit originally provided. Of course, *in terrorem* provisions are only effective if the potential challenger stands to lose something under the document as presented.

A somewhat disturbing trend has emerged over recent years where trustees have asserted that *any* challenge to the trustee's actions, or any proceeding brought with respect to a trust, triggers the *in terrorem* provision, often broadly written, even if the beneficiary is not challenging the terms of the instrument, but is merely seeking clarification of the meaning or seeking to ensure that the trustee is properly carrying out its obligations. As a result, some states have enacted statutes, or are considering statutes, that expressly limit the effect of an *in terrorem* provision so that, irrespective of how it is written, no beneficiary will be penalized for any action seeking clarification or instructions, or seeking to enforce the trust in the face of alleged trustee misconduct.

Accordingly, the author recommends that conditions *in terrorem* be drafted more narrowly, and explicitly, so that the provision will only be triggered by a challenge to the validity of the instrument or provision, but will not be triggered by any action for clarification or instruction, and certainly not for any action alleging a breach of trust.

Sample Provision:

In Terrorem Provision

Any beneficiary who commences any action challenging the validity of this instrument will thereafter be deemed to have predeceased all other beneficiaries hereunder, and any benefit for such person shall thereafter pass or be administered as if such challenging beneficiary had predeceased. This provision shall apply only to actions challenging the validity of this instrument or any provision thereof, and this provision shall not apply to any action seeking

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[11] *Will of Wolgith*, A.D. 1046, translation from Charles Watkins, Esq., *The Law of Tenures, Including the Theory and Practice of Copyholds* (1796).

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to construe any provision of this instrument or
any action to enforce this instrument as written,
whether against a then-acting fiduciary or
otherwise.
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III. Grantor Trust Status: "Trigger" and Avoidance Provisions

The income tax status of a trust is of obvious and critical importance to both the settlor and the fiduciary, to make sure that everyone is "on the same page" as to who bears the responsibility for the income tax on the trust's income. In most cases, it is clear whether a trust is a *grantor* trust, treated as owned by the settlor (or some other person) for federal income tax purposes, or a *non-grantor* trust that is responsible for its own income taxes, to the extent income is not distributed out in a given year.

Structuring a trust as a grantor trust can significantly increase the wealth transfer potential of the trust, since the settlor's payment of income tax liabilities associated with the trust allows the trust value to grow on a "tax free" basis, reduces the *settlor's* gross estate by the amount of the settlor's income tax payments, without the settlor being treated as having made a taxable gift,[12] and facilitates transactions, including installment sales, between the settlor and the trust, without the settlor recognizing capital gains or interest income.

On the other hand, some settlors do not wish to be responsible for a trust's income tax liability, or they want to make sure they can terminate grantor trust status in the future, in which case it is important to make sure that any lurking circumstance that might cause grantor trust status is effectively negated when grantor trust status is no longer desirable.

Where grantor trust status is intended, the trust will include one or more of the well-known "trigger" provisions that intentionally cause grantor trust status. In such cases, it is critical that the trigger provision is drafted to include every provision necessary to ensure grantor trust status, but without any provision that will cause unintended, and undesirable, consequences. Likewise, where grantor trust status is *not* intended, or needs to be terminated, it is critical to make sure that all potential triggers are adequately negated, but without undesirable and unintended consequences.

A. Grantor Trust *Trigger* Provisions

A detailed and thorough discussion of all of the circumstances that can cause grantor trust status is beyond the scope of these materials, so this discussion is limited to drafting issues that are known to be effective, as well as those that are known to be problematic.[13] Many attributes of a trust that would cause grantor

[12] In Rev. Rul. 2004-64; 2004-2 C.B. 7 (Jul. 6, 2004), the IRS changed its prior position on this issue, and held that a trust need not reimburse the grantor of a grantor trust for any income tax liability, and that the grantor's payment of such income tax liability did not constitute a gift transfer to the trust.

[13] For a thorough discussion of various methods of causing grantor trust status, *see* Stephen R. Akers, Jonathan G. Blattmachr, and F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP. TR. & EST. L. J. 207 (2009).

trust status will also cause the trust property to be included in the settlor's gross estate for estate tax purposes, so those attributes are not suitable where the goal is grantor trust status for income tax purposes only.

1. Corpus Substitution Power

The most popular trigger in use today is the nonfiduciary corpus substitution power under I.R.C. § 675(4)(C):

> The grantor shall be treated as the owner of any portion of a trust in respect of which - A power of administration is exercisable in a ***nonfiduciary*** capacity by ***any person*** without the approval or consent of any person in a fiduciary capacity . . . to ***reacquire*** the trust corpus by substituting other property of an equivalent value.

The author strongly prefers this particular trigger provision because there is reliable guidance both confirming the efficacy of the provision and providing a "road map" as to how to draft to avoid adverse estate tax consequences.

a. Power May Be Held by Any Person

While the use of the term "***re***acquire" might indicate that the power may only be held by the person who originally contributed the property, the IRS has confirmed that the words "any person" in the statute means that the power need not be held by the settlor, which may be important where there is some reason the power should not be held by the settlor.[14]

b. Rev. Rul. 2008-22 - No Estate Inclusion under I.R.C. §§ 2036 or 2038

While many grantor trust triggers will also trigger inclusion in the settlor's gross estate, the IRS has laid to rest any concerns that a corpus substitution power held by the settlor will cause the property subject to the power to be included in the settlor's estate. In Rev. Rul. 2008-22, the IRS ruled as follows:

> A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, ***by itself***, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, ***provided*** the trustee has ***a fiduciary obligation*** (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor ***are in fact of equivalent value***, and ***further provided*** that the substitution power ***cannot be exercised in a manner that can shift benefits among the trust beneficiaries***. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust

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[14] *See* Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (June 22, 2007) and Rev. Proc. 2008-46, 2008-30 I.R.B. 224 (July 28, 2008), in which the IRS issued sample *inter vivos* charitable lead trust forms, and suggested achieving grantor trust status by giving a corpus substitution power to someone other than the grantor, since the grantor is a "prohibited person" who should not hold such a power with respect to a charitable trust. Additionally, the IRS has issued numerous private letter rulings holding that a trust is a grantor trust under Section 675(4)(C) even though the holder of the power was not the grantor.

> instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; ***or*** (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.[15]

The first condition, the trustee's duty to ensure equivalent value, is probably satisfied as a matter of law in almost all, if not all, cases, because the settlor's power to substitute, without the trustee's consent, is conditioned upon the substituted property being of equivalent value, and the trustee's general duty to protect the trust property would require the trustee to take reasonable steps to ensure equivalent value. The second condition, prohibiting the shifting of benefits, will also apply in almost all cases, unless a trustee is prohibited by the trust from selling some asset (which is ill-advised) or the substituted property is subject to some outside restriction that would prevent its sale.

Some practitioners "carve out" a specific exception for ***controlled corporation stock***, which can be included in the estate under Section 2036(b) if the settlor retains the right to vote such stock, even though the ruling clearly addresses estate inclusion under Section 2036, meaning ***all*** of Section 2036, because the ruling is in no way limited to 2036***(a)***. The point of the ruling, as well as Rev. Rul. 2011-28, discussed below, is that no rights or powers of ownership over property will be attributed to the settlor merely because the settlor retained the right to acquire the property by paying fair market value. Not only is such an exception not necessary, it may be ***counterproductive***, because if the substitution power is not exercisable as to a particular asset, then that portion of the trust may not be a grantor trust, unless some other trigger provision applies.

c. Rev. Rul. 2011-28 – No Estate Inclusion under I.R.C. § 2042

A corpus substitution power may safely be held with respect to ***life insurance*** on the life of the power holder. In Rev. Rul. 2011-28[16] the IRS ruled that as long as the requirements of Rev. Rul. 2008-22 are satisfied, an insured's power to reacquire a policy on his own life would ***not*** be considered an "incident of ownership" in the policy, nor would any other incidents of ownership be attributed to the insured (prior to actually exercising the power).

As was the case with controlled corporation stock, discussed above, some practitioners continue to except life insurance from a corpus

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[15] Rev. Rul. 2008-22, 2008-1 C.B. 796 (Apr. 21, 2008) (emphasis added).

[16] Rev. Rul. 2011-28; 2011-49 I.R.B. 830 (Dec. 5, 2011).

substitution power, even though it is clearly not necessary and, as discussed above, is probably counterproductive.

d. Drafting Tip – Selective Plagiarism and Magic Words

The best way to ensure that a trust provision meets all of the requirements of a statute or a ruling is to use the words of the statute itself, which should include all of the "magic words" necessary to accomplish the desired result. For example, a corpus substitution power must be held in a ***nonfiduciary*** capacity. If the trust is silent as to whether the power is fiduciary or nonfiduciary, there may be a presumption that the power is held in a fiduciary capacity, unless the trust agreement expressly says otherwise.[17]

e. Drafting Tip – Tell Me What You Want and I'll Give It To You

One of the most fundamental charges to a court of equity construing a trust is to ***carry out the intent of the settlor***, to the extent that such intent can be determined. One would think that by quoting directly from the statute, the intent of the settlor to fit within the statute would be clear, but courts don't always see it that way. Therefore, if the purpose of the corpus substitution power, or any other grantor trust trigger, is to achieve grantor trust status without causing estate inclusion, then the best practice is to say so, to avoid any construction that may be contrary to that intent.

Sample Provision

Corpus Substitution Power

The settlor shall have the power, exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value. Such power shall be exercisable at any time and from time to time, with respect to all or any part of the trust corpus.

The trustee shall have the fiduciary obligation to ensure the settlor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the settlor are in fact of equivalent value.

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[17] For example, Delaware's directed trust statute, 12 Del. C. § 3313, provides that "where 1 or more persons are given authority by the terms of a governing instrument to direct . . . a fiduciary's actual or proposed investment decisions . . . or other decision of the fiduciary, such persons ***shall be considered to be advisers and fiduciaries*** when exercising such authority provided, however, that the governing instrument may provide that any such adviser (including a protector) shall act in a nonfiduciary capacity."

> The foregoing power shall not be exercised in a manner that can shift benefits among the trust beneficiaries.
>
> The settlor intends that this power shall cause the trust to be treated as owned by the settlor for federal income tax purposes pursuant to Internal Revenue Code Section 675(4)(C), and that this trust comply with all requirements of Rev. Ruls. 2008-22 and 2011-28, so that no property of this trust be included in the settlor's gross estate for federal estate tax purposes including, without limitation, under Internal Revenue Code Sections 2036, 2038, 2041 or 2042. Accordingly, the foregoing power shall be exercisable only in a manner that is consistent with the settlor's intent.

The first paragraph is quoted, almost *verbatim*, from I.R.C. § 675(4)(C), to ensure that the terms of the power align exactly with the requirements of the statute. The second and third paragraphs are likewise drawn directly from Rev. Rul. 2008-22, to ensure that the requirements for avoiding estate inclusion are all satisfied. Finally, if, for any reason, the direct quotes are not sufficient to convey the settlor's intent, the final paragraph expressly states the settlor's intent to cause grantor trust status without estate inclusion, so that such intent may guide any construction of the trust terms that may be necessary.

2. Power to Add Beneficiaries

I.R.C. § 674(c)(2) provides that a trust will be a grantor trust if ***any person*** has a power to add to the class of trust beneficiaries, other than after-born children. Therefore, a power to add beneficiaries is sometimes included as a grantor trust trigger, although it is usually limited to adding only ***charitable*** beneficiaries (in an effort to avoid its actually being exercised). The author disfavors this power and recommends extreme caution in its use, for several reasons.

First, whether the power is effective to establish grantor trust status may well depend upon who holds the power. The plain language of the statute indicates that it applies if ***any*** person holds the power. However, many trusts grant this power to ***the trustee*** or to some other non-trustee ***fiduciary***, such as a trust protector or advisor. If the power is held by any fiduciary, especially a trustee, the power may be deemed to be illusory, because there is no way the trustee can add beneficiaries to the trust without potentially impairing the interest of the present beneficiaries, which would be a breach of the trustee's ***duty of loyalty*** to the existing beneficiaries. A power that cannot legally be exercised may not be considered a valid power.

Second, this power could be disastrous if held by the ***settlor***, since the power to add beneficiaries may well be considered a power to designate who will possess or enjoy the property, which would cause estate inclusion under Section 2036(a)(2).

Finally, as discussed in more detail below, if the power is held by someone other than the settlor, it may be more difficult for the settlor to terminate the power, should it be desirable to terminate grantor trust status.

3. Power to Lend to Settlor without Adequate Interest or Security

I.R.C. § 675(2) provides that a trust will be a grantor trust if the settlor or a nonadverse party (including a trustee) or both has to the power to enable the settlor to borrow from the trust without adequate interest or security, ***unless*** the trustee is generally authorized to make such loans to others.

A potential danger with this trigger is that it could result in the trust property being included in the settlor's gross estate, if the ability to borrow on favorable terms is viewed as a retained benefit or enjoyment of the transferred property under Section 2036.

Even if the estate inclusion issue is resolved, the ability to lend to the settlor on favorable terms will not be an effective grantor trust trigger if the trustee generally has the authority to lend to others for inadequate interest or security, which is often the case, especially with regard to beneficiaries. In fact, there is a discussion later in these materials advocating that the trustee be given just such a power with respect to beneficiaries, and thus this trigger may not be reliable to cause grantor trust status.

4. One Trigger is Enough

As expressed by one of the great philosophers of all time, Mary Poppins, "enough is as good as a feast." The above referenced grantor trust triggers *other than* the corpus substitution power are often included as *additional* triggers, although the reason for additional triggers is not clearly evident except, perhaps, where certain assets of the trust have been excepted from the corpus substitution power which is wholly unnecessary in any event. The IRS has confirmed that corpus substitution powers, whether held by the settlor or anyone else, are sufficient to cause grantor trust status.[18] The IRS has stated from time to time that whether the power is truly held in a *fiduciary* or *nonfiduciary* capacity will depend upon the facts of each case, but so long as the power is ***expressly*** held in a nonfiduciary capacity and is not held by anyone who is otherwise a fiduciary, the efficacy of the power should not be an issue.

[18] *See* note 13, *supra*, regarding sample charitable lead trust forms published by the IRS, where the sole grantor trust trigger was a corpus substitution power.

B. Critical Considerations for Grantor Trust

1. Avoiding Estate Inclusion – Negating a *Right* to Reimbursement

The IRS has ruled that if the settlor has the ***right*** to be reimbursed for any income tax incurred from a grantor trust, the trust assets will be includable in the settlor's estate under section 2036(a).[19] Therefore, to eliminate this risk, any such right should be expressly negated.

Sample Provision

Negating Right of Reimbursement

The grantor shall have no right to be reimbursed from the trust for any income tax liability incurred by the grantor with respect to the taxable income of the trust.

While it would be an unusual circumstance for any right to reimbursement to be implied, where not specifically stated, the consequences of such a right are sufficiently undesirable to eliminate the issue entirely.

Note, however, that to avoid estate inclusion, ***only*** the settlor's ***right*** to reimbursement need be negated. The ***trustee's discretion*** to reimburse the settlor ***need not, and probably should not***, be negated because there are circumstances where the trustee can have such a power, without adverse consequences to the settlor, as discussed in the next section.

2. Trustee Discretion to Reimburse Settlor for Taxes

Rev. Rul. 2004-64[20] provides that if the trustee holds a ***discretionary*** power to reimburse the settlor for part or all of the settlor's income tax liability resulting from grantor trust status, that discretion will not, ***in and of itself***, cause estate inclusion under Section 2036(a)(1). ***However***, the ruling also states that such a discretionary power, ***coupled with other facts and circumstances***, may result in estate inclusion. Examples of such other facts and circumstances are:

- □ If there is evidence of any *arrangement or understanding* between the settlor and the trustee as to when and under what circumstances the trustee will exercise such discretion, the trustee's power may be viewed as not genuinely discretionary.
- □ If the settlor has the power to name himself or herself as successor trustee and, having done so, would have the power to reimburse himself or herself, such a retained power would likely be viewed as a retained power under Section 2036.
- □ If the trustee's discretion to reimburse the settlor would expose the trust property to the claims of the settlor's creditors, estate inclusion may result.

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[19] Rev. Rul. 2004-64.

[20] Rev. Rul. 2004-64; 2004-2 C.B. 7 (Jul. 6, 2004).

- The statutes of many jurisdictions provide that with respect to a ***self-settled*** trust, meaning any trust to which the settlor contributes property and from which any distributions to the settlor are permitted, "creditors . . . of the grantor may reach the ***maximum amount*** that can be distributed to or for the grantor's benefit during the grantor's life . . .."[21] If the settlor's creditors have the authority to seize any trust assets as a result of the trustee's power to reimburse the settlor, the result may be inclusion in the settlor's estate under Section 2036.
- However, an increasing number of jurisdictions provide specific exceptions to the "self-settled trust" rule where the trustee's discretion to distribute to the settlor is limited to the reimbursement of income tax liability attributable to the grantor trust.[22]
- Therefore, great care is required when including such a provision, because the same provision that would be "safe" for a trust administered in Virginia could become problematic if the trust were to later be administered in Georgia. It should be possible to address this issue by declaring that the trustee's power to reimburse will only be in effect when it will not create adverse tax consequences for the settlor.

Sample Provision:

Discretion to Reimburse Grantor

Any trustee who is not the grantor or related or subordinate to the grantor shall have the power, in its sole and absolute discretion, to reimburse the grantor for all or any part of any federal, state or other income tax liability incurred by the grantor with respect to the income of the trust, provided, however, that the trustee shall have no such discretion or power to the extent that such discretion would cause any trust property to be subject to the claims of the grantor's creditors or otherwise includable in the grantor's gross estate for federal estate tax purposes. No trustee shall be under any duty to exercise or refrain from exercising such power, and no trustee shall incur any liability to any person interested in this trust for

[21] UNIF. TRUST CODE § 505(a)(2) (2005); O.C.G.A. §53-12-82(2).

[22] *See* VA. CODE ANN. § 64.2-747.A.2.

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any exercise, or failure to exercise,
such power.
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Note that the foregoing power is only exercisable by a trustee who is ***not*** the settlor nor related or subordinate to the settlor, thus eliminating the possibility that the settlor would ever hold the reimbursement power.

The provision also exculpates the trustee from liability, if any beneficiary is inclined to claim that reimbursing the settlor when the trustee is not compelled to do so is not in the best interests of the beneficiaries. Even without such a provision, the exercise of a tax reimbursement power may be easily justified, from a fiduciary standpoint, if the alternative is that the settlor will terminate grantor trust status permanently. The whole point of a reimbursement provision is that it will likely be used only under unusual and extraordinary circumstances, such as an extraordinarily large capital gain, or a year in which the settlor is suffering an extraordinary inability to pay the tax.

3. Who is the "Grantor," Anyway?

Assuming the trust is a grantor trust, who is the settlor that is deemed to be the owner for income tax purposes? The answer is not necessarily the person(s) designated as the settlor at the beginning of the trust document. Treas. Reg. § 1.671-2(e)(1) states that for purposes of the grantor trust rules, the "grantor" is ***each*** person who gratuitously transfers property to the trust, regardless of whether that individual is actually referred to in the trust agreement as the "grantor." Likewise, the person identified as the grantor in the trust is not the grantor for income tax purposes if that nominal grantor does not contribute any assets.

Therefore, if multiple people (with the possible exception of spouses) contribute to a grantor trust, ***each*** contributor will be deemed the owner of a portion of the trust for income tax purposes, and none of the contributors will be deemed the owner of the entire trust, in which case:

- □ The accountant for the trust will have to figure out which tax attributes will flow through to which contributors, and be assured the accountant will hate you for it.
- □ No grantor will be able to engage in transactions with the trust without recognizing any capital gain, because the transaction will not be treated as a transaction between the grantor and herself.
- □ Payments of interest from the trust to the grantor will not be wholly ignored, since a portion of the interest will be deemed to come from persons other than the recipient.
- □ Even if the only two contributors are spouses, issues could still arise.
  - ♦ If the spouses file joint income tax returns, then it may not be necessary to determine what portion of the trust income is attributable to each spouse, since all of the income is aggregated on the joint return.

- ♦ If the spouses file joint income tax returns, there still should be no recognition of capital gains, nor would there be interest income from an installment sale, since capital gains and interest income would not be recognized in transactions between the spouses.
- ♦ If the spouses should subsequently divorce, they will no longer be filing joint income tax returns, and the grantor trust having two "owners" will become a much more profound issue, perhaps necessitating the splitting of the trust.
- ♦ ***Suggestion to Consider:*** For the foregoing reasons, rather than having both spouses contribute to the same trust, it may be preferable for one spouse to make all contributions, and the other to elect to split gifts (assuming there is no reason not to split). That way, the consenting spouse's annual exclusion, lifetime exclusion, and GST exemption can be used, but the consenting spouse will not be considered an owner for income tax purposes.

4. Settlor's Exit Strategy – Power to *Terminate* Grantor Trust Status

In creating a grantor trust, it is critically important to make sure that grantor trust status can be terminated, if circumstances change, such that the grantor can no longer afford to pay the income tax on the trust's income, or if the grantor simply no longer wishes to do so, whether she can afford to do so or not. This is especially true in these days of high lifetime exclusions, where the income on which the grantor is paying the taxes is being generated from as much as $10,000,000 or more of principal.

Generally, terminating grantor trust status is accomplished by terminating the circumstance causing grantor trust status. Thus, where the operative trigger is the grantor's corpus substitution power, the grantor's release of the substitution power should terminate grantor trust status, assuming, of course, that there are no other circumstances causing grantor trust status. One would think that anyone holding a power, particularly a non-fiduciary power, should be able to release or renounce that power at any time, but there are always those who will raise the question of whether a grantor may release a power if the trust agreement does not expressly say so.

Accordingly, it is wise to make sure that the corpus substitution power ***expressly states*** that the grantor may release the power at any time, after which it will no longer be in effect.

Some practitioners express concern that the grantor's retained ability to release the substitution power may pose some tax risk, albeit unspecified, and for that reason suggest that the power to terminate grantor trust status should be held by someone other than the grantor. The problem with this approach is that the grantor may be understandably apprehensive about the possibility that the person with the power to terminate grantor trust status may refuse or otherwise fail to do so, leaving the grantor powerless to avoid the tax. This problem is compounded exponentially when the person holding the power to terminate grantor trust status is the ***trustee***, or any other ***fiduciary***. A Trustee may be unwilling, or at least hesitant, to exercise the power to terminate grantor trust status, out of concern that doing so would be a breach of the duty of loyalty to the beneficiaries, since it is obviously in their best interests for the grantor to continue to pay the income tax. ***Therefore, no trustee should ever be the sole holder of a power to terminate grantor trust status, nor should a trustee ever have the power to cause a trust to be a grantor trust***.

The same concern applies with respect to other non-trustee fiduciaries, such as trust protectors and trust advisers, who owe fiduciary duties to the beneficiaries, although to a lesser degree. A trust agreement can expressly provide that exercising a power to terminate grantor trust status will not constitute a breach of trust, and that any fiduciary is absolved of liability for doing so. However, exculpating a fiduciary from liability always raises questions of enforceability. Such a provision for a limited purpose fiduciary, such as a protector, may be more palatable than for a general purpose fiduciary, such as a trustee.

The author is not aware of any statute, regulation, ruling, or other guidance suggesting that the release of a corpus substitution power has any tax consequences whatsoever beyond terminating grantor trust status. After all, the idea behind the grantor trust rules is that if the grantor insists on holding a certain power, the grantor has to pay for it by being taxed on the income. If the grantor no longer insists upon holding the power, there is no longer any reason for the grantor to be taxed on the income.

Accordingly, the author's strong suggestion is that the grantor hold the sole power to terminate grantor trust status, since that makes the most sense for the grantor, and creates the least heartburn for the trustee. If there is still lingering concern, perhaps a savings provision could be added, stating that the power to terminate grantor trust status only exists to the extent that it does not cause estate inclusion, and to the extent the power does cause estate inclusion, it will be held by some nonfiduciary third party, but this seems, to the author, to be overkill.

5. Power to Create Grantor Trust Status

Occasionally, trust agreements will give some person the authority to convert a non-grantor trust to a grantor trust, perhaps by giving a third party the ability to confer an asset substitution power on the grantor. For the same reasons discussed above, this power should not be held by a trustee or other fiduciary, and the grantor should have the power to terminate grantor trust status should the power ever be exercised. As with any "special" power, I would recommend that any provision creating such a power specify that the power holder is under no duty to exercise the power or to monitor circumstances to determine when or whether it may be appropriate to exercise the power, and that the power holder will not incur liability for any failure or refusal to exercise the power or for any exercise of the power in good faith.

C. Grantor Trust *Avoidance* Provisions

Provisions designed to *avoid* grantor trust status are important in all trusts, including trusts intended to be grantor trusts, and especially in those that are *not* intended to be grantor trusts. Given the need for the grantor to be able to terminate grantor trust status, as discussed above, it is important to make sure that when, for example, a corpus substitution power is released, there are no other grantor trust triggers that would cause the status to continue. Typical provisions are designed to negate the application of various parts of I.R.C. Section 675, as discussed below.

That being said, it is important ***not*** to go overboard on the avoidance provisions to the point of unnecessarily restraining the trustee's flexibility to deal with changing circumstances in the future. The author has noticed that many trust agreements include avoidance provisions that are significantly broader than they need to be to avoid a particular trigger. Perhaps this practice is out of an "abundance of caution" to ensure avoidance of grantor trust status, where it is undesirable, but such provisions can have unintended consequences.

1. Prohibition on Borrowing for Inadequate Interest or Security

I.R.C. Section 675(2) provides as follows:

> The grantor shall be treated as the owner of any portion of a trust in respect to which -- . . . [a] power exercisable by the grantor or a nonadverse party, or both, enables ***the grantor*** to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security ***except where a trustee*** (other than the grantor) ***is authorized under a general lending power to make loans to any person without regard to interest or security***.[23]

The following is an example of a common trust provision designed to avoid the application of the foregoing trigger:

> No loans shall be made to any person without adequate interest or adequate security.

This trust provision is far broader than necessary, since the statute applies only where certain persons have the power to enable ***the grantor*** to borrow without adequate interest or security, but even then, the provision does not apply if the trustee has the power to lend to others without adequate interest or security. Therefore, to avoid grantor trust status, it is not necessary to prohibit loans without adequate interest or security to persons ***other than*** the grantor, especially the beneficiaries. As discussed later in these materials, a very useful trustee power is a power to lend to beneficiaries, especially on terms that are more favorable than would normally be commercially reasonable. Often, where an outright distribution would be permissible and justified, a low interest loan to the beneficiary is better, because it gives the beneficiary access to liquidity needed in the short term, without depleting the trust principal. Such a provision would be in direct conflict with a provision prohibiting any

[23] I.R.C. § 675(2) (emphasis added).

loans for less than adequate interest or security. With respect to loans to anyone other than the beneficiaries, the general duties of trustees would already prevent such loans in most cases.

Therefore, to avoid this particular trigger, it would be preferable to use a more narrowly tailored, yet equally effective, provision:

Sample Provision:

Minimal Restriction on Borrowing

The grantor shall not be permitted to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security.

The foregoing provision completely avoids Section 675(2), because that provision only applies to loans to the grantor. This provision is actually more restrictive than it needs to be for grantor trust purposes, because the grantor could borrow on favorable terms if the trustee can lend to others on favorable terms, but allowing the grantor to borrow on favorable terms could be construed as a retained benefit that could cause estate inclusion under Section 2036.

2. Prohibition on Non-Trustee Voting of Stock or Direction of Investments

Section 675(4) provides as follows:

> The grantor shall be treated as the owner of any portion of a trust in respect of which-- . . . [a] power of administration is exercisable ***in a nonfiduciary capacity*** by any person ***without the approval or consent of any person in a fiduciary capacity***. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to ***vote or direct the voting of stock or other securities*** of a corporation ***in which the holdings of the grantor and the trust are significant from the viewpoint of voting control***; (B) a power to ***control the investment of the trust funds*** either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, ***to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control***.[24]

The following is an example of a trust provision designed to avoid the application of the foregoing trigger:

> No person, other than Trustee, shall have or exercise the power to vote or direct the voting of any corporate shares or other securities of the trust, or to control the investments of the trust either by directing investment or reinvestment or by vetoing proposed investment or reinvestment.

This provision is far broader than necessary, in the following ways:

- It prohibits the exercise of voting or investment direction by ***anyone*** other than the trustee, including any non-trustee ***fiduciary***, such as a trust

[24] I.R.C. § 675(4)(A) and (B) (emphasis added).

protector or investment director. All that is necessary to avoid trigger, with respect to any investment, is to prohibit voting or direction in a nonfiduciary capacity.

- The prohibitions apply to any type of securities, including interests in publicly traded corporations in which the holdings of the trust and grantor are not significant, and may apply to interests in other entities that are not corporations. All that is necessary to avoid this trigger is that the prohibition apply to interests in corporations in which the holdings of the grantor and the trust are significant, and then only if such powers are held in a nonfiduciary capacity. This trigger does not apply to holdings in any type of property other than interests in a ***corporation***.

The difficulty with such broadly drawn restrictions is that they may unnecessarily preclude conversion of the trust to a *directed* trust, which can be quite beneficial, as described later in these materials. Moreover, such provisions sometimes appear in trusts that have direction provisions, thus creating a direct conflict between the trust provisions.

Therefore, the better way to avoid this trigger, without being unduly restrictive, is to take the wording of the restriction directly from the statute:

Sample Provision:

Minimum Restriction on Investment Control

No person acting in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, shall have or exercise a power (a) to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control, or (B) to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.

This provision, which is essentially a verbatim regurgitation of the statute, will avoid the application of the statute by prohibiting what is described in the statute, but without going any further. Under this provision, the trust can be directed as long as the investment director is a fiduciary. Moreover, investments can be directed by a nonfiduciary if the securities don't involve a corporation in which the grantor holds voting control.

D. "Toggling" Grantor Trust Status On and Off

What is supposed to be the ultimate in grantor trust draftsmanship is a provision that allows the grantor or some other person to "toggle" grantor trust status on and off at will.[25] The author confesses that he has not spent any time studying such techniques, but is nevertheless concerned that such provisions could be seen as "abusive" by the IRS and could attract unwanted attention, at least if the grantor trust status is actually changed more than once.

E. Sample Corpus Substitution Power

Sample Provision

Corpus Substitution Power

The grantor shall have the power, at any time and from time to time, exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, to reacquire all or any part of the trust corpus by substituting other property of an equivalent value. Grantor expressly intends and expects that this power, so long as held by the grantor, shall cause the trust to be treated as owned by the grantor for federal income tax purposes pursuant to Internal Revenue Code Section 675(4)(C), and the grantor intends that this power shall be so construed. Notwithstanding anything herein to the contrary, the grantor shall have no right to be reimbursed from the trust for any income tax liability incurred by the grantor and attributable to the taxable income of the trust.

The trustee shall have the fiduciary obligation to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value. The trustee shall take reasonable steps, at the expense of the trust, to verify such value, if the trustee shall disagree that the substituted assets are of equivalent value, and shall have the power, at the expense of the trust, to have the value of the original corpus and the substituted property adjudicated by a court of competent jurisdiction.

The foregoing power shall not be exercised in a manner that can shift benefits among the trust beneficiaries.

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[25] *See* Akers, Blattmachr & Boyle, *supra*, note 13, at pages 271-278.

Grantor expressly intends that that this trust meet the requirements of Rev. Ruls. 2008-22 and 2011-28, and that the property of this trust not be included in the grantor's gross estate for federal estate tax purposes including, without limitation, under Internal Revenue Code Sections 2036, 2038, 2041 or 2042. Accordingly, the foregoing power shall be exercisable only in a manner that is consistent with the grantor's express intent and the grantor intends that this power shall be so construed.

[Any trustee who is not the grantor or related or subordinate to the grantor shall have the power, in its sole and absolute discretion, to reimburse the grantor for all or any part of any federal, state or other income tax liability incurred by the grantor with respect to the income of the trust, provided, however, that the trustee shall have no such discretion or power to the extent that such discretion would cause any trust property to be subject to the claims of the grantor's creditors. No trustee shall be under any duty to exercise or refrain from exercising such power, and no trustee shall incur any liability to any person interested in this trust for any exercise, or failure to exercise, such power.]

