A Trust Is Not Enough!

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Edwin P. Morrow and Edwin P. Morrow III explore the protection and flexibility added to an irrevocable trust through the use of a trust protector.

For many estate planning problems, the establishment of one or more trust agreements is the solution. Traditional wisdom has always held that trusts can provide effective management, probate and administrative cost reductions, family privacy, tax-efficient charitable giving and significant estate tax reduction. And they can do that. But traditional trust agreements, as drafted and empowered by most practitioners, lack the features necessary to continue the advice and support that caused their development. This article will focus on solving problems with irrevocable trusts.

The Problem

Most trust agreements spend great length enumerating the powers and privileges of the trustee to carry out the wishes of the grantor and support the interests of the beneficiary. But those instruments are frequently lacking any ability to enforce the effective administration by the trustee. When a trustee fails to perform, or simply underperforms, there is often no practical remedy.

Many trust agreements are produced by careful negotiation of the terms between the attorney and the grantor. Attorneys should be educating and advising the grantor regarding the possibilities and the power of the trust. Lengthy discussions help clarify the intent of the grantor as to distributions to future generations, continuation of business interests and relationships to institutions. But, when a death occurs, the counsel of the original attorney is often discarded for the social acquaintance of one of the beneficiaries.

Estate planning is often initiated by financial advisors or life insurance agents as part of addressing the comprehensive needs of their clients. These advisors and agents may point out

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to clients the tax implications of their present arrangements and emphasize the need for legal instruments, like trusts, to solve these problems. This helps to motivate the client concerning his financial and estate plan. Generally, one of the steps in this process is to assign existing or new life insurance policies to these trusts. But when the insurance matures, by virtue of the inevitable death, the proceeds are turned over to another financial institution for investment, along with the other assets of the estate. Not only is the financial advisor out of the loop, but the input of the beneficiaries is restricted as well.

This may not be the intent of the grantor if he knew he had a choice. These problems have been with us for centuries, and the solutions have always been at hand. In America, however, certain solutions have not been frequently used. Traditional documents have been reused without extensive edits, and professional advisors have not recognized how easily certain trust shortcomings can be addressed.

Many readers of this article have been aware of situations where a professional trustee delivers poor service. It might be a matter of sloppy administration, lack of privacy, poor investment performance or uncaring relationships with the beneficiaries. It is very difficult to fire a trustee, and a lawsuit to compel removal can be difficult, time-consuming and extremely expensive. Not only does it require a large retainer to a law firm, but in the meantime, the trustee is typically paying its legal bills from the trust. Beneficiaries frequently do not recognize for years that they have received poor service. Many law firms will not represent a beneficiary who wishes to sue a local bank trust department with whom they have other dealings. In fact, the firm may have conflicts of interest that prohibit this representation.

Many families have balked at using professional trustees in favor of family members in the thought that using family members will save money and give the family more control. This, however, may sometimes be just as great a disaster as an incompetent professional trustee, and sometimes worse. Nonprofessional trustees have no concept of the duties of a fiduciary, and can easily make mistakes that cost the family money or otherwise cause continuing strife within the family. This is especially the case with the many mixed, second (or third or fourth) marriage situations with multiple children and families all named together in a comprehensive estate plan. Any advisor can think of several clients who should definitely have independent professional trustees or executors.

Furthermore, the use of a family member as both trustee and beneficiary may erode important asset protection benefits and the flexibility of having an outside trustee. There is not much debtor-creditor or trust law on this issue, but most asset protection experts will tell you that naming an independent trustee is always better than naming a family member as trustee. In addition, the independent trustee can have the discretion to go beyond "health, education, maintenance and support," the ascertainable standard used to limit distribution in many such trusts. Such limitations are required to keep the assets of the trust out of the trustee/beneficiary's estate, but are not required when an independent trustee is used.

The Trust Protector

There is a very simple solution for this dilemma, and one that can correct other trust deficiencies as well: the appointment of a trust protector. *See* Figure 1. Trust protectors have been commonly appointed in England for centuries. The purpose was to assure that the intent and interests of the grantor would be carried out. The solution is quite simple and involves only a few steps:

- designation of a trust protector in the trust agreement;
- creation of trust protector successor provisions;
- description of the trust protector responsibilities; and
- delineation of trust protector limitations.

The concept of trust protector is not mentioned in many estate planning texts, although the use has been common for many centuries. A protector has been commonly employed in Great Britain and in foreign asset protection trusts. A trust protector is a person (individual, committee or organization) vested with powers to modify a trust that the grantor is unable or unwilling to retain personally. This generally includes the ability to perform one or more of the following, which are listed in ascending order of complexity:

- change the trustee;
- change the trust financial advisor;
- demand an accounting or the posting of bond for non-corporate fiduciaries;

- move the situs of the trust;
- amend the trust;
- change beneficiaries; and
- revoke or terminate the trust or even cause the funds to revert to the grantor.

