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# Considerations in Naming a Trustee

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This study is a discussion of the considerations to be taken into account when naming a trustee and providing for a trustee's removal and replacement. The practitioner may find it helpful to share this study with the client.

## INTRODUCTION

Perhaps the most important decision your client must make when he or she is creating a trust, whether it be a revocable trust that will become irrevocable at death or an irrevocable trust, is whom to name as the initial trustee or trustees and whom to name as the successor trustee or trustees and under what circumstances should an existing trustee be removed. The trustee or his or her designate will be responsible for making many decisions during the term of the trust involving not only how the trust assets will be invested, but probably more importantly, how distributions from the trust will be made to the beneficiaries.

The practitioner should plan to spend the amount of time necessary to advise the client concerning the appropriate options available with regard to these matters. This will involve a thorough discussion about the qualifications a trustee should have and the potential issues that may arise during the term of the trust. When the trust is to last for long time, such as in a typical dynasty trust, these concerns become even more vital, especially because it is likely that the first named trustee or trustees will not continue as the trustee throughout the entire term of the trust.

## SITUATIONS IN WHICH NAMING A TRUSTEE IS AN ISSUE

*Naming the initial trustee or trustees.* This will be necessary in every type of trust, regardless of its duration.

*Providing for the appointment of a successor trustee in the event of the resignation or removal of a trustee or other termination of a trustee's services.* Naturally, this will become more important as the term of the trust lengthens. Providing for the appointment of successor trustees avoids having to obtain court approval if it is necessary to appoint a new trustee for any reason.

*Providing for the removal of an existing trustee.* This may be necessary because the beneficiaries moved to another state, the trustee is no longer performing adequately, the trustee is charging excessive fees, or for other reasons.

*Providing for the resignation of an existing trustee.* Most trustees will want to have a provision in the trust agreement that allows them to resign. This will avoid having to obtain court approval for the trustee's resignation.

## DESIRABLE ATTRIBUTES OF A TRUSTEE

*Integrity.* Naturally, the person or institution chosen as trustee should have the highest degree of integrity.

*Competence.* The trustee, or at least one of the trustees, should have investment ability as well as administrative ability. If more than one trustee is appointed, then one trustee may have responsibility for administering the trust, while another trustee has the responsibility for making investments. Of course, a trustee serving alone who lacks investment or administrative skills or experience can engage someone who has the ability to handle these matters.

*Familiarity with family and family values.* It is unlikely that an institutional trustee (also referred to as a "corporate trustee") will have such familiarity, and if this is an important factor, then at least one trustee should be someone who has this familiarity, which may or may not be a family member. It could be a friend or a professional acquaintance. However, an institutional trustee may have such familiarity with high net worth families.

*Financial stability.* If an individual is named trustee, he or she should be someone unlikely to face financial hardship, including bankruptcy. This could have a detrimental effect on the individual trustee's performance. If the trustee is an institution, the institution should have demonstrated financial stability, which can be researched before the institutional trustee is actually named.

*Experience.* In most cases, an institutional trustee will have experience serving as trustee. Also, if a professional individual is named as a trustee, he or she should have such experience. If a family member or friend is being named as trustee, he or she may not have experience serving as trustee, but may engage professionals to assist him or her with respect to his or her duties.

## DUTIES OF A TRUSTEE

*Carry out the terms of the trust and the law.* This should go without saying, but the trustee is required to administer the trust according to the terms of the trust agreement and in the best interests of the beneficiaries. This means that the trustee must not only refrain from taking unauthorized actions, but must also be sure to comply with all mandatory provisions. If the trust agreement is too narrowly drawn, the trustee may have difficulty in adapting to changes in the beneficiaries' personal situations and in the investment environment.

*Impartiality.* In most cases, there will be more than one beneficiary. There may be only one current beneficiary, but at the death of the current beneficiary, the assets in the trust will pass to another beneficiary. Unless the terms of the trust provide otherwise, the trustee must be impartial in administering the trust as to the beneficiaries' differing interests.

*Reasonable.* A trustee, unless otherwise directed by the trust agreement, must carry out the terms of the trust in a reasonable manner.

*Prudent.* A trustee must exercise prudence in administering the trust and investing the trust assets. Generally, unless the terms of the trust provide otherwise, a trustee must diversify the investments so as not to incur uncompensated risk with respect to any particular company or segment of industry.

