Nontax Fundamentals in Trust Planning

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Abstract: We look at the selection of a trustee, a trustee's exercise of discretion, and designation of a successor trustee for maximum flexibility. Whether large or small, relatively complex or relatively simple, a trust arrangement that has a sound selection process, clear standards for distribution decisions, and procedures to ensure its continuation can work very well for its beneficiaries.

As we look ahead in this presidential election year, we can only speculate about what might be in store for us at its end. Left untouched by Congress, the federal estate tax applicable exclusion amount will revert to $1 million. Congress has to do something about that, right? If we learned anything as Congress addressed tax legislation at the end of 2010 and shadowboxed about the federal deficit in 2011, it's that Congress doesn't necessarily *have to do anything.* No tax issue is so pressing that it can't be deferred until a more convenient time. So, certainty in tax planning is held hostage to the notions of those newly elected who confuse the need for compromise with lack of conviction. Politics, it is said, is the art of the possible. Right now, it looks very possible that it will be awhile before there is a more permanent estate tax system that we may count on as we advise clients. So, pending further action or inaction in Washington, let's consider trust planning issues that will be with us no matter how the estate and gift tax law evolves.

Very often, this column covers estate and gift tax planning issues and techniques designed to reduce those taxes. This month, I will discuss other topics pertaining to estate planning with an emphasis on selection of a trustee, a trustee's exercise of discretion, and designation of a successor trustee for maximum flexibility.

Financial Planner's Viewpoint regarding Trustee Selection

Experience has taught us that the identity of the trustee may be as important as the terms of the trust in the successful management of trust assets. Success, in this case, should be measured by the ability of the trustee to carry out the instructions of the grantor for the best interest of the beneficiaries. An easy thought to express, but the proof is always in the pudding.

Let's consider the role of an independent financial planner in the trust management process. By "independent" I mean one who is not employed by a corporate trust company or otherwise beholden to an institution offering trust services. If the financial planner is investing funds for a client and has any say in the selection of a trustee to continue the management of funds after a client's death, the financial planner is not about to recommend a corporate trustee. The planner, who might otherwise maintain an investment relationship with the client's family following death, may be displaced by the corporate trustee if the estate planning process isn't well coordinated. Under state law and local practices, it is possible that the corporate trustee will provide only administrative services. In that case, the planner should be able to retain the role of an investment advisor to the trustee. The trust can be managed effectively with the right mix of professional coordination and personal touch, with a little luck. However, when that mix is not possible, the client who wants the planner to continue as an investment advisor might designate a family member or a friend to serve as trustee. Sometimes that works out just fine, either by design or because ignorance can be bliss, and at other times, it doesn't work well at all.

The friend or family member may be wholly unequipped to be a trustee. To be an effective trustee, one needs to have an educated grasp of the language in the trust document describing the grantor's intent, the backdrop of trust law that undergirds its operation, and an objective view that balances the needs of both today's and tomorrow's beneficiaries. In addition, if the trustee does not directly invest funds for the beneficiaries because the planner fulfills that role, the trustee nonetheless is responsible for managing and monitoring the investment manager's performance. For all of that, when left to his/her own devices, a client may select an individual as trustee who may be only vaguely prepared to undertake the role. If a testamentary trust is involved, the client may not really be engaged by a decision that won't be implemented until after his/her death.

Sometimes an effective trustee selection process may involve naming a corporate trustee and an individual trustee to serve as cotrustees. Ideally, the corporate trustee brings professional knowledge and skills, including investment responsibility, to the role. The individual trustee may have a role that is more limited or more expansive. In the more limited situation, the individual trustee would have a say in exercising discretion to make a distribution of income or principal to a beneficiary. The individual and the corporate fiduciaries may have equal voices and votes in exercising discretion as to distribution decisions. Otherwise, investment decisions, preparation of income tax returns, and following the requirements of state law with regard to notifying beneficiaries, etc., may be managed by the corporate trustee.