The trust protector is generally someone with one or more of these special powers over the trust, but with no day-to-day fiduciary responsibilities. The role of the protector is similar to that of a board of directors, overseeing the management of the trust. It is the hope of the grantor that the protector will *never* have to exercise these responsibilities. All of the above powers would not generally be recommended to most clients, but may have a place in certain estate plans. However, the circumstances that might stimulate the need for such a provision could be quite critical.

Change the Trustee

The designation of a trust protector provides a very strong incentive for the trustee to perform effectively. The trust protector can simply designate a new trustee if the trustee is inadequate. This is immeasurably cheaper and more effective than trying to remove a trustee without such a provision. Even the grantor of an irrevocable trust can have a limited power to change the trustee (generally, limited to appointment of nonrelated, nonsubordinate parties). However, in order to preserve objectivity, the trust protector usually cannot appoint himself or an organization or institution with which he has a relationship or interest (or the grantor or insured party for insurance trusts).

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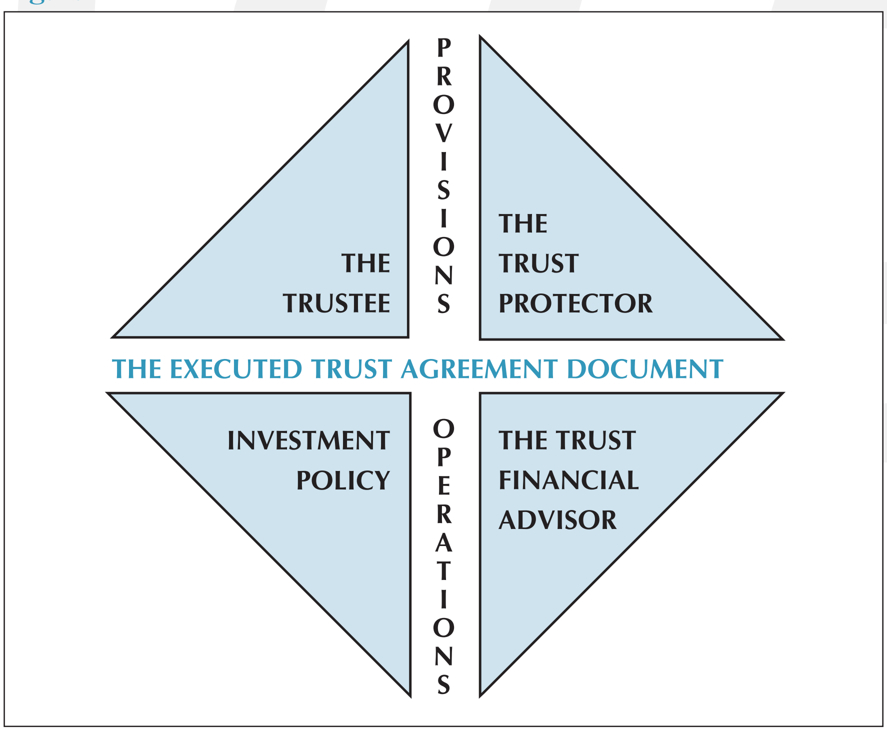
Move the Situs of the Trust

For state tax or creditor protection reasons, it may be desirable to move the situs of the trust to another state, or even to a foreign jurisdiction. This makes it far more difficult to attach trust assets and may save substantial taxes. But the trustee named initially in the trust agreement is frequently not empowered to do so, and it may be even considered in contempt of a local court when doing so.

For example, a beneficiary may be sued for some business-related activity. Trust income and even assets could be frozen and attached. But if the trust were moved to a more debtor-friendly state or even an offshore situs, this attachment would be far more difficult. This article will principally discuss non-self-settled trusts, but this reasoning may very well apply to so-called domestic asset protection trusts sited in Delaware, Alaska, Nevada or any state that allows self-settled spendthrift trusts to be effective. Otherwise, a grantor may not avoid legitimate creditors by transferring assets to thwart known or anticipated creditors under the Uniform Fraudulent Conveyance Act passed under various versions in all 50 states.