*Loyalty.* A trustee must be loyal to the trust beneficiaries. Except for receiving reasonable compensation or the compensation specified under the terms of the trust agreement, a trustee should derive no personal benefit as a result of serving as trustee. The trustee should not deal with the beneficiaries or the trust assets in personal transactions to avoid taking advantage of the fiduciary relationship between the trustee and the beneficiaries. Issues of loyalty will often arise if the trustee is also running a family business in which the trust owns an interest.

*Recordkeeping.* The trustee must maintain complete and detailed records of the trust assets, as well as any income earned and expense incurred. The trustee is also responsible for complying with all state and federal tax filing requirements and making appropriate tax elections.

## POSSIBLE CANDIDATES

The following are possible candidates to be named as a trustee:

*Adult family member* who is not a beneficiary of the trust, usually not appropriate if there are beneficiaries who are not descendants of the adult family member.

*Trusted friend,* but in many cases the trusted friend will not have the experience or expertise to serve without having to appoint a trust company or other professionals to provide the needed services.

*Trusted business associate,* but there are potential conflicts of interest issues if the business associate has an interest or is an officer in one of more businesses that will be assets of the trust.

*Adult family member who is a beneficiary of the trust,* again this could create conflict of interest issues if the adult family member has to make decisions concerning the allocation of assets among beneficiaries, including himself or herself.

*Professional individual fiduciary if permitted under state law (such as in California).* If this is a potential candidate, careful consideration should be given to the person's experience, particularly if the trust assets will include family businesses and other assets that may require experience in dealing with such assets.

### *Corporate trustee*

- Trust department of a bank, which in many cases will be a good choice because of the ability of the corporate trustee to deal with hard to manage assets and other administrative issues.
- Stand-alone public trust company, which involves the same considerations as stated immediately above.
- Private trust company, which may be considered if the family wealth is considerable and the cost of establishing the private trust company is warranted.

## WHO MAY SERVE AS TRUSTEE

Based on the considerations discussed above, the following are possible structures of the trustee:

1. An individual who is a beneficiary of the trust
2. Multiple individual beneficiaries of the trust
3. An individual who is not a beneficiary of the trust
4. Multiple individuals, none of whom is a beneficiary of the trust
5. Multiple individuals, some of whom are beneficiaries of the trust
6. A corporate trustee serving alone
7. A corporate trustee and an individual trustee who is not a beneficiary of the trust
8. A corporate trustee and a beneficiary of the trust
9. A corporate trustee and both a beneficiary and a non-beneficiary as individual trustees
10. A corporate or individual trustee with a trust protector or investment advisor

## MECHANICS IN NAMING A SUCCESSOR TRUSTEE

There are various options for determining how and when a successor trustee or trustees can be appointed, including the following:

1. Appointed by adult beneficiaries (majority or unanimous)
2. Appointed by all beneficiaries with guardian acting on behalf of minor or other incompetent beneficiaries (majority or unanimous)
3. Appointed by the departing trustee
4. Appointed by the remaining trustees
5. Either 1 or 2, plus consent of remaining trustees
6. Either 3 or 4, plus consent of adult (or all) beneficiaries

## MECHANICS IN REMOVING A CURRENT TRUSTEE

### *Reasons for removal*

- A current trustee or trustees could be removed for cause, such as increased fees, relocation of the trustee, relocation of the beneficiaries, irreconcilable conflict between the trustees, irreconcilable conflicts between the trustee and the beneficiaries, or poor investment performance.

- If the client wants to provide the current beneficiaries or some other person, such as a trust protector, with the maximum flexibility, then the trust agreement could provide that the current trustee or trustees could be removed for any reason. Of course, such a provision may make it difficult in getting someone or some institution to agree to serve, either initially or as a successor trustee.

### *By whom*

- Other trustees
- Adult (or all) beneficiaries (majority or unanimous)
- Other trustees with consent of beneficiaries
- Beneficiaries with consent of other trustees

## TAX CONSIDERATIONS

*Estate tax.* Generally, beneficiaries of a trust should not have a general power of appointment so that when the beneficiary dies, the assets will not be included in the beneficiary's estate. A general power of appointment for this purpose is the power to appoint to the beneficiary holding the power, to creditors of such beneficiary, to such beneficiary's estate, or to the creditors of such beneficiary's estate.

It is generally unnecessary to give the beneficiary a general power of appointment. Instead, special powers of appointment (holder cannot appoint for holder's benefit or to holder's creditors) are frequently used to provide flexibility if circumstances change among remainder beneficiaries.

