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OCTOBER 2017

Modern trusts: Fiduciary and non-fiduciary positions

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Modern trust drafting and planning is changing how irrevocable trusts should be planned, drafted, and administered, and how practitioners should advise clients. One of the significant ways in which trust drafting and planning is evolving, and the focus of this monograph, is in terms of the positions created in trust instruments, including:

- general trends affecting trust positions
- characteristics of the modern trust that affect trust positions
- persons/positions to designate

Historically, the traditional trust had a trustee and beneficiaries. The modern trust may have four, five, or more fiduciary and non-fiduciary positions that might include: administrative trustee, distributions trustee, trust protector, investment advisor, loan director, charitable designator, person holding a power to add beneficiaries, persons holding powers of appointment, person holding the power to swap or substitute assets, and more. Many of these positions, because they are relatively new, are known by different names. Different state laws might use different terminology, and there are wide variations in how different attorneys draft the provisions governing these positions. Thus, trustees, beneficiaries, and anyone involved with a trust should be cautious to review the specific terms of each instrument governing each position and not presume that a particular title has a specific meaning without verifying.

Practitioners will have to help clients understand and apply these new trust concepts. This will require that clients be educated about the new concepts and the accompanying jargon. This monograph may also aid practitioners in discussing these positions with clients by serving as an explanatory checklist of the various trust positions, concepts, terms, and decisions involved.

This article will explain many of these new and evolving positions and how practitioners can use them to craft trusts that can more creatively and flexibly help clients achieve a variety of objectives.

General Trends Affecting Trust Positions

There are a number of conditions helping transform the various positions incorporated into trust drafting and planning:

Tax uncertainty. The tax system faces incredible uncertainty. Perhaps by the time this article is read, significant tax changes will have been enacted. Regardless, the tax system has been, and is likely to remain, in flux. The estate tax has been repealed and reinstated three times. Even if the estate tax is repealed, a future administration may reenact it, or a sunset provision may automatically result in its reinstatement. Even if income tax rates are lowered, they too may be increased by a future administration. When trusts are drafted, infusing flexibility to be able to address future income, estate, and other (e.g., a proposed capital gains tax on death) taxes is important. Many of the newer fiduciary and non-fiduciary positions can be used creatively to accomplish this goal. For example, it might be useful for someone to be given a limited power to appoint trust principal, and another person the power to transform that limited power into a general power of appointment to cause estate inclusion.

Economic, social, and political changes. The changing environment has clients worried about transferring assets to irrevocable trusts because of the perceived difficulties in addressing different circumstances in the future. The response should not be for clients to avoid irrevocable trusts, especially considering the protective benefits that they can afford, but rather to incorporate flexibility into the irrevocable trust instrument and plan. For example, giving a spouse a limited power to appoint trust assets among heirs can provide the flexibility to modify how trust assets are to be inherited by the next generation. That can provide significant flexibility. If the tax laws or other circumstances change, the spouse can exercise the power and appoint trust assets to a new trust that better meets then-current circumstances. Similarly, powers of appointment can be given to each succeeding generation of beneficiaries to recast the trust at their level.

Aging. Longevity is a key concern that affects planning for many clients. Whereas it might have been common in the past for a client to forecast expenses to age 85, now using age 95 or an even older age is viewed as more reasonable. Longevity also brings increased cognitive and other health challenges, such as providing a safe structure to protect against Alzheimer's disease and other perceived challenges of aging, identity theft, and other issues. This matter can be addressed in trust drafting in two different manners. First, it may be important to create a safety valve to permit the client to benefit from trust assets in the future. This might be prudent even for a wealthy client who might not be likely to need the assets transferred to an irrevocable trust. Access to trust assets can be accomplished in many ways, including by giving a spousal beneficiary the power to appoint back to the settlor spouse, if the trust has situs in a state that permits such a power without exposing trust assets to the settlor's spouse's creditors (and thus causing estate inclusion). The second facet of this planning is to create checks and balances to protect an aging beneficiary from elder financial abuse and other risks. There are many ways to address this, and often a combination of steps is advisable. One such step may be to mandate that the trustee hire an independent care manager to evaluate the elderly or infirm beneficiary and issue a written report to the trustee. Although the trustee can do this of its own volition each year, in some instances this can be drafted into the governing trust instrument.