The grantor may release the foregoing power at any time, after which such power shall cease.[26]

IV. General Powers of Appointment to Avoid GST Tax – New Rules Apply!

The author frequently reviews trust documents, including newly drafted documents, which subject all trust property that is *not* exempt from the GST tax to a general power of appointment at the death of a trust beneficiary who is a non-skip person, to prevent a *taxable termination* from occurring as a result of the non-skip beneficiary's death.[27] In some cases, the general power applies any time the death of a non-skip beneficiary would cause a taxable termination, as might be the case where the non-skip beneficiary is the transferor's child, and all remaining beneficiaries after the non-skip person's death are grandchildren of the transferor. In other cases, however, the general power applies even though the non-skip person's death does not result in a generation skipping transfer, as might occur where the beneficiary has no

[26] As discussed in more detail below, it is imperative that the grantor have a means to negate the trust's status as a grantor trust.

[27] I.R.C. § 2612(a) provides that a *taxable termination* occurs upon the termination of an interest in property held in trust unless immediately following such termination, either a *non-skip person* has an interest in the trust or no distributions may thereafter be made to skip persons.

descendants, resulting in the property passing to or for the benefit of the beneficiary's siblings.

While this may have been reasonable tax planning, at least in most cases, prior to EGTRRA,[28] the result under current law could be a dramatic increase in the overall tax liability at the beneficiary's death, if the beneficiary lives in, or owns real property in, one of the 22 states that imposes a state level estate or inheritance tax.

A. Conventional Wisdom Prior to EGTRRA – Trade GST Tax for Estate Tax

Prior to EGTRRA, the conventional wisdom was as follows:

- If the beneficiary's death would result in a taxable termination, 100 percent of the trust property will be subject to federal *GST* tax, which will be imposed at a flat rate equal to the highest marginal *estate* tax rate of 55 percent.[29]
- By contrast, if the trust property was included in the beneficiary's gross estate, the trust property would avoid GST tax and be subject instead to estate tax,[30] which might be lower, since the first $3,000,000 of the beneficiary's taxable estate was subject to estate tax rates lower than 55 percent, and beyond that amount, the estate tax would never be more than the GST tax, since the GST tax rate is, by definition, equal to the highest marginal estate tax rate.
- Even though every state imposed a state level estate tax, in almost all states, the *state death tax credit*[31] would entirely offset the state death tax, so state death taxes were essentially a non-issue.
- Therefore, avoiding the GST tax by incurring the estate tax in all cases poses no tax risk, because the estate's aggregate tax burden may be less than, but will never be more than, the tax burden under the GST tax.

B. EGTRRA Changed the Rules

EGTRRA phased in increased estate tax exemptions and lower maximum estate tax rates such that, beginning January 1, 2006, the estate tax is imposed at a single flat tax rate. Therefore, if a beneficiary's estate is large enough to be subject to federal estate tax, the rate will be no lower than the GST tax rate.

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[28] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

[29] I.R.C. § 2641(a)(1).

[30] Treas. Reg. § 26.2612-1(b)(i)(1) provides that a taxable termination will *not* occur if the termination of the interest results in a transfer of the trust property subject to federal gift or estate tax. Therefore, if a non-skip beneficiary holds a general power of appointment over trust property, causing the property to be subject to estate tax in the beneficiary's estate, then a taxable termination with respect to the trust property will not occur as a result of the beneficiary's death. Moreover, the beneficiary will thereafter be treated as the *transferor* of such property for GST tax purposes, such that distributions thereafter will not be taxable distributions unless the distributee is a skip person as to the deceased beneficiary, rather than the original transferor of the property. I.R.C. § 2652(a)(1).

[31] I.R.C. § 2011.

Additionally, EGTRRA phased out the state death tax credit over four years, and then replaced the credit with a *deduction*, which, of course, provides less than 100 percent relief from the effect of the state death tax. Since most state death tax statutes simply imposed a state tax equal to the maximum available credit against federal estate tax, the elimination of the credit resulted in the effective elimination of state death tax in almost all of the states. To avoid the loss of tax revenue, many states subsequently "decoupled" their death taxes from the federal credit, by either imposing tax based upon what the credit would have been, but for EGTRRA, or by imposing a tax calculated on some other basis. Currently, 19 states impose some form of state death tax on resident decedents and/or non-resident decedents who own property in the state, and given the widely publicized budget shortfalls in many states, it is entirely possible that more states may impose some form of state death tax.[32] Moreover, in most of the decoupled states, the amount of the exemption from state death tax is lower than the federal exemption.[33] As a result, the death of a resident of a decoupled state may well trigger both federal and state death tax, which may result in an aggregate tax liability that is greater than the federal GST tax would have been otherwise.

C. Even Prior to EGTRRA, Conventional Wisdom Failed in Some Cases

Even prior to EGTRRA, it was possible, in very large estates, that the estate tax would actually be higher, at least on a portion of the estate, than the GST tax, due to the ***five percent surtax*** on estates in excess of $10,000,000, which had the effect of phasing out the benefit of the lower tax rates on the first $3,000,000 of the taxable estate. As a result, the portion of such estates from $10,000,000 to $18,340,000 was actually subject to a marginal tax rate of ***60 percent***, which was 5 percent higher than the 55 percent GST tax. Therefore, where the beneficiary had an estate larger than $18,340,000, swapping the GST tax for the estate could result in a tax increase of as much as ***$417,000***.

D. Estate Inclusion Still Beneficial in Some Cases

All that having been said, in many, perhaps most, cases, it may still be beneficial to cause ***some*** property to be included in a beneficiary's estate, especially given the current $5,490,000 exemption from estate tax.[34]

- If the beneficiary's gross estate is less than the applicable exclusion amount, then an amount of property equal to the difference between the beneficiary's

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[32] As of January 2017, 14 states impose an estate tax, 6 states impose an inheritance tax, and 2 states, New Jersey and Maryland, impose both. Under the American Taxpayer Relief Act of 2012, Pub. L. 112-240, 126 Stat. 2313 (2013), the elimination of the state death tax ***credit*** has become permanent, so states that were expecting to resume collection of death taxes after the "sunset" of EGTRRA now know that no such revenue will be forthcoming without decoupling their taxes from the credit.

[33] Three of those states allow an exemption equal to the current federal applicable exclusion amount, and the rest allow exemptions of $1,000,000 or more, but less than the federal exemption, although some jurisdictions are in the process of "phasing in" exemptions that will eventually equal the federal exemption.

[34] The current gift and estate tax applicable exclusion amount is $5,000,000, indexed for inflation in $10,000 increments for years after 2011. For 2017, the indexed amount is $5,490,000.

estate and the exclusion amount will eliminate any federal tax on that portion of the trust property, even if a state death tax applies, since the highest state death tax rate currently is 19 percent, which is still considerably less than a 40 percent GST tax.

- If the beneficiary lives in a state that does not impose any state level tax, and a beneficiary's $5,490,000[35] GST exemption would not otherwise be used, then inclusion in the beneficiary's estate of an amount equal to the GST exemption that otherwise would be wasted might facilitate the allocation of the beneficiary's available GST exemption to the property, rendering the property GST exempt thereafter. This could be a benefit even if the beneficiary's death does not result in a taxable termination, as long as the inclusion in the estate does not trigger estate tax.
- Finally, if the property in the trust has a low basis, and inclusion of part or all of the property in the beneficiary's estate will not increase the overall tax liability, then inclusion in a beneficiary's estate could result in the basis of the property being stepped up to fair market value.

Needless to say, the potential tax benefit of causing estate inclusion must always be weighed against the grantor's desire to limit a beneficiary's ability to control the disposition of the property, since a beneficiary may exercise a power in a manner that is not desirable. On the other hand, a beneficiary power can still be a general power even though the power requires the consent of a third party before the power can be exercised.

E. Requiring Third Party Consent to Exercise of General Power

Giving a beneficiary a power to appoint to the beneficiary's estate or, to a lesser extent, the creditors of the beneficiary's estate, can be cause for concern that the beneficiary may actually exercise the power in a manner that is contrary to the intentions of the grantor. While this may be considered a "cost" of avoiding the GST tax, one possible solution is to provide that the power is exercisable only with the consent of a non-adverse third party.

I.R.C. §2041(b)(1)(C) includes within the definition of a general power of appointment a power that is exercisable ***only in conjunction with another person as long as*** such other person is neither the ***creator of the power***, nor a person with a ***substantial interest in the trust property*** that is adverse to the beneficiary's exercise of the power in favor of the beneficiary's estate. See the discussion below regarding additional considerations where the trustee or some other person has the power to grant a general power of appointment.

F. Formula Contingent General Power of Appointment

So what is the answer? Include the general power of appointment for non-exempt property, ***but*** make the general power contingent on estate inclusion

[35] The GST exemption is also $5,000,000, indexed for inflation in $1,000 increments for years after 2011. For 2017, the indexed amount is $5,490,000.

resulting in a lower aggregate tax (or other tax benefit) ***and*** make the general power applicable only to that portion of the property that will result in a benefit.

The following formula is designed to minimize *wealth transfer tax*, and does not include provisions designed to maximize basis step-up. For sample provisions designed specifically for basis step-up, see the appendices at the end of Steve Akers's ***Heckerling Musings 2014 and Other Current Developments***, *February 2014*, which may be found at: http://www.bessemertrust.com/portal/site/Advisor, then enter the search terms "Heckerling Musings 2014."

G. Sample Provision: General Power of Appointment – Contingent

If upon the death of the beneficiary for whose primary benefit a trust is established hereunder, all or any part of the trust property would, but for the grant of a general power of appointment to the beneficiary under this paragraph, pass in a manner that would cause such property to be subject to the federal generation-skipping transfer ("GST") tax,[36] then such beneficiary shall have the power by his or her last will and testament, or by other written instrument executed before a notary public,[37] making express reference to this power, to appoint to such beneficiary's estate[38] a fractional share of the property in such trust, the numerator of which is the smallest amount, if any, that, when included in the beneficiary's gross estate by virtue of this power, will, irrespective of whether such power is *actually* exercised,[39] result in the

[36] Note that this provision causes the power of appointment to become operative only if the property would otherwise pass in a manner that would trigger GST tax. Therefore, if the non-skip beneficiary is not survived by issue, causing the beneficiary's trust to instead pour-over into a trust for a sibling, the power would not be operative, because no GST tax would have been imposed.

[37] Most powers of appointment are only exercisable by will, but there is no legal reason for this restriction, and such a restriction could force the power holder to make a will that must be probated, where a will otherwise would not be necessary, because the power holder's estate is disposed of by means of a revocable trust. Perhaps the reason for this requirement is to help ensure that the exercise of the power is genuine, since it will be subjected to the rather rigorous rules that apply to the execution and probate of wills. Still, perhaps the desired level of security could be achieved by allowing the power to be exercised by a written instrument other than a will, as long as it is executed in the presence of a notary.

[38] Some practitioners prefer to make the power exercisable in favor of the *creditors* of the estate, which allows for estate inclusion without actually giving the beneficiary the power to control the disposition of the property. Another option, whether the power is exercisable in favor of the estate or the creditors, is to make the power be contingent upon the consent of the trustee or some third party.

[39] This parenthetical is intended to make clear that the conditional general power is only triggered where estate inclusion will result in tax savings even if the power is not actually exercised. Thus, for example, the general power would not be triggered where the reduction in tax is contingent upon the general power being exercised in favor of a spouse or charity, to take advantage of the marital or charitable deduction, but no tax reduction would result if the power was not exercised at all.

maximum reduction in the sum of the federal and state GST, estate, legacy, succession, inheritance and similar taxes imposed by reason of such beneficiary's death with respect to the property in such trust, when compared to the sum of such taxes that would be imposed by reason of such beneficiary's death with respect to the property in such trust if no general testamentary power of appointment were conferred on such beneficiary under this paragraph, and the denominator of which shall be the aggregate fair market value of the trust estate on the date of such beneficiary's death, as determined under federal estate tax principles.[40] [Notwithstanding the foregoing, however, any such general power of appointment shall only be exercisable with the written consent of the Trustee, but the trustee shall be under no duty to either grant or to withhold such consent.[41]]

[Additionally, the foregoing general power of appointment shall be exercisable with respect to an amount of property equal to such beneficiary's unused GST exemption, to the extent that the inclusion of such property in the beneficiary's gross estate does not result in an increase in such taxes.][42]

The trustee shall, prior to distributing such trust as hereinabove directed, distribute to the beneficiary's estate or directly to the appropriate taxing authority, as the trustee may determine, that portion of such taxes payable by such beneficiary's estate, if any, which is attributable to the inclusion in such beneficiary's estate of the assets of the trust over which the beneficiary had a general power of appointment.[43] Such payment shall be equal to the amount by which (1) the total

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[40] Note that this sentence only triggers the power if the result is a *reduction* in overall taxes, so it will not trigger the power if the tax burden would be exactly the same, but see the following sentence.

[41] The requirement of trustee consent provides a "hedge" against a beneficiary's irresponsible use of the general power that is, after all, granted in this case to provide a tax benefit, and not because the grantor truly wants to expand the scope of the beneficiary's power, but see the discussion below.

[42] This provision would apply even if there is no reduction in overall taxes, if the result will be the benefit of allowing the power holder to allocate GST exemption to the included property without increasing taxes.

[43] Note that the power holder's estate already has a right to recover any tax attributable to the power of appointment under I.R.C. § 2207, but including this provision might serve as a gentle reminder to a trustee to hold back the funds so that the power holder's estate does not have to chase after any third party that might receive the property either pursuant to an exercise of the power or as a result of a failure to exercise the power.

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of such taxes payable by the beneficiary's estate
exceeds (2) the total of such taxes that would have
been payable if the value of the trust property had
not been included in the beneficiary's estate.  The
amount of such taxes due hereunder shall be based
upon the values in the beneficiary's estate as
finally determined for federal estate tax purposes.
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H. Power to Grant General Power of Appointment

An alternative approach in some documents is to give the trustee, trust protector, or other person the power to confer a general power of appointment on the beneficiary, if the power holder determines that inclusion in the beneficiary's estate will be in the best interests of the trust beneficiaries. The author believes that a "hard wired" provision, such as the sample above, is preferable to relying upon the trustee to grant a general power of appointment, at least with respect to avoiding GST tax. On the other hand, general powers to facilitate a basis step-up for appreciated assets may be sufficiently complex that the better route is to give someone the authority to grant a general power of appointment to a beneficiary or to modify an existing power.

Note, however, that, as discussed above, if there is a desire that the general power be exercisable only with the consent of a third party, the person whose consent is required must be someone ***other than*** the person who granted the general power in the first place, as well as being a person with no adverse interest in the trust, or else the power will not be a general power.

Generally speaking, a thorough review of Section 2041 and the regulations thereunder is recommended before drafting such a provision.

It should be noted that one commentator raises the question of whether there is a real difference between a third party having the power to grant a general power vs. a pre-existing power that is exercisable in conjunction with a third party. *See* Ronald Aucutt, *When is a Trust a Trust?*, at 17, Printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools,* State Bar of Tx. 20th Ann. Adv. Estate Planning Strategies Course (2014). The concern is that if there is no real difference, then perhaps the beneficiary may be deemed to hold a general power of appointment even if it is never formally granted by the third party. The author believes that argument unlikely, however, because Treas. Reg. § 20.2041-3(b) states that where a power of appointment that is contingent upon the happening, *during the lifetime of the beneficiary*, of an event or contingency that did not *in fact* happen during his lifetime, then the power is not general. Therefore, if the general power is clearly contingent upon a third party granting the power during the beneficiary's lifetime, then that contingency would have to be satisfied for a general power to exist. Moreover, in Rev. Ruls. 2008-22 and 2011-28, discussed above, the IRS was clear that the rights and powers incident to the ownership of property would not be attributed to the grantor holding a power to reacquire that property, even though the power to regain ownership was wholly under the grantor's control.

Giving the *trustee* the power to grant a general power places the trustee in a potentially awkward position and exposes the trustee to potential liability unless the trustee is exculpated from any liability for either granting such a power or failing to do so. On the one hand, if the trustee grants a general power to one beneficiary to secure a tax benefit, and the beneficiary exercises the power in a way that is detrimental to the interest of another beneficiary, the trustee could incur liability to the other beneficiary. On the other hand, if the trustee fails to grant a general power, resulting in a significant tax liability that could have been avoided, the trustee could incur liability for the omission. Therefore, a trustee, particularly an institutional trustee, may not be willing to accept such a power, unless the document expressly states that the trustee is under no duty to exercise the power and will incur no liability for exercising the power.

That having been said, crafting a contingent general power to allow for a step-up in basis is considerably more difficult than avoiding the GST tax, since a basis step-up may not apply to all assets of the trust. Therefore, perhaps one solution may be to include a provision similar to the sample provision above and, in addition, to give the trustee the additional authority to grant a general power even if there is no GST benefit, as long as the general power results in some other benefit.

I. Sample Provision: Trustee Power to Grant General Power of Appointment

> The trustee of any trust hereunder, other than any trustee who is a beneficiary or otherwise interested in such trust, is authorized, with respect to all or any part of the trust property, in its sole discretion and by an instrument in writing filed with the records of the trust, to create in a beneficiary a testamentary general power of appointment, within the meaning of Section 2041 of the Code (including a power the exercise of which requires the consent of some person other than the person creating such power or any person with a substantial interest in the trust property that is adverse to the beneficiary's exercise of the power in favor of the beneficiary's estate or creditors[44]) or to eliminate or modify any such power previously created hereunder, or to release the foregoing power in whole or in part.
>
> The settlor intends that the foregoing power be available to the trustee whenever the exercise of such power will or may result in some significant tax or other benefit to the

[44] Treas. Reg. 2041(b)(1)(C)(i) provides that any power of appointment that is exercisable only with the consent of the creator of the power is not a general power of appointment. Therefore, it is important that the person with the power to consent be someone other than the person with the authority to grant the general power.

beneficiaries such as, for example, the reduction of aggregate federal and state wealth transfer taxes, or the ability to allocate a beneficiary's unused GST exemption to trust property, or to facilitate an adjustment to the capital gains tax basis of such property.

The trustee shall be under no duty to exercise the foregoing power, to inform any beneficiary or other person of the potential benefit of exercising the power, or to monitor any fact or circumstance to determine whether to exercise such power, regardless of whether, or the extent to which, the trustee may have previously undertaken any such exercise, informing, or monitoring. The settlor's expectation is that each beneficiary will engage in responsible estate planning and will alert the trustee whenever the exercise of such power may be beneficial, but that the final decision rest with the trustee. The Trustee shall incur no liability to any person for its exercise of such power or its refusal or failure to exercise such power, absent willful misconduct proved by clear and convincing evidence in the court with primary jurisdiction over the administration of such trust.[45]

The trustee shall distribute to the beneficiary's estate or directly to the appropriate taxing authority, as the trustee may determine, the amount by which the wealth transfer taxes imposed upon the beneficiary's estate exceed the amount of such taxes that would have been imposed, had the trustee refrained from granting a general power of appointment hereunder.

Any legal expenses, fees, or other expenses incurred by the trustee in connection with the exercise of the power granted hereunder shall be borne by the trust to which the exercise of such power relates.

V. Dealing with Changing Circumstances – Looking Ahead

Generally speaking, it is quite helpful to provide as much *flexibility* in a trust, particularly a long term trust, as possible, since the longer the trust term, the more

[45] This is a strong exculpation provision expressly designed to relieve a trustee of any duty to monitor or determine whether to exercise the power to confer a general power of appointment, and this provision recognizes that imposing any such duty on the trustee would be an unreasonable burden.

likely it is that unforeseen changes to the parties' circumstances, the tax or other governing law, or all of the above, will occur. The following are examples of trust provisions that can add the flexibility to deal with those changing circumstances, without the expense, delay, and public disclosure of private matters that is often necessary when court involvement is required.

Some of the matters discussed in this section may already be covered by governing state law, especially in UTC jurisdictions. However, it is well to remember that there is always a possibility that the situs (referred to in the UTC as the *principal place of administration*) and, thus, the law governing the administration of the trust, could be transferred in the future to a jurisdiction that has not enacted such provisions, or whose versions of these provisions are less desirable than they could be. Therefore, the author recommends that certain provisions be included in the trust agreement, even if they are already covered under governing state law, *just* to be sure.

A. Virtual Representation

Virtual representation is a doctrine whereby minor, incapacitated, or missing beneficiaries of a trust can be bound by the actions of others who "represent" their interests, without having a guardian *ad litem* or other official representative appointed for them by a court. The doctrine of virtual representation is a common law doctrine, not universally recognized, that had traditionally applied only with respect to judicial proceedings where it was impossible to get all interested parties before the court.[46]

In more recent times, virtual representation has been recognized by state statutes even in a non-judicial context, where parties with an interest in a trust seek to protect their interests by agreement in a way that is reliable, but does not require the expense, time, and potential public disclosure that a court action typically involves.

The most common example of settling by agreement matters that otherwise would require court action is the final "settlement" of a trustee's account with respect to its administration of a trust. When a trust terminates, or where a trust continues, but a trustee has resigned, or has been replaced, the trustee will typically request a "receipt and release" agreement with the beneficiaries and, where appropriate, the successor trustee, where all of the interested parties are satisfied with the trustee's administration of the trust, and are willing to "settle" the trustee's account by agreement, thus dispensing with the cost and time associated with a formal judicial settlement of account.

Such agreements are generally reliable and, therefore, a reasonable substitute for a formal judicial settlement, because the common law recognizes generally that a beneficiary of a trust cannot sue a trustee for any action constituting a breach of trust where the beneficiary consented to the action, or has released the

[46] RESTATEMENT (THIRD) OF TRUSTS § 65, cmts. b & c. The Reporter's notes to this comment include citations to numerous cases, statutes and secondary source materials discussing the common law doctrine of virtual representation.

trustee from liability, or has subsequently affirmed the action.[47] The UTC and the statutes of many non-UTC jurisdictions limit the ability of a trust agreement to exculpate a trustee from all liability in advance, by providing that a trust agreement may not exculpate a trustee for liability from "breach of trust committed in bad faith or intentionally or with reckless indifference to the interest of the beneficiary or for liability for any profit which the trustee has derived from a breach of trust."[48] Such limitations, however, only apply to trust agreements themselves, to the extent that they relieve trustees of liability for future actions, but do *not* apply to a release executed by the beneficiaries after the alleged breach has occurred.[49]

The problem, however, is that most trusts have one or more beneficiaries who lack the capacity to bind themselves to an agreement, because they are minors, or are otherwise incapacitated, or have not yet been born, or cannot be located. In such cases, it is impossible to obtain the consent of all of the beneficiaries in a manner that binds them to the agreement unless their interests are adequately represented, traditionally by a court appointed guardian or conservator.

The UTC includes extensive virtual representation provisions,[50] and virtual representation provisions also appear in the statutes and/or common law of some non-UTC jurisdictions.[51] As discussed above, the author recommends including a virtual representation provision in the document itself even if representation is provided for under state law, since the law governing the trust may not be as broad as a provision that could be included in the instrument and, even if governing law is acceptable, governing law might change to another jurisdiction without virtual representation or with a less favorable statute. See the footnotes below discussing the differences between the sample provision and the provisions found in various state versions of the UTC.

Sample Provision:

Virtual Representation

1. Effect of Representation. Notice to a person who may represent and bind another person

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[47] RESTATEMENT (SECOND) OF TRUSTS §§ 216-218 (1992), UNIF. TRUST CODE § 1009 (2005).

[48] *See* UNIF. TRUST CODE § 1008; O.C.G.A. § 53-12-303(a).

[49] *Heiman v. Mayfield,* 300 Ga. App. 879; 686 S.E.2d 284 (Ga. App. 2009). In *Heiman*, the beneficiary had executed a general release of all claims against the trustee at the time of the final distribution of the trust, but later sued the trustee alleging "multiple acts of fraud, negligence and other misfeasance." The trustee counterclaimed for breach of release agreement, but the counterclaim was dismissed by the trial court based upon the exculpation limitation provision of the Trust Code (O.C.G.A. § 53-12-194 (a), recodified in 2010 as 53-12-303(a)). The Georgia Court of Appeals reversed, holding that the limitations only applied to trust agreements, and that a release agreement was not a trust agreement under the code, so the release was valid and enforceable.

[50] *See* UNIF. TRUST CODE §§ 301-304.

[51] *See, e.g.*, §760 ILL. COMP. STAT. ANN. 5/16.1, which is essentially a combination of the virtual representation and nonjudicial settlement agreement provisions from the UTC.

under this trust has the same effect as if notice were given directly to the other person. The consent of a person who may represent and bind another person under this trust is binding on the person represented, irrespective of whether the person represented is aware of the representation, unless the person represented objects to the representation before the consent would otherwise have become effective.[52]

2. Representation by holder of power of appointment. The holder of a power of appointment, general or limited, may represent and bind all persons whose interests are subject to the power, including but without limitation, permissible appointees and takers in default of the exercise of such power.[53]

3. Representation by Fiduciaries and Ancestors. To the extent there is no conflict of interest between the representative and the person represented or among those being represented with respect to a particular question or dispute: (1) a conservator may represent and bind the estate that the conservator controls; (2) a guardian may represent and bind the ward if a conservator of the ward's estate has not been appointed; (3) an agent having authority to act with respect to the particular question or

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[52] This provision is based upon UNIF. TRUST CODE § 301, but adds the phrase "irrespective of whether the person represented is aware of the representation," in an effort to negate any argument that notice of the representation must be given to the person to be represented. The UTC provision permitting a represented person to object could imply a right to be notified of the pending representation, but that does not appear to be the intent of the UTC.

[53] This provision is based upon UNIF. TRUST CODE § 302, but is considerably broader than the uniform act provision, in three respects. First, this provision applies to both testamentary *and inter-vivos* powers of appointment, whereas the uniform act provision applies only to *testamentary* powers of appointment. Second, this provision applies to holders of both general *and limited* powers, whereas the uniform act provision applies only to holders of *general* powers. Finally, the uniform act provision requires that there be no conflict of interest between the power holder and the person represented, whereas this provision does *not* require an absence of any conflict of interest. The theory behind these expansions of the uniform act provisions is that a power of appointment, whether limited or general, is generally a power to completely eliminate the interest of certain beneficiaries in favor of certain other beneficiaries, and such powers themselves generally are not contingent upon the lack of a conflict of interest. Such a broad representation provision might not be appropriate where a power is not a power to completely eliminate one interest in favor of another. State versions of this provision vary considerably. For example, Oregon permits representation by holders of both general and limited testamentary powers, to the extent there is no conflict of interest. O.R.S. § 130.105. Alabama eliminates the requirement regarding conflicts of interest for inter-vivos powers of appointment exercisable in favor of the power holder, and also allows holders of testamentary limited powers to represent others. ALA. CODE § 19-3B-304(b). Still others permit representation by the holder of a limited power if the power is exercisable in favor of anyone *other than* the power holder's creditors, estate, etc., but not for powers exercisable only in favor of a more limited class.

dispute may represent and bind the principal; (4) a trustee may represent and bind the beneficiaries of the trust;[54] (5) a personal representative of a decedent's estate may represent and bind persons interested in the estate; (6) an individual may represent and bind his or her minor or unborn children if a conservator or guardian for the issue has not been appointed; and (7) a grandparent or other direct ancestor may represent and bind the minor or unborn issue if a conservator or guardian for the issue has not been appointed and the issue is not otherwise represented hereunder. Whenever two or more persons may serve as representative under (6) or (7) above, notice to or consent of all such persons shall not be necessary, and any one of such persons may act as representative, but in the event of any disagreement between such persons, such disagreement shall be resolved in favor of the representative who is a descendant of the settlor.[55]

4. Representation by person having substantially identical interest. Unless otherwise represented, a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable, may be represented by and bound by another having a substantially identical interest with respect to the particular question or dispute, but only to the extent there is no conflict of interest between the representative and the person represented with respect to a particular question or dispute.

5. Representation by Presumptive Remainder Beneficiary. A presumptive remainder beneficiary, meaning a person who would be eligible to receive distributions of income or principal from the trust upon the termination of the interests of all persons currently eligible to receive distributions of income or principal, may represent and bind contingent successor

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[54] Obviously, the trustee cannot bind the beneficiaries with respect to the trustee's own actions, as that would be a clear conflict of interest in any case, but where, for example, Trust B is a remainder beneficiary of Trust A, and the trusts have different trustees, then the trustee of Trust B may represent the beneficiaries of Trust B with respect to some action to be taken regarding Trust A.

[55] This provision is based upon UNIF. TRUST CODE § 303, but has been expanded, by adding subsection (7), which allows any number of later minor or unborn generations to be represented, while giving priority to the parent of a minor child, if available.

remainder beneficiaries, including, but not limited to charitable entities, with respect to matters in which there is no conflict of interest between the representative and the person represented with respect to a particular question or dispute.[56]

6. Appointment of Representative by Court. A court of competent jurisdiction may appoint a representative to receive notice, give consent, and otherwise represent, bind, and act on behalf of a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown, if no other representative for such individual is available. A representative may be appointed to represent several persons or interests. A representative may act on behalf of the individual represented with respect to any matter arising under this trust agreement, whether or not a judicial proceeding concerning the trust is pending. In making decisions, a representative may consider general benefit accruing to the living members of the individual's family.[57]

Some states have enacted versions of the UTC, or non-UTC provisions, that do not permit the settlor to waive the duty to inform the beneficiaries of the administration of the trust, but permit someone to be designated as a representative for a *sui juris* beneficiary, to receive any notice, information, accounting, or report, and to otherwise represent and bind the beneficiary. This generally occurs with respect to "quiet" trusts where the settlor wishes that the

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[56] *See* ALA. CODE § 19-3B-304(b). The concept of the *presumptive remainder beneficiary*, as defined in ALA. CODE § 19-3B-103(12), is not found in the uniform act, but it recognizes that, in most cases, the interest of the beneficiary who is expected to receive the remainder will be the same as the interest of the contingent beneficiary who will take only if the presumptive remainder beneficiary fails to survive. Note that, as with the Alabama statute, this provision requires that there be no conflict of interest, but it does *not* require that the interests of the presumptive remainder beneficiary and the contingent remainder beneficiary be identical. Curiously, the other representation provisions in the uniform act and the Alabama statute provide that the representative may represent ***and bind*** the person represented, but the presumptive remainder beneficiary provision in the Alabama statute omits the words "and bind." Discussions with ACTEC fellows in Alabama suggest that the omission probably was not intentional, and that the provision was intended to permit the presumptive remainder beneficiary to represent and bind the contingent remainder beneficiaries as fully as in the other provisions. Nevertheless, the author has added those words to the sample provision here to eliminate any issue. Finally, the sample provision expressly states that the contingent remainder beneficiaries to be represented include *charitable* organizations, in an attempt to eliminate the requirement that any state attorney general be involved in any matter involving the trust prior to the vesting of an interest in a charity.

[57] This provision is based upon UNIF. TRUST CODE § 305, and is designed to facilitate the appointment by a court of a representative, even though no judicial action is pending. This might be appropriate where, for example, other potential representatives may have a conflict of interest with the person to be represented.

beneficiary ***not*** receive information about the trust, at least for a period of time.[58] It is likely imprudent to depend upon the concept of a designated representative where the law governing the administration of the trust does not expressly recognize this form of representation. Where the office is recognized, the representative should be subject to fiduciary duties to the represented party. Not all state laws require that the representative be a fiduciary, but a court may be less likely to agree that a beneficiary without knowledge of circumstances may be bound by another who owes no fiduciary duty to the beneficiary.

Sample Provision:

Designated Representative (Florida)

Pursuant to section 736.0306 of the Florida Statutes, I appoint _________ as Designated Representative of all beneficiaries of the trust.

A. Power to appoint and remove Designated Representative.

1. If no Designated Representative is acting on behalf of one or more beneficiaries of any trust under this document and the foregoing provisions do not effectively provide for the appointment of a Designated Representative, I, or, if I am unable to act, the Primary Beneficiary of such trust, or, if the Primary Beneficiary is unable to act, a majority of the Eligible Beneficiaries of such trust, may appoint one or more Designated Representatives to represent one or more beneficiaries of such trust.