First, a plaintiff would have to win the initial suit and all appeals, and receive a judgment. Although a U.S. state must honor a valid judgment of another state under the Full Faith and Credit Clause of the Constitution, it may apply its own law as to the ability of the judgment to attach a

Figure 1



beneficiary's interest under a spendthrift trust within its jurisdiction. If the trust is moved offshore, the burden is higher. Many jurisdictions may not accept a U.S. judgment, and will require that an entirely new action be brought in their country, and their asset protection legislation might shield the trust contents. Foreign attorneys generally will not undertake these cases on a contingency.

The irrevocability pertains to the ability of the settlor to make changes, not in the ability of a third party to make changes.

The ability to move the trust situs to another state or outside of the country is even more important in an era when major tax law changes occur on an annual basis (or more often). If Tyco, Stanley Tools and every major insurance company can go offshore, why not the family trust? The topic of foreign trust taxation is much too complicated for this article to tackle, and it is not normally recommended that a typical U.S. citizen set up a foreign trust either while alive or at death. That said, every trust should have the *ability* to do so, if tax and asset protection laws later warrant the shift.

More common is the issue of state income taxation. Nearly every state in the country is in major budget deficit and crisis at the moment. A case in point is Ohio. Prior to 2002, Ohio did not impose an income tax on non-grantor trusts. However, to resolve the current budget crisis, Ohio decided to impose a "temporary" tax on such trust income. How much money will Ohio trust beneficiaries lose to Ohio income taxation over the next few years? Estimates are $119 million every year. Why wouldn't you want a trust to be eligible to move to Delaware, Alaska or some other state without income taxation? Advisors typically focus on federal income taxation because it is a larger percentage, but state income taxation can be just as important to the ultimate bottom line.

Especially for larger trusts, the ability to move to another state (or even country) is a must. Realize that state income tax savings may more than pay for hiring an outside professional trustee that will charge at most one percent of trust assets (and such fees may at least be an above-the-line deduction).

There are also circumstances where all the family members are located in another part of the country or world, and the beneficiaries would appreciate the convenience of a local trustee.

Change the Trust Financial Advisor

It is becoming more common to name a separate party other than the trustee as the trust financial advisor, effectively bifurcating the traditional notion of trust management into two duties managing distributions and accounting, and managing the investments. Many states, such as Ohio or Delaware, have specific statutes sanctioning the authority of a trust to use a separate financial professional to direct trust investments. Most states have passed some form of the Uniform Prudent Investor Act that permits delegation of investment authority to a separate financial advisor. The investment needs of the beneficiaries may shift over time. There is a need for the person empowered with this responsibility to be accountable just as the trustee should be. The investments and insurance must match the current needs of the beneficiaries. By having the ability to replace the trust financial advisor, the protector can assure good investment performance, or take quick corrective action.

Likewise, in order to preserve objectivity, the protector can be prevented from appointing a new trust financial advisor with whom he has a beneficial interest or relationship.

Amend the Trust

Subsequent changes in legislation, regulations and court decisions may create the need to modify the administrative provisions of the trust. However, if the trust was, or has become, irrevocable, it is extremely difficult (if not impossible) to make necessary amendments. People have the misconception that the requirement that when a trust is "irrevocable" it means that a trust can never be changed. This is largely incorrect. The irrevocability pertains to the ability of the settlor to make changes, not in the ability of a third party to make changes.

A charitable trust, for instance, may have a clause that permits the amendment of a trust to comply with Internal Revenue Code sections pertaining to split-interest trusts. Such a clause may permit a limited amendment, and of course, such an amendment would not be permitted to benefit the settlor, since it would jeopardize the charitable deduction. The trust protector, not being a grantor or beneficiary of the trust, can make such changes to carry out the original intent of the grantor, without changing the irrevocable nature of the trust, and without requiring a costly court proceeding.

In some ways, the trust protector may essentially, depending on the breadth of the trust provision, have the equivalent of a limited power of appointment over the trust assets. This concept is very old and accepted under tax law, and there is case law and statutes to interpret general and limited powers of appointment. Most powers of appointment that we encounter are testamentary powers of appointment. For instance, you may leave your assets in a bypass trust to your spouse, giving her a limited power to appoint any remaining assets at her death to a class of beneficiaries (such as descendants of the settlor). However, such a power need not be testamentary.

For instance, you may leave assets in trust for a spouse, but give your brother the power, as the trust protector, to appoint assets to your spouse. Under common wisdom, we are taught this would be foolhardy. Why do this? Because the wife may not be subject to estate taxes and the loss of step-up in basis may be hundreds of thousands of dollars! For example, a husband leav es $1.5 million in a bypass trust to wife in 2004. Years go by and the wife spends down her own assets, leaving the bypass trust assets to appreciate to $3 million, with a basis of $1.5 million. In the meantime, the estate tax "unified credit" (if it becomes reunified) settles at $3 million. The bypass trust will not get a step-up in basis at the wife's death, and if kids sell the property at mom's death, the capital gains taxes would likely exceed $300,000. However, brother could appoint some of the highly appreciated assets in the bypass trust to wife (assuming her total assets do not exceed the exemption amount) so that the assets are in her estate and children could receive a step-up in basis at the wife's death. Bingo—kids save $300,000. This is not so outlandish a scenario with the estate taxes in flux and exemptions increasing.