Characteristics of the Modern Trust That Affect Trust Positions

Modern trusts, and the many positions that they might involve, are evolving in ways that make them markedly different from the more traditional, simplistic, historical trust. Modern trusts differ from historical trusts in many fundamental ways. Many of these new characteristics trigger the need for some of the new trust positions that will need to be addressed.

Complexity. The modern trust is more flexible than the traditional trust. This results in more complex trust instruments and plans. The uncertainties and rate of change described above are reflected in trust documents that try to anticipate future tax law changes and provide different mechanisms to deal with those changes. State taxation of trusts is evolving. Society has grown more complex. Today, only about 20% of American family units consist of a traditional husband, wife, and children from that marriage. All of this brings more complex goals to trust planning and more complicated provisions in trust instruments. The complexity makes it more important to create mechanisms to correct a trust that might prove less than optimal in the future. So a modern trust is more likely to include a provision permitting the trustee to decant (merge) the trust into a new trust, thus permitting the trust administrative, and other, provisions to be improved if advisable. To make the decanting provision practical, it might be helpful, if not essential, that a person have the authority to change trustees, situs, and governing law for the trust. The significantly increased complexity of the modern trust also might suggest that including a trust protector, and providing the protector the power to correct scrivener's errors, might be useful.

Situs. Traditional trusts have tended to be formed in the state where the settlor resides. Many lawyers are familiar with the historical approach of creating trusts in the jurisdiction where they practice and the client resides. However, in many instances, forming a trust in a tax-friendly jurisdiction may make sense from the outset. Similarly, moving an existing trust to a better jurisdiction might prove advisable at any point in the life of the trust. Moving to a lower-tax state might provide significant annual savings, depending on the circumstances. The settlor's home state may have a limited duration for which trusts can last, and it may be preferable to create the trust in a jurisdiction that has a longer-term perpetuities period. The client might own a family business and want to name an independent institutional trustee. That might necessitate a directed trust structure, as discussed below. If the client's home state law does not permit a directed trust, that factor might require forming the trust in a different jurisdiction. So, the more common use of different jurisdictions in the modern trust might give rise to having to name specific additional fiduciaries or non-fiduciaries in the trust instrument. If the client's home state has unfavorable laws, it might be essential to name an administrative trustee in the desired jurisdiction to have nexus in that state so that the trust can avail itself of the favorable laws or tax rules of that jurisdiction. The opposite side

of this discussion might suggest limiting the persons appointed and acting in the client's home state to avoid taxation in that home state or to avoid courts in that state having jurisdiction. This might give rise to another position or technique. For example, settlor, a resident of State A, sets up a trust in State B naming an administrative trustee in State B. Settlor named herself as investment trustee and her sister as trust protector. Some commentators have suggested that instead of specifying their names and positions in the trust instrument, the trust specify that a limited liability company (LLC) formed in State B will fill these roles, and the persons are named as manager of that LLC. The theory is that naming the LLC in that role is not equivalent to an individual in State A serving and may minimize the risks of State A asserting tax or legal jurisdiction over the trust.

