How a Corporate Trustee Can Help a Financial Planner Meet Their Client's Goals

Thomas M. Forrest, CPA, AEP
Charles Schwab & Co., Inc.

234 Weldin Ridge Road
Wilmington, DE 19803
(302) 764-1050
thomas.forrest@schwab.com

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Trusts are established for a variety of reasons. Whether a trust is created for tax reasons, reducing probate costs, consolidating assets for control purposes or for professional asset management reasons, the trustor (creator of the trust) will have to name someone to serve as the trustee. Trustees can either be individuals or corporations who will assume legal ownership of the property funding the trust. The duties and responsibilities of a trustee begin at the time the trust is created for *inter vivos* trusts, whereas a testamentary trustee will not assume responsibility until the testator's death, and the trustee is generally appointed by the court having jurisdiction. The following describes the role of a trustee and the process for selecting a trustee and also explains how a corporate trustee could add value and should be considered as a trustee.

Trustee Duties and Responsibilities

The trustee is responsible for identifying all trust property and maintaining, protecting, and controlling such property completely separate from their own property. In addition, fiduciary duties include:

- To dutifully and loyally administer the trust property according to the trust instrument.
- To act impartially regarding the application or payment of trust property. Must be able to fairly represent both income and remainder beneficiaries according to the terms of the trust instrument.
- To invest and reinvest the trust property according to the trust instrument.
- To exercise any discretionary powers granted by the trust instrument over both income and principal.
- To make distributions to beneficiaries in accordance with the trust instrument.
- To maintain clear and accurate financial records and report such information to trust beneficiaries by providing periodic statements.
- To prepare and file fiduciary income tax returns.
- To follow up on any claims that may be due the trust and to defend the trust against any actions brought by third parties.
- To distribute principal of the trust to the proper persons or entities upon termination of the trust term.
- To follow other rules that may pertain under applicable state law.

The above list is not meant to be inclusive. Specific language in a document can determine the nature and extent of the duties and powers of a trustee. Without such language, state trust law will apply. It is important for a trustee to read and understand the terms of the trust, including all amendments and addenda to any original trust agreement. The trust instrument can determine state tax filing requirements, termination date, trustee powers, and distribution requirements, to name a few key provisions.

Selecting a Trustee

There are many factors to consider when selecting a trustee. Understanding the duties and responsibilities of a trustee can make the selection much easier. The size of a client's estate will also impact the trustee selection decision. For example, it may not be cost effective to use a corporate trustee for a $500,000 trust, but a $10 million trust may best be suited for a corporate trustee depending on the complexity and asset composition.
The following factors should be considered when selecting a trustee:

1. *Expertise of the Trustee*
   Trustees must know what roles and responsibilities they are undertaking and fully understand the terms of the trust instrument, so experience is very important for selecting a trustee. The following questions should be asked while searching for a trustee.
   - Does the trustee have prior experience or is he or she a professional trustee?
   - Will the trustee understand all legal issues that may arise during the term of the trust and have fiduciary accounting and taxation knowledge?
   - Is the trustee able to select the proper investments or have the experience to select an appropriate investment manager for the trust?
   - Does he or she have experience in trust administration and understand the terms of the trust?

   Experienced trustees play a crucial role for mitigating risks during the life of a trust.

2. *Independence*
   Independence is crucial for large multi-generational family trusts! Will the trustee act in the best interest of all parties, make sound decisions, and be impartial to all beneficiaries? Family members serving as trustee often find these issues challenging and can damage family relations if the decisions are not agreed upon by all family members.

3. *Availability and Service*
   Continuity of existence for the term of the trust is important in selecting a trustee so a successor or back-up should be determined in advance. Is the trustee willing to serve as trustee and is he or she committed to timely responses and available on a daily basis? Does the trustee have a back-up in case of incapacitation or death? One thought to consider – a corporate trustee will not die and, in most instances, its successors, by merger or acquisition, will succeed to its obligations.

4. *Financial Security and Safeguarding Assets*
   Can an individual provide financial security and safeguarding of the trust assets? Does the trustee have the proper custodian in place for collecting dividends, interest, and other trust income and to record and report such information on a timely basis? Is the trustee regulated or audited, and does he or she have enough money or insurance for any errors or omissions caused by the trustee?