For example, a surviving spouse may be given the right to change how assets in a QTIP or Bypass Trust will be distributed to the descendants of the first spouse to die. This will allow the surviving spouse to change the allocation of assets at the surviving spouse's death to take into account the possibility that some of the children may have particular financial problems, while others may have been extremely successful financially. A special power of appointment will not cause the assets to be included in the powerholder's estate for estate tax purposes.

When a beneficiary serves as trustee, special care must be taken to avoid unintentionally giving the beneficiary a general power of appointment over the trust assets by virtue of the trustee's power to make distributions. This includes distributions to support a beneficiary that the trustee has an obligation to support under state law.

*Generation-skipping transfer (GST) tax*—allocation of GST exemptions and use of GST annual exclusion. If it is possible that assets in a trust will pass to grandchildren or more remote descendants of the creator of the trust, then the allocation of the creator's GST exemption ($15,000,000 in 2026) or the use of the creator's GST annual exclusion, which has different requirements than the gift tax annual exclusion, must be considered. Generally speaking, a separate trust for each grandchild or more remote descendant must be established if transfers to the trust are to qualify for both the gift tax and the GST tax annual exclusions.

*Independent vs. related or subordinate trustee as defined in I.R.C. § 672(c).* If a beneficiary has the right to remove a trustee for any reason, then the replacement trustee should be an independent trustee as opposed to a related or subordinate party as defined in I.R.C. § 672(c), unless none of the trustee's powers under the trust agreement would cause inclusion in the beneficiary's estate if the beneficiary held such powers. Under that section, a related or subordinate party means any non-adverse party who is the grantor's spouse if living with the grantor and any one of the following: the grantor's father, mother, descendants, brother or sister, an employee of the grantor, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, and a subordinate employee of a corporation in which the grantor is an executive. A non-adverse party means any person who is not an adverse party. An adverse party is any person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of the power that he or she possesses respecting the trust. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust.

In some cases, the client may want to name a family member who is also a beneficiary of the trust. As long as the beneficiary trustee does not have any power that would cause the trust assets to be included in his or her estate, then naming the beneficiary as trustee would be appropriate. If the client wanted to provide flexibility, the client could provide that the beneficiary trustee could later name an independent trustee who could then exercise powers that would otherwise cause the beneficiary trustee to have the assets included in his or her estate. For example, the beneficiary trustee may have the power to make distributions to himself or herself pursuant to an ascertainable standard. Later, if the trustee beneficiary wanted additional distributions from the trust, he or she could name an independent trustee, who, under the terms of the trust, would have the power to make distributions to the beneficiary trustee that were for reasons other than health, education, maintenance or support, such as to make gifts to take advantage of the annual gift tax exclusion.

*State income tax issues.* In some cases, it may be desirable to have the situs of the trust in a state that will not subject the trust to income tax, or will subject the trust to a lower income tax rate than in some other state.

## TYPES OF TRUSTS

*Duration.* The duration of the trust may have a significant bearing on the appropriate provisions dealing with trustees.

*Short-term*—A trust that will last during the initial beneficiary's minority or until the initial beneficiary reaches a certain age. Here, the provisions for naming a successor trustee need not be overly complicated.

*Mid-term*—A trust that will last during the initial beneficiary's lifetime, with remainder going outright to remainder beneficiaries, subject to a trust until the remainder beneficiaries reach the age of majority or a specified age. Here, the naming of a successor trustee will become more important. In some cases, if the trust is lasting for the beneficiary's lifetime for a reason other than because the beneficiary is a spendthrift, the beneficiary may be one of the trustees of the trust or the sole trustee of the trust. However, in this case, the beneficiary should not have a general power of appointment.

The beneficiary could have the right to receive the income and to access the principal pursuant to an ascertainable standard, such as for the beneficiary's health, education, maintenance, and support. Generally, support has been defined to mean continuing to have the same standard of living that the beneficiary enjoyed before the death of the creator of the trust. The trustee who is also a beneficiary could have the right to appoint an independent trustee who could then make distributions to the beneficiary for any reason.

*Long-term*—A trust that is designed to last for more than one generation or a dynasty trust created in a state that does not have a rule against perpetuities. The rule against perpetuities requires that a trust terminate after a certain period of time. Under common law, a trust could not last longer than 21 years after the death of a specified person or specified persons who were alive at the time the trust was created. Some states provide that the trust can last no longer than either the common law period or 90 years. A number of states have eliminated the rule against perpetuities or extended the time for when interests must vest. In long-term trusts, the provisions for naming a successor trustee are extremely important, since it is unlikely that anyone named as an initial trustee will serve for the duration of the trust.