Grantor trust. The default approach for most irrevocable trusts are for them to be structured as grantor trusts for income tax purposes. The advantages of a grantor trust include the fact that the income of the trust is taxed to the grantor, thereby further reducing the grantor's estate and providing better asset protection. This status also will permit the grantor to swap appreciated trust assets back into his or her estate so that those assets can qualify for an increase in income tax basis on death. Under the current planning paradigm for many, this is a critical estate planning goal. Also, grantor trust status may permit the grantor to sell appreciated business, real estate, or other interests to the trust without triggering a capital gain. That may prove to be a key to transitioning the client's business to the next generation without tax costs and protecting the business for those intended heirs. However, even for those not subject to an estate tax, a note sale to a grantor trust can be a powerful divorce or asset protection planning tool. A common provision included in trusts to achieve grantor trust status is the power to substitute or swap assets. This provision requires a special trust position, sometimes referred to as the "substitutor," for which the settlor will have to appoint a person to serve. The default person named is generally the settlor of the trust, but that is not required. The settlor could appoint another person, such as a sibling of the settlor. Who should be named might depend on the nature of the trust, the assets in the trust, and the tax objectives for the trust. There is also a different approach to achieving grantor trust status using what is sometimes referred to as a beneficiary defective irrevocable trust (BDIT) in which the settlor creates a trust, but the trust is characterized as a grantor trust as to the beneficiary through the mechanism of the annual demand or *Crummey* power in the trust instrument.

Directed trust. Traditionally, the trustee of a trust had control over all investment decisions. But, as explained above, the settlor may have to name an institutional trustee to secure situs in a trust-friendly jurisdiction. For example, the settlor might have a long-term relationship with a particular local trust company. The settlor might want to take advantage of the laws of a more trust-friendly state, but still continue the long-term relationship with the local financial institution. The use of a directed trust can permit such a client to have both the advantage of the better state law for the trust and still continue the relationship by naming an institutional administrative trustee in the desired state and having the trust direct the home state long-time institution to invest assets. There are other common applications of this technique. If an institutional trustee were responsible for insurance, business holding, and investment decisions generally, the settlor would have less control over those decisions, and the costs could be more significant. Further, if the settlor's plan might include the transfer of closely held real estate or business interests to the trust, it could be difficult to do so with an institutional trustee, as many institutions will not accept the risk of holding a closely held business as trustee. Although some institutions will, in fact, serve as trustee for assets other than marketable securities, e.g., a closely held business or real estate investment, that might not be a desirable option while the settlor is alive and not incapacitated. Some settlors may prefer not to pay the fees to an institutional trustee that would be commensurate with the risks of an institution holding such assets.

One solution is to structure the trust as a directed trust. A "directed" trust must be formed in a state that permits this type of trust; not all do. In contrast to a traditional trust where there is one trustee with responsibility for all trustee functions, in a directed trust the trustee functions are bifurcated. The institutional trustee may serve as only a general or administrative trustee. A second person is designated to manage investments, called an investment trustee, although a variety of different titles are used for this role. If the institutional trustee is "directed" to follow the instructions of that investment advisor or investment trustee, the institution should have very limited or no liability for that investment. A bit of semantics might be useful. If a trust "delegates" investment management, the trustee still will have an oversight responsibility, so that may not suffice as a structure for many client situations. In contrast, if the trust agreement and state law permit the trustee to be "directed" as to investments, the trustee should not have any liability. Hence, directed administrative trustees may charge only an annual flat fee for serving as trustee, rather than a percentage of assets that may be more reflective of the risks associated with having investment responsibility. It is this modest flat fee that makes this technique viable for a much broader range of clients than the way more traditional trusts were structured. So, if a trust is to be structured as a directed

trust, a number of different positions will have to be incorporated into the trust. These are discussed in more detail below.

Dynastic trust. Trusts generally should be planned so that the assets of the trust will remain outside the transfer tax system, and be protected within the trust, for as long as state law permits. As noted above, the future of the tax system is very uncertain. Keeping assets inside flexible trusts for a very long term or indefinitely can provide more safety and more planning options as the tax system, and other circumstances, evolve. This long-term approach may suggest that the trust be formed outside the client's home state in a jurisdiction that permits longer-term trusts than the client's home state. Also, the longer the trust, the more flexibility that should be built into the instrument. The trend of modern trust drafting favoring long term-trusts affects each of the positions designated in the trust as well as the importance of succession considerations for each position.