A more expansive role for an individual trustee may grant the power of final decision regarding distributions of income or principal to the individual, rather than the corporate fiduciary. In such case, the corporate trustee may require that the beneficiaries and individual trustee release the corporate trustee from liability with regard to the exercise of the individual's discretion regarding decisions to distribute, or to refrain from distributing, income and principal to trust beneficiaries. Another grant of more expansive authority may be made when the trust authorizes the individual trustee to have the right to remove and replace the corporate trustee. A further step in that direction could also grant the individual trustee the discretion to decide whether to serve alone or to designate a successor corporate trustee immediately or at a time of the individual's choosing in the future.

Trustees' Exercise of Discretion

One of the most difficult parts of being a trustee is to strike the right balance in making decisions to distribute income and principal to beneficiaries. A marital trust must necessarily distribute all of its income in order to qualify for the federal estate or gift tax marital deduction. As a matter of design, it may be preferable for a nonmarital trust to pay all income to a surviving spouse, rather than to have income paid at the trustee's discretion. However, if the spouse does not need the income and it would only increase the spouse's taxable estate later, it might be better to have income paid on a discretionary, rather than a mandatory, basis. Trusts designed to provide for children after both parents' deaths, whether the beneficiaries are minors or young adults, may also have income paid on a discretionary basis according to the terms of an ascertainable standard, i.e. for health, education, maintenance and support.

A requirement that trust income be paid may be no more meaningful to the beneficiary than that which the investment environment makes possible. Payments of income in the low-rate environment produce much less income than had been the case many years ago. Of course, swings in income yields and varying rates of principal growth or loss in equity markets led to the unitrust approach that became more prevalent when uniform trust acts became widely adopted several years ago.

When trustees and beneficiaries are in sync, distribution decisions are painless and the governing terms of the trust instrument are seamlessly digested into the operation of the trust. However, many trusts have beneficiaries whose needs may vary, or may be regular and predictable until one day when they aren't, for whatever personal situation may develop. Certainly, precatory language ("I hope that my trustees will supplement my beneficiary's income") may provide guidelines for all to see. It might be worthwhile for the trust grantor to give a private note to the trustee that will describe particular wishes, specific courses of action, or personal values that the trustee should keep in mind as the trust is administered in the near future, and in the far future when the trustee may no longer be around and unforeseen circumstances may have arisen. Sometimes, a grantor would like to specify dollar amounts to be distributed at certain intervals or certain durations. That may be useful in a note as a reminder to the trustee, but better left unavailable to the beneficiary. Understanding the grantor's intentions is a key element of the trustee's role, but specific numbers that operate as good examples today but not tomorrow may only create mischief if included in the trust terms that become gospel to the beneficiaries.

Trustee Removal and Succession

Suppose we've selected effective trustees and drafted a trust with clear guidelines. Are we all set? That is, can the trust function well in the future and be self-adjusting, particularly when it may last for a succession of beneficiaries over many years? As with many entities that may exist for a long time, a plan of succession that addresses probable contingencies is advisable. Covering the various aspects of trustee removal and replacement is a bigger topic than we can explore today, but a few examples of typical provisions may be helpful. First, when a third party serves as trustee, a spouse-beneficiary may have the right to remove and replace the trustee. If estate tax exclusion is important, the spouse's right to replace should prevent the spouse's appointment of a trustee who is related or subordinate to the grantor. Broadly speaking, the need to replace the trustee may be created by the perceived poor performance of the trustee or friction between the trustees and the beneficiaries of the trust. A third party, often called a trust protector, may have the right on behalf of the beneficiaries to remove and replace the trustee. If the grantor's children are beneficiaries, each of them may have the right to remove and replace the trustee, provided that they have attained a specific age, such as 25 years old. In that case, it may be prudent to require that a corporate trustee be the successor to avoid permitting a beneficiary to name a too-friendly trustee such as a personal friend, who might then dismantle the arrangement.

Another key point is to provide that the designated individual trustee, and its successor, while serving as trustee, may have the right to name a successor. As a fallback, given that an individual trustee may die, become disabled, or resign, the person named to designate a successor trustee should also be granted the right to name a corporate trustee, which may serve with an individual or may act alone in its own right.

Of course, many trusts are specialized vehicles that exist to serve a particular purpose. Those trusts have their own requirements that must be independently satisfied. Whether large or small, relatively complex or relatively simple, a trust arrangement that has a sound selection process, clear standards for distribution decisions, and procedures to ensure its continuation can work very well for its beneficiaries. ■

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