2. Any person or class of persons who appointed a Designated Representative pursuant to the foregoing subsection may remove such appointed Designated Representative at any time.

3. A Designated Representative is authorized to resign at any time without court approval.

4. The resignation, appointment or removal of a Designated Representative shall be exercised in the same manner as provided in the section entitled "Procedures" governing the appointment, resignation and removal of Trustees. A Designated Representative who is incapacitated shall be deemed to have resigned as Designated Representative and to have released his or her power to remove a Designated Representative.

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[58] *See*, e.g., FS §736.0306.

5. For the sole purpose of this Article, a person is "unable to act" if he or she is then deceased, incapacitated, or disqualified by law from acting.

B. Provisions concerning Designated Representatives.

1. No then acting Trustee of any trust under this document shall serve as or appoint a Designated Representative of a beneficiary of such trust.

2. Except as otherwise provided under Chapter 736 of the Florida Statutes, but only to the extent such law is not modified by this document, a Designated Representative who is also a beneficiary of a trust may not represent and bind another beneficiary of such trust unless the Designated Representative (i) was appointed by me; (ii) is such other beneficiary's spouse; (iii) is a grandparent of such other beneficiary or such other beneficiary's spouse; (iv) is a descendant of a grandparent of such other beneficiary or such other beneficiary's spouse; or (v) is authorized to act under the section of this document entitled "Virtual representation."

3. My Trustees shall provide the Designated Representative of a beneficiary of a trust with any notice, accounting or other information that is required by law to be distributed to such beneficiary or that my Trustees consider pertinent to the administration of such trust (referred to as "trust information") and the Designated Representative shall represent and bind the beneficiary with respect to such trust information, regardless of any provision of Chapter 736 of the Florida Statutes to the contrary. My Trustees shall not give trust information directly to any beneficiary who is otherwise represented by a Designated Representative.

4. A Designated Representative who is not a beneficiary of such trust shall be entitled to receive from such trust (i) reasonable compensation for serving as a Designated Representative and (ii) reimbursement for expenses incurred while acting in such capacity.

5. A Designated Representative shall not be liable to any beneficiary whose interests he or she represents, or to anyone claiming through such beneficiary, for any actions or omissions to

act, provided such actions or omissions are made in good faith.

6. My Trustees shall not be liable to any beneficiary represented by a Designated Representative for giving trust information to such Designated Representative in lieu of giving trust information to such beneficiary.

By way of *caveat*, it should go without saying that allowing persons to be represented by virtual representation does not present the same degree of protection and oversight as would the requirement of the appointment of a guardian *ad litem* and/or supervision of a court. Therefore, virtual representation should only be made available where the practitioner agrees that the additional flexibility justifies the loss of oversight and protection.

B. Nonjudicial Settlement Agreements

Further to the UTC's philosophy of encouraging action by agreement, without court involvement, as facilitated by virtual representation, is the concept of the Nonjudicial Settlement Agreement. In a nutshell, this provision states that any action a court could take with respect to a trust can be accomplished without court involvement, as long as:

- The action is consented to by all of the interested parties who would have to participate in the court proceeding to take such action;
- The action is not contrary to a "material purpose" of the trust; and
- The action is an action the court would be authorized to take.

Such agreements are frequently employed in UTC jurisdictions to clarify uncertain rights and obligations of the parties, to approve accountings, to replace trustees, to grant administrative powers to trustees, etc.

The potential effectiveness of such agreements is demonstrated by *In Re Frank*,[59] decided under Ohio's version of the UTC. In *Frank*, the trust was subject to a local probate court rule requiring that the trustee post a bond equal to double the value of the trust, unless the trust agreement provided otherwise, and the trust apparently did not expressly waive the requirement. After the probate court refused the trustee's request to reduce the amount of the required bond, the trustee entered into a nonjudicial settlement agreement with the beneficiaries to eliminate the bond requirement altogether. The trustee moved to have the court approve the agreement, and the court refused. The Court of Appeals reversed the probate court, holding that the parties had the right to modify the trust by agreement in any way that was not inconsistent with the purposes of the trust, and that the probate court did not have the discretion to not approve the agreement otherwise.

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[59] *In Re Frank*, 910 N.E.2d 523 (Ohio App. 2009).

In jurisdictions that have not enacted the UTC or borrowed this notion from the UTC (such as Illinois), practitioners might consider grafting such a provision into the trust. Below is a sample provision largely borrowed from the UTC:

Sample Provision:

Nonjudicial Settlement Agreement

Except as otherwise provided in subsection (c), the persons whose consent would be required in order to achieve a binding settlement were the settlement to be approved by a court of competent jurisdiction, may enter into a binding nonjudicial settlement agreement with respect to any matter involving any trust created hereunder, so long as such agreement does not violate a material purpose of the trust, includes terms and conditions that could be properly approved by a court of competent jurisdiction under applicable law.

Matters that may be resolved by a nonjudicial settlement agreement include, without limitation: (1) the interpretation or construction of the terms of the trust; (2) the approval of a trustee's report or accounting; (3) direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power; (4) the resignation or appointment of a trustee and the determination of a trustee's compensation; (5) transfer of a trust's situs or principal place of administration; and (6) the liability of a trustee for an action relating to the trust.

Any interested person may request a court of competent jurisdiction to approve a nonjudicial settlement agreement, to determine whether the representation as provided in [Article __] was adequate under the terms thereof, and to determine whether the agreement contains terms and conditions the court could have properly approved. The grantor's intent is that the court approve any such agreement, irrespective of the court's opinion of the wisdom of such an agreement, unless the court concludes that the agreement could not, under any circumstances, have been approved by the court in settlement of a judicial dispute.

C. Definition of Charitable Trusts - No Good Deed Goes Unpunished

In most states, for any trust that is a "charitable trust" as defined in governing state law, the state Attorney General or a similar state official represents the interests of the charity in any judicial action and, perhaps, in nonjudicial settings as well. Accordingly, to obtain the valid consent of the charity, the consent of the state Attorney General may be necessary as well. The difficulty is that many state laws define the term "charitable trust" rather broadly.[60] Such broad definitions raise the question of whether a trust becomes a "charitable trust" even if the only interest held by any charity is a contingent remainder interest. The UTC is clear that a charity has certain rights of a *qualified beneficiary* only if the charity is specifically named and otherwise would be a qualified beneficiary, because the charity is either a permissible distributee or would become a permissible distributee at the termination of the trust or the termination of the interests of the current permissible distributees.[61] However, the UTC also defines a "beneficiary" generally as including future contingent beneficiaries.[62] Therefore, in any circumstance that requires notice to, the consent of, or other involvement of all beneficiaries, and not just qualified beneficiaries, a contingent charitable beneficiary could be included in that class.

The typical situation is that a trust is created for members of the grantor's family, but includes an "Armageddon" provision stating that in the (presumably unlikely) event that all of the grantor's descendants or other individual beneficiaries should fail to survive to the end of the trust term, the trust property will be paid to one or more named charities, rather than to the so-called "laughing heirs." In such a case, it is fairly clear that the grantor was not creating a trust for charitable purposes, if the charitable interest only arises after all non-charitable beneficiaries have died out, and the expectation is that they will not, in fact, die out before the trust terminates. Nevertheless, under the laws of many states, there are matters that require notice to, or the consent of, contingent beneficiaries as well as current or presumptive future beneficiaries. Does that mean that the Attorney General must get involved in every matter where a trustee seeks the consent of beneficiaries to some action, or the release of the beneficiaries with respect to some action requested by the beneficiaries? If so, then all of the virtual representation and nonjudicial settlement agreement provisions discussed above may not work as well as intended, since dealing with the Attorney General can be a bureaucratic process.

One way to deal with this issue in the trust might be to simply state that the intention is ***not*** to create a charitable trust since, after all, the status as a charitable trust depends upon grantor intent, or lack thereof, and if that grantor intent is expressly stated, perhaps that would negate the charitable trust rules.

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60 For example, the UTC defines a charitable trust as "a trust, or portion of a trust, created for a charitable purpose described in Section 405(a)." UNIF. TRUST CODE 103(4). Similarly, Georgia law defines a charitable trust as a trust "where the grantor provides that the trust property shall be used for 'charitable purposes.'" O.C.G.A. § 53-12-170.

61 UNIF. TRUST CODE § 110(b).

62 UNIF. TRUST CODE § 103(3).

In the above discussion of virtual representation, the sample provision attempts to address this issue by stating that a presumptive remainder beneficiary may represent and bind the interest of contingent remainder beneficiaries, specifically including charitable contingent beneficiaries. Will it work? Who knows?!

Sample Provision:

Negation of Charitable Trust Provisions

The Grantor does not intend to create a charitable trust, notwithstanding that one or more contingent beneficiaries hereunder may be charities, and no trust hereunder shall be subject to any special provision of law regarding charitable trusts, such as the power of the attorney general of any other state to represent the charity, unless and until all conditions precedent to the interests of the charitable beneficiaries have been satisfied (i.e., all other noncharitable beneficiaries have died).

See also the above discussion of *virtual representation*, and the sample provision permitting presumptive remainder beneficiaries to represent the interests of all contingent remainder beneficiaries, charitable and non-charitable.

Additionally, trusts often will expressly negate the duty of impartiality with respect to future beneficiaries, by stating that the grantor's purpose is to provide for current beneficiaries, and that their needs may take priority over remaindermen, even to the extent of exhausting the trust before the remainder interests become possessory.

D. "Decanting" to Another Trust

A "decanting" power is a power to appoint or distribute property to another trust for the benefit of the permissible appointees or distributees of trust property. Decanting powers can be extremely useful to deal with changing circumstances or to cure "defects" in trusts, by simply pouring the trust assets over to a new trust with more desirable provisions.[63]

1. Powers of Appointment

Many states recognize that a *power of appointment* may be exercised in favor of a trust.[64] Some state laws consider *any* distribution power, including a

[63] *See* William R. Culp, Jr. & Briani Bennett Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 45 REAL PROP. TR. & EST. L. J. 1. *See also* M. Patricia Culler and Diana S.C. Zeydel, *Decanting: An In-Depth View of the Latest Techniques*, ACTEC FALL MTG. (2009). *See also* Alan S. Halperin, *You May Not Need to Whine about Problems with Your Irrevocable Trust-State Law and Tax Considerations in Trust Decanting*, U. MIAMI INST. ON EST. PLAN. (2008) and Laird F. Lile, *Decanting 101*, ACTEC ANN MTG. (2008).

[64] *See* Culler & Zeydel, *supra*, note 63, at 3, and RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 19.3 (1983), and the comments thereto, for a listing of many state court decisions supporting the right of a holder of a power of appointment to appoint in further trust. *See also* VA. CODE ANN. § 55-

fiduciary principal encroachment power, to be a power of appointment, while others only consider *non*-fiduciary powers to direct distributions to be powers of appointment. If state statute or case law recognizes a trustee's distribution power to be a power of appointment, then the distribution power should be exercisable in further trust to the same extent that any other power of appointment may be so exercised.[65]

2. Fiduciary Distributions

Several states have enacted decanting statutes specifically permitting a trustee to make distributions to trusts, as well as outright, assuming the trust instrument does not indicate that the grantor intended otherwise.[66] Decanting has also been recognized in case law.[67] Perhaps the most often quoted case recognizing decanting is *Phipps v. Palm Beach Trust Company*, which held that "the power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent."[68] The statutes and cases vary as to the circumstances under which decanting is permitted, such as whether decanting is permitted where the trustee's discretion is limited by an ascertainable standard, or is only permitted where the trustee has unlimited discretion.

25.1, as an example of a statutory provision (found in the property statutes, rather than the trust statutes) supporting this view, and Regents of the University System of Georgia v. Trust Company of Georgia, 186 Ga. 498; 198 S.E. 345 (Ga. 1938), which is an early case holding that a testamentary power to appoint property in fee simple includes the power to appoint a lesser estate, absent an expression of intent to the contrary.

65 *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 cmt. d (1983), which states that a trustee's power to make discretionary distributions is a power of appointment, but unlike § 19.3, cited above, § 11.1 does not cite to any authority for this proposition, and a *Shepard's* search at the time of this writing (April 2017) turned up no case law adopting this rule. By contrast, RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS, § 17.1, cmt. g, states that while a fiduciary distribution power is a power of appointment, the new Restatement defers to the RESTATEMENT (THIRD) OF TRUSTS §86 with respect to distribution powers held in a fiduciary capacity, because the Restatement (Third) of Property provisions generally refer to powers of appointment held in a nonfiduciary capacity. Some states have enacted statutes expressly addressing whether a fiduciary distribution power is a power of appointment, but many have not. Therefore, where a document does not expressly grant a decanting power, but it would be useful to have, a thorough review of state trust law and property law provisions dealing with powers of appointment would be in order. It may be that a recognition that a distribution power is a power of appointment may be cobbled together with a recognition that a power of appointment may be exercised in further trust.

66 For a list of state decanting statutes, see *State Decanting Statutes Passed or Proposed*, updated through April 28, 2016, Prepared by M. Patricia Culler, on the public side of the ACTEC website: http://www.actec.org/assets/1/6/Culler-Decanting-Statutes-Passed-or-Proposed.pdf. See also Summaries of State Decanting Statutes, updated through February 20, 2017, compiled by Susan T. Bart, http://www.actec.org/assets/1/6/Bart-State-Decanting-Statutes.pdf.

67 *See,* RESTATEMENT (SECOND) OF TRUSTS § 17, cmt. f (1992); *Phipps v. Palm Beach Trust Company*, 142 Fla. 782; 196 So. 299 (Fla. 1940); Marx v. Rice, 1 N.J. 574 (1949).

68 *Phipps* at 785-6, 196 So. at 301. *Phipps* continues to be good law in Florida, in addition to Florida's decanting statute, cited above.

In any event, if the power to decant is expressly stated in the trust agreement, then there should be no doubt about the existence or extent of such a power.

Sample Provisions:

Beneficiary Power of Appointment Including Decanting Power

The beneficiary shall have a special power . . . to direct the trustee to distribute all or any part of the property . . . to such person(s) or entity(ies), and in such amounts, ***in trust or otherwise***, as the beneficiary shall choose.

Fiduciary Decanting Power

The authority of the trustee to distribute income or principal to, and/or for the benefit of, any beneficiary hereunder shall include the power to distribute income or principal from such trust (the "Invaded Trust") to another trust (the "Receiving Trust") for the benefit of one or more beneficiaries of the Invaded Trust. All beneficiaries of the Invaded Trust need not be beneficiaries of the Receiving Trust, but all of the current and presumptive remainder beneficiaries of the Receiving Trust must be current or presumptive remainder beneficiaries of the Invaded Trust.

The Receiving Trust may be an existing trust or may be a trust established by the trustee of the Invaded Trust for the purpose of receiving a distribution hereunder.

The trustee of the Receiving Trust may be anyone other than the settlor. The Receiving Trust may include fiduciary powers of appointment exercisable by the trustee, so long as such powers are exercisable only in favor of one or more beneficiaries of the Invaded Trust. The Receiving Trust may include beneficiary powers of appointment, general or non-general, exercisable in favor of anyone, including persons who have no beneficial interest in the Invaded Trust.

The trustee's discretion with respect to distributions from the Receiving Trust may be greater or less than the trustee's discretion under the Invaded Trust, subject to the restrictions below.

The trustee's distribution authority hereunder shall not be exercisable in any manner that would cause any property of the Invaded Trust or the Receiving Trust to be included in the gross estate of the Settlor, nor shall such authority be exercisable in any way that would disqualify either the Invaded Trust or the Receiving Trust for any tax benefit otherwise applicable to the Invaded Trust. By way of example, and not by way of limitation:

- If the Invaded Trust is a "QTIP" trust, transfers to which qualified for the marital deduction, then the Receiving Trust must also meet the requirements of a QTIP Trust;
- If prior transfers to the Invaded Trust qualified for the gift tax annual exclusion as a result of a beneficiary withdrawal right that is still exercisable by any beneficiary, then such beneficiary must have the same withdrawal right over the property of the Receiving Trust;
- If prior transfers to the Invaded Trust qualified for the GST tax annual exclusion under Code Section 2642(c), then the Receiving Trust must also satisfy the requirements of such Code section.

It is my desire, which is not binding on the trustee, that in exercising any power such person be mindful of the potential effect of (1) Sections 2041(a)(3) and 2514(d) of the Code, (2) any similar tax provision, and (3) any relevant generation-skipping transfer tax provision.

3. Cautionary Note— Tax Consequences of Decanting

Even with a power to decant under the trust agreement and/or the governing provisions of state law, the actual exercise of the power requires great care, since there may be adverse tax consequences.[69]

a. Delaware Tax Trap

A taxable gift or inclusion of trust property in a beneficiary's estate can result if a ***beneficiary*** exercises a power of appointment by appointing

[69] See Culp & Mellen, *supra*, note 63, at Section IV of the article, entitled "Tax Treatment of Decanting."

property in further trust, if the property is thereafter subject to additional powers of appointment in others, if the other powers of appointment *can be* exercised in a manner that postpones the vesting of the trust property for a period of time ascertainable *without regard to the date of the creation of the first power*.[70] Note, however, that the Delaware Tax Trap *only* applies to an exercise of a *beneficiary* power of appointment, and should *not* be an issue with respect to a distribution power held by a *corporate or other independent* trustee, but see below.

b. IRS Current Study of Tax Implications of Decanting

In 2011, the IRS announced that it was studying the income, gift, estate and GST tax implications of trust decanting that results in a change in any beneficial interest, and therefore would not issue any further private letter rulings on the tax implications of decanting that results in any change of beneficial interest.[71] Additionally, Treasury requested comments from the public on the appropriate tax implications of decanting, particularly in certain situations including, but not limited to, any decanting that changes the grantor trust status of trust property.[72] Treasury received substantial and voluminous comments, as requested, and though such issues remain on the annual "no ruling" list published by the IRS, there has been no indication as to when, or whether, any guidance may be forthcoming, and this project has not appeared on the "Priority Guidance Plan" in many years.

c. Regulations on Decanting "Grandfathered" GST Trusts

The only reliable guidance thus far on the tax implications of trust decanting is a regulation setting forth certain "safe harbor" transactions involving modification of trusts, whether by decanting or otherwise, that are "grandfathered" because they were created prior to the effective date of the GST tax.[73] While no such guidance has been issued with respect to trusts that have a zero inclusion ratio resulting from the allocation of GST exemption, the IRS has ruled in at least one private letter ruling that any

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[70] I.R.C. §§ 2041(a)(3) and 2514(d). This rule is called the ***Delaware Tax Trap*** because it arose from a provision of Delaware law providing that whenever property is transferred in trust by the exercise of a power of appointment, the rule against perpetuities measuring period for the property thereafter runs from the date of decanting, not from the date of the original trust. *See also* Richard W. Nenno, *Terrors of the Deep: Tax Dangers When Exercising Powers Over Trusts — The GST Regulations and the Delaware Tax Trap*, 34 EST., GIFTS AND TR. J. 76; James P. Spica, *A Trap for the Wary: Delaware's Anti- Delaware-Tax-Trap Statute is Too Clever by Half (of Infinity)*, 43 REAL PROP. TR. & EST. L. J. 673. *See also* Culp & Mellen, *supra*, note 63.

[71] *See* Rev. Proc. 2014-3, Section 5 (24).

[72] Notice 2011-101. See *ACTEC Comments on Transfers by a Trustee from an Irrevocable Trust to Another Irrevocable Trust (Sometimes called "Decanting")(Notice 2011-101) Released December 21, 2011*, on the public side of the ACTEC website at: http://www.actec.org/resources/comments-on-transfers-by-a-trustee/.

[73] Treas. Reg. § 26.2601-1(b)(i).

transaction that qualifies for the safe harbor for grandfathered trusts should not result in the loss of GST exempt status with respect to a zero inclusion ratio trust.[74]

E. Power to Amend Trust

The trustee or, perhaps, a third party special trustee, protector, or advisor, can be given the power to make certain modifications in the terms of the trust to maintain or achieve certain tax or other advantages for the beneficiaries or for other purposes.[75] Generally, such powers are limited so as to prevent abuse of the power to the detriment of beneficiaries. Moreover, such powers should generally be restricted to corporate or other independent trustees, to prevent such a power giving rise to a taxable general power of appointment.

A "real life" example of where such a power came in handy involved a trust that gave the trustee broad discretion to distribute income and principal to the beneficiaries, but did not expressly provide that undistributed income be added to principal. In such a case, if income is *not* distributed, the trustee may be required to hold the accumulated income in a separate account indefinitely, and may be limited as to investment options, instead of investing the funds as part of the principal. The trustee was able to administratively amend the trust to provide for the addition of undistributed income to principal *assuming*, of course, that doing so does not favor one group of beneficiaries to the detriment of another.

Sample Provision:

Power to Amend to Secure Grantor Objectives

Any corporate or other independent trustee shall have the authority to amend this agreement from time to time as it deems necessary or advantageous to secure tax or other legal benefits for the beneficiaries, but no such amendments shall adversely affect any beneficial interests hereunder.

F. Power to Terminate

The trust instrument may confer upon the trustee the power to terminate the trust under certain circumstances.[76] Such a power allows the trustee to terminate a trust if its purpose is no longer being served. If the power is coupled with a "decanting" power, this may permit the trustee to deal with certain circumstances by terminating one trust and distributing the assets to a new trust with more favorable terms. Many trust forms in common use provide for termination of very small trusts, but sometimes termination may be desirable even for a larger trust.

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[74] PLR 200141024.

[75] *See, e.g.*, UNIF. TRUST CODE § 808(c) and O.C.G.A. § 53-12-61, both of which expressly permit giving the trustee or another a power to amend.

[76] *See, e.g.*, O.C.G.A. § 53-12-64.

Sample Provisions:

Trustee Power to Terminate Trust - Short

Notwithstanding any other provision hereunder, if at any time the Trustee (other than any Beneficiary), in its sole discretion, shall determine that the size of any trust does not warrant the cost of continuing the trust or that its further administration would defeat or fail to serve the grantor's purposes in creating the trust, or be otherwise impractical, the Trustee, in full discharge of its duties, without formal judicial accounting, may distribute the then remaining trust assets to the Beneficiary. Upon making any such distribution, all beneficiaries' interests in the trust, whether vested or contingent, shall be terminated and the Trustee shall be relieved of all liability and accounting requirements with respect to the trust.

Protector/Advisor Power to Terminate Trust - Detailed

The Trust Advisor (who may not be a Beneficiary of this Trust) shall have the power to terminate the Trust if the Trust Advisor determines, in the Trust Advisor's sole and absolute discretion, that:

(1) The continued retention of the principal in trust is uneconomical or otherwise inadvisable;

(2) The Trust no longer serves any material purpose of the Grantors or of the Beneficiary or Beneficiaries of the Trust; or

(3) For any other reason, termination of the Trust will be in the best interests of the Beneficiary or Beneficiaries.

The Trust Advisor shall provide the then serving Trustee with written notice of the decision to terminate and the date of termination, if any. Upon the Trust Advisor's exercise of the power to terminate, the Trustee may (1) distribute the remaining principal and undistributed income of the Trust to the current beneficiary or beneficiaries of the Trust as the Trustee, in the exercise of sole and absolute discretion, determines to be most consistent with the Grantors' manifested plan of distribution, or (2) purchase an annuity contract with the remaining principal and undistributed income of the Trust which provides life income for the current beneficiary or beneficiaries of the Trust under such terms and conditions as the Trustee, in the exercise of sole and absolute discretion, shall determine. No Trust Advisor or Trustee who acts under this power to terminate and distribute shall be liable to any Beneficiary unless such power was exercised in bad faith.

VI. Trustee Powers to Enhance Flexibility and Benefits

A. Power to Hold Property for Beneficiary Use

Traditional rules require a trustee to invest trust assets for the production of income (or, perhaps, total return) to be distributed to or for the beneficiaries. Moreover, all trust investments typically must comply with any applicable *prudent investor* standards with regard to risk, productivity, liquidity, diversification, etc. However, it may be beneficial for a trustee to retain or purchase a *primary or secondary residence*, or even *tangible personal property*, for a beneficiary's use, rather than distributing property to the beneficiary or distributing the funds to purchase the property. After all, once the funds are distributed, they are in the beneficiary's gross estate and fully subject to creditor claims.

The challenge is that even though the purchase and maintenance of such property benefits a beneficiary, it may be difficult to justify the retention or purchase of such property under normally applicable "prudent investor" principles. Moreover, even where a trustee can justify holding such property, the custody and control of the property will necessarily be turned over to the beneficiary, thus limiting the trustee's ability to protect the property from loss or damage at the hands of the beneficiary.

To eliminate any doubt, consider a provision that expressly permits the retention or acquisition of property for the personal use of the beneficiaries, while at the same time reasonably exculpating the trustee from liability for loss or destruction of the property while under the control of the beneficiary.

Sample Provision:

Power to Hold Personal Use Property

To acquire, hold and maintain for investment or for the use and benefit of such one or more of the beneficiaries of any trust, as the trustee, in the exercise of sole and absolute discretion, determines, any residence (whether held as real property, condominium or cooperative apartment), and/or any tangible personal property, and to permit any one or more beneficiaries as the trustee shall determine to occupy any real property and to use any tangible personal property forming part of the trust estate on such terms as the trustee, in the exercise of sole and absolute discretion, may determine, whether for rent, rent-free, in consideration of payment of taxes, insurance, maintenance or ordinary repairs, or with such expenses being paid by the trust, or otherwise as the trustee, in the exercise of sole and absolute discretion, determines; provided, however, that the trustee is authorized to grant custody over any such property to any trust beneficiary, and shall not be liable for any damage to, destruction of, or other loss of such property while in the custody of a beneficiary; and provided, further, that in the case of any trust hereunder which is eligible for the marital deduction, such occupancy shall be rent free and any other condition shall be consistent with the grantor's intention that the spouse have that degree of beneficial enjoyment of the trust property during life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust, so that the Spouse's interest is a qualifying income interest for life for purposes of the marital deduction;[77]

B. Power to Change Situs and Governing Law

Attorneys are understandably fond of specifying that their home state law applies for all time to come, because that is the law they know, and they do not wish to be accused of the unauthorized practice of law in another jurisdiction. However, home state law may not always be in the best interests of the beneficiaries over the long haul, so great flexibility can be achieved by permitting a trustee to change the situs, principal place of administration and governing law of a trust. By way of example, the ability to move the situs of a trust from one state to another might allow the trust to avoid state income tax on any undistributed income or capital gains. Moreover, governing law may change anyway, if there is a change of trustees to a new trustee that is resident in another state, but great confusion can arise as to what law applies if it is not clear which law applies in such an event, or it is not clear that the governing law may be changed. Therefore, it is most helpful to specify in the document the governing law at the outset, ***but*** to permit the trustees to change the situs and governing law when it deems it beneficial to do so.

Sample Provision:

Power to Change Situs and Governing Law

If at any time, in the opinion of the trustee, it is in the best interests of the beneficiary or distributee for the trust to be located in a

[77] Note that this marital deduction savings clause is advisable whenever such a provision applies to a marital deduction qualifying trust.

> jurisdiction other than the one in which the trust is administered at the time, the trustee may move the trust to such other jurisdiction. The trustee may elect that the law of such other jurisdiction shall govern the trust to the extent necessary or appropriate under the circumstances, but not so as to enlarge or shift any beneficial interest. The trustee shall be under no duty to exercise the foregoing powers, to inform any beneficiary or other person of the potential benefit of exercising the powers, or to monitor any fact or circumstance to determine whether to exercise such powers, regardless of whether, or the extent to which, the trustee may have previously undertaken any such exercise, informing, or monitoring. The Trustee shall incur no liability to any person for its exercise of such power or its refusal or failure to exercise such power, absent willful misconduct proved by clear and convincing evidence in the court with primary jurisdiction over the administration of such trust.

C. Power to Lend to Beneficiaries

It may be beneficial for a trust to make a loan to a beneficiary to assist the beneficiary to purchase a home or for another purpose, particularly where an outright distribution may not be appropriate, or where an outright distribution would be appropriate, but a loan would be better, since it maintains the value of the trust. The UTC specifically grants to a trustee the power to make loans to beneficiaries,[78] but in other jurisdictions, the power is not so clear, in which case loans may not be permitted unless, perhaps, the loan can be justified as a trust investment under prudent investor standards.[79] The following are but a few examples of circumstances where such a power would be beneficial:

- Outright distribution will increase the beneficiary's taxable estate, but a loan will not do so, at least not until the property appreciates to an amount more than the loan, plus interest.
- Outright distribution may be inappropriate as providing too much benefit to the current beneficiary at expense of the remainder beneficiary, while a secured loan may preserve principal for remainder beneficiary, while still assisting the current beneficiary.
- The beneficiary needs a new house, but has a history of financial irresponsibility such that making a distribution out of the trust to purchase the house may give the beneficiary too much access to the value of the house, if

[78] UNIF. TRUST CODE § 816(18).

[79] O.C.G.A. § 53-12-261(12) permits loans for the "benefit or the protection of the trust," which indicates that loans must be justified more as an investment than as a method of providing benefit to a beneficiary.

the beneficiary is inclined to sell or mortgage the house to raise cash that can be squandered. However, the trust does not wish to own the house because the beneficiary's history of drug abuse indicates that the house may be used for illegal purposes and may involve activities that would expose the owner of the house to unacceptable risk of liability, liability insurance notwithstanding. The trust can loan the money on the house, thus preventing the beneficiary from being able to blow the money, without exposing the trustee to liability as property owner.

The common law recognizes loans to beneficiaries to be appropriate in some circumstances.[80] Nevertheless, the law differs substantially from state to state, so if the trust expressly permits loans and, more specifically, loans to beneficiaries, perhaps even on less than commercial terms, then the trustee should have the flexibility to use the trust assets to benefit the beneficiary, again under circumstances where an outright distribution is ill-advised.

Sample Provision:

Power to Lend to Beneficiaries — Broad

In their discretion to make loans to the beneficiary with or without security and with or without interest, upon such terms as they deem advisable;

D. Power to Invest in Fiduciary Managed Funds (Self-Dealing)

The UTC provisions regarding the duty of loyalty make clear that a trustee's investment in its own mutual funds or common trust funds is *not* presumed to involve a conflict of interest, so long as the investment otherwise complies with prudent investor standards and meets certain disclosure requirements, and many other state statutes provide likewise.[81] These provisions state that a trustee can invest in common trust funds, mutual funds, alternative assets, etc., that are managed by the trustee, without being accused of self-dealing. Of course, such investments still must meet prudent investor standards, and should be no more expensive than investments available outside the institution. Most states have adopted provisions that automatically permit a trustee to invest in its own common trust funds and, in many cases, its own stock or mutual funds. Nevertheless, since the exact wording of such rules differs from state to state, such a provision may be helpful. Set forth below is the provision recommended

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[80] "The loan need not qualify as a prudent investment under § 90 [Restatement Third, Trusts (Prudent Investor Rule) § 227]. It is a form of discretionary benefit, and may be made at a market rate of interest or at low or no interest; and funds may be advanced with recourse only against the beneficiary's interest, without personal liability." RESTATEMENT (THIRD) OF TRUSTS § 50, cmt. d(6) (2003).

[81] UNIF. TRUST CODE § 802(f). VA. CODE ANN. § 64.2-1506 permits a fiduciary to invest in a mutual fund from which it receives advisory or management fees, but prohibits the charging of additional fiduciary fees, absent express permission in the trust or unless certain disclosures are made to the beneficiaries. *See also* O.C.G.A. § 53-12-261(b)(2), which permits the purchasing of common trust funds, O.C.G.A. § 53-12-262, which permits a trustee to purchase its own stock and securities, and O.C.G.A. § 53-12-261(b)(2), which states that a trustee is not precluded from purchasing interests in its own mutual funds.

by Bessemer Trust Company, N.A. at the time of this writing, but most financial institutions have their own preferred forms of such provisions, which they are happy to provide.