Quiet trusts. Some settlors may wish to prevent beneficiaries from receiving information about the trust. In contrast, trustees, especially institutional trustees, are well aware of the myriad of advantages to everyone of beneficiaries being informed about the existence of a trust as well as trust performance. In some instances, depending on state law, the terms of the trust instrument, and the preferences of the parties, it may be advisable to designate a person to receive notice on behalf of one or more beneficiaries. This might reconcile some of these competing goals by providing the protections of someone being responsible for being informed of trust matters, but limiting disclosures to a beneficiary who may be harmed by the disclosures. If a beneficiary is incapacitated or has special needs, this type of structure might be valuable to incorporate into the instrument. The person designated to receive trust information on behalf of someone else might be referred to as a "designated representative," or by other titles. In other instances, this responsibility might be given to another fiduciary, e.g., the trust protector.

Non-reciprocal trusts. With high exemptions, longevity, and tax uncertainty, it has become more common for married couples to structure spousal lifetime access trusts (SLATs) than merely trusts for children or other descendants. In this way, the couple can remain beneficiaries of trusts, although the assets in those trusts are arguably outside their estate and secure from the reach of creditors. SLATs may be created by the husband creating a trust for the wife and descendants and wife creating a trust for husband and descendants. For SLATs to be effective, the trust instruments and plans should be differentiated. If the trusts are identical (e.g., all identical terms and merely different names), they may be disregarded under a concept called the "reciprocal trust doctrine." The preferable approach is to draft each trust from scratch, incorporating meaningful legal, tax, and economic differences in each. Differences may include different fiduciary and non-fiduciary positions, different persons named for positions that are the same in each trust, and so on. So, making a couple's SLATs distinct one from the other will have a significant impact on the positions and persons named in each trust.

Powers of appointment. Powers of appointment can and should be integrated into a number of provisions in modern trusts, more so than what was done in a traditional trust. Traditional trusts often only used powers to avoid the unintentional triggering of GST tax. But powers can infuse so much more flexibility and planning capability into trusts. Powers can provide a valuable and flexible mechanism to virtually rewrite the trust at each generational level. Given the tremendous uncertainty in the tax, legal, and other environments, this can be incredibly useful.

Securing an increase in income-tax basis on death is valuable to eliminate capital gains on pre-death appreciation. Because capital gains can be nearly as costly (and potentially under some scenarios, more costly) than estate tax, this can be valuable to consider in the planning process. It may be feasible, if your client can designate a trustworthy and reliable relative, that such person could be given a power of appointment. A power of appointment is the right to designate how assets, such as those held in a trust, will be distributed. If that power of appointment is characterized as a "general" power, the assets over which it can be exercised will be included in that person's estate. If that person's estate is not subject to state or federal estate tax, then a basis step-up may be achieved at no estate tax cost. Further, this basis step-up may be realized long before the settlor's death so that the settlor could affirmatively capitalize on this tax advantage during his or her lifetime.

If the settlor believes that he or she could name such a person, but there is concern about granting a general power, several approaches can be used to mitigate its scope without sacrificing the intended tax result. The general power could be a "narrow" general power so that the power holder can only appoint to a designated class of persons and the person's creditors to cause estate inclusion. This limits the scope of the power so as to lessen its use to appoint assets to those other than those the settlor intended. Also, the power can be subject to the consent of a non-adverse person. More specifically, the person holding the consent power cannot have a substantial interest adverse to the exercise of the power

in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate. Another approach is for the trust document to grant the right to a person designated in the trust instrument so as to modify the terms of a limited power of appointment (e.g., to appoint only to the settlor's children and descendants) and convert it to a general power of appointment. For example, the relative involved might be given the right to appoint to settlor's descendants, but the trust protector could be given the right to only broaden that power to include the relative's creditors. If your client wishes to pursue this type of planning, your client has to identify a potential candidate for holding the power and inclusion as a beneficiary.