Change Beneficiaries

The protector may be given the ability to add beneficiaries, or remove them, to reflect the interests of the grantor. This is a more complicated proposition of course, and would only rarely be recommended. After all, who is to say what the settlor's intent is after death? However, with a more limited scope, such a provision may have some use. This might work in tandem with some expression of the grantor, such as incentive provisions to prevent beneficiaries from becoming trust fund addicts. It may also be used to trigger an uneven distribution among different beneficiaries, based on needs.

For instance, say one child has become disabled and has to receive disability and nursing home care. Being a beneficiary under a discretionary or support style trust simply disqualifies the beneficiary from receiving government benefits under SSI or Medicaid. In such a circumstance, it may be more appropriate to put aside some funds into a special needs trust for the child. Or perhaps on the flip side, government benefits do not apply and more funds are needed for that child for a special operation not covered by insurance. If allowed under a trust protector provision, the trust may change to cover this situation, much as if the trust had been started as a "pot" style trust, but with even greater flexibility.

Or, a trust protector may have the limited ability to add spouses or descendants of a child as beneficiaries. This may be beneficial in some instances. Say the child has creditor problems or other reasons not to be named as beneficiary. The trust protector may have the power to add the spouse as beneficiary to receive the income instead. Or, perhaps the child does not need the money and the trust originally provided funds to the child for life, with no provisions for grandchildren until the death of the child. Here, the trust protector may be able to add the grandchildren as immediate beneficiaries without the need for an unqualified disclaimer or taxable gift from the child.

Revoke or Terminate the Trust

Certainly, this could be critical in many circumstances, as in the situations discussed above. It may even be possible to give a trust protector the power to appoint assets back to the grantor if the grantor suffered some major reversal and needed the funds. Having such a fail-safe provision might encourage a grantor to more fully fund his or her trusts, knowing that there are protections in the event of unforeseen personal financial circumstances.

This is a more aggressive use of a trust protector provision, and would not be recommended unless a client insisted on including it. Realize there is a chance that the IRS or court could argue that the trust protector is at that point merely an agent of the grantor or that it is essentially a self-settled trust, because all of the funds could revert back to the grantor. But then, so could any gift, and that generally doesn't jeopardize tax or asset protection treatment. This technique, of course, would be easier to justify in a state with clear self-settled asset protection legislation.

Who Should Be the Trust Protector?

The trust protector could only be a beneficiary under a more limited provision or limited use, such as the limited ability to fire the trustee. With an expanded trust protector provision, naming a beneficiary as a trust protector over his own share of the trust would jeopardize the tax advantages and asset protection of the trust. A power to amend could be considered a general power of appointment, and any power of appointment might be considered a gift to that beneficiary. The power to amend his own share of the trust would place the assets in his estate and essentially confer self-settled trust status for purposes of state spendthrift law. Thus, a beneficiary should only have limited powers of appointment under such provisions. It is critical that there be a continuity provision to establish a successor trust protector, since many trusts are now being established with "dynasty" provisions. While a family member could serve, that person may have no logical successor, and may lack the business acumen to verify if the trustee and trust financial advisor are performing effectively.

The protector should not be the investment advisor, insurance agent or financial planner, since that person (or firm) is generally named as trust financial advisor.

The best solution is probably the grantor's attorney or tax advisor. They might be named as an individual or firm, and successorship may be therefore provided. It may also be a trusted friend or relative who is not a beneficiary.

What type of fee is paid to a trust protector? This would depend entirely on the nature of the trust, the amount of funds involved and whether there has been any concern expressed by a beneficiary. If the trustee and trust financial advisor provide periodic accounting and copies of correspondence, this may involve only an hour or so yearly, unless there is a matter to be investigated and acted on. In many cases, a trust protector may not even monitor a trust until requested to do so by beneficiaries. After all, the trust protector is not like a fiduciary with ongoing responsibilities to monitor the trust. In case a matter needs looking into, normal professional billing rates would apply.

Continuity of Service

When affluent families initiate long-term estate planning, which advisor is generally responsible for prompting the action?