Sample Provision:

Corporate Fiduciary "Self-Dealing" Power

[   ]. To invest in investment instruments owned or controlled by Bessemer Trust Company, N.A. (the "Corporate Trustee") or its affiliates, or from which the Corporate Trustee or its affiliates receive compensation for providing services in a capacity other than as trustee, and to do so without notice to or the approval of any court or trust beneficiary. The Corporate Trustee or its affiliates may receive fees, profit allocations, expense reimbursements, or other compensation from such investments in addition to and without any offset or reduction in the compensation payable to the Corporate Trustee for administering the trust. Such investments are expressly authorized and shall not be presumed to be affected by a conflict between the personal and fiduciary interests of the Corporate Trustee. Without limiting the foregoing, the Corporate Trustee is authorized to engage in the following transactions which may be considered as involving self-dealing, divided loyalty, or conflicts of interest on the part of the Corporate Trustee:

(a) Mutual Funds. To make investments in shares of regulated investment companies ("mutual funds") for which the Corporate Trustee or its affiliates act as investment advisor and receive the customary fee for so acting. The [Grantor/Settlor/Trustor/Donor] understands that this fee is disclosed in the mutual funds' prospectuses and may change from time to time by a vote of the shareholders or the mutual funds' boards of directors. The [Grantor/Settlor/Trustor/Donor] also authorizes the Corporate Trustee or its affiliates to receive a shareholder servicing fee of up to 0.25 percent per annum of the mutual funds' average daily net assets and a custody fee from the mutual funds for providing custodial services at the prevailing rate, which is currently up to 0.10 percent per annum.

(b) Private Investments. To make investments in (i) private investment funds or pools, whether in the form of a limited partnership, limited liability company, corporation, trust, or other form, including (but not by way of limitation) private investment funds sponsored, organized, managed, advised, administered, or privately placed by the Corporate Trustee and its affiliates; and (ii) private investment funds of which the Corporate Trustee and its affiliates may serve as general partner, manager, advisor, administrator, placement agent, or other service provider, and from which the Corporate Trustee and its affiliates may receive fees, expense reimbursements, profit allocations and other payments. The [Grantor/Settlor/Trustor/Donor] acknowledges that investments in private investment funds contain inherent investment risks including the possible loss of principal invested, are speculative in nature, are illiquid, and are not guaranteed as to either principal or income by the Corporate Trustee or its affiliates.

(c) Sweeps. To make temporary investments ("sweeps") of funds in mutual funds for which the Corporate Trustee or its affiliates furnish administrative and record-keeping services and receive an expense reimbursement from such mutual funds at the prevailing rate, which is currently up to 0.25 percent of the net cash assets so invested annually.

(d) Cash. To make temporary deposits of any cash in the trust awaiting distribution or permanent investment in money market or similar interest bearing accounts of the Corporate Trustee’s or Corporate Trustee’s affiliate or correspondent banks. Funds in the process of collection will not be invested, while trust balances in a negative collected funds position will automatically offset against the trust's positive collected funds as determined on an average monthly balance.

(e) Borrowing and Pledging. To borrow from or otherwise to incur indebtedness in favor of the Corporate Trustee or its affiliates, and to pledge, mortgage, hypothecate or otherwise encumber trust assets in favor of the Corporate Trustee or its affiliates to secure any such indebtedness.

VII. Savings Provisions to Express Settlor Intent and Avoid Inadvertent Errors

It should go without saying that attorneys should always strive for careful drafting to ensure that a trust operates as intended, and provides all of the benefits intended, including tax and asset protection benefits, where applicable. Nevertheless, as complex as trust and tax law have become, it is now distressingly easy to inadvertently disqualify a trust for some tax benefit or treatment that is specifically intended by the grantor, by including in a trust some provision that is inconsistent with the benefits sought, even though such inconsistency may well be inadvertent. Therefore, many drafters will include various "savings" provisions to make clear the grantor's intent to achieve a certain result, and to invalidate any provision of the trust that might have the effect of inadvertently frustrating that intent. After all, since the trustee has a duty to administer the trust to carry out the grantor's intent, and courts will typically seek to interpret a trust in such a manner as to carry out grantor intent, it is quite helpful if all doubt as to the intent of the grantor is removed.

However, as discussed below, a savings provision is no substitute for careful drafting, and should not be relied upon from the outset.

A. Intent to Reduce Taxes and Protect Assets from Creditors

The following recital is taken from the preamble of an irrevocable trust, and generally states that the grantor specifically intends that the trust be construed so as to reduce wealth transfer taxes and protect trust property from the claims of creditors:

Sample Provision:

Intent to Achieve Creditor Protection and Tax Savings

WHEREAS, the Grantor desires to give the Trustee broad discretion with respect to the management, distributions and investments of the various trusts created herein with the intention of generally obtaining the objectives of benefiting the beneficiaries of the trusts while attempting to minimize the extent to which the trust estate is subject to the claims of creditors, to minimize all wealth transfer taxes on the trusts, and to minimize the income and wealth transfer taxes which any beneficiary hereunder or his or her estate may pay on any trust created herein, ...

B. Intent to Qualify for Marital Deduction

Consider the QTIP[82] trust, which appears in the vast majority of wills and revocable trusts of affluent married persons, and is intended to qualify for the

[82] Qualified Terminable Interest Property, as defined in I.R.C. § 2056(b)(7).

estate tax marital deduction. The requirements for QTIP qualification are very specific, so almost all wills and trusts that include QTIP trust provisions will include dispositive provisions that are carefully drafted to meet those requirements. Elsewhere in the document, however, there may be provisions of general application, often considered to be "boilerplate" provisions, that, if applicable to the trust intended to qualify for QTIP status, could end up disqualifying the trust, albeit inadvertently.

For example, one QTIP requirement is that all income be payable to the surviving spouse at least annually, that such income be payable solely to the spouse, and that it be payable in all events. If the trust holds any property that is not productive of income, then the spouse must have the power to compel the trustee to convert such property into property that is productive of income. Even if the dispositive provisions recite these requirements, consider the following circumstances that could derail the qualification:

- Elsewhere in the trust agreement is a spendthrift trust provision, applicable to all trusts created under the instrument, that provides that if a trustee is prevented from distributing income directly to a beneficiary because of a lien by a judgment creditor of the beneficiary, the trustee is permitted to accumulate income that otherwise is required to be distributed. If this provision applies to ***all*** trusts, and no exception is carved out for a QTIP trust, then this term would violate the "all income" requirement because it would establish the possibility that some income might not be paid out to the spouse.
- The trustee has the power to allocate receipts between income and principal in a manner other than as specified by state law. Such a power could be construed to give the trustee the power to avoid distributing income to the spouse by designating certain receipts as principal, even though they would normally be allocated to income.
- The trustee has a power to hold and retain a personal residence for the use of the beneficiaries. Such a property is likely not productive of income, so unless the spouse has the power to compel the trustee to sell the property and reinvest the proceeds in productive property, this provision could disqualify the trust.
- The trustee has the power to purchase one or more life insurance policies on persons in whom the trust beneficiaries have an insurable interest. Since insurance policies are not productive of income, this power could disqualify the trust, unless, again, the spouse has the power to compel the trustee to convert the insurance to an income producing asset.

The best course of action, of course, would be to carve out exceptions to each of the above powers to expressly provide that they do not apply to a QTIP trust. As an additional measure, consider a "savings" provision stating the grantor's intent to qualify trust property as QTIP property and directing that any provision of the trust inconsistent with such intent be inapplicable to the marital trust. In

Rev. Rul. 75-440,[83] the IRS ruled that the marital trust qualified as QTIP property even though the general trustee powers permitted investment in life insurance, because the marital trust provisions expressly stated the grantor's intention and provided that no fiduciary power was exercisable by the trustee in a manner that was inconsistent with this intent.

Sample Provision:

Intent to Qualify as QTIP Trust

It is the grantor's intention by this paragraph to create an interest which is a "qualifying income interest for life" as defined in section 2056(b)(7) of the Code and which, if and to the extent the grantor's executors so elect, will constitute "qualified terminable interest property" as defined in that section. This Agreement shall be construed and this trust shall be administered in all respects so as to effectuate this intention, and no fiduciary power generally exercisable by the trustee under this instrument or applicable law shall be exercisable in a manner that is inconsistent with such intent.

It should be noted, however, that a savings provision will not be effective if the dispositive provisions of the marital trust (as distinguished from general trust provisions that apply to non-marital trusts) clearly violate the requirements. For example, another requirement for QTIP qualification is that no income or principal may be distributable to anyone other than the surviving spouse during the spouse's lifetime, so where the dispositive terms of a marital trust expressly permitted distributions to the surviving spouse *and the decedent's descendants*, the court held that a savings provision would not rescue the trust from disqualification.[84]

C. Intent to Exclude Assets from *Settlor's* Estate

It is generally accepted as a "given" that when a grantor creates an irrevocable trust, the intention is that the trust assets ***not*** be included in the grantor's gross estate following the transfer to the trust or, in the case of a GRAT, QPRT, or other retained interest trust, following the termination of the retained interest. But what if a trust provision previously thought to be "safe" turns out to cause inclusion of the trust property in the grantor's estate? Recall the discussion above regarding corpus substitution powers and Rev. Rul. 2008-22. The sample provision there

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83 Rev. Rul. 75-440, 1975-2 C.B. 372 (July 1975).

84 *See* Mark Merric, *Do Savings Clauses or Statutes Mitigate Estate Inclusion Issues of Choosing the Wrong Trustee for a Discretionary Trust?*, LISI Estate Planning Newsletter # 1610 (February 25, 2010) at http://www.leimbergservices.com; Jeffrey N. Pennell, TAX MANAGEMENT PORTFOLIO 843-2ND, ESTATE TAX MARITAL DEDUCTION (BNA), at Section VII.C.

includes a statement making clear the grantor's intent to comply with the ruling. The following is a more general savings provision:

Sample Provision:

Intent to Exclude Trust Assets from Grantor's Estate

It is the intent of the Grantor that nothing in this Agreement be construed in such a way that would cause any portion of this trust to be includible in her gross estate for estate tax purposes at her death.

Again, such a provision would probably not be effective for a trust where a grantor retained an income interest in the trust property, which clearly causes estate inclusion, but it *might* be helpful where some retained power, previously thought to be "safe," is found to cause estate inclusion.

D. Intent to Exclude Assets from *Beneficiary's* Estate

If the goal is to prevent the inclusion of assets in a ***beneficiary's*** estate, or to make such inclusion subject to contingencies, that intent should be stated.

Sample Provision:

Intent to Exclude Assets from Beneficiary's Estate

It is the intent of the Grantor that, except as otherwise expressly set forth herein, nothing in this Agreement be construed in such a way that would cause any portion of [this trust] [a beneficiary's non-exempt trust] to be includible in his or her gross estate for federal estate tax purposes at his or her death.

VIII. Guiding the Trustee – Accomplishing the Settlor's Goals

One of the most difficult tasks trustees face is how to exercise broad (and generic) discretion in the administration of trusts, whether the trust is fully discretionary, with no standards whatsoever, or discretionary subject to an ascertainable standard. To the extent that the grantor's intent is expressed in the trust, it is much easier for the trustee to carry out that intent. For example, if the primary purpose for passing property in trust, rather than outright, is to gain tax and asset protection advantages, and separating the control over the property from the beneficial enjoyment of the property (more than necessary to obtain tax and asset protection benefits) is *not* a primary motivation behind using a trust, then the trust can be drafted to make that intent clear, so that the trustee can act more liberally than might be the case where control *is* a key issue. The importance of setting forth the grantor's intent can be demonstrated by a brief discussion of the default rules governing trustees where the trust instrument contains no contrary expression of intent. What follows is a sampling of different discretionary guidelines. Needless to say, these should be tailored to reflect a grantor's desires, but they are examples of the type of detail that can be invaluable.[85]

An alternative, especially for trusts that are already in existence, is for the grantor to provide the trustee with a *letter of wishes* giving guidance as to how discretion should be exercised.[86]

A. Priority Among Multiple Beneficiaries

Where there are multiple beneficiaries of the trust, meaning either concurrent beneficiaries or successive beneficiaries (current and remainder), a trustee needs guidance as to how to exercise that discretion with respect to the various competing interests, given the trustee's duty of *impartiality* among trust beneficiaries.[87]

The most traditional conflict among beneficiaries occurs in the case of a trust that directs that income be paid to a current beneficiary and that the principal be paid to a remainder beneficiary at the death of the current beneficiary. The current beneficiary will expect the trustee to invest the trust to maximize the production of income, while the remainder beneficiaries will expect the trustee to invest to maximize the growth of principal. The trustee, therefore, must balance these needs by investing to produce a reasonable amount of income, while at the same time preserving the value of the principal by ensuring sufficient growth in value to keep up with inflation.

But what about a trust that gives the trustee the discretion to distribute not only income, but to encroach upon principal for the current beneficiary? The trustee will normally be hesitant to encroach on principal for the current beneficiary if doing so is contrary to the interests of the remainder beneficiary, unless circumstances can justify such action.

Take a typical family trust that gives the trustee discretion to distribute income and principal to or among the grantor's spouse and descendants during the spouse's lifetime, with the trust splitting into separate shares for each child at the spouse's death.

How much discretion does the trustee have? In most cases, the intent is probably to give primary consideration to the surviving spouse for his or her lifetime, even if that means encroaching on the principal that otherwise would pass to the descendants at the spouse's death. On the other hand, there may be circumstances, particularly in second (or third, or fourth) marriage situations,

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[85] Two excellent articles on this subject are Edward C. Halbach, Jr., *Problems of Discretion in Discretionary Trusts*, 61 COLUM L. REV. 1425 (1961) (hereinafter "Halbach") which, although published more than 50 years ago, still appears to be the seminal article on this subject, and Michael J. Cenatiempo and Caroline S. Marciano, *Discretionary Trusts Primer*, TR. & EST., Feb. 2008, at 42.

[86] *See* Alexander A. Bove, Jr., *The Letter of Wishes: Can We Influence Discretion in Discretionary Trusts?* 35 ACTEC J. 38 (2009).

[87] *See* UNIF. TRUST CODE § 803. This is discussed at some length in the RESTATEMENT (THIRD) OF TRUSTS § 50, cmt. f.

where the grantor's intent is that principal be used for the spouse's benefit only to the extent that trust income and/or other resources are insufficient for that purpose. Absent some indication of that intent, however, the trustee would typically be expected to balance the needs of both sets of beneficiaries, which might mean restricting distributions to the spouse so as to preserve principal for the current or future needs of the children.

Therefore, it is always advisable to address the following issues in the trust agreement:

- Is the trust primarily for the benefit of current beneficiaries, with remainder beneficiaries being entitled only to that amount, if any, that is left over after the current beneficiary's death, or is the intent to preserve assets for later generations?
- As to current beneficiaries, should the trustee give priority to the interests of one beneficiary over another? For example, if the trust is for the benefit of a spouse and descendants, are the needs of the spouse to be given paramount consideration, even to the point of depleting principal? Likewise, where a trust is for a child and his or her issue, what consideration is the trustee supposed to give the issue, particularly after they are grown and have left home?

In the author's experience, the grantor usually desires that that trusts be for the primary benefit of the oldest generation of living beneficiaries, with the rights of later beneficiaries being secondary.

It is important to state whether discretionary distributions to beneficiaries must be equal, or can be unequal, and whether and to what extent there is an intent to preserve principal for remaindermen. The following are examples of various distribution provisions:

Sample Provisions:

Trustee Discretion – Priority to Current Beneficiaries

The trustee may distribute to or for the benefit of the beneficiaries, equally or unequally, so much, all or none of the net income and principal of this trust, even to the complete exhaustion of the trust, as the trustee [determines in its sole and absolute discretion] [deems desirable to provide for their health, education, maintenance and support]. It is not my intention that the assets of any trust created hereunder be conserved for the benefit of remaindermen. On the contrary, my primary purpose in creating this trust is to provide for the named beneficiaries' health, education, maintenance and support in reasonable comfort. The rights and interests of remaindermen are subordinate and incidental to that purpose.

Trustee Discretion – Priority to Particular Beneficiary

The trustee may distribute to or for the benefit of the primary beneficiary and his or her descendants, equally or unequally, so much, all or none of the net income and principal of this trust, even to the complete exhaustion of the trust, as the trustee [determines in its sole and absolute discretion] [deems desirable to provide for their health, education, maintenance and support]. The trustee shall at all times give priority to the interests of the primary beneficiary, with the interests of the primary beneficiary's descendants and/or future beneficiaries being subordinate and incidental to the interests of the primary beneficiary.

Additional Permitted Transfers

The trustee may also distribute to or for a beneficiary to enable the person to (i) make a down payment on the purchase of a home consistent with such beneficiary's standard of living; (ii) invest a reasonable amount in business enterprises in which the beneficiary would be an active participant, including the purchase by the trustee of such enterprises as investments of the trust; and (iii) pay for a wedding and honeymoon, or other special trip at any time. I may provide the trustee with additional guidance by letter or memorandum to assist the trustee in ascertaining my intent, but any such writing would be non-binding.

Note: A good addition to this provision would be to expressly permit distributions to facilitate estate and tax planning by the beneficiary, such as to prevent waste of the beneficiary's unified credit or GST exemption, or to facilitate gifts by the beneficiary, to take advantage of the tax exclusive nature of the federal gift tax.

B. Guidance on Exercise of Distribution Discretion

The following are examples of various provisions governing or guiding trustee discretion with respect to distributions.

Sample Provision:

Grantor Intent for Distributions

It is the Grantor's intent that this trust be used to enhance the beneficiaries' quality of life, including (without limitation) travel, purchase of a home, cultural appreciation and enjoyment (music, arts, etc.), and education. In addition, the Grantor would like this trust to provide a source of funds in the event that a beneficiary, through accident or misfortune, does not have sufficient sources of income to provide for his or her own support. The Grantor expects the Grantor's descendants to support themselves independently and to be productive members of their communities and not to become dependent upon distributions from the trusts to the extent that they lose their ambition and incentive. Where a beneficiary is able to be gainfully employed and is not actively engaged in raising his or her children, income and principal of a trust established hereunder should not be used to replace the beneficiary's own efforts to work and accumulate financial security. However, it is not the Grantor's intent to force a parent to work outside the home when he or she has determined that it is important to stay at home to raise a family. In addition, the Grantor does not intend that the trustee place undue emphasis on the amount a beneficiary earns if he or she is actively engaged in a worthwhile pursuit, including working as an unpaid volunteer for charitable purposes.

Sample Provisions:

Distribution Standard - Alternate Levels of Restriction

The Trustee may pay to or apply for the benefit of any one or more of the beneficiaries, at any time and from time to time,

alt. 1 (most flexible): so much or all of the net income and principal of the trust estate as the Trustee determines, in its sole and absolute discretion.

alt 2 (ascertainable standard): so much or all of the net income [and accumulated income] of the trust estate as the Trustee determines, in its sole and absolute discretion, is necessary to provide for their support in their accustomed manner of living, or for medical, dental, hospital and nursing expenses, or for reasonable expenses of education [or to take advantage of a business opportunity]. [In addition, the Trustee may pay to or for the benefit of any one or more of the beneficiaries, at any time and from time to time, so much of the principal of the trust estate as the Trustee determines is necessary for medical expenses and for basic support needs such as basic food, shelter, and clothing.]

alt. 3 (restrictive): so much or all of the net income and principal of the trust estate as the Trustee determines, in its sole and absolute discretion, is necessary for their medical expenses and for their basic support needs such as food, shelter, and clothing.

The Trustee shall not be required to equalize payments among the beneficiaries. Any income not distributed currently shall be accumulated and added to principal. [Before making any distribution, the Trustee shall consider the funds then available to that beneficiary from other sources and the duty of anyone to support that beneficiary.] OR [In deciding whether to exercise its discretion to make distributions, the Trustee may, but need not, consider any other resources of the beneficiary.]

Distributions to Guardians

Distributions to Guardians. The trustee is specifically authorized, in its sole discretion, to make distributions of income or corpus directly to the guardian of any beneficiary of this trust for expenses incurred by the guardian because of his or her care for such beneficiary. Such expenses are to include, by way of illustration and not limitation, the guardian's reasonable travel expenses in visiting the beneficiary, the reasonable cost of additions or improvements to the guardian's home, and the reasonable cost of additional household help or appliances in the guardian's home, providing such expenditures are necessary in the judgment of the trustee to enable the guardian to care for such beneficiary. It is my intention that such expenses be paid even though such payments may directly or indirectly benefit the guardian or the guardian's family. To the extent that such expenditures do not frustrate the primary purpose of this trust, I direct the trustee to be generous in making such distributions to guardians, and direct that whenever feasible, doubts should be resolved in favor of the guardian. Notwithstanding any provision in this paragraph to the contrary, however, if a guardian is also serving as trustee of this trust, and there is no corporate or other disinterested co-trustee, then no payments for the benefit of the guardian may be made pursuant to this section.

C. Full Discretion vs. Ascertainable Standards

Careful thought should be given to the use of the famous "ascertainable standard" which is often included in trusts *automatically*, without regard to whether it is the best standard, or even necessary. The HEMS standard is "safe harbor" language that prevents a trustee subject to the standard from holding a taxable general power of appointment, so the standard is often included by default, just in case a beneficiary may serve as trustee. However, if the trustee is independent, or if there is an independent co-trustee, such a standard may not be necessary, and may even be counterproductive.

1. Ascertainable Standard May Unduly Limit Flexibility

Imposing an ascertainable standard where it is not necessary may eliminate or reduce options available in the future.

For example, a marital deduction qualified trust will be included in the surviving spouse's gross estate at his or her death, so it might be beneficial, if resources permit, to make distributions from the trust to the spouse to facilitate annual exclusion gifts, tuition and medical gifts, or even taxable gifts that take advantage of the tax exclusive nature of the gift tax. However, if distributions of principal are limited to amounts needed for the spouse's health, maintenance and support, it may be difficult to justify a distribution that is requested by the spouse so that the funds may immediately be given away.

2. Protection from Spouses and Creditors: HEMS = Entitlement

a. Unlimited Discretion Provides Most Complete Protection

Clearly, the most complete protection of trust assets is achieved where the trustee has ***unlimited discretion, not subject to any standard***, assuming, of course, that such discretion is otherwise appropriate to the purposes of the trust. A well-established concept in the law of trusts, property and debtor-creditor law is that where the trustee has unlimited discretion with respect to distributions, including the discretion to make no distribution, the trust property, and the beneficiary's interest in the trust property, cannot be reached by a beneficiary's judgment creditors until the trustee exercises the discretion to make a distribution and the distribution is received by the beneficiary. A judgment creditor can obtain no greater right to a debtor's property than the debtor had, and where a debtor has no enforceable right to any distribution, because all distributions are in the sole discretion of the trustee, no distribution may be compelled by any creditor.

Some states have enacted statutes providing that a judgment creditor may not compel a distribution from a trust, even if the beneficiary could compel such a distribution, but other states allow the creditor to proceed. To the author's knowledge, a trust where the trustee has unlimited discretion provides strong protection in all jurisdictions.

Of course, a potential issue with fully discretionary trusts is the risk that the trustee will be unduly "stingy," even where the settlor intended more generosity. One effective way to reduce any such risk is for the settlor to provide to the trustee a ***non-binding "letter of wishes,"*** providing guidance as to how the settlor would like for the discretion to be exercised. Non-binding guidance can also be included in the trust agreement itself, but it is imperative that such guidance be expressly non-binding, so as not to create any unintended entitlements.

Another effective way to reduce the risk of difficulty is to give the beneficiaries or some other responsible party the power to remove and replace the trustee without cause. If the trust is substantial, then the trustee will naturally be inclined to be more attentive and reasonable if not doing so will result in the loss of the business, and there is no shortage of trustees looking for trusts to administer. In such a case, however, be careful not to impose such stringent qualifications on the successor trustee that a qualified alternative cannot be found.

b. Ascertainable HEMS Standard May Expose Trust to Creditors

In many cases, the extent to which a creditor may reach a beneficiary's interest in a trust, or the determination as to whether the creditor can reach the interest at all, will depend upon whether, and to what extent, the beneficiary has a ***legally enforceable right*** to compel a distribution within the standard. Even if the trust includes a spendthrift provision, such a provision typically prevents a creditor from reaching distributions before they are made to the beneficiary, but they do not necessary prevent a judgment creditor from forcing a distribution to which the beneficiary is entitled.

It is often the case that a trust includes a HEMS standard rather than full discretion standard to avoid the possibility of any trustee holding a general power of appointment over trust property. Even if the trustee is a clearly independent corporate trustee who can safely have complete discretion, distributions may be subject to a HEMS standard out of an abundance of caution. However, in many cases, the courts have construed a HEMS standard as conferring on the beneficiary a legally enforceable right to distributions within the standard, and to the extent there is a legally enforceable right, the right may be reached by the beneficiary's judgment creditors.

(1) *Pfannenstiel v. Pfannenstiel*

The question in *Pfannenstiehl v. Pfannenstiehl*,[88] was whether a beneficiary's interest in a trust where a trustee had "sole discretion," but the discretion was subject to an ascertainable standard, was a legally enforceable interest that rose to the level of "marital property"

[88] *Pfannenstiehl v. Pfannenstiehl*, 88 Mass. App. Ct. 121, 37 N.E.3d 15 (Mass. App. 2015), *rev'd Pfannenstiehl v. Pfannenstiehl*, 475 Mass. 105, 55 N.E.3d 933 (Mass. 2016).

that was subject to equitable division on divorce, or was instead a mere "expectancy" in which the beneficiary had no enforceable rights, and which was therefore not divisible as marital property.[89] The actual distribution provision was as follows:

> [T]he Trustee ***shall*** pay to, or apply for the benefit of, a class composed of any one or more of the Donor's then living issue such amounts of income and principal as the Trustee, ***in its sole discretion***, may deem advisable from time to time, whether in ***equal or unequal shares***, ***to provide for the comfortable support, health, maintenance, welfare and education of each or all members of such class***."[90]

The class of beneficiaries consisted of all issue of the settlor, including his three children, one of whom was the husband, and the settlor's eight grandchildren, for a total of 11 current permissible distributees, even though actual distributions had been limited to the three children. Since the class of beneficiaries was "open," the number of beneficiaries would grow as additional grandchildren or great-grandchildren were born. No distributions were made for the first few years of the trust, but for the few years immediately preceding the divorce, the trust had made substantial discretionary distributions to husband and his siblings, allowing them to enjoy standards of living they could not have afforded without the distributions. The trustees were husband's twin brother and the family attorney.

As soon as the husband filed for divorce, the trustees announced that they would make no further distributions to him, and they refused all subsequent requests by the husband for distributions.

The trial court determined that the husband's interest in the trust should be considered marital property subject to equitable division, and valued the interest by dividing the value of the entire trust by the number of current beneficiaries, thus valuing the husband's interest in the trust at 1/11 of the total value of the trust. The court then awarded 60% of all marital property to the wife, including the husband's trust interest. The court did not attempt to compel any distribution by the trustee, but ordered the husband to pay to the wife an amount equal to 60% of the determined value of his interest in the trust in 24 monthly installments. The amount of the ordered payments exceeded husband's monthly income, since he was no longer receiving distributions from the trust.

On appeal, the husband argued that since the trustee had "sole discretion," the trust was a ***discretionary trust*** under which he had no legally enforceable right to distributions, so the interest did not rise to

[89] Massachusetts, unlike most jurisdictions, includes in the definition of "marital property" any property received during the marriage by either spouse by gift or inheritance.

[90] *Pfannenstiehl*, 88 Mass. App. Ct. 121, 132, 37 N.E.3d at 21-22.

the level of "property," but was a mere unenforceable *expectancy*, which should not have been included in marital property. The Massachusetts Court of Appeal rejected the husband's arguments and affirmed the trial court, concluding that the ascertainable standard created in the husband a legally enforceable right that constituted property that was subject to division. The court distinguished the facts from an earlier case in which the trustee had ***unlimited discretion***, not subject to any standard, where it was determined that the beneficial interest was a mere expectancy because there was no legal right to compel any distribution. The Court of Appeal left no doubt that had the trustee's discretion not been subject to any standard, the interest would not have constituted marital property.

On further appeal, the Supreme Judicial Court of Massachusetts reversed the Court of Appeal on the grounds that the husband's interest was too speculative to be valued with sufficient certainty to include the interest in divisible marital property, because the Husband was only 1 of 11 beneficiaries, and the class of beneficiaries could expand over time before complete distribution, so there was no way to value the husband's interest with certainty. The court distinguished the case from another case where the trust had only one beneficiary who also held a testamentary power of appointment, and there was no possibility of additional beneficiaries, in which case the interest was found to be marital property, notwithstanding trustee discretion. The court further held that while the interest was not itself marital property subject to division, it could be considered by the trial court to determine the equitable division of the remaining property that ***was*** marital property. In other words, the trial court could award the wife more than 60% of the marital property that did not include the trust. Moreover, since the trust interest was not marital property, it would be appropriate for the trial court to consider the husband's potential income from the trust in determining the amount, if any, of alimony to award to the wife. Unlike a property settlement, which is not subject to later modification, an alimony award could be modified later if the actual income from the trust turned out to be substantially less than the amount assumed in setting the alimony.

(2) *Duckett v. Enomoto*

In *Duckett v. Enomoto*,[91] the issue was whether a federal tax lien could attach to, and be levied against, the property of a trust (subject to Arizona law) in which the delinquent taxpayer held a beneficial interest. The federal tax lien, by statute, attaches to all ***property*** of the taxpayer and, in appropriate circumstances, may be levied against by the government. As in *Pfannenstiel*, a mere expectancy that could not be enforced by the beneficiary would not constitute a property interest

[91] *Duckett v. Enomoto*, 2016 U.S. Dist. Lexis 51502, 117 A.F.TR.2d (RIA) 1358 ((D. Ariz. 2016).

to which a tax lien could attach. The distribution standard under the trust was as follows:

> The Trustee ***shall*** pay to [the beneficiary] so much or all of the net income and principal of the trust ***as in the sole discretion of the Trustee may be required*** for support in the beneficiary's accustomed manner of living, for medical, dental, hospital, and nursing expenses, or for reasonable expenses of education, including study at college and graduate levels. . . [t]o the extent the Trustee deems advisable, the Trustee may consider or disregard the funds available to the beneficiary from other sources or the duty of anyone to support the beneficiary. Should the principal of the trust drop below $10,000, the Trustee shall distribute the balance of the principal, together with the undistributed income therefrom to [the beneficiary].

The court rejected the beneficiary's contention, on motion for summary judgment, that as a matter of law, no tax lien could attach to the discretionary interest, because it was a mere expectancy. As in *Pfannenstiehl*, the court acknowledged that the lien may not attach where the trustee had unlimited discretion, because the beneficiary would have no enforceable right to any distribution, but since the discretion was not unlimited, and was subject to a standard, the beneficiary could have enforceable rights to distributions, to the extent he could demonstrate that the cost of his maintenance and support could not be met by other resources. Therefore, the court held that the tax lien would attach to the beneficiary's interest.[92]

In the two cases discussed above, and numerous others, the case turns on whether the beneficiary has a ***legally enforceable right*** which, in turn, depends upon the court's determination of whether the settlor intended to create an enforceable right. Subtle nuances in language can lead to an interpretation one way or the other. For example, the distribution provisions in both of the cases stated that the trustee ***shall*** make certain distributions, which the courts interpreted as evidence that the trustees did not have the discretion to distribute nothing. Presumably, if the standard used the word ***may***, instead of ***shall***, there would have been a stronger argument that the trustee was not required to make any distributions. Likewise, the legal significance of giving the trustee "sole and absolute discretion" over distributions under a HEMS standard may turn on *where* in the sentence those words appear, and whether the trustee had discretion as to whether to make any distribution at all, or whether the discretion was limited to a determination of the amount of the distribution.

(3) Conclusions from *Pfannenstiel* and *Duckett*

[92] The court also held, however, that the IRS could obtain no greater rights in the trust than the beneficiary, so until such time as the circumstances materialized under which the beneficiary could compel a distribution, the IRS could not compel a distribution from the trust, nor could the IRS seize the entire trust.