Persons/Positions to Designate

2038 power. Obtaining a basis step-up is a key focus of trust planning and having various options to create this result may be useful in planning and drafting trusts. Consider granting someone the ability to grant the settlor a power under Code Section 2038 so as to cause estate inclusion. The trust could give the trustee, or perhaps a third party acting in a non-fiduciary capacity, a power to grant the settlor the right to control the beneficial enjoyment of trust assets. This would cause estate tax inclusion in the settlor's estate under IRC Sec. 2038. A corporate trustee may be unwilling to exercise such a power, so it may be advisable to grant the power to an individual. Consider giving the power to a non-fiduciary. This can provide a mechanism to cause estate inclusion and obtain a basis step-up on the settlor's death, if that proves advantageous. It might be advantageous to grant the trustee the right to select which assets to grant this power over. If an asset has declined in value, it may be preferable to avoid changing the basis at death. Caution, if the estate tax is repealed, there presumably will be no Section 2038, so how the step-up in basis would be effected under a repeal regime is uncertain.

Administrative and general trustee. An institutional administrative and general trustee may be designated. This position will hold all trustee powers in the governing instrument that have not been allocated to other fiduciaries. For example, if the trust names a trust protector and investment trustee, the general and administrative trustee will have all trust authority not given to those other two positions. Naming an administrative trustee can permit the client to choose to have the laws of any state apply, while continuing to have flexibility and control over trust investments. There is some disagreement among commentators whether this approach suffices for a self-settled domestic asset protection trust (DAPT). A DAPT is a trust for which the settlor is also a beneficiary, but for which the position is that the assets are out of the reach of the settlor's creditors and estate. For example, if the settlor lives in State A, which does not permit self-settled trusts, and sets up a DAPT in State B, which does, and names a trust company in State B as trustee, not all are convinced that this will suffice to protect the settlor from claims made in his or her home state against the DAPT.

Distributions trustee. The trust could name a person, or group of persons acting as a committee, to be responsible for trust distributions. Caution should be exercised as the power to distribute is a tax-sensitive power that could cause trust assets to be included in the power holder's estate if not properly handled. The settlor may be safer in terms of accomplishing trust goals by leaving this function under the auspices of an independent institutional general trustee.

Investment trustee. This position has been called by a variety of names including "investment advisor," "trust protector," and so forth. A person could be designated to be responsible for investment decisions of the trust. This could include investments of securities and business and real estate interests transferred to the trust (e.g., a closely held business or rental real estate). The settlor might serve in this role, but caution is in order. If the trust owns stock in a closely held business, the trust objectives might be better served by proscribing the settlor from voting stock. In some trusts it might be advantageous to bifurcate the investment trustee provision and provide for a separate trustee to manage marketable securities, which might be the institutional trustee, and an investment trustee, which may be a family member, to be responsible for family business or other private equity interests. A third delineation is suggested in the following paragraph.

Insurance trustee. It might be advisable to bifurcate the investment trustee provision into several investment trustee positions. A person could be designated to be responsible for life insurance decisions of the trust. This person should not be the insured. By providing for a separate person to be responsible for insurance decisions, and including prohibitions against the settlor/insured being involved in these decisions, the trust can hold both life insurance and other assets. Some of the advantages of this include the ability to use a single trust to hold business interests and life insurance, instead of multiple trusts, and the ability to use income generated by trust investments to pay for life insurance premiums. If a new trust is created to integrate these characteristics, review existing insurance trusts to determine if they can be decanted (merged) into this new trust to simplify planning.

Power to add class of individual beneficiaries. Consider hybrid DAPT provisions. If the trust is formed in one of the states that permit self-settled trusts as DAPTs, the client can be a beneficiary of his or her own trust. However, if he or she resides in a state that does not permit these trusts, some advisors view it as too risky to create a DAPT in a state that does. But there is a hybrid solution that might reduce the risk that some experts perceive, yet leave open the possibility of the client benefiting from that trust. Do not name the client initially as a beneficiary. Instead give someone the right to add as beneficiaries of the trust the descendants of the client's grandparents. If the client is not a beneficiary initially, the trust should not face that risk. But this may afford the client the possibility of being a beneficiary if he or she needs access in the future. Some practitioners are not comfortable with even a hybrid DAPT approach, as they are concerned that if the settlor is even a potential appointee of the trust that could make the trust a self-settled trust and cause estate inclusion under IRC Sec. 2036 because creditors might be able to reach the corpus. These practitioners prefer to create a hybrid DAPT in a DAPT jurisdiction.