### *Distribution provisions*

*Completely discretionary.* Such a trust would provide that the trustee could make distributions of income and principal in the trustee's sole discretion. Of course, the trustee must be reasonable in exercising this discretion, and must also be impartial to the beneficiaries, unless the trust agreement or state law provides otherwise. This does not mean that the trustee must make equal distributions to the beneficiaries. The terms of the trust may include non-binding directions to the trustee so as to inform the trustee's exercise of his or her discretion. If the trustee is a family member and the beneficiaries are adults, such a discretionary power may lead to conflict.

*Pursuant to a standard.* In many cases, the standard will be the so-called health, education, maintenance, and support standard. A beneficiary may possess a right to access the income or principal of the trust pursuant to such a standard without having the assets subject to the right included in the beneficiary's estate.

*Income or unitrust amount, plus discretionary distributions of principal.* In this type of trust, it is necessary to distinguish between income and principal if the income is going to be distributed on an annual basis to one or more beneficiaries. Income generally means interest, dividends, rent, royalties, and other ordinary types of income. Income generally does not include capital gains from the sale of appreciated assets, although the trust agreement could provide that income includes capital gains. Principal refers to the investments themselves, such as promissory notes, stocks or bonds, or rental real estate. If the amount to be distributed annually is a unitrust amount, then it is not necessary to distinguish between income and principal. This generally allows the trustee to make investments to achieve the highest overall return, including current yield and future growth.

A unitrust amount is a percentage of the fair market value of the assets in the trust, usually determined over a period of more than one year, such as the average fair market value of the assets over the preceding three-year period. The percentage generally varies between 4% and 6% of the fair market value of the trust assets.

### *Other possibilities include:*

- Income or unitrust amount, plus distributions of principal based on a standard.
- Income or unitrust amount, plus incentive distributions of principal. Incentive distributions are distributions that are tied to specific behavior of the beneficiaries. For example, a distribution could be made to a beneficiary on the beneficiary's graduation from high school or college. The distribution could be made to a beneficiary equal to the amount the beneficiary earns each year up to a certain amount. A beneficiary could be denied a distribution if the beneficiary is using drugs or abusing alcohol. If incentives are used, it is important either to specify precisely how performance is to be measured or else to give the trustee complete and absolute discretion to determine if a condition has been satisfied.
- Income or unitrust amount only. Such a provision provides the trustee with the least amount of flexibility with regard to distributions, and, if income is the only item that can be distributed, with regard to investments.
- Incentive provisions, plus discretionary distributions. Such a combination of provisions may create conflict between the trustee and beneficiaries, and the existence of the discretionary power may weaken the effect of the incentive provisions in the beneficiaries' minds.
- Incentive provisions with no discretionary distributions. Like the income or unitrust amount only, this provision also severely restricts any discretion the trustee has to adapt to changed circumstances.

### *Number of current (as opposed to remainder) beneficiaries*

- Only one beneficiary at any time
- One beneficiary in the oldest generation, and descendants of that beneficiary
- Multiple beneficiaries in same generation, but no other beneficiaries
- Multiple beneficiaries in same generation and descendants of the multiple beneficiaries

### *When effective*

An irrevocable living trust could be created during the trustor's lifetime for the benefit of one or more beneficiaries, none of whom is the grantor. A trust created during the grantor's lifetime could become effective at his or her death. The trust provisions could be in a will or could be pursuant to a revocable living (inter vivos) trust that becomes irrevocable at death.

### *Funding*

*During lifetime.* Funding during lifetime applies only to a living trust. Lifetime funding is appropriate when the trust is not designed to benefit the grantor of the trust (usually an irrevocable trust) or when the grantor of a revocable trust desires to use the trust to avoid probate or to provide for the grantor's incapacity. The grantor's attorney-in-fact under a durable power of attorney may transfer the grantor's financial assets to a living trust if the grantor becomes incapacitated.

*At death.* A testamentary trust or a revocable unfunded trust would normally be funded after the death of the testator or grantor. Probate assets (assets owned directly by the grantor at death and not passing by beneficiary designation) would pass to the trust under the grantor's will and non-probate assets (such as life insurance proceeds and retirement plan benefits) would pass to the trust pursuant to beneficiary designations.

### *Revocability*

A *revocable trust* is generally used for probate avoidance and tax planning purposes. An *irrevocable trust* (all living trusts become irrevocable at the grantor's death) is generally used when the grantor wishes to transfer assets during lifetime so as to exclude them from his or her federal gross estate for estate tax purposes and also to take advantage of the gift tax annual exclusion, the GST tax annual exclusion, the applicable exclusion amount (exemption) for estate tax purposes, and the GST exemption. In a testamentary trust, the trust provisions are contained in the testator's will. The terms of a *testamentary trust,* like the revocable living trust, can be changed at any time before the grantor's death.