The lesson of both of the foregoing cases is that a trust subject to an ascertainable standard and a spendthrift provision may not necessarily provide the degree of protection from a beneficiary's creditors that the settlor originally intended. Both cases also seem to hold, however, that if the trustee clearly has unlimited discretion, including the discretion to distribute nothing, then a beneficiary's interest should not constitute marital property, property subject to a tax lien, or property subject to any other creditor claim.

c. Where Ascertainable Standards are Necessary

If unlimited discretion is not appropriate, and an ascertainable standard is necessary, there are ways to limit the ability of the provision to expose the trust to a beneficiary's creditors. Both *Pfannenstiel* and *Duckett* turned on the conclusion that if the trustee's discretion is not unlimited, and the trustee therefore does not have the discretion to make no distribution under any circumstances, the beneficiary may hold a legally enforceable interest. Perhaps, therefore, the same result could be reached, notwithstanding an ascertainable standard, if it is clear that the trustee does have the discretion to distribute nothing, and that the distribution standards are intended only as "upper" limits on the trustee's authority.

(1) Avoid "Shall" in distribution standards

Many cases finding that distributions to a beneficiary to be enforceable depend, at least in part, on the use of the word "***shall***" in the distribution provision, rather than the term "***may.***" Therefore, unless it is necessary to mandate a distribution, such as distributions of income in a QTIP marital trust, avoid stating in the distribution provision that the trustee ***shall***, ***must*** or ***will*** make certain distributions, and instead provide that the trustee ***may*** make certain distributions.[93]

(2) Negate Presumption of Standard as Entitlement

In the cases discussed above, it was clear that the reason unlimited discretion avoids creditor claims is that the trustee has the discretion to distribute nothing, so the beneficiary has no enforceable right to compel distributions. The same result should be obtainable with an ascertainable standard by simply stating that the trustee is not required to make any distribution, but to the extent the trustee does distribute, the distribution must be within the limitations imposed by the standard.

Sample Provision Limiting Standard

To the extent that any trustee's discretion to distribute income and principal is limited by a standard related to the health, education,

[93] *See* RESTATEMENT (THIRD) OF TRUSTS § 50, cmt. g.

maintenance and support of a beneficiary, such standard shall be construed solely as a limitation on the discretion of certain trustees for the sole purpose of preventing such trustee from holding a "general power of appointment" over such trust, and shall not be construed as imposing any duty, enforceable by or on behalf of any beneficiary, to distribute income or principal for such purposes, it being the settlor's express intent that the all trustees retain discretion to make no distributions.

The explanation as to why the standard is included helps to prevent any court from determining that there must have been an intention to create an entitlement, by explaining that there is a valid reason, other than an entitlement, for including the provision.

(3) Discretion, But Not Duty, to Pay Obligations

If there is a desire to give the beneficiary certain enforceable rights, it might be possible to do so while limiting the reach of creditors by providing that the trustee may, but shall not be required to, distribute to a beneficiary to enable the beneficiary to make a payment to a spouse, ex-spouse, or other person to in settlement of a dispute or to satisfy a legal obligation.

Sample Provision – Discretion to Pay Claims

An independent trustee may, in its sole and absolute discretion, distribute income and/or principal to the beneficiary in such amounts as the trustee deems appropriate to enable a beneficiary to settle a dispute or discharge a legal obligation including, but not limited to, an obligation arising out of a marriage or similar relationship or the dissolution of any such relationship, if the trustee determines such distribution to be in the best interests of the beneficiary. No trustee shall be under a duty to make such distributions, and no beneficiary or person acting on behalf of or claiming under a beneficiary may compel the trustee to make any such distribution at any time.

Needless to say, no beneficiary trustee should be permitted to exercise this power, since it amounts to a power to appoint to creditors, which would be a general power of appointment. This provision should negate any argument that a trustee can be compelled to make distributions to pay the beneficiary's creditors based on the logic that payment of one's debts is part of one's support and maintenance. This provision should also make clear that a beneficiary's enforceable right to distributions for current expenses does not equate to a right of any creditor to compel a distribution. On the other hand, the provision also makes clear to the trustee that if the trustee feels it appropriate to relieve a beneficiary of a financial obligation, the trustee is not prevented from doing so by a spendthrift provision or other indication that trust funds may not be paid to a beneficiary's creditors.

Note also the specific reference to marital claims. At least one court has ruled that a spendthrift provision protecting trust property from a beneficiary's "creditors" did not apply against the beneficiary's spouse for claims incident to a divorce, because a spouse with divorce claims is not considered a "creditor." Therefore, at some point in the document, it is wise to specifically state that any protection from "creditors" or with respect to "debts" does include any claims incident to a marriage or divorce.

d. Ascertainable Standard and Gift Splitting

The gift splitting regulations provide that gift splitting is only available for gifts to a trust in which the spouse has an interest if the spouse's interest is *ascertainable* and *severable* from the interests of the other beneficiaries,[94] and if distributions to the spouse are limited by an ascertainable standard after consideration of other available resources, and it can be demonstrated that the spouse's resources *other than the trust*, including expectancies from the grantor, are sufficient to maintain the spouse's standard of living such that the likelihood of actual distributions is "so remote as to be negligible," the value of the spouse's interest will be zero, and gift splitting will be available for the entire gift.[95] Note, however, that gift splitting is not available for the portion of the gift over which the spouse has a withdrawal right.[96]

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[94] Treas. Reg. § 25.2513-1(b)(4).

[95] *See Falk v. Commissioner*, T.C. Memo 1965-22 (distributions limited to amount needed to maintain standard of living). *See also* PLR 200130030 (April 30, 2001) and PLR 200345038 (July 28, 2003), ruling that an ascertainable standard for gift splitting is the same as that under I.R.C. §§ 2041 and 2514. If the trustee has unlimited discretion, no gift splitting is permitted. Rev. Rul. 56-439, 1956-2 C.B. 605.

[96] Diana S.C. Zeydel, *Gift-Splitting – A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, Douglas W. Conner 34th Annual Advanced Estate Planning and Administration Seminar, Virginia CLE (2013). In Ms. Zeydel's materials, she notes that the IRS has ruled in several private letter rulings that any gift that is subject to beneficiary withdrawal powers is treated as a gift to the power holder.

Therefore, where a spouse is a permissible, but not an expected, distributee, and gift splitting is desired, distributions to the spouse should be subject to an ascertainable standard, and should also be subject to the requirement that other resources be considered. It is probably helpful to further include the suggested language set forth above, to further demonstrate the remoteness of the likelihood of distributions to the spouse.

D. Consideration of Beneficiary Resources

One issue of critical significance to a trustee is the question of whether a beneficiary's other resources should be considered in making discretionary distribution decisions, especially where the trustee's discretion is not absolute, and the trustee is to make distributions for the beneficiary's support. May, or must, the trustee consider other resources? What other resources should the trustee consider? Assuming there are or are not other resources, how should that information impact the trustee's distribution decisions?

Many trust documents routinely say that the trustee should take other resources into consideration, but in many cases, that may not be consistent with the grantor's desires, especially for a surviving spouse. If the trust mandates that other resources be taken into consideration, then the trustee must request information regarding such resources from the beneficiary, which may include requests for tax returns and/or bank or investment account statements.

Many, if not most, beneficiaries of trusts, particularly surviving spouses and children, are of the opinion that the trust assets are *their* assets, to which they are entitled, and they do not appreciate being made to "jump through hoops" to get *their* money. Beneficiaries often resent the fact that property was passed in trust, rather than outright, in the first place, especially where the trust was created at the grantor's death, and the beneficiaries were not expecting a trust to stand between them and *their* money. Such conflicts are often exacerbated when a beneficiary is required to produce tax returns or other financial information to the trustee, since most beneficiaries feel that their personal finances are none of the trustee's business.

Needless to say, conflicts of this type may be unavoidable where the grantor's purpose in passing property in trust is to limit the beneficiary's access to the funds, as may be the case where the grantor considers the beneficiary to be financially irresponsible, or where the grantor considers a trust necessary to preserve assets for remainder beneficiaries (as may be the case with a marital trust for a surviving spouse who is not the parent of the grantor's children). On the other hand, if the grantor has no particular concern about a beneficiary's access to trust property, and passed the property in trust only because the grantor's attorney recommended that structure to achieve tax or asset protection benefits, the grantor very well may *not* intend for the beneficiary to be required to produce tax returns or otherwise "jump through hoops" to get distributions, especially in the case of a trust for a surviving spouse who was happily married to the grantor for decades.

Of course, to a certain extent, if a trustee is to make distributions for support and maintenance, the trustee must obtain *some* information about the beneficiary's needs and resources to carry out its duties.[97]

1. Silence Is Not Golden – Default Rules Vary by Jurisdiction

It is critical to address this issue in the trust instrument itself, because, as Ron Aucutt might say, with respect to the default rules that apply where a trust is silent on these issues, "the states are all over the map."

> *Significance of beneficiary's other resources*. It is important to ascertain whether a trustee, in determining the distributions to be made to a beneficiary under an objective standard (such as a support standard), (i) is ***required*** to take account of the beneficiary's other resources, (ii) is ***prohibited*** from doing so, or (iii) is to consider the other resources but has some ***discretion*** in the matter. If the trust provisions do not address the question, the general rule of construction presumes the last of these.[98]

Even if the attorney knows that the default rule under the law initially governing administration is consistent with the grantor's intent, a change in the situs of the trust later on may result in a very different default rule governing trust administration. For example, the rule in Georgia (which was the author's state of residence when the author's will was executed) is that the trustee is under no duty to investigate a beneficiary's resources,[99] and is, in fact, *forbidden* from considering other resources, absent expression of intent to the contrary.[100] However, in Virginia (the state . . . oops!, I mean *Commonwealth*, to which the author migrated from Georgia, and the law of which will govern any trust created under the author's will), is that a trustee *may* consider the beneficiary's other resources, absent an expression of intent to the contrary.[101]

Assuming that the trustee has some discretion to consider other resources, and is aware that the beneficiary does, in fact, have other resources, how is that knowledge supposed to impact the trustee's decision? The view of the

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97 "The trustee has a duty to act in a reasonable manner in attempting to ascertain the beneficiary's needs and, under the usual rule of construction, other resources that may be appropriately and reasonably available for purposes relevant to the discretionary power. The trustee generally may rely on the beneficiary's representations and on readily available, minimally intrusive information requested of the beneficiary. This reliance is inappropriate, however, when the trustee has reason to suspect that the information thus supplied is inaccurate or incomplete." RESTATEMENT (THIRD) OF TRUSTS § 50, cmt. e(1) (2003). *But see* O.C.G.A. § 53-12-245, which expressly holds that a trustee is under no duty to investigate a beneficiary's resources.

98 RESTATEMENT (THIRD) OF TRUSTS § 50, cmt. e (2003).

99 O.C.G.A. § 53-12-245.

100 *Hamilton Nat'l Bank v. Childers*, 233 Ga. 427, 211 S.E.2d 723 (1975).

101 *NationsBank of Va. v. Estate of Grandy*, 248 Va. 557, 450 S.E.2d 140 (1994). The RESTATEMENT (THIRD) OF TRUSTS cites this case for the proposition that other resources *must* be considered, but the court's actual holding was that it was *not improper* for a trustee to consider other resources.

Restatement (Second) of Trusts appears to be that, absent some expression of intent to the contrary, the grantor of a trust for support intends that the trust provide for all of the beneficiary's support needs, irrespective of whether the beneficiary may have other resources that could be used for that purpose:

> *e. Trust for support*. By the terms of the trust it may be provided that the trustee shall pay or apply only so much of the income and principal or either as is necessary for the education or support of a beneficiary. In such a case the beneficiary cannot compel the trustee to pay to him or to apply for his benefit more than the trustee in the exercise of a sound discretion deems necessary for his education or support.
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> It is a question of interpretation whether the beneficiary is entitled to support out of the trust fund even though he has other resources. The inference is that he is so entitled. It is a question of interpretation whether the trustee is authorized to pay the funeral expenses of the beneficiary. The inference is that he is so authorized.[102]

The Restatement (Third) of Trusts, however, provides as follows:

> Specifically, with several qualifications (below), the presumption is that the trustee is to take the beneficiary's other resources into account in determining whether and in what amounts distributions are to be made, except insofar as, in the trustee's discretionary judgment, the settlor's intended treatment of the beneficiary or the purposes of the trust will in some respect be better accomplished by not doing so.
>
> One qualification is that, if the discretionary power is one to invade principal for (or to distribute additional income to) a beneficiary who is entitled to all or a specific part of the trust income, or to an annuity or unitrust amount, the trustee must take the mandatory distributions into account before making additional payments under the discretionary power. Where a beneficiary is entitled to payments from another trust created by the same settlor (e.g., nonmarital and marital deduction trusts for a surviving spouse), or as a part of coordinated estate planning with another (such as the settlor's spouse), required distributions from the other trust--and the purposes of both trusts--are to be taken into account by the trustee in deciding whether, in what amounts, and from which trust(s) discretionary payments are to be made.
>
> Another qualification is that, to the extent and for as long as the discretionary interest is intended to provide for the support, education, or health care of a beneficiary (or group of beneficiaries, Comment *f*) for periods during which a beneficiary probably was not expected to be self-supporting, the usual inference is that the trustee is *not* to deny or reduce payments for these purposes because of a beneficiary's personal resources. (But contrast the effect of *another's* duty to support the beneficiary, Comment *e(3)*).[103]

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[102] RESTATEMENT (SECOND) OF TRUSTS § 128, cmt. e (1992). The Reporter's notes to this comment include citations to numerous cases holding that a beneficiary is entitled to distributions irrespective of other resources, and other cases holding to the contrary.

[103] RESTATEMENT (THIRD) OF TRUSTS § 50, cmt. e (2003).

It is not entirely clear why the two comments appear to be inconsistent, other than to reflect that the states are not all of one mind as to whether a trustee should take other resources into consideration and, assuming that there are such other sources, what impact that has on distributions. The first statement would seem to indicate that even if the beneficiary does have other resources, if the trustee is directed to provide for the beneficiary's support, then it does not matter whether the beneficiary has other resources or not. The second statement does not necessarily say that the fact that a beneficiary has other resources necessarily means that the distributions from the trust are any less than they otherwise would be.

A review of the extensive comments and Reporters Notes to Section 50 of the Restatement (Third) of Trusts demonstrates that while many states agree that there is no duty to consider other resources, many other states have adopted the opposite rule. Accordingly, the only way to assure that the grantor's wishes will be followed in this regard is to spell it out.[104]

In many cases, the trustee will be guided by the grantor's intent as expressed in provisions of the trust that do not specifically address consideration of other resources. For example, if the grantor's intention is to preserve principal to the maximum extent possible for later generations, and to limit distributions to current beneficiaries based upon actual need, then other resources probably should be considered, with an eye toward limiting distributions. On the other hand, if the grantor's intention is to provide as well as possible for current beneficiaries, and the rights of remainder beneficiaries are merely incidental, then it may be that the beneficiary's other resources are significant only to the extent that they demonstrate that the trustee can be more generous in making distributions, because the beneficiary is not wholly dependent upon the trust for support for the beneficiary's lifetime.

2. What Impact Should Beneficiary Resources Have on Distributions?

Presumably, if the trustee has discretion to consider other resources, then the trustee also has discretion to determine the *significance* of other resources, based upon all of the surrounding circumstances. If, however, the trust mandates consideration of other resources, how is that knowledge supposed to impact the trustee's decision? Georgia case law holds that even if a trustee is required to consider other resources, the existence of other resources does not necessarily mandate that distributions from a trust be less than they would be in the absence of such other resources.[105]

The view of the Restatement (Second) of Trusts, and the rule in some, but not all states, appears to be that, absent some expression of intent to the contrary, the grantor of a trust for support intends that the trust provide for *all* of the beneficiary's support needs, irrespective of whether the beneficiary may

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104 *See* Halbach, *supra*, note 85, at 1442.

105 *Griffith v. First Nat'l Bank*, 249 Ga. 143; 287 S.E.2d 526 (1982).

have other resources that could be used for that purpose.[106] The Restatement (Third) of Trusts, however, suggests that a trustee *should* consider other resources, unless the grantor's purposes are better served by not doing so.[107]

Again, the author's experience is that most people assume that the existence of other resources will serve to reduce distributions from the trust, but this is not necessarily so. If the trustee knows that the beneficiary's other resources are adequate to support the beneficiary, and that the beneficiary will not need to rely upon the trust for support, the trustee may be more liberal in making distributions, especially if the grantor has expressed the intent that the primary purpose of the trust is to provide for current beneficiaries, and that the rights of remainder beneficiaries are merely incidental. On the other hand, if the trust resources are limited, and the beneficiary has no other resources, the trustee may need to limit distributions in an effort to ensure that the trust will not be exhausted during the beneficiary's lifetime, leaving the beneficiary without support.

3. If So, What Resources Should Be Considered?

Should the trustee consider only the beneficiary's sources of *income*? What about *principal*? Is the beneficiary expected to deplete his or her assets?

The general rule seems to be that the resources to be considered are limited to *income*, and not the beneficiary's assets in general.[108] Nevertheless, there are certainly circumstances where the trust may require the beneficiary to consume his or her own assets before encroaching on the principal of a trust. For example, a marital deduction trust for the benefit of a surviving spouse that is not the parent of the decedent's children may mandate that the spouse consume his or her own resources before any principal is distributed, so as to preserve the principal for the decedent's children. Also, a trust may specify that a beneficiary's assets that will be taxable in the beneficiary's estate be consumed before encroaching upon GST exempt trust principal that will not be subject to transfer tax at the beneficiary's death.

4. What Evidence of Resources Should Be Required?

Assuming the foregoing questions are answered, what evidence may or should the trustee request or demand from the beneficiaries? Should the trustee request the beneficiary's tax returns? Bank and investment statements? Beneficiaries can be quite resistant to providing copies of tax returns and other information, on the grounds that the grantor did not intend for the beneficiary to bare his or her entire financial soul to the trustee in order to get distributions. However, the trustee is expected to maintain some degree

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[106] RESTATEMENT (SECOND) OF TRUSTS § 128, cmt. e (1992). The Reporter's notes to this comment include citations to numerous cases holding that a beneficiary is entitled to distributions irrespective of other resources, and other cases holding to the contrary.

[107] RESTATEMENT (THIRD) OF TRUSTS § 50, cmt. e (2003).

[108] *Id.*

of diligence in collecting reliable information, especially where the trustee is required, or at least encouraged, to consider other resources.

If the trust *mandates* consideration of other resources, the trustee may not have much choice, unless the trust agreement specifically states that the trustee may rely solely upon the beneficiary's statement of other resources assuming, of course, there is no reason to question the beneficiary's veracity. If the trust merely *permits* the trustee to consider other resources, there is an increased likelihood of conflict with the beneficiary, who may well argue that the trustee is not required to obtain such information, and therefore should not do so.

Sample Provision:

Consideration of Other Resources

The trustee may pay to or for the benefit of each descendant of mine who is the primary beneficiary of a trust created hereunder, and such primary beneficiary's descendants from time to time living, (i) such amounts from the income and principal of that trust as the trustee may deem appropriate for the support of those persons in their accustomed manner of living and for their health and education, ***taking into consideration any other resources available to them to the knowledge of the trustee***, and (ii) such additional amounts of income and principal of that trust, in such amounts and proportions among them, as the trustee in its sole discretion deems best.

In determining the advisability and amount of any payment, the trustee may, but need not, rely on a statement of any beneficiary's or distributee's assets, signed by such beneficiary or distributee, or any parent, guardian, or similar fiduciary of such beneficiary or distributee. Within the scope of the trustee's discretion, the trustee's judgment as to the advisability, amount and recipient of any such payment shall be final and conclusive upon all parties interested or who may become interested in the trust; and upon making any such distribution, the trustee shall be fully released and discharged from all further liability therefor.

IX. Choosing and Discarding Trustees (with Minimal Fuss)

A. Divesting Undesirable Trustees (Without Court Action)

1. Powers to Remove Corporate Trustee

Giving someone, whether the beneficiary or some other person, the power to remove and replace a corporate trustee is the best way to keep a corporate trustee honest and responsive, and avoids the awkward situation that is created where a corporate trustee must be asked to resign, and the even more awkward situation where the corporate trustee refuses to do so.

Sample Provision:

Power to Remove and Replace Corporate Trustee

Notwithstanding anything herein to the contrary, the individual co-trustee of any trust created hereunder, if any, and if none, the primary beneficiary of such trust, may remove the corporate co-trustee or trustee serving hereunder from office by instrument in writing delivered to such trustee or co-trustee being so removed, provided that such instrument designates a successor corporate trustee that is not a related or subordinate party, within the meaning of Section 672(c) of the Code, to any person holding such a removal power or his or her guardian.

2. Incapacity of Individual Trustees - HIPAA Lingering Concerns

In the case of individual trustees or co-trustees, the trust agreement should address the issue of an individual trustee who loses the capacity to administer the trust, but will not, or is medically unable to, resign. Most trusts provide that an individual trustee's (or beneficiary's) loss of mental capacity is to be established by *physician certification*. Where the individual is clearly unconscious, obtaining such a certification may not be problematic, but if the individual suffers from a progressive dementia, such that loss of capacity may not be immediately apparent, obtaining an examination, and the physician's findings, could be quite difficult, especially if the individual trustee refuses to submit to examination or refuses to permit the physician to disclose his or her findings. Under HIPAA,[109] a physician is not at liberty to disclose the results of an examination, or any other "protected health information," unless authorized to do so by the patient or a person holding a medical power of attorney.

[109] Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, 42 U.S.C. § 1171 *et seq.* For an excellent discussion of HIPAA issues in the context of estate planning, *see* Michael L. Graham and Jonathan G. Blattmachr, *Planning for the HIPAA Privacy Rule*, 29 ACTEC J. 307 (2004).

The author frequently encounters trust agreements that purport to waive HIPAA protections on behalf of an individual trustee, sometimes by saying that acceptance of a trust constitutes automatic consent by the individual to the release of "protected health information." The HIPAA rules, however, are fairly clear that a consent to the release of protected health information must be in writing and signed by the individual, and may not be implied. Moreover, HIPAA rules state that a release of information must be a stand-alone document, and may not be incorporated into any other agreement.[110]

Perhaps the simplest way to address this issue is to provide that interested persons, such as co-trustees, beneficiaries, etc. can ask a trustee to submit to examination, and execute a HIPAA authorization for the physician to release the protected health information to the requesting party. Such a release can be limited in scope to the information necessary to determine the trustee's capacity to discharge his fiduciary office, and need not authorize the release of other protected health information.

Yet another option would be to provide that the trustee is deemed to be incapacitated if the holder of the trustee's medical power of attorney executes an affidavit to that effect, thus eliminating any need for direct access to the medical information.

Sample Provision:

HIPAA Avoiding Provision for Incapacitated Trustee

Incapacity Defined. Any individual Trustee, Trust Protector, or Trust Advisor [or the Grantor (in the case of a revocable trust),] shall be deemed to be incapacitated and no longer able to discharge his or her duties hereunder at such time as the individual, as a result of illness, age or other cause, no longer has the capacity to act prudently or effectively in financial affairs or to otherwise discharge the office held by such person with respect to the trust. Such capacity may be established: (1) by determination of a court of competent jurisdiction; (2) by the appointment of a conservator or guardian for such person by a court of competent jurisdiction; (3) by written certification of two physicians licensed to practice medicine; or (4) by written certification of anyone holding such

[110] 45 C.F.R. § 164.508(b)(3) prohibits "compound authorizations," meaning an authorization to release "protected health information" that is combined with any other document. The only exception to this rule is that a medical power of attorney may include an authorization, but the holder of a medical power of attorney is already deemed to be the principal's "personal representative" under HIPAA, whether the medical power of attorney says so or not.

individual's medical power of attorney, or otherwise qualifying as such individual's "personal representative" under the Health Insurance Portability and Accountability Act Of 1996 ("HIPAA"). Additionally, if any co-Trustee, successor Trustee, Protector, or current beneficiary of the trust requests in writing that the individual submit to examination by two physicians and authorize the physicians to release to the requesting person such physicians' opinions as to such individual's capacity and the requesting person does not receive the requested opinions within thirty (30) days of making such written request, the individual will be deemed to be incapacitated.

[For purposes of this Trust Agreement, the Grantor will be deemed to have regained capacity if: (1) there is a finding to that effect by a court of competent jurisdiction; (2) when any conservatorship or guardianship has been judicially terminated; or (3) upon the written determination by two physicians licensed to practice medicine in the State of ____________________ (who need not be the same physicians who made the initial determination of the Grantor's incapacity)[111] that, in their opinion, the Grantor's capacity is restored, and the Grantor shall again serve as the Original Trustee hereunder as of the effective date of his restoration of capacity if the Grantor was serving as the Original Trustee hereunder at the time he was determined to be incapacitated, if the Grantor so elects.]

3. Prohibit Termination Fees

Some corporate trustees charge a fee for terminating a trust or removing a trustee, generally as a disincentive to removing the trustee, and some state laws specifically permit such a fee. Generally speaking, however, the author's view is that one should not receive a bonus for being fired. Prohibiting such a fee helps to facilitate the orderly replacement of a trustee, where such replacement is necessary.

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[111] While the physicians certifying to the individual's recovery from incapacity need not be the same physicians who originally declared such incapacity, they should be made aware of the earlier declaration. In *Rands v. Rands*, 178 Cal. App.4th 907, 100 Cal. Rptr. 3d 632 (2009), the court held that a physician's certification of a grantor's capacity did not restore the grantor's ability to revoke a trust where the physician was unaware that the grantor had previously been declared to be incapacitated.

Sample Provision:

Prohibition of Trustee Termination Fee

The Trustee shall not charge a termination or distribution fee upon resignation or removal of the Trustee unless, upon acceptance of its trusteeship, the Trustee obtains written consent of the grantor, if living, or if not, the individual co-trustee, or if none, the beneficiary of each trust that is in a generation closest to mine.

4. Non-Judicial Settlement of Account

Most trust agreements, and the laws of many states, eliminate the requirement of formal judicial settlement of accounts. In most such cases, where a trustee ceases to serve, due to the termination of the trust or for other reason, the trustee will accept an informal settlement with the beneficiaries, in the form of a release executed by the beneficiaries, especially where minor and unborn beneficiaries can be "represented" by *sui juris* beneficiaries.

Where informal settlement is not adequate, either because one or more beneficiaries refuses to release the trustee, or because one or more minor, disabled, or unborn beneficiaries cannot be adequately represented without a court appointed guardian *ad litem*, the trustee may petition a court for judicial settlement, even though it is not required to do so, especially if the only alternative is to wait out the limitations of actions period. Naturally, the trustee will want to charge the expense of judicial settlement to the trust, rather than incurring that expense on its own.

In many, if not most, states, the trustee is entitled to have the cost of the settlement paid by the trust, even though judicial settlement is not mandatory, assuming, of course, that the petition is granted and there has been no breach of trust.[112] In other states, there may be some question as to whether the trustee's incurring such an expense on behalf of the trust is appropriate, especially if no breach of trust action has been asserted or threatened. In still other states, such as Delaware, a trustee clearly is *not* entitled to have the cost of judicial settlement paid by the trust, unless the trust agreement says otherwise.[113]

The argument against permitting a trustee to charge the trust for a non-required judicial settlement is that the expense is incurred solely for the benefit of the trustee (to protect the trustee from future claims) and provides no benefit to the beneficiaries. On the other hand, a trustee who has faithfully executed its duties should not be denied the closure that is provided by full and final settlement merely because an obstinate beneficiary refuses, without

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112 *See, e.g.*, O.C.G.A. § 53-12-230(e).

113 *Bankers Trust Co. v. Duffy*, 295 A.2d 725 (Del. 1972); *Merrill Lynch Trust Co. v. Campbell*, 2009 Del. Ch. Lexis 160, C.A. No. 1803 - VCN (Del. Ch. 2009).

cause, to agree to informal settlement, especially where the grantor has specifically provided a means for informal settlement in the document itself. Moreover, an argument can be made that a beneficiary's refusal to consent is sufficient evidence of a possible claim to justify judicial settlement. The ability of the trustee to charge the expenses of judicial settlement to the trust should serve as an incentive to the beneficiaries to either assert any claims they have or to respect the grantor's desire to keep administrative burdens and expenses to a minimum.

The following provision expressly permits the beneficiaries to settle a trustee's account, provides for virtual representation of certain beneficiaries (which may not be necessary if there is a general virtual representation provision, as discussed above) and permits the trustee to seek judicial settlement at the expense of the trust.

Sample Provision:

Release of Trustee by Beneficiary Approval of Account

The trustee, in its sole and absolute discretion, may render an account or similar report of its proceedings as trustee to any or all living or then existing beneficiaries at any time. The then existing beneficiaries shall have full power to settle finally any such account or report and, on the basis of such settlement, to release the trustee from all liability for its acts or omissions as trustee. Such settlement and release shall be binding upon all interested parties, including those who may be under legal disability or not yet in being. Nothing herein shall preclude the trustee from having its accounts judicially settled at the expense of the trust if it shall so desire. If any beneficiary is suffering under a legal disability (including minority), then accounts or reports may be requested by or issued to or settled by the parent, guardian, or similar fiduciary of such person.

B. Acquiring Desirable Trustees

1. Powers to Fill Vacancies in Office of Trustee

This power allows certain persons to fill a vacancy without the need for court involvement. Note that the UTC also permits vacancies to be filled by agreement of the beneficiaries without court approval, but the laws of some states still require court approval of any appointment that is not specifically provided for in the trust instrument.[114]

Sample Provision:

Beneficiary Power to Fill Vacancy in Trustee Office

If a vacancy occurs in the office of executor of this will or of trustee of any trust created by this will and there is no other provision for appointing a successor, my spouse, if then living, and if not, the persons who are then income beneficiaries of my estate or such trust (or, if any such beneficiaries are then minors or otherwise under legal disability, their parents or guardians), [acting by majority[[acting unanimously] shall, within sixty (60) days after such office becomes vacant, appoint a successor executor or trustee by written instrument delivered to the retiring executor or trustee, to the executor or trustee being appointed and, in the case of an executor, to the court having jurisdiction over the administration of my estate. Should such persons fail or refuse to appoint a successor within sixty (60) days, then such successor may be appointed by any court having jurisdiction over my estate or such trust upon application of any person interested in my estate or such trust, or upon application of the retiring executor or trustee.

2. Successor Trustee Qualification Issues

Trust instruments often establish the criteria that any successor corporate trustee must meet in order to serve in that capacity. The most common types of criteria typically appear in the form of minimum requirements as to capital and surplus, assets under management, and/or years of experience administering trusts. While such requirements certainly may have their place, they can have the result of unduly narrowing the possible universe of qualified trustees, especially in the case of a relatively small trust that might get more attention from a smaller corporate trustee than from a larger trustee. For example, a corporate trustee with $100,000,000 capital and surplus may be advisable for a $20,000,000 trust, but may well be overkill for a $200,000 trust.

Moreover, it is often the case that there are benefits to be gained by using a fiduciary in a particular jurisdiction, such as Delaware, to facilitate a

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[114] *See, e.g.*, O.C.G.A. § 53-14-2.

perpetual trust, an asset protection trust, a directed trust, or some other structure that may not be as "reliable" in other jurisdictions. In the case of Delaware, many Delaware trust companies are relatively small, and cannot, standing alone, meet the criteria set forth in certain trust instruments, but they may be part of an affiliated group of trust companies that, in the aggregate, can easily meet such requirements. Accordingly, if such qualification requirements are to be imposed, consider allowing an institution to meet the requirement on an aggregate basis, by including the type of language shown below:

Sample Provisions:

Minimum Capital and Surplus

Any successor executor or trustee appointed hereunder shall be a bank or trust company with trust powers and combined capital and surplus (***when combined with the capital and surplus of all corporations that control, are controlled by, or are under common control with, such bank or trust company***) of not less than One Hundred Million Dollars ($100,000,000).

Minimum Assets under Management

Any successor executor or trustee appointed hereunder shall be a bank or trust company with trust powers and assets under management (***when combined with the assets under management of all corporations that control, are controlled by, or are under common control with, such bank or trust company***) of at least Five Hundred Million Dollars ($500,000,000).