5. *Investment Capabilities and Fees*
   Does the trustee work with outside investment advisors or have the systems to analyze and generate performance reporting for the trust investments? Are the fees charged by the trustee reasonable, are they bundled or separate transaction fees?

All of the factors above are important at some time during the life of a trust. Many trustors name individual trustees who are family members or friends and who feel obligated to say yes as a favor when asked to be a trustee. Family trustees or friends are still exposed to claims from beneficiaries, and many individual trustees are not likely to have any fiduciary malpractice or errors and omissions insurance.

How many individuals will have fiduciary expertise, provide impartiality to all decisions, provide excellent service to beneficiaries, safeguard the trust assets, and provide investment management experience? If an individual trustee does not meet all of these criteria, then do they have the means to obtain all of the above and at a competitive fee? If an individual does not have any experience, he or she will need to engage a custodian who has separate principal and income accounting, hire an investment manager to manage the trust assets, hire an accountant or fiduciary tax expert to prepare the fiduciary income tax returns, and hope all the costs are competitive if that individual also charges a fee. That individual trustee generally will still be responsible for the performance of the third party providers he or she selected.

There remains one more important factor for selecting a trustee. Where does the trustee reside? Is the trust governed by the laws of more than one state? The situs of a trust can be very important for a client to achieve his or her goals and objectives!

Trust Situs

The general process for selecting a trustee based on duties and responsibilities is fairly standard across the country. However, the trustee's state of residence can provide additional planning opportunities that otherwise may not be available. Many individuals have assumed that a trust is governed, administered, and taxed according to the laws of the state in which the trust was created. This may have been the case many years ago, but today, state laws can differ significantly. In selecting a trustee, a review of the various states' tax and trust law should be researched to determine if a client's goals and objectives will be met. For example, if a client's goal is to have the trust go on for an extended period of time (dynasty trust) and not pay any state income tax, then an individual residing in New York may not want to select a New York trustee for his or her family trust. New York will tax an irrevocable trust created by a New York resident if he or she is using a New York trustee for custody and administration. Many individuals are trying to achieve goals such as perpetual trusts, asset protection, and state income tax savings, which are not all available in their home states. The term "change trust situs" has become a common theme in the financial and estate planning world and has taken on several meanings. For example, a trust can be administered in one state, governed by the laws of another state, and subject to tax in multiple states.

Governing law of a trust can differ with respect to validity, construction, and administration. Generally, matters involving validity are determined by the law of the testator's domicile in the case of testamentary trusts. In the case of an *inter vivos* trust, generally the laws of the state where the settlor wished to apply will govern. Matters of validity include issues related to the rule against perpetuities, avoidance of creditors, and spousal rights. Matters of construction are generally determined by the laws of the state where the testator or settler wishes to apply. Matters of construction include issues relating to the identity of beneficiaries. Administration matters are generally determined by the law of the state in which the trust is administered. However, a careful analysis should be done to determine which state's law actually does govern administration. Matters of administration include fiduciary powers, compensation, and investment authority.

<u>State Law Differences:</u>

In addition to understanding the validity, construction, and administrative aspects of a trust, it is important to understand other benefits each state may have to offer. The clients' goals and objectives will probably dictate whether or not a change of trust jurisdiction is needed or not. The following factors will have an impact in selecting the governing law and trust situs for your clients.

1. *Rule against Perpetuities*
   Perpetual trusts, or dynasty trusts, are a very popular techniques used by planners and clients today. As of December 31, 2006, 24 states permit either perpetual trusts or trusts of significant duration (five states range from a low of 150 years to a high of 1,000 years).

2. *Avoidance of State Income Taxes*
   Avoiding state income tax is another key objective for planners to achieve for their clients. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose an income tax on trusts. Delaware does not impose an income tax on trusts if the income or capital gains are accumulated or distributed to non-resident beneficiaries.
   Many trusts are created in states which do not have an income tax on accumulated trust income or capital gains. States that do impose an income tax on trusts base their tax filing requirements on one or more of the following:
   1. The trust was created under the will of a testator residing in the state at his or her death.
   2. The *inter vivos* trust was created by a resident grantor, and he or she was a resident at the time the trust became irrevocable, or was a resident at the time the trust was funded.
   3. The trust is administered in the state.
   4. One or more trustees live or do business in the state.