## REASONS FOR USING TRUSTS

*Qualify for the marital deduction.* The following trusts could be used to qualify for the marital deduction:

*An estate trust* qualifies for the marital deduction because the assets remaining at the surviving spouse's death pass to his or her estate. However, the surviving spouse may be restricted with regard to his or her access to income or principal during his or her lifetime. Of course, the surviving spouse will have the power to determine where the remaining assets in the trust will go through his or her will.

*A qualified terminable interest property trust (QTIP trust)* provides for the payment of trust income at least annually to the surviving spouse and that no distributions can be made during the lifetime of the surviving spouse to anyone other than the surviving spouse; at the death of the surviving spouse the remaining assets will pass as directed by the first spouse to die. Such a trust accomplishes the objectives of the first spouse to die to provide for the surviving spouse, to defer the payment of estate tax by qualifying for the marital deduction, and to control the disposition of any remaining assets at the death of the surviving spouse.

*A life income/general power of appointment trust* provides that the income will be payable at least annually to the surviving spouse and gives the surviving spouse either a lifetime or a testamentary general power of appointment (or both) over the assets. Because this type of marital deduction trust permits the surviving spouse to determine where the assets in the trust will go either during lifetime or at death, it does not accomplish the objective of the first spouse to die to control the disposition of the assets remaining at the death of the surviving spouse.

*A charitable remainder trust with the surviving spouse as the beneficiary of the annuity or unitrust payment* provides for the surviving spouse during his or her lifetime and qualifies the surviving spouse's interest for the marital deduction and the remainder interest for the charitable deduction at the death of the first spouse to die.

*Take advantage of the applicable exclusion amount through the use of a credit shelter or bypass trust.* In this case, the beneficiaries of the trust would depend on the client's wishes. For example, the spouse may be the only current beneficiary where the client has no children of his or her own or has provided for his or her children and more remote descendants through other trusts or b outright bequests. Spouse and descendants of the decedent may be the current beneficiaries, in some cases designating the spouse as the primary beneficiary. Finally, only descendants of deceased spouse may be the only beneficiaries. This would be appropriate when the surviving spouse has other significant assets.

*Avoid GST tax.* Trusts can be used to avoid the GST tax to use the GST annual exclusion. Such trusts require that the only beneficiary of the trust be a skip person (such as a grandchild), and that, if the trust does not terminate while the skip person is alive, the assets be includable in the skip person's gross estate. An irrevocable lifetime trust could use the GST exemption during the grantor's lifetime. Instead, a testamentary trust could be designed to use the GST exemption at the death of the first spouse to die or at the death of the surviving spouse

*Hold assets during the minority of a beneficiary or until the beneficiary reaches a certain age.*

*Hold the assets during the lifetime of a beneficiary.* The trust could provide for spendthrift provisions, provide creditor protection during the beneficiary's lifetime as well as preventing the trust assets from becoming subject to spousal rights, provide for the beneficiary's care in the event of his or her disability, and provide for GST planning.

*Benefit multiple generations.* So-called dynasty trusts could provide transfer tax savings, preserve the family's wealth for multiple generations, provide for the needs of future generations, and provide professional management, including investment management.

## COMPENSATION OF TRUSTEES

The trust agreement should provide for the compensation of the trustee or trustees. Possible options include a fee schedule or reference to a fee schedule, usually appropriate for corporate trustees; a specified hourly rate, usually appropriate for an individual trustee who is a professional, such as a lawyer, accountant or investment advisor; or a reasonable fee, usually for an individual who is not engaged in a professional business. If a family member is being named as the trustee, perhaps no fee should be specified. The compensation provision should also include, when applicable, the allocation of fees for investment and administrative services handled by different trustees.

## TRUSTEE LIABILITY ISSUES

*Protection of trustees from liability.* The trust agreement could provide exculpatory provisions, which normally would not excuse the trustee from gross negligence or fraud or embezzlement. There could also be specific reimbursement/indemnity provisions to protect the trustee from expenses incurred on behalf of the trust.

*Liability of Trustees.* Note that trustees can be found liable to the trust for negligence, gross or willful negligence, fraud or embezzlement, violation of his or her contractual duties under the trust agreement or state law, or torts. In connection with the trustee's violation of his or her duties or other damages to the trust assets, surety may provide protection for the beneficiaries.

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