Minimum Experience Administering Trusts

Any successor executor or trustee appointed hereunder shall be a bank or trust company with trust powers and (along with all corporations that control, are controlled by, or are under common control with, such bank or trust company) not less than twenty-five (25) years continuous experience administering trusts.

3. Compensation of Trustees

A trust should provide that a corporate trustee is entitled to compensation according to its published fee schedule, in the absence of a written agreement to the contrary. Many trust agreements, and many state statutes, including the

UTC, provide simply for "reasonable" compensation.[115] While provisions for "reasonable" compensation or compensation at the "prevailing rate" may sound good, the reality is that most corporate fiduciaries will require compensation according their published schedules, and if the trust agreement does not provide for such compensation, the issue may have to be addressed by agreement with the beneficiaries or by judicial action, which can delay the transition of a trust from one trustee to another. In this day and age, the competitive marketplace serves as a check on unreasonable fees, especially where the trustee can easily be replaced, as discussed above. Another consideration is that there are some state fiduciary compensation statutes that call for compensation at a much higher level than the standard rates charged by corporate fiduciaries, which could tempt a corporate fiduciary to charge the statutory rate, rather than the published rate that the grantor likely anticipated.

If the named trustee is a lawyer, accountant, or other professional who customarily charges for his or her time at a given hourly rate, and such rate is higher than would typically be charged for service as a fiduciary, a provision permitting such person to be compensated at that rate can avoid the conflicts of interest that may otherwise arise, especially if those hourly rates are higher than might otherwise be appropriate for a trustee. For example, if a lawyer cannot charge as much for trustee services as she can for legal services, the lawyer may not be inclined to accept the appointment, or may have an incentive not to spend as much time on the trust as the situation requires.

There is always the possibility that special circumstances may call for compensation at rates higher than, or different from, a corporate trustee's fee schedule or a professional's normal hourly billing rate, so a compensation provision should also contemplate a possible fee agreement.

Sample Provision:

Trustee Compensation

Each trustee shall be entitled to receive reasonable compensation, which may be charged to principal or to income or partly to each at the discretion of the trustee.[116] Reasonable compensation may be established by a written fee agreement between the trustee and the person by whom the trustee was appointed or

[115] UNIF. TRUST CODE § 708(a). Georgia law, by contrast, expressly provides that a corporate trustee is entitled to compensation pursuant to its published fee schedule, absent some other provision in the trust or agreement to the contrary. O.C.G.A. § 53-12-210(c)(1).

[116] Most (all?) states have principal and income acts which specify how certain expenses are to be apportioned between income and principal, in the absence of a contrary provision in the trust agreement. It is sometimes helpful for a trustee to have the discretion to apportion such expenses in a manner other than provided for in the state statute, if the terms of the trust and the investment policy, and the interests of the beneficiaries are such that some other method of apportionment would be more equitable. As with any discretionary authority of a trustee, such a power is exercisable subject to fiduciary duties.

who holds the power to remove and replace the trustee. A corporate trustee's compensation specified in its published fee schedule in effect at the time it renders services shall be presumed reasonable in the absence of a fee agreement. In the case of an individual professional who maintains standard hourly rates for his or her professional services, such professional's hourly rate at the time services are rendered shall be presumed to be reasonable compensation, in the absence of a fee agreement. Notwithstanding the foregoing, however, no trustee shall charge a termination or distribution fee upon resignation or removal of the trustee unless, upon acceptance of its trusteeship, the trustee obtains written consent of the grantor, if living, or if not, the individual co-trustee, or if none, the beneficiary of each trust that is in a generation closest to mine.

Note that this above provision expressly prohibits termination fees, which some corporate trustees routinely charge, generally as a disincentive to removing the trustee. The author's view is that a trustee should not receive a bonus for being fired. Some state laws specifically permit the charging of a termination fee, absent a provision to the contrary, even if the fee is not included in the trustee's published fee schedule. The above provision is intended to negate a termination fee, even if it is included in the trustee's fee schedule.

4. Trustee Power to Resign

In many states, other than UTC jurisdictions, the default rule is that a trustee cannot resign without court approval, which can cause a trustee to be stuck with a bad situation if there are unreasonably litigious beneficiaries or persons who make the efficient administration of the trust impossible.[117]

Sample Provision:

Trustee Power to Resign Without Court Approval

Any trustee of any trust under this agreement may resign at any time from such trust by giving prior written notice of his, her or its resignation, such resignation to become effective immediately or upon such date or contingency as the resigning trustee may specify in such notice, without the need for any judicial or other approval. The notice of resignation shall be delivered to any other

[117] *See, e.g.,* O.C.G.A. § 53-12-220(a)(2). By contrast, the UTC permits a trustee to resign after 30 days' notice to the qualified beneficiaries. UNIF. TRUST CODE § 705(a)(1).

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trustee then serving, or if none, to any
nominated successor trustee, or if none, to a
majority of the adult beneficiaries (or the
parents or guardians of any minor
beneficiaries) of that trust to whom the
trustee could at that time distribute income.
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An alternative would be to provide that such resignation becomes effective at the earlier of the acceptance of the trust by a replacement trustee or a stated period of time, such as 60 or 90 days, to allow the interested parties a reasonable time to find and nominate a replacement trustee.

X. Varying Default Rules in Terms of Trust – Deviant Trusts

Some trusts contemplate or mandate that the trustee administer the trust in a way that deviates from what are normally considered to be standard, prudent, or otherwise "good" practices. Institutional trustees should have well established policies and procedures on matters such as investment policies for trusts, frequency and mode of communication with beneficiaries, discretionary distribution decision making, etc. Presumably, these practices and procedures are developed to help the trustee carry out its fiduciary duties to the best of its ability and in a manner that will not cause the trustee to incur liability. Often, however, the grantor will desire, or even mandate, that the trust be administered in a way that significantly deviates from established normal procedure, and in a way that, under normal circumstances, might even be considered a breach of the trustee's fiduciary duties.

A. Introductory Reminder – We Are Still Counselors!

The following discussion revolves around the potential difficulties that arise where a grantor demands trust provisions that are "deviant," in that they deviate from fiduciary practices that would be considered "normal," or "prudent." The discussion includes suggestions about ways to increase the likelihood that the grantor's desires are carried out, even if they deviate radically from normal practices.

The author's use of the term "deviant" is somewhat, but not entirely, tongue-in-cheek. The statutory and common law rules governing the administration of trusts and good fiduciary practices did not capriciously pop into being overnight, but have evolved over many decades out of the collective experience of lawyers, judges, trust administrators, and others. To be sure, the rapidly changing landscape of modern trust planning often demands special drafting that deviates from long established rules. However, before blindly charging ahead to facilitate a grantor's peculiar demands, the author believes it is our job, as counselors, to give due consideration to established practices and to only deviate from those practices where we are satisfied that such deviation is necessary to obtain the best result for the client.

As counselors to our clients, we should at least attempt to dissuade clients from courses of action that we believe are ill-advised, so that we can help them make better decisions. By way of example, one issue discussed below is how to carry out the grantor's desire that the investments of a trust be managed in a way that is quite different from what would normally be considered "prudent" investing. To be sure, there are circumstances where such provisions make sense, at least for a while, but there are many cases where such demands are simply the result of erroneous beliefs on the part of the grantor.

For example, a grantor may strongly believe that a particular stock is likely to substantially outperform a more diversified portfolio, based upon the grantor's personal knowledge of the company, the industry in which it operates, etc. Accordingly, the grantor may wish to relieve the trustee of the "prudent investor" duties that would normally apply and that would normally require the trustee to maintain a more diversified investment portfolio for the trust, because the grantor understands the risk involved in doing so, but believes that the trust beneficiaries will be well compensated for that risk. This is well considered "deviance."

On the other hand, if the grantor wishes to mandate that a concentration in the stock that made the grantor wealthy be retained in the trust *forever*, because it would be "disloyal" to the company to permit the trustee to sell the stock, such "deviance" would *not* be well considered, and could potentially be quite contrary to the best interests of the beneficiaries, if the Trustee has no power to sell the stock later on.

The point is that the discussion below about how to increase the likelihood that the grantor's intent is carried out, no matter how peculiar that intent may be, should not be taken as a suggestion that doing so is always the best course of action, because the best course of action may well be to persuade the client to follow a different course that eliminates the deviance from the plan, or at least reduces the deviance, by giving the trustee the flexibility to take prudent action as demanded by changing circumstances.

B. General Rule – Trust Terms Trump Default Rules

The vast majority of legal rules governing trusts and their administration, whether statute or common law, are *default* rules that apply only to the extent that the subject matter of such rules is not otherwise provided for in the terms of the trust itself, except for certain statutory requirements that may not be waived or modified.[118] The trustee is under a duty to administer the trust according to the terms of the trust or, where the trust does not address a particular issue, as provided by law, and as long as the trustee follows that rule, it should not incur liability.[119] The general rule, however, is not without its exceptions or limitations.

The UTC sets forth a list of "mandatory" rules that may *not* be varied by the terms of the trust instrument, although the states have varied considerably over which rules are included on the "mandatory" list. The most controversial "mandatory" item in the UTC is the requirement as to information that must be

[118] UNIF. TRUST CODE § 105; O.C.G.A. § 53-12-7.

[119] UNIF. TRUST CODE § 801; O.C.G.A. § 53-12-240(b).

provided to beneficiaries under the *Duty to Inform and Report*.[120] These "mandatory" provisions are so controversial, in fact, that they have been omitted from most states' versions of the code, because there is a strong desire on the part of many trust grantors to keep the provisions of a trust, or even the existence of the trust, secret from the beneficiaries, at least for a certain period of time.

Even where certain issues are not specifically included in the "mandatory" list, there are more general "mandatory" requirements, that have been included in all states' versions of the code and that may limit the extent to which a grantor may negate the default provisions of state law:

> The terms of a trust prevail over any provision of this Code ***except***:
>
> * * *
>
> (2) the duty of a trustee to act in good faith and in accordance with the terms and purposes of the trust ***and the interests of the beneficiaries***;
>
> (3) the requirement that a trust and its terms be ***for the benefit of its beneficiaries***, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve;[121]

These provisions leave open the possibility that *any* provision of a trust that deviates from normal fiduciary practice might be found to be "out of bounds" on the grounds that such a provision violates the rule that the trust provisions must be "in the interests of" and "for the benefit of" the beneficiaries.

Certain trust terms will be void, *ab initio*, such as trust terms that are, or require the trustee to act in a way that is, illegal, impossible or against public policy.

C. Permission, Prohibition, and Expectation

It is never wise to assume that a trustee, especially a corporate trustee, will be willing to take some action that is permissible under the express terms of a trust, or even under the default provisions of governing law. Likewise, one should never assume that a trustee will *not* do something that it is not required to do under the default provisions of governing law, or that it is relieved from doing under the terms of a trust. A trustee's actions, particularly in the case of a corporate trustee, are going to be governed not only by the terms of the trust and governing law, but by federal and state banking regulations, internal policies,

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[120] UNIF. TRUST CODE § 105(b)(8) & (9) provides that the duty to inform beneficiaries of the existence of the trust and to provide information on request cannot be waived. *Accord* RESTATEMENT (SECOND) OF TRUSTS § 164(b) (1992). Oregon's variation, O.R.S. § 130.020(1)(h) & (i) & O.R.S. § 130.020(3) provide that while the duty to inform and report cannot be waived entirely, it is possible to waive reports to anyone other than the grantor during the grantor's lifetime, or the grantor's spouse, if the spouse is a qualified beneficiary. Moreover, there is an option to provide reports to someone other than the beneficiary, to be designated by the grantor. Finally, Virginia has omitted the reporting requirements from the mandatory list entirely, so the duty to inform and report apparently can be waived. VA. CODE ANN. § 64.2-703(b).

[121] UNIF. TRUST CODE § 105(b)(3)(emphasis added).

procedures and best practices, and considerations of business judgement, administrative feasibility and reputational risk.

For example, the prudent investor rule may provide that any type of investment is potentially proper, and a trust agreement may specifically permit certain otherwise questionable investments, but a trustee, particularly a corporate trustee, may nevertheless be unwilling to accept or purchase such an investment, or may impose certain conditions, for any number of reasons.

Likewise, many state laws only require trustees to provide regular reports to current beneficiaries, and many trust agreements even waive that requirement, but the trustee may routinely provide the reports anyway, both to current and remainder beneficiaries and may be unwilling to refrain from doing so, regardless of the trust terms.

Therefore, whenever a settlor has any particular expectation or desire about what a trustee may do or not do, especially if the expectation deviates from otherwise normal practices, it is not enough to simply permit the action or negate the duty to take some action. Instead, the agreement should expressly state the desire and expectation, and it should be discussed with the trustee in advance. It may be that the settlor's wishes can be accommodated, but in a particular way. A desire for special investments may be met by making the trust a "directed trust" as to certain investments. A desire to refrain from providing statements to certain beneficiaries might be accommodated by appointing a "Designated Representative" to represent the interests of the beneficiaries.

D. Trustee Duties Where Circumstances Change Over Time

Some provisions may be fine when the trust is created, but may, due to a change in circumstances, become so contrary to the interests of the beneficiary that it is no longer reasonable for the trustee to comply with the provisions. Of course, a trustee is always free to seek direction from a court or to seek permission from the interested parties to deviate from the terms of a trust where compliance with the terms of the trust is sufficiently detrimental to the beneficiaries.[122] In an emergency, there is authority that a trustee may deviate from the express terms of a trust even without court approval, if necessary to prevent some harm to the beneficiaries, and if there is not adequate time to seek court review.[123] The question, then is whether the trustee is *required* to seek court permission to deviate from the terms of the trust.

Both the Restatement (Second) and the Restatement (Third) take the position that a trustee is subject to liability for failing to petition a court for permission to deviate from the express terms of the trust, if the trustee knows or should know that circumstances have changed so dramatically from the creation of the trust that

[122] RESTATEMENT (SECOND) OF TRUSTS § 167(1) (1992); RESTATEMENT (THIRD) OF TRUSTS § 66(1) (2003); *Accord* UNIF. TRUST CODE § 412.

[123] RESTATEMENT (SECOND) OF TRUSTS § 167(2) (1992).

deviation from its terms is necessary.[124] The UTC, by contrast, intentionally stops short of imposing on the trustee an affirmative *duty* to petition the court for permission to deviate.[125]

The point is that even if a trustee may rely on the mandate of a trust when the trust is created, that does not mean that the trustee is protected forever by the trust provisions, if circumstances change materially.

E. Trustee's Right to Rely on Trust Terms and Exculpation from Liability

Because of the potential uncertainties associated with trust terms that deviate from the norm, many trusts, and many trust statutes, include exculpatory provisions that are intended to protect a trustee from liability for any action taken in reliance upon the trust terms. Such provisions are necessary in many cases to encourage a trustee to act other than in the most conservative manner.[126] The UTC provides as follows:

> A trustee who acts in ***reasonable*** reliance on the terms of the trust as expressed in the trust instrument is not liable to a beneficiary for a breach of trust to the extent the breach resulted from the reliance.[127]

Note that the above cited statute only protects the trustee where reliance upon the terms of the trust is "***reasonable***," which would provide no protection to a trustee relying on a trust provision that a court determines is so deviant that reliance on the term is unreasonable. If the trust instrument seeks to expand the protection of the trustee beyond that provided above, it may expressly exculpate the trustee from any liability for following the grantor's instructions. However, state law also imposes limits on trustee exculpation as well. The following UTC provision is fairly typical of state law limits on exculpation:

> A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it . . . relieves the trustee of liability for breach of trust committed in ***bad faith*** or with ***reckless indifference*** to the purposes of the trust ***or the interests of the beneficiaries***.[128]

The foregoing provision may be cause for concern, depending upon how deviant a trust provision might be, because even if a trustee is not acting in bad faith, who is to judge when the trustee's following of the trust terms rises to the

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124 *See* RESTATEMENT (SECOND) OF TRUSTS § 167(3) (1992) and RESTATEMENT (THIRD) OF TRUSTS § 66(2) (2003). While the RESTATEMENTS are generally supposed to be reflective of the common law, it is noteworthy that the Reporters Notes to these provisions contain no citations to any judicial decisions that have actually imposed liability on a trustee for failing to seek judicial deviation from the express terms of a trust.

125 UNIF. TRUST CODE § 412, Comment.

126 *See* Charles W. Pieterse and Charles E. Coates III, *Exculpatory Clauses May Give Trustees Extra Protection from Liability,* EST. PLAN. Mar. 2010 at 26.

127 UNIF. TRUST CODE § 1006 (emphasis added).

128 UNIF. TRUST CODE § 1008(a)(1) (emphasis added). *See also* RESTATEMENT (SECOND) OF TRUSTS § 222 (1992), O.C.G.A. § 53-12-303(a).

level of reckless indifference to the interests of the beneficiaries? After all, a court could determine that the original mandate of the trust was, from the very beginning, so contrary to the interests of the beneficiaries that the following of the mandate would be considered reckless.

There is wide variation among the states as to the degree to which a trustee may rely on deviant trust terms, and may be exculpated for doing so. Therefore, depending upon how deviant a trust provision is, it may not be possible, in some states, to carry out the grantor's intent, because it may not be possible to provide adequate protection to the trustee. In such cases, the best solution may be to establish the trust under the laws of a different jurisdiction that is more permissive of trusts that stray far afield of normal practice, and to take steps to avoid the application of any less tolerant state law.

1. New York Law – Low Tolerance for Deviance from Standard Practice

New York law appears to prohibit exculpation from even ***ordinary*** negligence, declaring that it is against public policy to exonerate a trustee "from liability for failure to exercise *reasonable care, diligence and prudence*."[129] In *Matter of Dumont*[130] the decedent's estate consisted almost exclusively of stock in Eastman Kodak Company, about which the Decedent's will provided as follows:

> It is my ***desire and hope*** that said stock will be held by my said Executors and by my said trustee to be distributed to the ultimate beneficiaries under this Will, and ***neither my Executors nor my said trustee shall dispose of such stock for the purpose of diversification of investment and neither they or it shall be held liable for any diminution in the value of such stock***.
>
> The foregoing provisions ***shall not prevent*** my said Executors or my said Trustee from disposing of all or part of the stock of Eastman Kodak Company in case there shall be some ***compelling reason other than diversification*** of investment for doing so.[131]

Based upon the foregoing provision, the trustee retained the concentration in Kodak stock, and the stock fairly consistently outperformed the benchmarks for the first 17 years following the decedent's death. In the early 1970's, the stock price began to fall, but no more so than the stock market in general. When the market later recovered, however, Kodak's recovery was significantly more sluggish than the overall stock market. Thirty years later,

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[129] N.Y. EST. POWERS & TRUSTS LAW § 11-1.7(a)(1) (emphasis added).

[130] *In re Judicial Settlement of the Second Intermediate Account of Chase Manhattan Bank (Matter of Dumont)*, 4 Misc. 3d 1003A, 791 N.Y.S.2d 868, 2004 Slip Op. 50647U (N.Y. Sur. Ct., June 25, 2004) (all citations to particular pages of this opinion are citations to the Slip Opinion page number), *rev'd.*, 26 A.D.3d 824; 809 N.Y.S.2d 360 (N.Y. App. Div. 4th Dep't, Feb. 3, 2006); *appeal denied*, 28 A.D.3d 1257; 813 N.Y.S.2d 689 (N.Y. App. Div. 4th Dep't, Apr. 28, 2006); *appeal dismissed* 2006 N.Y. LEXIS 2560, (N.Y. Ct. App., Sept. 12, 2006).

[131] 26 A.D.3d at 826; 809 N.Y.S.2d at 362 (emphasis added).

the beneficiaries sued the bank for breach of trust for failing to sell the stock when its value began to decline. The bank argued that it was bound to follow the terms of the trust, and was exculpated from liability for any loss resulting from the retention of the Kodak stock, and that there had been no compelling reason to sell the stock.[132]

The Surrogate's Court held that while a trustee is supposed to follow the terms of the trust to carry out the intent of the testator, the trustee is still required to act in a prudent manner, and if the terms of the trust are contrary to the best interests of the beneficiaries, then the testator's intent and wishes must yield to the best interests of the beneficiaries:

> It is clear that a fiduciary must use good faith and prudence to carry out its duties (EPTL 11-2.3,b,3,A), and that a retention clause cannot trump the application of prudence in the management of an estate. *In Re Hubbell*, 302 N.Y. 246, 97 N.E.2d 888). ***The Hubbell case holds that where a retention clause conflicts with the legal duty of prudence imposed upon a fiduciary, the clause must lose***.[133]

The court held that the language in the will directing retention of the Kodak stock was not a mandate, but was merely "precatory,"[134] and that the trustee was at all times free to sell the stock under the general administration provisions of the trust, which included a *general* power to purchase and sell investments. The end result was a surcharge against the trustee of nearly ***$21,000,000***. This holding was particularly troublesome in light of an earlier New York decision, *Matter of Kettle,*[135] which involved a testamentary trust that provided as follows:

> I am particularly ***desirous*** that my TRW, Inc., securities be retained by my Executrix and by my Trustee unless ***compelling reasons*** arise for the disposal thereof.[136]

The trustee in *Kettle* would have made the *Dumont* Surrogate quite proud, since the trustee determined that the prudent course of action was to sell most of the TRW stock, notwithstanding the objections of the beneficiary, and to reinvest the proceeds in a well-diversified portfolio. Unfortunately for the trustee in *Kettle*, the diversified portfolio did not perform as well as the concentration in TRW stock would have performed. Consequently, the beneficiary sued the trustee for breach of trust because the trustee did not

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132 The bank was even able to cite to authority that a decline in stock price does *not* necessarily compel its sale by a trustee.

133 Slip Op. 50647U at 5-6 (emphasis added). A review of the *Hubbell* case really does not support the court's assertion, however, since the trust agreement in *Hubbell* merely *permitted* the retention of the trust property, rather than *mandating* such retention.

134 *See* Frank L. Schiavo, *Does The Use of "Request," "Wish," or "Desire" Create a Precatory Trust or Not?*, 40 REAL PROP. PROB. & TR. J. 648 (2006).

135 *Matter of Kettle*, 73 A.D.2d 786; 423 N.Y.S.2d 701 (N.Y. App. Div. 1979).

136 *Kettle* at 786; 423 N.Y.S.2d at 702 (emphasis added).

follow the directions in the trust agreement. The trustee argued not only that the statement of the testator's *desire* was merely precatory, but that in any event, the general provisions of the trust permitted the trustee to buy and sell any asset, so it was authorized to diversify the portfolio. Does this sound familiar? The end result was that the court found the trustee liable for breach of trust for not following the testator's instructions, and the court ordered the trustee to repurchase the TRW shares, even if it had to use its own money to do so. *Kettle* does not appear to have been cited by any of the parties or the various courts involved with *Dumont*, but if the trustee in *Dumont* had followed the holding in *Kettle*, it would likely have concluded that its duty was to follow the trust, not the general standards of "prudence," and it would still have been found liable for doing so.

The most troublesome aspect of *Dumont*, from a fiduciary standpoint, was the court's willingness to find that general rules of prudence, as interpreted by the court, trump the grantor's express wishes, when the two are in conflict, such that a trustee cannot rely on the express terms of the trust. *Dumont* appears to be aberrational, but it demonstrates the potential difficulty of a grantor having his or her wishes followed if a court decides that it does not like the grantor's wishes. In any event, one must be mindful that no matter how emphatic the language of the trust, a trustee may be compelled to seek direction from a court before following the grantor's wishes in such cases.

Dumont was eventually reversed by the New York Court of Appeals, but the reversal was on procedural grounds, and not with respect to substantive law, so the higher court did not address the Surrogate's holding that the grantor's desires must take a back seat to the court's notion of what constitutes prudent administration. Accordingly, it is still open to question as to whether New York law requires a trustee to ignore the terms of a trust, to the extent they are imprudent.

A primary lesson of these cases is that "deviant" trust provisions can cause significant risk for trustees, at least in some jurisdictions, thus making it more difficult for the grantor of the trust to have his or her wishes honored. Such deviant trust provisions can greatly multiply the work and the risk of a trustee, which may result in higher trustee fees and higher trust expenses, especially if the trustee must repeatedly seek court guidance to comply with the grantor's wishes. Accordingly, such difficult trusts are better established in a "friendlier" jurisdiction.

2. Delaware Law – Strong Emphasis on Settlor's Intention

In contrast with New York's general unwillingness to tolerate much deviation from normal trust administration practices, Delaware law provides that the trust terms can vary any provision of state law, and can exculpate a trustee for relying upon trust provisions that do so:

> Notwithstanding any other provision of this Code or other law, the terms of a governing instrument may expand, restrict, eliminate or otherwise vary the rights and interests of beneficiaries, including the right to be informed of the beneficiary's interest for a period of time, the grounds for

> removal of a fiduciary, and a fiduciary's powers, duties, standard of care, rights of indemnification and liability to persons whose interests arise from that instrument; provided however, that nothing contained in this section shall be construed to permit the exculpation or indemnification of a fiduciary for the fiduciary's own ***wilful misconduct*** or preclude a court of competent jurisdiction from removing a fiduciary on account of the fiduciary's wilful misconduct. ***The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this section. It is the policy of this section to give maximum effect to the principle of freedom of disposition and to the enforceability of governing instruments***."[137]

Note that the only conduct from which a trustee cannot be exculpated is ***wilful misconduct***, and that there is no mention of gross negligence or the best interests of the beneficiaries.

The foregoing provision makes very clear Delaware's policy that the grantor's wishes are to be carried out, and that courts are not to substitute their own judgement for that of the grantor. Moreover, Delaware's Chancery court has exclusive jurisdiction over matters involving trusts and corporations, and the judges of the Chancery Court are carefully selected to ensure that they understand Delaware's public policy favoring freedom of disposition, thus further reducing the risk that a court will try to substitute its own judgement for that of the grantor or the legislature.

To be sure, not every deviation from the default provisions of state law or typical fiduciary practices requires running to Delaware, but the further "off the reservation" a grantor wishes to stray with the terms of a trust, the more that Delaware should be considered for the governing law.

As a final note, the author does not wish to imply that trustees of Delaware trusts are not under the same duties as trustees anywhere else. To the contrary, Delaware common law is one of the richest sources of traditional trust law. By way of example, the *McNeil* case, discussed below, is a key decision of the Delaware courts confirming a trustee's duty to inform a trust beneficiary of the existence of a trust. The difference in Delaware is its tolerance of substantial deviation from traditional trust law, where such deviation is clearly intended by the grantor of the trust.

3. Beyond the Pale, Even in Delaware

There are, of course, limits beyond which a grantor's wishes cannot be carried out, even in a permissive jurisdiction such as Delaware. By way of example, the so-called "Rule against Capricious Purposes" is a doctrine that prohibits carrying out certain trust terms, such as a requirement to destroy valuable property.[138]

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[137] 12 DEL C. § 3303 (a) (emphasis added).

[138] See John J. Langbein, *Burn The Rembrandt? Trust Law's Limits on The Settlor's Power to Direct Investments*, 90 BOSTON L. REV. 375 (2010).

F. Negating or Reducing The Duty to Inform and Report

1. The General Duty to Inform

Among the most thorny issues facing fiduciaries is a request or demand by a trust grantor, or the parent of a trust beneficiary, to withhold from a beneficiary the details of a trust's investments and administration, or even the very existence of the trust itself, usually out of a concern that the knowledge of such available wealth will "ruin" the beneficiary. While the concern is understandable, the duty of the trustee to provide information to beneficiaries about the trust is, in most cases, clear. The Restatement (Second) states that, at the very least, a trustee is required to provide certain information to a beneficiary if the beneficiary so requests.

> The trustee is under a duty to the beneficiary to give him ***upon his request*** at reasonable times complete and accurate information as to the nature and amount of the trust property, and to permit him or a person duly authorized by him to inspect the subject matter of the trust and the accounts and vouchers and other documents relating to the trust.[139]

While the foregoing provision might seem to limit the trustee's duty to provide information only when requested, the comments suggest otherwise:

> Although the terms of the trust may regulate the amount of information which the trustee must give and the frequency with which it must be given, ***the beneficiary is always entitled to such information as is reasonably necessary to enable him to enforce his rights under the trust or to prevent or redress a breach of trust.***[140]

The UTC is far more detailed in its requirements for notice. First, the trustee is generally required to keep the qualified beneficiaries reasonably informed about the administration of the trust with sufficient information for them to protect their interests, and to respond promptly to any beneficiary request for information.[141] Additionally, within 60 days after the creation of the trust or the date the trustee becomes aware that a revocable trust has become irrevocable, the trustee must provide certain information to the beneficiaries, including, if requested, a copy of the trust agreement.[142] Finally, the trustee is required to provide certain information, on an annual basis to all of the current beneficiaries and such of the other beneficiaries as request the information.[143] Any beneficiary may waive his or her right to such information, and the

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[139] RESTATEMENT (SECOND) OF TRUSTS § 173 (1992) (emphasis added). For a good discussion of this topic, *see* T.P. Gallanis, *The Trustee's Duty to Inform*, 85 N.C. L. REV. 1595 (hereinafter, "Gallanis").

[140] RESTATEMENT (SECOND) OF TRUSTS § 173, cmt. c (1992) (emphasis added).

[141] UNIF. TRUST CODE § 813(a).

[142] UNIF. TRUST CODE § 813(b).

[143] UNIF. TRUST CODE § 813(c).

notification requirements at the inception of the trust only apply to trusts created after the enactment of the uniform act.[144]

The duty to inform generally applies to ***qualified beneficiaries***, meaning those persons who are current permissible distributees of income or principal, or would be the distributees of income or principal if the interests of the current permissible distributees were to terminate.[145] Some of the duties, however, such as certain information to be provided on request, apply to beneficiaries other than qualified beneficiaries, and the UTC defines a ***beneficiary*** as being ***any*** person with a present, future, vested ***or contingent*** beneficial interest in a trust, as well as a person holding a non-fiduciary power of appointment over the trust property.[146]

In a 2002 Delaware case, *McNeil v. McNeil*,[147] a trust beneficiary successfully sued the trustees for failing to inform him that he was a permissible beneficiary of a trust, thus denying him the opportunity to request distributions from the trust. Note that *McNeil* did not involve a situation where the trust agreement mandated keeping the existence of the trust a secret.

2. The Settlor's Desire *Not* to Inform

Note that the issue under discussion is not merely withholding knowledge of the trust until a beneficiary reaches adulthood and obtains a certain level of maturity. Even the UTC contemplates that information about a trust may be withheld from a beneficiary until the beneficiary reaches age 25.[148] The concern arises where a grantor feels a need to keep even fully grown beneficiaries from having knowledge of the trust. Given the controversy surrounding the UTC's attempt to make the provision of information mandatory, and the refusal of many states to enact any version of the requirement, it would appear that, at least in some jurisdictions, it is possible to largely or entirely negate a trustee's duty to inform beneficiaries.

Settlors may have many reasons for not wanting beneficiaries to have information about a trust, particularly at a young age. One of the most prevalent concerns is that if the beneficiary is aware that the trust exists, the beneficiary may decide that there is no need to seek responsible employment for his or her support. Even worse, the beneficiary may develop a sense of "entitlement" and engage in irresponsible, or even self-destructive, behavior.

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[144] UNIF. TRUST CODE § 813(c) & (d). Georgia law imposes a requirement for notification of the existence of a trust and periodic reports. O.C.G.A. § 53-12-242 & 243. *See, also* O.C.G.A. § 53-12-261(29).

[145] UNIF. TRUST CODE § 103(13); O.C.G.A. § 53-12-2(10).

[146] UNIF. TRUST CODE § 103(3); O.C.G.A. § 53-12-2(2).

[147] *McNeil v. McNeil*, 798 A.2d 503 (Del. 2002), affirming in part and reversing in part *McNeil v. Bennett*, 792 A.2d 190 (Del. Ch. 2001).

[148] UNIF. TRUST CODE § 105(b)(8).

Another concern is that if the beneficiaries know of the trust, their friends, spouses, paramours, etc. may attempt to gain access to the funds.