Trust protector. This is a person appointed in a fiduciary capacity (although some commentators disagree and believe that the protector can act in a non-fiduciary capacity) to hold important powers over the trust and, perhaps, to perform certain other defined roles. The protector may be given the power to remove and replace existing trustees, correct scrivener's errors, modify administrative provisions, change trust situs and governing law, have the power to restrict or eliminate the right of the trustee to use income of the trust to pay life insurance premiums on the life of the grantor so as to facilitate turning off grantor trust status if that becomes desirable, and other powers depending on the circumstances and goals.

Substitutor. This person, who may be the settlor or another person, can be given the power to exchange or "swap" assets of the trust for assets of equivalent value. This can be a powerful mechanism to move assets between the client personally and the trust if it becomes advantageous, or merely desired, to hold an asset personally that is in the trust, or vice versa. The common application of this technique is to swap highly appreciated trust assets back into the grantor's estate so that on death they will qualify for a step-up in income tax basis. For example, if a capital gains tax on death is enacted, the swap power may be used in the opposite manner than it generally has been envisioned, namely to move appreciated assets out of the grantor's estate where they might be subjected to a capital gains tax on death into the trust, where perhaps they may not be. Provisions should be added to the client's durable power of attorney to address this power in the event of disability. It also is prudent to arrange lines of credit to facilitate acting on this swap power in an emergency situation. Because none of the powers to trigger grantor trust status are absolutely assured, it may be advisable to provide for more than one mechanism. Others are noted below.

Loan designator. Another means of creating grantor trust status is to empower an independent person to loan the grantor/settlor principal of the trust without adequate security. Because none of the powers to trigger grantor trust status are absolutely assured, it may be advisable to provide for more than one mechanism. Given the uncertainty of the estate tax, and the economic issues of longevity, it may be advisable to consider a loan provision in many trusts, as this may provide another means to allow the settlor to access value or cash inside the trust if needed. Although grantor trust status can, according to most commentators, be assured with a swap power, perhaps a loan provision should still be included, but now more for providing a means for the settlor to access trust principal than for grantor trust characterization. If the estate tax is repealed, the settlor might be more comfortable with the planning, knowing that there is a means to provide access to trust funds, even if that is as a loan.

Charitable designator. One of the means of creating grantor trust status is to empower a person to add to the class of beneficiaries, such as a charity. Because none of the powers to trigger grantor trust status are absolutely assured, it may be advisable to provide for more than one mechanism. Also, in light of the reciprocal trust doctrine discussed above, it may be advisable when spouses create trusts to use a different power in the second spouse's trust. With the discussions about restrictions on income tax benefits of itemized deductions and even charitable contributions, perhaps it is advisable to include a mechanism to add charitable beneficiaries in more trusts to provide flexibility for settlors to make contributions out of irrevocable trusts if that proves advantageous in the future.

Power-of-appointment holders. Powers of appointment should be included to provide further flexibility. Granting someone else the power to transmute limited powers of appointment into general ones can be used to cause some or all the trust assets to be included in an estate so as to qualify for a basis step-up on death, should that prove advantageous under a future tax system.

Conclusion

Modern trust drafting, tax uncertainty, longevity, and a range of other factors are transforming how trusts are planned, drafted, and administered. The wide array of positions, fiduciary and non-fiduciary, that may be included in a trust instrument are among the most affected areas. Creative and careful selection of these positions, and the persons named to serve in them, can infuse substantial flexibility into trust planning.

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