- The family attorney?
- The accountant or tax preparer?
- The commercial banker?
- A trust officer?
- A securities stockbroker?
- A general insurance agent?

In practice, the financial advisor or life insurance agent triggers most estate planning. This is not meant to diminish the role served by other advisors, but to recognize the instigator who gets the ball rolling. And this is logical.

Which financial asset generates substantial amounts of cash—just when cash is needed for the estate plan?

- Residential properties?
- Commercial real estate?
- Privately held companies?
- Professional practices?
- Stock options?
- Life insurance?

The answer, of course, is life insurance—the most liquid of financial instruments. But when the estate plan finally comes to fruition, and there is a lot of money to manage, who normally gets control of it and who gets paid the most? Frequently, this is the corporate trustee, who is now aggressively selling life insurance, annuities and investments! Who will provide legal counsel to the beneficiaries of the trust? The trustee bank's favorite white glove law firm and the heirs' new attorney who will now involve his or her circle of favorite associates!

This may not have been the intent of the grantor, or of the initial team of advisors that have helped with the estate plan. How did this happen?

- Estate plans require trusts and trusts require trustee.
- Attorneys and accountants generally won't serve as trustee.

- Family members generally can't or shouldn't serve.
- Trusts offer management services for the family.

How can the grantor of a trust assure that the matters will receive the same careful attention and service he or she has been receiving? How can an agent/advisor be protected against this probable replacement by a corporate trustee, and preserve the long-term relationship with this estate? One solution is to name within the trust agreement a person to serve as the trust financial advisor. This may be complemented with the naming of an *independent* corporate trustee or a bank trust department that is willing to take the administrative responsibility while leaving the responsibility and compensation for the investments and insurance to another qualified party. Such a trustee generally serves for less compensation than a trustee with full investment responsibility.

The Trust Financial Advisor

Let's examine the advantages of having a trust financial advisor named in the trust agreement (subject to removal by the trust protector, as previously recommended). What are the responsibilities of the trust financial advisor?

- Write and service trust-owned life insurance and investments.
- Develop an investment policy statement.
- Give investment guidance for the trust investments.
- Communicate investment and insurance information to the trustee.
- Provide guidance to family beneficiaries.
- Communicate with family members with regard to trust operation and the investment policy statement.
- Communicate with other family advisors (attorney, accountant, *etc.*).
- Monitor insurance needs of the family and the trust's ability to respond.

It is important that the trust financial advisor be able to assign or transfer this relationship to a successor. This provides continuity of service, and will help create significant value to the professional advisor. Of course, the trust protector could remove this successor, so there is really no danger here to the beneficiaries of the trust.

The financial advisor might provide a portfolio management service working closely with the trustee/custodian, use a wrap program or manage a portfolio of mutual funds to meet the objectives of the trust. In some cases, it may be preferable to sell the investments on a commission basis to the trustee. Insurance is normally provided on a commissionable basis, but the quality of fee-based insurance products is increasing, and that may offer a more effective solution.

When investment services are provided (other than just for variable life or annuities), the trust financial advisor will be acting as a registered investment advisor or as an affiliate of an RIA, such as a broker/dealer.

A critical responsibility for the trust financial advisor is the annual preparation and communication of the trust's investment policy statement. This clearly applies whenever the trust contains any asset other than perhaps a term life policy. This does not need to be a lengthy document. In fact, it may even be produced on a single page. The investment policy must match the original intent of the grantor, and the needs of the current beneficiaries. It must be communicated in writing to the trustee and the family (initially to the grantor, later to the beneficiaries).

Trustee Selection

Obviously, the trustee must accept the terms of the trust agreement and be willing and capable of serving. This includes the acceptance of a trust protector provision and the appointment of a trust financial advisor. Some traditional bank trust departments are prepared to do this, others are not. Some may charge even higher fees. However, there is really no reason why a trust department could not serve with these provisions

One issue is the location of the trustee, and the jurisdiction that would apply for the operation and taxation of the trust. Some states, such as Delaware, have extremely favorable legislation. In fact, Delaware is the only jurisdiction with specific statutory authority to pay trust advisor fees (other states allow it, but do not have a specific statute). Delaware also has very favorable asset protection and dynasty trust provisions.

If a grantor or a family member is to serve as the initial trustee, then it is important to name a corporate trustee as successor.

Checks and Balances

An important purpose of most trusts is to manage funds for the beneficiaries, in accordance with the intention of the grantor, over a long period of time. No one knows the exact future. We don't even know what next year's tax schedules will be. What laws will see the sunrise, and which the sunset. That is why there is a need for better trust documentation that includes the protection and service elements described. The watchword for estate planning in the 21st century is flexibility.