3. Quiet Trusts Are NOT Advisable

The author is firmly of the opinion that keeping a trust secret from a beneficiary is seldom, if ever, the best choice, or even a reasonable option. Professional fiduciaries, and fiduciary litigators, know from experience that keeping trusts secret tends to create more problems than it solves.

It is axiomatic that in just about any relationship, whether personal or business, ***communication*** is essential and that many, if not most, problems that arise in any relationship can be traced, at least in part, to a failure to communicate. When trust beneficiaries eventually discover that information about arrangements for their benefit has been kept from them, they tend to very much resent the secrecy, and can be prone to assume that secrecy indicates untoward activity. Moreover, most disputes over trusts that result in litigation could be resolved early on if the beneficiaries are kept better informed. If a trustee is behaving badly, the beneficiary may become aware of such fact before much damage is done. If the trustee is not behaving badly, but the beneficiary disagrees with the trustee's decisions, such differences can be brought to light early on, and can be more easily resolved.

From the ***beneficiary's*** perspective, an informed beneficiary can be made aware early on if the trustee is improperly administering the trust, or if the trustee is administering the trust in a way that is unsatisfactory to the beneficiary. If such disagreements are brought to light, they can be addressed and resolved early on. If there is some deficiency in the trustee's administration, regular reporting may very well prevent, or at least minimize, the damage to the trust from the trustee's actions.

From the ***trustee's*** perspective, providing full information can help identify and address areas of disagreement before the alleged damages become significant, and if the beneficiary does not raise any complaint within the applicable statute of limitations, the trustee is protected from litigation covering decades of activity.[149] Even where a specific limitation of actions period does not apply, the equitable defense of *laches* may apply to beneficiaries who have sufficient information to protest, but sit on their rights.[150] Therefore, if the trustee is prohibited from providing information to the interested parties, the trustee may have a potentially very long liability "tail." In the *Dumont* case, discussed above, the court determined that the trust had been mismanaged for a ***30 year period***, and determined damages in

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[149] UNIF. TRUST CODE § 1005 provides a 1 year limitations period from the time that the beneficiary was provided with adequate information such that the beneficiary knew or should have known of the claim if the notice also informs the beneficiary of the limitations period for bringing the claim. O.R.S. § 130.820(2) is similar, but with additional requirements. Finally, O.C.G.A. 53-12-307 provides for a 2 year limitations period following a report, but without a requirement that the limitations period be disclosed.

[150] RESTATEMENT (SECOND) OF TRUSTS § 219 (1992).

excess of $21,000,000 based on how the trust would have grown over that period, had the alleged breach of trust not occurred. Ultimately, the surcharge was reversed on appeal based upon other considerations,[151] but there is no doubt that had there been adequate accounting and disclosure early on, the damage to the trust's value, and the damage to the trustee's reputation, could have been avoided.

As to the various reasons why grantors want trusts kept secret, knowledge of a trust's existence should not create a disincentive to the beneficiary's leading a productive life ***if*** the trust is properly structured and makes clear that the trustee's discretion should not be exercised to enable a non-productive lifestyle. If the trust is written so as to reward industrious lifestyles and to penalize "loafers,"[152] then the trustee should not be forced to support an unhealthy lifestyle and, to the contrary, the beneficiary might have more incentive to be more productive than would be the case in the absence of the trust. If the beneficiary has full information, the beneficiary will know that the trust will not be used to encourage sloth.

Concerns about creditors and greedy spouses can be effectively addressed by giving the trustee sufficient discretion to prevent unwanted access by others or, at the very least, through spendthrift provisions.

If the trustee is *not* under a duty to report to the beneficiaries, then the trustee should be under a duty to report to *someone*.[153] If the trustee is answerable to nobody, one wonders whether a trust even exists. While there is no question that the trustee may be, and typically is, relieved of the obligation of filing regular returns with a court, the courts have uniformly held that any attempt to provide that the decisions of the trustee are not subject to review by any court, even in the event of a controversy, is void as against public policy.[154] After all, a fundamental requirement for the existence of a trust is that the trustee have some ***fiduciary duty*** to the beneficiaries.[155] Some courts hold that making a trustee's decisions non-reviewable is tantamount to removing any fiduciary duties, thus effectively conferring upon the trustee an

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[151] However, this method of determining damages was found to have been improper on appeal, because the court held only that the trustee was liable for loss in value, not for failure to increase in value.

[152] The author once reviewed a trust, drafted by a prominent estate planning attorney, that included the phrase "should any of my children have the misfortune of being a drug addict . . . or a loafer, ..." Perhaps "loafer" is not a widely recognized term of art, but nobody who read the instrument suffered from any uncertainty as to its meaning.

[153] Oregon's version, O.R.S. § 130.020(3)(b) modifies the UTC provision to expressly allow required information to be provided to someone other than the beneficiary, if designated by the grantor.

[154] *McNeil*, *supra*, note 147; UNIF. TRUST CODE § 105(b)(13) ("The terms of a trust prevail over any provision of this [Code] except: . . .the power of the court to take such action and exercise such jurisdiction as may be necessary in the interests of justice."). *See also* Gallanis, *supra*, note 139 at 1623.

[155] O.C.G.A. § 53-12-20(b)(5); UNIF. TRUST CODE § 402(a)(4).

unrestricted fee simple interest in the trust property.[156] One cannot help but wonder, therefore, whether a grantor may *indirectly* eliminate court oversight by relieving the trustee of the duty to inform the beneficiaries. After all, if all of the persons with any interest in the trustee's conduct are successfully kept in the dark about that conduct, or even the very existence of the trust, then presumably no complaint will ever be brought before any court, which is not very different than eliminating a court's power of oversight.

In the case of a ***revocable trust***, see the discussion below regarding whether the trustee's duty to inform and report applies to remainder beneficiaries of a revocable trust while the grantor still holds the power of revocation.

G. Negating the Duty to Diversify

Trust grantors often feel that their beneficiaries will be better off if the trust retains a concentration in a particular security, typically the stock that made the grantor wealthy in the first place (*Dumont*), or some other undiversified asset, such as real estate or a closely held business. While modern portfolio theory would indicate that such a belief, much less a mandate, is ill-advised, many grantors have remarkably strong opinions to the contrary.

It may not be sufficient to provide general waivers of the Prudent Investor Rule, the duty of diversification, and whatnot, since there is a growing trend toward holding that such duties can only be waived with regard to specific circumstances. Such a position is not wholly unreasonable, since grantors wishing to avoid diversification are generally not opposed to the idea in general, but believe that a particular investment will be superior overall to a diversified portfolio. As shown in *Dumont*, even an express direction with regard to a named security may not be enforceable in some jurisdictions where such a mandate is not in the best interests of the beneficiary.

Accordingly, where a grantor wishes for a trustee to substantially depart from what is considered to be normal practice, such as diversification of investment, consideration should be given to a state such as Delaware, with a stated public policy of enforcing the wishes of the grantor, above all else. That having been said, the following is an example of a provision permitting retention of a stock concentration, with specificity.

Sample Provision:

Retention of Undiversified Portfolio

The trustee is authorized to receive and retain, without regard for diversification or prudence, all assets it receives upon the funding of this trust. Specifically, the trustee is authorized to retain indefinitely all shares of

[156] *McNeil, supra*, note 147. *See also* George T. Bogert, *The Law of Trusts and Trustees* § 181 (Rev. 2d ed. 1979).

_______________, even though such a concentration is generally considered inappropriate for trusts. The grantor realizes that there are specific reasons for engaging in certain estate planning techniques, with particular assets, and that the retention of such assets by the trustee, and other facts and circumstances, may conflict with a fiduciary's reasonable business judgment, but may, nonetheless, further the purposes of the trust and the grantor's intent. This trust's purpose represents the grantor's intent to plan his estate with shares of _______________, and not necessarily to provide beneficiaries with a diversified portfolio. The grantor hereby waives the prudent investor rule, the trustee's standard of care and performance, a fiduciary's reasonable business judgment, and the trustee's duty to diversify, including but not necessarily limited to sections ___________ and __________ of the ___________ Statutes. The trustee shall be held harmless from all liability for holding and retaining shares of name of security.

1. Investment Direction Adviser and "Directed" Trusts

An alternative to "hardwiring" investment requirements into a trust instrument is to provide for an investment *direction adviser* with the authority to direct the trustee as to all or certain trust investments, *combined with* provisions making clear that the trustee bears no responsibility for losses resulting from following the adviser's instructions.[157] This may be particularly useful where there is a desire for a corporate or independent trustee, but there is also a desire that the trust to be able to invest outside traditional "prudent investor" guidelines without having to obtain an investment committee's approval for each such investment. This is also a useful provision where there is a desire to maintain a concentration in a single stock, or a closely held business. The laws of some states expressly recognize the trustee's right to follow the instructions of such an adviser without fear of liability:

a. Uniform Trust Code

The UTC provides that a trustee shall follow the instructions of a direction advisor, if so required under the terms of the trust instrument. However, this provision also goes on to provide an exception where the instruction is "manifestly contrary to the terms of the trust" or the trustee knows that following the direction would constitute a "serious breach of a fiduciary duty."[158] Certainly, such a provision could open the door to a claim that if the direction advisor's instruction was sufficiently outside the

[157] RESTATEMENT (SECOND) OF TRUSTS § 185 (1992).

[158] UNIF. TRUST CODE § 808(b).

realm of "prudent" investing, then following the direction could result in a breach of trust.

b. Delaware

Delaware law has one of the more explicit statutes stating that where a trust requires a trustee to take direction on investment, distribution or other matters from a third party *adviser*, a trustee has no liability for negative consequences flowing from following such direction, and is exculpated from all but "wilful misconduct." Thus, to impose liability on a trustee, the beneficiary must meet a standard even greater than "gross negligence."[159]

H. Recommendations

The estate planning attorney, when presented with a client who wants to include deviant provisions in a trust, should consult with the client in an effort to make sure the client understands the inherent risks in trying to dictate future investment policy. At the very least, by delving into the issue, perhaps the attorney can get a handle on what the client is really trying to accomplish and can include in the trust document better guidance for the trustee.

One of the issues that engendered much argument in the *Dumont* cases was the intent of the testator. The trustee argued that the intent was to maintain the Kodak stock. The beneficiaries and the court argued that the intent was to benefit the beneficiaries, and that the stock should have been sold as soon as retention of the stock became inconsistent with that intent. Therefore, the drafter should be very clear as to the grantor's intent, which may include the following:

- Specific identification of the investment to be retained, without reliance upon general trustee investment powers;
- Specific acknowledgement that retention of the investment or the concentration is contrary to normal prudent investment practices and may increase the risk of loss to the trust;
- Specific expression of the grantor's intention that the investment be retained, notwithstanding the increased risk;
- Specific exculpation of the trustee for following the grantor's wishes, absent intentional misconduct and, preferably, specific authority for the trustee to sell the investment if it determines to do so, without incurring liability to the beneficiaries; and
- Specific guidelines regarding the circumstances under which the trustee may sell the investment.

Hopefully, this process will cause the grantor to conclude that mandating a retention is not such a good idea or, at the very least, that the trustee should be

[159] 12. DEL. C. § 3313(a). This provision is also read in light of 12. DEL. C. § 3303(a), which provides that the terms of the trust may vary the default rules of law, and that the public policy of the state of Delaware is that the grantor's desires are to be followed.

empowered to sell the investment without incurring liability. In any event, careful drafting can avoid endless squabbles over the grantor's true intent.

Finally, deviant trust provisions are a good example of where virtual representation provisions can be most useful. If a trustee requires additional comfort that following the peculiar dictates of a trust will not result in liability, the trustee can seek the consent of all of the interested beneficiaries, which may not be difficult to obtain where there is virtual representation.

XI. Revocable Trusts – Special Considerations

A. Power to Revoke by Attorney-In-Fact or Guardian

The UTC provides that a grantor's power to amend or revoke may be exercised by an agent or attorney-in-fact under a power of attorney *only* if expressly authorized in the trust or the power of attorney.[160]

The UTC provides that a conservator or, if no conservator, a guardian, can exercise powers of amendment or revocation only with court approval.[161]

Consideration should be given to expressly providing in the trust that the power to amend and revoke is personal to the grantor and may *not* be exercised by any agent, attorney-in-fact, conservator or guardian. After all, the power to amend is tantamount to the power to change a will, and most people do not wish for anyone else to have the power to change a will. Moreover, any general power of attorney should likewise expressly state that that the agent may not exercise any such power.

B. Revocation by Inconsistent Will Provision

The UTC provides that a grantor may amend or revoke a trust by "executing a later will or codicil that expressly refers to the trust ***or specifically devises property that would otherwise have passed according to the terms of the trust***."[162] Accordingly, even if the grantor has titled property in the name of the trust, so that it should avoid the probate process, a later will specifically devising the property would constitute an amendment to the revocable trust.

As a general rule, a client's disposition of property at death should be governed by a will or a revocable trust, but not both. If there is a revocable trust, then the will should be limited in scope to pouring-over all probate property to the revocable trust, and handling other matters that can only be accomplished by

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[160] UNIF. TRUST CODE § 602(e).

[161] UNIF. TRUST CODE § 602(f).

[162] UNIF. TRUST CODE § 602(c)(A). O.R.S. § 130.505(6) expressly provides that a trust may not be revoked by an inconsistent will provision. Virginia neither included the UTC provision, nor did is expressly negate the provision, but presumably, the failure to include the provision means that an inconsistent will provision may not amend or revoke a trust by mere implication.

will.[163] Otherwise, there is a risk of inconsistent dispositions and inconsistent provisions regarding such matters as which fiduciaries hold certain powers, such as making tax elections.

Consider including a provision in the trust specifically negating this possibility by stating that the trust may only be amended or revoked expressly, not impliedly.

C. Effect of Divorce

Typically, most state probate codes provide that the testator's divorce either revokes a will or causes the ex-spouse to be treated as having predeceased the testator for all purposes of the will. The UTC, however, has no corresponding provision with respect to revocable trusts, so under that act, a grantor's divorce may not nullify provisions for a spouse by operation of law.[164]

Accordingly, it would be advisable for a revocable trust to specifically provide that in the event of divorce, all provisions for a spouse are revoked and the spouse is otherwise to be treated as having predeceased the grantor.

Sample Provision:

Effect of Separation, Divorce or Annulment

From and after the filing of an action for divorce by the grantor or the grantor's spouse or the annulment of the grantor's marriage, the grantor's spouse shall thereafter be treated as if the spouse had predeceased the grantor and any trust created hereunder shall thereafter be interpreted and administered as if the grantor's spouse had divorced the grantor. By way of example, and not by way of limitation, from and after the time of any such event, no distributions shall be made to or for the benefit of the grantor's spouse, no power of appointment shall be exercisable by the spouse, and the spouse shall be ineligible to serve in any fiduciary or other capacity with respect to the trust.

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[163] For example, many powers of appointment are, by their terms, exercisable only by will. Moreover, many state laws permit a parent to name a guardian for a minor child only in a will.

[164] Note that the Uniform Probate Code, where enacted, may address this issue with respect to trusts, whether testamentary or inter-vivos. Some UTC jurisdictions have addressed this issue, however. For example, O.R.S. § 130.535, in Oregon's version of the UTC, *does* include a specific provision that divorce revokes all provisions in favor of the spouse and otherwise treats the spouse as having predeceased. Nevertheless, if an Oregon resident relies upon this provision and then moves his or her residence to another state, the statutory provision would likely no longer apply.

D. Mandatory Income Distributions to Settlor

Most revocable trusts include a provision that during the grantor's lifetime, all income is to be distributed to the grantor. Such a provision bears reconsideration. After all, if the goal is for property to avoid probate, then why mandate that the income be distributed out of the trust? Instead, consider simply providing that the trustee will distribute income and principal in such amounts as the grantor directs.

E. Duties to Beneficiaries other than Settlor

The UTC provides that while a trust is revocable and the grantor has capacity, all rights of beneficiaries are subject to the control of, and all duties of the trustee are owed exclusively to, the grantor.[165] Moreover, while the trust is revocable, the trustee may follow a direction of the grantor that is contrary to the terms of the trust.[166]

These provisions are important because in their absence, the trustee may owe duties to other beneficiaries. In *J.P. Morgan Chase Bank, N.A. v. Longmeyer*,[167] the Kentucky Supreme Court held that the (third party) trustee of a revocable trust *did* owe a duty to inform the remainder beneficiaries when the grantor revoked the trust, thus eliminating the remaindermen's interests.[168] The Kentucky legislature acted swiftly to legislatively overrule this outcome by changing the statute to specify that no such duty existed in the case of a revocable trust.[169]

It should be noted, however, that even where it is clear that a trustee owes duties only to the grantor during the grantor's lifetime, the future beneficiaries may have standing, after the grantor's death, to sue the trustee for the trustee's breach of a duty to the grantor during the grantor's lifetime, especially if the beneficiaries can demonstrate that the breach of trust diminished their interest in the property.[170] In *Estate of Giraldin*, the California Supreme Court, reversing the

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[165] UNIF. TRUST CODE § 808(a). *See also* Ronald M. Volkmer, *Duty Owed by Trustee of Revocable Trust*, EST. PLAN., Feb. 2012, which discusses two cases, one from a UTC jurisdiction and another from California, holding that while the grantor of a revocable trust is living and has the power to revoke, the trustee owes no duties to any other beneficiary, so such persons have no standing to sue, even after the death of the grantor, for any alleged breach of duty prior to the grantor's death.

[166] UNIF. TRUST CODE § 603(a).

[167] *J.P. Morgan Chase Bank, N.A. v. Longmeyer*, 275 S.W.3d 697 (Kentucky 2009).

[168] In *Longmeyer*, the corporate trustee actually did notify the remainder beneficiaries of the revocation of the trust, because the trustee suspected that the revocation of the trust was the result of undue influence. The beneficiaries of the replacement trust sued the trustee for breach of its duty of confidentiality in making the disclosure, and the trustee defended itself by asserting its duty to inform and report. While the facts indicate that the exoneration of the trustee was probably the just result, the court should have been able to find that the trustee acted properly without declaring a general duty of all trustees of revocable trusts to provide information to remainder beneficiaries.

[169] O.R.S. 130.510(1) includes the usual UTC language about owing duties solely to the grantor, and goes further to expressly state that the beneficiaries other than the grantor are entitled to no reports or notices during such period.

[170] *See* Ronald R. Volkmer, *Beneficiaries of Revocable Trust and Standing to Sue*, EST. PLAN., Apr. 2012.

Court of Appeal, held that contingent beneficiaries had standing to sue a third party trustee of a revocable trust for a breach of trust committed against the grantor during the grantor's lifetime.[171] The court acknowledged there would be no breach of duty for any action of the trustee that was directed by the grantor, but that any trustee action that was *not* authorized by the grantor could form the basis for a breach of trust that could be enforced by the remainder beneficiaries. In that case, the trust agreement specified that the trustee take action *at the written direction of the grantor*, and the trustee could produce no such written direction with respect to certain actions that were alleged to constitute breaches of trust.

Accordingly, it is advisable to expressly state in a revocable trust that while the grantor is living and competent, the trustee owes no duties to anyone other than the grantor, but it is equally advisable for any trustee of a revocable trust who is not the grantor of the trust to carefully document all instructions from the grantor.

Sample Provision:

Trustee Duties Exclusive to Grantor during Lifetime

During the grantor's lifetime, any distribution of trust income or principal made by the trustee, or any other action taken by the trustee at the direction or consent of the grantor, shall be considered proper and authorized by this instrument, notwithstanding any provision of this instrument or rule of law to the contrary. During the grantor's lifetime, the grantor shall represent the interests of all beneficiaries of the trust, whether present or future, contingent or vested, irrespective of any conflict of interest between the grantor and the person so represented, and any actions by grantor shall be binding on all such beneficiaries, and the Trustee shall owe no duties whatsoever to any beneficiary other than the grantor.

XII. *Crummey* Withdrawal Powers – Miscellaneous Thoughts

Crummey withdrawal powers, designed to qualify gifts in trust for the gift tax annual exclusion under I.R.C. § 2503(b), have been around for quite some time.[172] They have been around for so long, in fact, that practitioners sometimes take them for

[171] See *In Re Estate of Giraldin*, 55 Cal. 4th 1058, 2012 Cal. Lexis 11381 (2012), *reversing In Re Estate of Giraldin*, 199 Cal. App. 4th 577, 131 Cal. Rptr.3d 799 (2011). The lower court decision, now reversed, was discussed in Volkmer, *supra*, note 170.

[172] *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), held that where a gift to a trust is subject to a beneficiary's immediate and unrestricted right to withdraw the gift from the trust, the gift is of a present interest that qualifies for the gift tax annual exclusion under I.R.C. § 2503(b), even if the withdrawal right lapses, to the extent not exercised, thereafter.

granted, and don't carefully review their provisions in light of current law. The author has therefore encountered many situations where withdrawal provisions have, for a variety of reasons, been less than optimal. Additionally, the validity of *Crummey* provisions continues to arise, thus indicating that it has not dropped off the radar screen of the IRS.

Turner v. Commissioner

In *Turner v. Commissioner*,[173] the taxpayer established an irrevocable life insurance trust, then proceeded for several years to pay the insurance premiums directly to the insurance company from a checking account held jointly with his wife. The trust agreement expressly provided that beneficiaries had withdrawal rights over both direct ***and indirect*** gifts to the trust, that the withdrawal rights could be satisfied by the trustee by distributing cash or other property, and that the trustee had the power to borrow against policy cash values, and provided that the withdrawal rights would lapse, to the extent not exercised 30 days after the date ***of the gift***. The case does not state whether the trust expressly required that the beneficiaries be notified of the gifts, but the facts, as recited by the court, were that the beneficiaries were not, in fact, notified of any of the premium payments or of their withdrawal rights.

The IRS argued that the premium payments did not qualify for the annual exclusion because (a) the payments never came into the hands of the trustee and (b) the beneficiaries were not notified of the gifts or their withdrawal rights, and therefore the withdrawal right was illusory because the beneficiaries had no meaningful opportunity to withdraw the funds.

The court, citing to both *Crummey* and *Cristofani*,[174] held against the IRS, ruling that the only relevant inquiry is whether the beneficiaries had the legally enforceable right, ***not*** whether the beneficiaries were aware of the right or were otherwise likely to exercise that right. The court pointed out that the beneficiaries in *Crummey* had no notice of the withdrawal rights, but the Ninth Circuit still held that the gifts qualified for the annual exclusion. The court also seemed wholly unconcerned that the trustee never came into actual possession of the premium payments, especially since the trust agreement expressly provided that withdrawal rights could be satisfied out of any property and that the trustee could borrow, if necessary.

Turner is noteworthy for demonstrating the IRS's willingness to challenge the efficacy of *Crummey* provisions, more than 40 years after the case was decided.

It is somewhat ominous to consider how many tens of thousands, or more, insurance trusts are in existence today where the insured routinely pays premiums directly, rather than following the recommended procedure of making a cash gift to the trustee, which the trustee then uses to pay the premium, preferably after the withdrawal rights period has expired. There is no way to know whether the IRS intends to continue to assert this position, but the Tax Court did not treat the question

[173] *Turner v. Commissioner*, T.C. Memo 2011-209 (2011).

[174] *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 78 (1991).

as being the least bit novel or requiring any analysis beyond the application of long standing case law favoring the taxpayer.

The argument about not giving notice to the beneficiaries is consistent with anecdotal evidence on listservs and at continuing legal education presentations that the IRS has, at least in some cases, asked taxpayers to provide evidence that beneficiaries holding withdrawal powers have been notified of those powers. Again, imagine how many trusts are in existence today where, irrespective of whether notice was actually given, there is no documentary evidence of notice. Again, the tax court cited back to the original *Crummey* case in holding that as long as a withdrawal right existed, it matters not that the beneficiary received no notice.

While the court's holding in *Turner* will no doubt be welcome news to every grantor or trustee who has an imperfectly administered *Crummey* trust, the best practice is still for the insured to make gifts to the trust and let the trustee pay the premiums and for the beneficiaries to be notified of withdrawal rights, because there is no way to tell if the IRS will continue to press this issue. Moreover, *Turner* indicates the importance of drafting *Crummey* provisions to expressly state that:

- The withdrawal right applies to *all* gifts, both direct and indirect;
- The withdrawal right runs from the date of the gift, irrespective of whether notice is given; and
- The trustee may satisfy the withdrawal right out of any property of the trust.

Following the discussion below of individual issues is a sample withdrawal rights provision that incorporates the author's suggestions.

A. Expressly State That Withdrawal Right Applies to *Indirect* Gifts

In *Turner*, the IRS asserted that a direct payment of an insurance premium did not qualify for the annual exclusion because no property ever came into the hands of the trustee. The tax court cited specifically to language in the trust stating that the withdrawal right applied to both direct *and indirect* gifts, and the IRS had already acknowledged that the payment of the premium was an indirect gift to the trust.

The court did not say whether it would have ruled differently had the reference to indirect gifts not been included in the trust. However, the court did say that gifts which are taxable include indirect gifts, so if the withdrawal right applied to "gifts," without specifying indirect gifts, the court might have still ruled in favor of the taxpayer. Anyway, the best drafting practice is clearly to expressly include both direct and indirect gifts.

B. Make Sure Withdrawal Right Exists From Time of Gift, Not Time of Notice

It is important to make clear that the withdrawal right arises at the instant of the gift, irrespective of when, if ever, the beneficiary is notified of the gift. Many withdrawal provisions provide that the withdrawal right will lapse a certain number of days following *notice* of the gift, but there should be no question that the withdrawal right is not contingent upon the giving of notice.

Turner held that the gifts to the trust qualified for the annual exclusion because the withdrawal right existed, even though the beneficiary was not aware of the gift or the right. However, if the trust had been written such that the withdrawal right arose only after notice was given, the outcome could well have been different.

See also the discussion below advising against making withdrawal rights contingent upon the donor electing to split gifts with a spouse.

C. Limit Withdrawal Right to Taxable Gifts, Rather Than All Additions

Some withdrawal powers are worded so as to apply to "any addition" to the trust, without limiting the application of the powers to transfers that, but for the qualification for the annual exclusion, would be taxable gifts by the donor. Consequently, a literal reading of such provisions would mean that the beneficiaries have withdrawal rights over amounts passing to the trust as pour-over bequests from an estate, or the distribution of a remainder interest in a successful GRAT. Accordingly, the application of withdrawal powers should be limited to those additions to the trust that need to qualify for the annual exclusion to avoid being treated as a taxable gift.

D. Limit Withdrawal Right by Statute Reference, Not by Amount

It is certainly prudent to limit withdrawal rights to the maximum available annual exclusion, *but* that limit should be expressed as the maximum amount set forth in the statute, rather than a specific dollar amount.

From 1982 to 1998, the amount of the annual exclusion was fixed at $10,000 per donee, per year. Consequently, many trust withdrawal powers from that era limit the withdrawal right to a maximum of $10,000 per beneficiary. Since 1997, however, the exclusion has been indexed for inflation such that as of January 1, 2017, the annual exclusion is $14,000 per year, rather than $10,000, and will continue to increase in the future.[175] Arguably, therefore, in those trusts that limit the withdrawal right to $10,000, a donor may not be able to make an annual exclusion qualified gift up to the available annual exclusion.[176] For that reason, the better practice is to limit the withdrawal right by reference to the statute itself, rather than the amount stated in the statute, so that the limit applicable to the trust will automatically adjust with changes in the statute.

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[175] Under the Taxpayer Protection Act of 1997, P.L. 105-34 (1997), the $10,000 annual exclusion is indexed for inflation in $1,000 increments.

[176] *Helpful hint:* When faced with a trust that limits withdrawal rights to $10,000, all may not necessarily be lost. Remember that the purpose for the withdrawal provision is to provide the beneficiary with a "present" interest. Therefore, perhaps the donor of the gift to the trust could make the gift expressly subject to a beneficiary's right to withdraw up to the full amount of the annual exclusion, even if that is more than the amount specified in the trust. Even if the trust does not expressly permit a donor to vary the terms of withdrawal rights, is there any reason why a donor cannot subject any gift to special conditions of his or her choosing? If the gift is expressly subject to the withdrawal right imposed by the donor, rather than the trust instrument, does that make the beneficiary's ability to reduce the gift to a possessory interest any less of a present interest? No guaranties, but food for thought.

E. Do Not Make Amount Contingent on Gift-Splitting Election

Many withdrawal provisions anticipate that the donor of a gift to the trust will be married and will elect to split gifts with the donor's spouse under I.R.C. § 2513, so the amount subject to a beneficiary's withdrawal right will potentially be twice the annual exclusion amount, if the donor is married at the time the gift is made. The author occasionally encounters withdrawal provisions that provide that the maximum amount subject to the power increases to twice the annual exclusion *only* if the donor and the donor's spouse elect to split gifts for that year. Presumably, the condition is intended to prevent an overly large withdrawal right should the donor and the donor's spouse *not* elect to split gifts for the year. The problem, however, is that imposing such a condition *disqualifies* the portion of the gift in excess of a single annual exclusion, because the withdrawal right is conditioned upon an election that will not be made until the filing of gift tax returns during the calendar year following the calendar year in which the gift is made, thus preventing the beneficiary from having the *present* interest necessary to qualify for the exclusion.[177]

Moreover, if the beneficiary's potential access to the funds is contingent upon a tax election that is necessarily within the control of the donor, then the donor arguably has retained a power "to designate the persons who shall possess or enjoy the property" under I.R.C. § 2036(a)(2), because the donor retains the ability to determine whether the beneficiary will gain access to the funds after the property becomes property of the trust by retaining the power to elect gift splitting (or not). Even more troublesome is that if the donor retains a § 2036 power over trust property, the property could be included in the donor's estate under § 2035 if the donor dies during the three year period of time following the release or lapse of that power.

From a practical standpoint, a well advised married donor will rarely give more than the amount of a single annual exclusion unless he or she intends to split gifts, in which case the amount of the withdrawal right is limited by the amount of the transfer, rather than the amount of the exclusion. Moreover, the trust can permit the donor to vary the terms of the withdrawal rights as to any specific gift, as discussed below.

F. Consider Prior Annual Exclusion Gifts, But Protect the Trustee

Withdrawal provisions frequently provide that the amount subject to the withdrawal power is the lesser of the amount of the gift or the amount of the annual exclusion as set forth in the code, but *without* any express adjustment to

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[177] *See* P.L.R. 8022048 (Mar. 4, 1980), which held that where the right to withdraw twice the amount of the annual exclusion was contingent upon a gift splitting election, only one-half of the gift would qualify for the exclusion, because the beneficiary's right to withdraw the other half was subject to a condition subsequent. *See also* P.L.R. 9030005 (Apr. 19, 1990), which includes the following statement: "When the delivery of property to a trust is accompanied by limitations upon the donee's present enjoyment of the property in the form of conditions, contingencies, or the will of another, either under the terms of the trust or other circumstances, the interest is a future interest even if the enjoyment is deferred only for a short time. The question is not when title vests, but when enjoyment begins."

account for annual exclusion gifts the donor may have already given to one or more beneficiaries during the same calendar year. If a reference to the amount of the annual exclusion under § 2503(b) is worded so as to make clear that it is referring to the amount of annual exclusion *available to that donor at the time of the gift*, then the power may automatically take prior gifts into consideration. On the other hand, if the provision simply states that the amount that may be withdrawn is the amount set forth in § 2503(b) (without particular reference to the donor) the provision could be construed as a right to withdraw the full $14,000, even if that is more than the annual exclusion available to that donor with respect to that beneficiary.

Of course, if a donor has a power to vary withdrawal rights, that power can be exercised to account for earlier gifts, but it may be helpful for the trust to include an "automatic" adjustment provision that lowers the maximum withdrawal right by the amount of any prior annual exclusion gifts.

Please note, however, that adjusting the amount of a withdrawal power based upon other gifts by the donor may place a trustee in the difficult position of not knowing for sure whether the entire amount of the gift is subject to the withdrawal power, or only a part of the gift. Such information is crucial, where the trustee is charged with notifying the beneficiaries of the gift and the withdrawal right. Therefore, the document should specify that the trustee may assume that there have not been any such prior gifts, unless the trustee is notified to the contrary by the donor.

G. Specify That Any Property Satisfies Right, Not Just the Gift

The Tax Court in *Turner* specifically noted that the trust agreement in that case permitted the trustee to satisfy any beneficiary withdrawal demand with cash or any other property of the trust, including the power to borrow against cash values to obtain cash for the distribution. This could be important, given the IRS argument that the withdrawal right was illusory, in part because the trustee never took custody of the gift property, because the trustee clearly could satisfy the withdrawal right out of other property without ever having taken custody of the gift.

H. Limit Lapse of Withdrawal Right by Statute Reference, Not by Amount

Most withdrawal rights lapse, to the extent not exercised by the beneficiaries within a limited period of time, but the lapse of a withdrawal right is treated as a release (by the beneficiary) of a general power of appointment under I.R.C. § 2514(e), to the extent that the amount subject to the lapsed withdrawal power exceeds the greater of $5,000 or 5 percent of the property out of which the withdrawal right could have been exercised. Therefore, trusts often provide that a withdrawal right will *not* lapse, to the extent that the amount subject to the right exceeds the foregoing limit, and that the beneficiary's withdrawal right will continue until such future time as a lapse does not result in a release under I.R.C. § 2514(e). Alternatively, many trusts limit the withdrawal right to the lower of the annual exclusion or the I.R.C. § 2514(e) amount from the outset, so that there will never be withdrawal rights that "hang" into the future.

As is the case with the limit on the annual exclusion, the I.R.C. § 2514(e) limit is frequently expressed either by reference to the statute or by actually limiting the lapse to the greater of $5,000 or 5 percent. Unlike the annual exclusion, the I.R.C. § 2514(e) amount has *not* been indexed for inflation, nor are there any pending proposals to do so. Nevertheless, it is always possible that I.R.C. § 2514(e) could be amended in the future, in which case it would likely be preferable for withdrawal right lapses to be limited by the amount set forth in the statute, rather than by the specific dollar amount.

I. Take Prior Lapses into Consideration, But Protect the Trustee

The IRS has taken the position that the I.R.C. § 2514(e) limitation is a *single* limitation that applies to the *aggregate* amount of *all* withdrawal rights of a single beneficiary with respect to all trusts for the benefit of that beneficiary in a single year. Thus, the IRS position is that where a single individual holds withdrawal powers over multiple trusts in a single year, the limit on the amount of the withdrawal power that may lapse without such lapse being treated as a release of a general power of appointment is *not* $5,000 *per trust*, but $5,000 *in the aggregate*, at least with respect to trusts where $5,000 is greater than 5 percent of the trust assets.[178] Therefore, it may be prudent to word the lapse provision in such a way that takes into consideration other withdrawal right lapses during the same year.

Please note, however, that such a provision should direct the trustee to presume that there have been no such other lapses, unless the trustee is informed otherwise at the time of the gift.

J. Consider Giving Donor Power to Vary Withdrawal Right

It may prove beneficial to give any donor the power, exercisable at or before (but never after) the time of the transfer, to expand or contract withdrawal rights of any or all beneficiaries so that the donor can deal with changing circumstances.[179] Examples of circumstances where a power to change withdrawal rights would include the following:

- A concern that a beneficiary will exercise a withdrawal right;
- A concern that a judgment creditor of a beneficiary will attempt to attach the property subject to the withdrawal right, if local law provides that a creditor may seize property subject to a beneficiary's general power of appointment; and

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178 In Rev. Rul. 85-88, 1985-2 C.B. 201 (July 1985), the IRS held that a trust beneficiary was entitled to only one $5000/5% lapse exception per year for a single trust, irrespective of the number of separate gifts during a single year, and only one lapse exception per year for gifts to multiple separate trusts, where all of the trusts were settled by the same grantor. This ruling, and others, however, indicate that powers over separate trusts created by different grantors may be aggregated as well, although the IRS has never actually taken that position in a published ruling. *See* Georgiana J. Slade, TAX MGMT. PORTFOLIO 807-1ST, PERSONAL LIFE INSURANCE TRUSTS (BNA), at Section II.B.2.(3)(f).

179 Sebastian V. Grassi, Jr., *Key Issues to Consider When Drafting Life Insurance Trusts*, EST. PLAN., Aug. 2004, at 390.

- The donor has already made annual exclusion gifts to one or more beneficiaries, thus reducing, or entirely eliminating, the available annual exclusion to such beneficiaries. If the amount of the gift to the trust is less than the total available annual exclusion, the donor may wish to reduce the withdrawal right of the beneficiary who received other gifts, and expand another beneficiary's withdrawal rights, so that the entire gift still qualifies for the annual exclusion, even though one beneficiary's annual exclusion is no longer entirely available.

Some practitioners are not comfortable giving the grantor or other donor any power to change withdrawal rights, out of a concern that such a power could be construed as a retained "right … to designate the persons who shall possess or enjoy the property" under I.R.C. § 2036(a)(2) and/or as a retained power to "alter, amend, revoke, or terminate" under I.R.C. § 2038(a)(1). However, as long as the donor's power is limited to changing the beneficiary withdrawal rights over property *before* the property is transferred to the trust, and the donor retains no powers to alter withdrawal rights *after* the transfer, neither 2036 nor 2038 should be implicated.[180] That having been said, the author has been unable to find any binding authority that directly addresses this issue.

Sample Provision:

Withdrawal Rights Provision

After each direct or indirect[181] transfer to this trust which is treated as a gift under the federal gift tax law,[182] each beneficiary who is a current permissible distributee of income or principal from this trust shall have the absolute right and power to withdraw from this trust an

180 Grassi, *supra*, note 179. Footnote 14 of the article cites to four private letter rulings that are not precisely on point (and, of course, may not be cited as binding authority), but support the notion that the power to vary withdrawal rights as to future gifts should not be cause for concern. In all of the rulings, the donor retained the power to eliminate the withdrawal rights of some or all of the trust beneficiaries, as long as the power was exercised in advance of a gift. In P.L.R. 8003033 (Oct. 23, 1979) and P.L.R. 8103074 (Oct. 23, 1980), the IRS ruled that gifts to the trust would be complete under I.R.C. § 2511 and Treas. Reg. § 25.2511-2(b) because the donor so parted with dominion and control as to leave him no power to change its disposition. In P.L.R. 8901004 (Sep. 16, 1988), the IRS ruled that the power to eliminate withdrawal rights was not a retained power to affect beneficial enjoyment under I.R.C. § 674(a), because the power was only exercisable before the contribution of the property to the trust and once the property became property of the trust, the donor no longer retained any control. Finally, in P.L.R. 9030005 (Apr. 19, 1990), the IRS discussed possible grounds for estate inclusion, including I.R.C. §§ 2036 and 2038, and concluded that the property would not be included in the grantor's gross estate, except in a certain circumstance not relevant to this discussion.

181 Note that the withdrawal right expressly applies to both direct and *indirect* transfers.

182 Note that the withdrawal right is limited to taxable gift transfers, and therefore does not apply to other additions to the trust, such as a bequest under a will, that would not be considered a gift and therefore would not need to qualify for the annual exclusion.

amount equal to[183] the lesser of: (i) the maximum amount that can qualify for the gift tax "annual exclusion" as set forth in Internal Revenue Code Section 2503(b) (currently $14,000, or $28,000 if the donor is married and his or her spouse is then living), considering any prior annual exclusion gifts by the donor to such beneficiary during the same calendar year, or (ii) the amount of such transfer, divided by the number of beneficiaries holding such withdrawal rights, provided, however, that for purposes of this provision, the trustee shall presume that there have been no prior annual exclusion gifts by the donor to the beneficiary, unless the donor provides written notice to the contrary at the time of the transfer to this trust.

Whenever any transfer is made that gives rise to a withdrawal right under this item, the trustee shall give immediate notice of such transfer to each person who has a withdrawal right or, if any such person is under a legal disability, to his or her legal guardian or, in the case of any such person for whom no legal guardian has been appointed, to a parent of such person other than the donor. If any person who has a withdrawal right under this item, or has the power to exercise a withdrawal right on behalf of a beneficiary under this item, is then acting as trustee of this trust, he or she shall be deemed automatically to have received the notice required to be given by the trustee under this item.

Any person may exercise his or her withdrawal right granted hereunder by delivering a written instrument to the trustee at any time on or before the earlier of the thirtieth (30th) day after notice of the transfer to the trust that gives rise to the withdrawal right as provided hereinabove.[184] If any such person is under legal

[183] Note that what the beneficiary has a right to withdraw is an *amount equal to* a portion of the transfer, and is not limited to a right to withdraw a portion of the actual transfer. If the withdrawal right is limited to the actual subject of the gift, it cannot be satisfied out of other assets and if the gift is not made directly to the trustee, it might not be subject to an exercisable withdrawal right.

[184] Note that this provision causes the right to lapse after "notice" rather than after the *receipt* of notice. Proving the giving of notice is easier to prove (assuming such proof is necessary) than proving actual receipt of notice. Note that this provision provides for lapse only after giving notice, which is not technically necessary under the *Turner* decision. If no actual notice is given, then the withdrawal right would presumably continue indefinitely until notice is given. If ensuring a rapid lapse of the withdrawal right is considered more important that hedging against a possible future IRS victory on the issue of

disability, such written instrument may be executed by his or her legal guardian or, in the case of any such person for whom no legal guardian has been appointed, by a parent of such person acting solely on such person's behalf.

Upon timely receipt of a written instrument of withdrawal, the trustee shall forthwith distribute out of the trust the amount necessary to satisfy the withdrawal right, and for this purpose the trustee shall, notwithstanding any other provision of this agreement, retain in the trust sufficient transferable assets to satisfy any outstanding and exercisable withdrawal rights. The trustee, in satisfying any withdrawal right, may distribute cash or other property of the trust, including a share of the interest of the trust in any insurance policy, and the trustee may borrow against the cash value of any policy to obtain cash for such distribution.

To the extent that a withdrawal right has not been exercised by a timely delivery of a written instrument to the trustee as specified above, such withdrawal right shall lapse and the beneficiaries shall forever cease to have any further withdrawal right with respect to the transfer to the trust which gave rise to the withdrawal right, except to the extent that the amount subject to such lapse exceeds the amount as to which a withdrawal right may lapse without the lapse constituting a release of a general power of appointment under Code Section 2514(e) (currently the greater of $5,000 or 5 percent of the assets out of which the withdrawal right could have been satisfied). Any portion of the withdrawal right that does not lapse as provided in the foregoing sentence shall continue in existence, and shall lapse at such future date to the extent that such lapse shall not constitute a release of a general power of appointment under Code Section 2514, after giving due consideration to any prior lapse during the same calendar year of any withdrawal right held by such beneficiary over property in this or any other trust. It is the grantor's express intent that after such initial thirty (30) day period, all unexercised withdrawal rights lapse as soon as possible

whether notice is necessary to qualify a withdrawal right for the annual exclusion, consider making the lapse date be based upon the date of the gift, rather than the date of notice.

without causing any holder of such lapsed right to have made a taxable gift as a result of the release of a general power of appointment, and this Item shall be so construed. For purposes of this provision, the trustee shall presume that there have been no such prior lapses with respect to gifts to any other trust unless the donor provides written notice of such lapses to the trustee at the time of such gift.

Notwithstanding the foregoing provisions of this item, the donor shall have the right, by a written instrument filed with the trustee at the time of the transfer, (i) to exclude any individual who would otherwise have a power of withdrawal from exercising the power over such transfer, (ii) to increase or decrease the amount subject to such power of withdrawal over such transfer, or (iii) to change the period during which any power of withdrawal may be exercised with respect to such transfer.

XIII. Grantor Retained Annuity Trusts – Miscellaneous Thoughts

A. Grantor Trust Provisions Continue After Final Annuity

If a GRAT is funded with low basis stock and is successful, meaning that there is a substantial residue for the remainder beneficiaries, an "in-kind" distribution to the remainder beneficiaries will result in the beneficiaries holding a low basis asset as well. By contrast, if the low basis stock is sold while the GRAT is still a grantor trust, then the grantor can pay the capital gains tax resulting from the sale, thus further reducing the grantor's estate and substantially enhancing the real value of the property passing to the remaindermen. If the grantor is not comfortable with the trustee having that power, the grantor can simply sell an equivalent number of shares received as the final annuity payment and then exercise a corpus substitution power after the final annuity payment, but before the actual distribution to the beneficiaries. Therefore, consider wording a corpus substitution power, or any other grantor trust "trigger" provision in a GRAT, so that it can continue to apply until all assets are distributed. Some GRAT documents the author has seen provide that a corpus substitution power is in effect during the "term" of the trust, which, by definition, may end when the final annuity payment comes due, thus giving rise to a question about whether transactions between the grantor and the trust continue to be non-recognition transactions.

B. Separate GRAT Document from "Continuing" Trust Document

A good planning strategy with respect to GRATs is to provide that following the termination of the "qualified annuity interest," any property remaining in the GRAT will thereafter be held in trust, rather than being distributed outright to the remainder beneficiaries. One way to accomplish this result is for the trust agreement for the GRAT to provide that following the retained annuity period, any remaining property will be retained in trust by the trustee, subject to more traditional trust terms than those required for a qualified annuity interest. The author strongly recommends *against* using a single document to create both the GRAT and the trust to hold the property thereafter. A better practice is to create two separate trusts from the outset, one of which qualifies as a GRAT, but terminates at the end of the retained annuity period, and the other of which is a traditional trust that is named as the remainder beneficiary of the GRAT.

One reason why separate agreements are preferable is that circumstances may change in the future, calling for remedial action that may not be possible with a single trust.

1. Example: Disclaimer of Remainder Interest in GRAT

Circumstances could arise where, within 9 months of funding, it might be desirable to "undo" the GRAT through a disclaimer. If the remainder beneficiary can validly disclaim the remainder interest, resulting in the original gift being incomplete, then that could cause the GRAT to never have existed in the first place, especially if the disclaimer results in all interests in the trust property "merging" such that the grantor owns the property outright. For a disclaimer to be valid, the disclaimant must not have accepted the property. If the remainder beneficiary is the same trust as the GRAT, a disclaimer may not be possible, because the trustee of the GRAT, which is also the remainder beneficiary, has already accepted the property. If, on the other hand, the remainder trust is a separate trust with a different trustee then the acceptance of the transfer by the GRAT trustee should not constitute acceptance of the remainder interest by the remainder beneficiary.

If the disclaimer causes the remainder interest to "re-vest" in the grantor, then the creation of the GRAT may be negated *ab initio*. If the grantor is the trustee of the GRAT, then the disclaimer should cause a common law "merger of interests" to occur, since all legal and beneficial ownership in the property will be held by the grantor, thus causing the trust to cease to exist. If the trustee is anyone other than the grantor, a trust may still be found to exist, since there is a separation of legal and beneficial title. The author does not suggest that anyone plan on using disclaimers as a matter of course, but it may be helpful to leave the option open, just in case. If so, then the remainder trust should specifically permit the trustee to disclaim any transfer, without liability, and should expressly state that any disclaimed transfer is deemed incomplete, since the legal result of disclaimers of gifts is not as well established as disclaimers of transfers at death.

2. Example: Sale of Remainder Interest to Grantor

Suppose that the grantor of a GRAT is diagnosed with a terminal illness two years into a five year GRAT, and the grantor is not expected to survive until the end of the retained annuity period, but the GRAT assets have already grown to the point that, if the grantor survived, a successful and substantial wealth transfer would result. Perhaps the grantor could purchase the remainder interest from the remainder beneficiary for its present value, based upon the current value of the trust property.[185] Arguably, even though the GRAT property is included in the grantor's estate, the price paid for the remainder is removed from the grantor's estate. Since the valuation is not based upon life expectancy, but is based upon a fixed term of years, the grantor's health should not prevent the use of the standard tables for term interests and remainders. While it is true that "commutations" of GRATs must be prohibited, the transfer of a remainder interest is not necessarily a commutation, especially if the GRAT itself continues.

If the remainder trust is the same trust as the GRAT, such a transaction could be viewed as a "commutation" since the sale of the remainder interest would necessarily require the involvement of the trustee of the GRAT. If, however, the remainder beneficiary is a separate trust with a different trustee, the sale would not involve any action by the GRAT trustee.

Since the implications of a GRAT remainder sale have never been "tested" in the courts, one should probably not consider such a transaction unless very real benefits will otherwise be lost.

C. Omit Spendthrift Provisions from GRATs

In the foregoing fact scenario, it would not be possible for the grantor to purchase the remainder interest in the GRAT from the remainder beneficiary if the GRAT contains a spendthrift provision that prohibits any transfers of a beneficiary's interest. Moreover, as a general rule, spendthrift provisions do not provide any protection from the creditors of the grantor of a self-settled trust. Accordingly, it is better practice to omit spendthrift provisions from GRATs.

D. Have Grantor Serve as GRAT Trustee

As discussed above, if the grantor serves as the trustee of the GRAT, and holds both legal title and equitable title with respect to everything other than the remainder, then it may be possible to cause a trust merger if the grantor purchases the remainder interest or the remainder beneficiary disclaims the remainder. Of course, counsel should plan to "supervise" the grantor to ensure that the requirements for GRAT qualification and administration are properly followed during the GRAT term.

If a purchase of the remainder by the grantor is contemplated due to mortality risk, it may be better for the grantor to step aside in favor of another trustee. This might prevent a merger of title, but it would also prevent the GRAT trustee from having any involvement in the sale of the remainder, which may be desirable.

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[185] See Handler & Oshins, *The GRAT Remainder Sale*, 142 TR. & EST. 33 (Dec. 2002).

XIV. Relatives – All One Big Happy Family!

A. Relations of the Half-Blood

The laws of most, if not all, states provide that for purposes of intestate succession and, in many cases, interpreting wills, trusts and other documents, relatives of the "half-blood" are treated the same as relatives of the "whole-blood," unless a contrary intent is expressed in the document. Accordingly, great care should be employed in defining classes of persons by relationship.

In *Larson,*[186] the issue was whether a reference in a trust to a beneficiary's "brothers and sisters" referred only to siblings of the whole blood, who were the lineal descendants of the grantor, or included also siblings of the half-blood, who were not lineal descendants of the grantors. In this case, the grantors had a grandchild, Matthew, who was the child of the grantors' daughter, Cindy. Cindy and Matthew's father, Greg, later divorced, Greg remarried, and Greg and his second wife had two additional children, who were half-siblings to Matthew.

The grantors had created trusts for Matthew in 1996 and 1998, while Cindy and Greg were still married. The grantor's created a third trust in 2009, to replace the 1998 trust, but by that time, Greg's additional children had been born. All of the trusts provided that if Matthew died unmarried without descendants, the trust property would pass to his "brothers and sisters."

Matthew died unmarried and without descendants. North Dakota law provides that relations of the half-blood inherit equally with relations of the full blood, and this rule also applies to trusts. The grantors petitioned the court to reform the trusts to clarify that the "brothers and sisters" entitled to take at Matthew's death included only those siblings of the whole blood who were lineal descendants of the grantors. The grantors argued that they were unaware of this legal provision when the trusts were created and never intended to benefit anyone other than their own descendants. Needless to say, Greg argued that his children were entitled to take. The lower courts ruled against the grantors and in favor of the half-siblings, but the North Dakota Supreme Court reversed and held that the trusts should be reformed based upon mistake of law.

While the grantors ultimately prevailed, they had to engage in expensive litigation to get to that result. The issue could have been avoided by using terminology that was more precise. Instead of referring to the beneficiary's "brothers and sisters," the trusts should have provided that the property would pass to:

> The lineal descendants of the beneficiary's nearest ancestor who is a lineal descendant of the grantors.

While this terminology seems to say the same thing as "brothers and sisters" or "siblings," and in fact means the same thing *in most cases*, it clearly would have

[186] *In Re: Matthew Larson Trust Agreement*, 2013 ND 85, Docket: 20120319.

had a different meaning in this case. There is no question that Greg's additional children are not lineal descendants of Cindy.

The same issue could arise when using terms such as ***niece*** and ***nephew***, rather than "descendants of the children of my parents," and even then, if there are any known half-siblings, that should be dealt with, either inclusively or exclusively.

B. Relations by Adoption (or not)

1. Adoptee Establishes Relations to Extended Adoptive Family

The laws of most states provide that adopted persons are treated the same as persons naturally born into the family, even out several generations. This applies both with respect to inheritance ***by or from*** an adopted person, and with respect to all relations across generations. Therefore, an adopted person is the child of the adoptive parent, the grandchild of the parents of the adoptive parent, the sibling of the other children of the adoptive parents, and so forth. The best practice is to specifically state, in every document, whether persons related by adoption are to be treated the same as persons related by blood, or not. Especially if not.

2. Adoption Terminates All Relations to Extended Birth Family

It is also important to remember that under the laws of most states, adoption also ***terminates*** all legal relationships of the birth family. Therefore, once the child is adopted, the child is no longer legally a "descendant" of the parents or other relations of the birth mother or father. Thus, for example, if a child is adopted, but grandparents or other relations through the birth mother or father wish to continue to include the adopted child in a beneficiary class, it will be necessary to specifically say that the adopted person is included, because simple references to "my grandchildren" or "my descendants" will not suffice.

3. Adoption Limitations by Age at Adoption

Finally, many people wish to limit the rights of adopted persons to those persons who are adopted into the family prior to reaching adulthood, to exclude "strategic" adoptions of adults seeking to share in the estate of a wealthy individual. Such provisions often limit inclusion to persons adopted during minority or even at a younger age, such as 14. The author recommends considering an adoption age of 21, which may allow for adoption when the child is old enough to be adopted without the consent of both birth parents, but young enough to make "strategic" adoption unlikely. The author has a client who married a woman with two children whom the client considered to be his own children and whom the client (and the client's siblings and parents) wanted to share in the family wealth. The adoption was not feasible while the children were under age 18, since the consent of their father would be required. However, once the children reached age 18, they were old enough to consent to adoption on their own, which worked out well for all involved.

C. Relations by Marriage

1. In-Laws

An individual's "sister-in-law" could be the sister of the individual's spouse, or could be the wife of the individual's sibling. Therefore, rather than using the term "sister-in-law," use the term "sister of my spouse" or "wife of my brother." Of course, be mindful of half-siblings and adopted siblings.

2. Nieces and Nephews

The terms "niece" and "nephew" refer to both the children of one's siblings and the children of one's spouse's siblings, so it is best to be specific as to whether the reference is to the children of the grantor's siblings or the children of the siblings of both the grantor and the spouse. Again, be mindful of half-siblings and adopted persons.

D. Out-of-Wedlock Descendants

The laws of most, if not all, states provide that for purposes of intestate succession and, in some cases, interpreting wills, trusts and other documents, terms such as "child" and "descendant" include persons born out-of-wedlock, if (as to the father) paternity is proved and certain other conditions are met.[187] Moreover, if necessary to prove paternity, a person claiming to be a biological child of a decedent may be entitled to obtain an order requiring exhumation of a decedent's body to get tissue samples for DNA testing.[188] Needless to say, such actions can make an already difficult time for a decedent's family all the more stressful, especially where the putative illegitimate child was previously unknown to the family.

The author is aware of one case in Georgia where the decedent's will divided the estate *per stirpes* among the testator's "*descendants*," but the will did not specifically name the testator's children (or any other descendants), nor did the will specifically address the status of out-of-wedlock descendants. After the testator's death, an individual, previously unknown to the testator's immediate family, claimed to be the decedent's out-of-wedlock child, and therefore claimed a right to one-fifth of the decedent's rather sizable estate, much to the chagrin of the other four children. The probate court held that under applicable law, an ambiguous provision in a will should be construed in a manner that is consistent with the rules of intestacy, if possible, and since the applicable intestacy rules permitted an out-of-wedlock child to inherit from a father, assuming paternity could be proved, the court determined that the term "descendants" as used in the will, *could* include persons born out-of-wedlock. The parties settled the case after this ruling.

The result would likely have been different in Kentucky, where out-of-wedlock children have inheritance rights under the rules of intestacy, but terms

[187] *See, e.g.*, VA. CODE ANN. § 64.2-102.

[188] *See, e.g., Martin v. Howard*, 273 Va. 722, 643 S.E.2d 229 (Va. 2007).

such as "child" and "descendant" when used in a will are generally presumed to refer only to legitimate children, and not to include out-of-wedlock children, absent some expression of intent to the contrary.[189]

Accordingly, a provision used by some practitioners expressly provides that terms such as "children" and "descendants" do not include persons born out-of-wedlock unless the parents subsequently marry or the father otherwise acknowledges the child to the trustee or the community. The idea is not so much to punish children born out-of-wedlock for their status, as much as to prevent protracted litigation by persons, previously unknown, who claim to be descendants. The presumption is that where an out-of-wedlock child is well known to the family, paternity will have been acknowledged, even if not by formal legitimation.

Sample Provision:

Definition of "Descendants"

An individual born out of wedlock shall be treated as a "child" or a "descendant" of the individual's father only if the individual's father subsequently marries the individual's mother, formally legitimates the individual, informally but publicly acknowledges paternity, or actually acknowledges paternity to the trustee during the putative father's lifetime.

XV. Valuation Date for Unitrust Payments

Unitrusts, such as charitable remainder unitrusts and QTIP or other "all income" trusts that have been converted to unitrusts, base distributions upon the value of the trust assets determined annually, typically at the beginning or the end of the year. A variation on the unitrust is a provision that calls for distributions of all income or a stated percentage of trust assets, whichever is greater (or less, in some cases). The author recommends that in such circumstances, the valuation date should be the *last* day of a month, quarter or year, and *not* the *first* day or the first *business* day, since financial institutions, whether serving as trustee or as custodian of the assets of the trust, will, in the normal course of business, produce statements showing the value of the trust assets on last day of a month, quarter or year. By contrast, if the trust assets are to be valued as of the *first business day of the year*, then a special valuation of the trust assets is necessary, which can take extra time or expense. Moreover, if there is a fluctuation in value between, for example, the last day of December and the first business day of January, a beneficiary that is provided with regular year-end statements may become unduly concerned if the distribution is calculated based upon a value different than the

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[189] *See Carey v. Janes*, No. 2007-CA-000138-MR, 2008 Ky. App. Lexis 72 (Mar. 21, 2008, *modified* Apr. 11, 2008).

value reported to the beneficiary on his or her most recent statement, even if the difference in value is very small.

Similarly, the author once was faced with a situation where a decedent's will included a specific bequest to a theretofore unfunded inter-vivos trust, and distributions from the trust were to be determined as of the first business day following the date of the decedent's death. This meant that in addition to calculating the value of the decedent's estate on the date of death, all assets had to be re-valued as of one day later. Needless to say, matters would have been much simpler had date of death values been used.

XVI. Adding Undistributed Income to Principal

A provision included in most, but not all, trust agreements is a provision stating that any income that is not distributed currently is to be added to principal at least annually. This seemingly innocuous provision is so commonplace (although not universal) that it rarely attracts notice. However, *without* this provision, a trustee may be required to retain any undistributed income in an accumulated income account, which must be invested separately from principal, typically in highly liquid short term investments, which may not be what the grantor intended. In cases where the beneficiaries' interests in income and principal are the same, and there is otherwise no advantage to be gained by segregating income from principal, the ability to add income to principal greatly simplifies record keeping.

XVII. Allocating Between Principal and Income; and Capital Gains as DNI

The Uniform Principal and Income Act provides for a default rule in absence of a provision in the document. Often the UPAIA includes rules that are insufficient in real life. One of these areas is the characterization of receipts and disbursements as principal or income.[190] This includes ensuring the allocating is consistent with the settlor's intent and designed to further the purpose of the trust. As a result, many professional fiduciaries prefer discretion to make characterization**.**

Sample Provision:

Principal and Income

To make discretionary allocations of receipts and disbursements between principal and income and, regardless of any statutes, to allocate any trustee's fee between principal and income in any proportion.[191]

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[190] *See* FS §738 generally. For a thorough outline on this issue, please email Mark R. Parthemer at Parthemer@bessemer.com.

[191] The law on the allocation of trustee fees varies dramatically, and is 50% income and 50% principal in Florida, absent language otherwise in the document. FS §738.701, 702.

Further, with increased capital gains rates, plus the Section 1411 Net Investment Income Tax, it is more frequently relevant for a trustee to consider passing out capital gains so they are taxed to a beneficiary. That being said, the general school of thought is that general authority will not enable the trustee to take advantage of I.R.C. § 643. Treasury Regulation section 1.643(a)-3(b)(1)-(3) provides that capital gains are "not excluded" from DNI if (1) authorized under state law/ trust agreement and (2) allocated in one of three fashions:

- The trustee allocates gains to income (Income Exception);
- The default allocation to principal applies, but gains are consistently treated on the trust's books, records, and tax returns as part of a distribution to a beneficiary (Deeming Rule Exception); or
- The default rule applies, but gains are actually distributed to the beneficiary or utilized in determining the amount that is distributed or required to be distributed (Utilization Exception).

The Income Exception under Treasury Regulation section 1.643(a)-3(b)(1) is available only when the trust agreement specifically empowers the Trustee with appropriate discretion.

Sample Provision:

Capital Gains as DNI

My Independent Trustees may, in their absolute discretion, treat, within the meaning of section 1.643(a)-3 of the Treasury Regulations under the Code, any discretionary distribution of principal made pursuant to this document or applicable state law from any trust hereunder as being paid from capital gains realized by such trust during the year and include such capital gains in the distributable net income of such trust. My Independent Trustees may take any action that may be necessary for such treatment to be respected for tax purposes.

XVIII. Digital Assets

An area of evolving interest is the conflict between outdated Federal laws, an absence of state laws, and burgeoning use of digital assets for things of financial value (bitcoin) and sentimental value (flickr). The challenge is that under Federal law, accessing another person's digital assets may constitute a criminal offense. There is a push to establish an artfully crafted uniform law, the current version of which is known as the Uniform Fiduciary Access to Digital Access Act, which would facilitate the ability to ensure a fiduciary can distribute all such assets as intended. For example, in Florida's 2015 legislative session, a battle developed between the Florida Bar and Florida Bankers on one side and the internet service providers on the other – no legislation was adopted, but many are hopeful that progress will continuing to be made behind the scenes that ultimately will result in law. The balance is between access to information and privacy (not just if the decedent was the sender of an email, but what about the privacy rights of the recipient who may have responded?). In the meantime, it would be helpful to include some contemplation of the settlor's intent as the ISPs have made clear that, at a minimum, they would look for authorization and permission.

Sample Provision:

Digital Assets

To hold, control, and have access to and the use of any asset held by any kind of computing or digital storage device or otherwise in digital form, including, without limitation, lists of passwords and account information; social media sites; blogs, e-books or other web-hosted materials of which the Settlor is the owner or author; digital albums; videos; and websites on which the Settlor conducts business transactions. I hereby authorize any person or entity that possesses or controls any electronically stored information or that provides to me an electronic communication service to divulge to the Personal Representative any electronically stored information or any record or other information pertaining to me. This authorization is to be construed as my lawful consent to all such access or disclosure under the Electronic Communications Privacy Act of 1986, the Computer Fraud and Abuse Act of 1986, and any other applicable state or federal data privacy law, as they may be amended.

To employ any consultants or agents to advise or assist the Personal Representative in decrypting any encrypted electronically stored information of mine or in bypassing, resetting, or recovering any password or other kind of authentication or authorization, and I hereby authorize the Personal Representative to take any of these actions to access: (1) any kind of computing device of mine; (2) any kind of data storage device or medium of mine; (3) any electronically stored information of mine; and (4) any user account of mine. The terms used in this paragraph are to be construed as broadly as possible, and the term "user account" includes without limitation an established relationship between a user and a computing device or between a user and a provider of Internet or other network access, electronic communication services, or remote computing services, whether public or private.

Concluding Thought—Consult the Fiduciary before Signing

The foregoing discussion demonstrates that much value can be added by seeking the input of a proposed fiduciary *before* the document is finalized and executed, with the result that the grantor's (and the planner's) intentions are more likely to be fulfilled. A professional fiduciary can often provide valuable advice about how to improve language in a document to meet objections and how to avoid technical administrative issues later on.

APPENDIX A

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