5. One or more of the trust beneficiaries live in the state.

If one or more of the above applied in a particular state, then the trust would be classified as a resident trust for fiduciary income tax purposes. A trust could be classified as a resident trust for income tax purposes in more than one state. For example, a trustor residing in Pennsylvania creates an irrevocable trust for his children who live in Pennsylvania and California. The trustor names his brother, a California resident, co-trustee of his family trust. The trust could be classified as a resident trust in both Pennsylvania and California.

A thorough review is required to determine if changing the trust jurisdiction can avoid state income tax in a client's home state.

3. *Asset Protection*

   Alaska was the first state to permit domestic asset protection trusts (1997). Since then, domestic asset protection trusts are permitted in 10 states (as of June 2007). There are several differences in the rules applicable to these trusts depending on which state's law applies.

4. *Total Return Trusts and Power to Adjust*

   Many states have enacted total return trust or power-to-adjust statutes. These statutes help eliminate the investment conflicts a trustee may face with trying to meet the income demands of the income beneficiaries and the capital appreciation demands of the trust remaindermen. Trustees can now invest based on a total return approach and satisfy both classes of trust beneficiaries. These statutes are far from uniform and it is important to explore the differences. Delaware is perceived to have the most flexible and favorable total return trust statute[i]. Most states with total return trust legislation have the ability to convert a trust to a unitrust percentage between 3% and 5%.

5. *Investment Functions*

   As of December 31, 2006, 45 states have adopted the Uniform Prudent Investor Act. Investment performance appears to be one of the leading reasons for fiduciary litigation, so it is important to review state flexibility in dealing with investment issues when seeking to change a trust's jurisdiction.

6. *Investment Management - Delegation*

   Directed trusts are common today where a third party investment advisor manages the assets of the trust. It is important to review state statutes permitting segregation of duties. The Uniform Prudent Investor Act permits "delegation" of investment responsibility whereas states such as Delaware permit "bifurcation" of the investment management responsibility[ii]. States with bifurcation statutes may provide extra protection to the trustees since the investment management responsibility is provided by an outside investment advisor according to the terms of the trust instrument. Trustees who delegate investment management to an outside investment advisor may still be responsible since the trustee selected the investment manager.

7. *Allocation of Income and Principal Receipts and Expenses*
   All but eight states have adopted the Uniform Principal and Income Act (UPIA). Delaware, Georgia, Illinois, Minnesota, Mississippi, Rhode Island, South Dakota and Vermont have not adopted the UPIA as of December 31, 2006. Many states have made some additional changes to the UPIA, so it is important to review the state law before a trust jurisdiction is selected based on allocating receipts and disbursements.

8. *Privacy*
   Most states do have methods for insuring that fiduciary matters will not be a matter of public record, although some are stronger than others. However, state laws do differ on beneficiaries' entitlement to trust information and only a few states, such as Delaware, allow a trust instrument to delay or prohibit disclosure of trust information to future beneficiaries.[iii]

9. *Fees*
   Fees vary among trust companies and from state to state. Some states have statutes that allocate fees 50% to income and 50% to principal. Other states have flexible rules were 1/3 can be charged to income and 2/3 to principal. However, the trust document can over ride state law and provide for any allocation method.

Individual Trustee

An individual trustee can be an excellent trustee for many trust situations. Generally, an individual serving as trustee knows the grantor and his or her family on a personal basis and most likely will be a relative or close family friend. That individual may also be familiar with the grantor's finances and how the funds should be managed and distributed over time. Every family situation is unique and an individual could serve well as a trustee as long as he or she can manage and invest the trust according to the terms of the trust instrument and knows when to seek professional assistance related to trust issues that may occur.

Potential Benefits for Selecting an Individual Trustee

Some of the benefits of selecting an individual trustee are:

1. The trustee may have firsthand knowledge of the family's financial situation.
2. The trustee may be a family member or friend who will waive the trustee fee (or charge a nominal trustee fee).
3. The trustee may be located in the same city as the trust beneficiaries for local contact.
4. The trustee may be familiar with any family business that may be owned by the trust.
5. Beneficiaries may feel more comfortable when dealing with a family member.

However, every family situation will be different and the complexity will vary. In some cases, a corporate trustee may be the best option available.

Corporate Trustee

Now that the process for selecting a trustee has been reviewed and the duties and responsibilities have been identified, it is fairly obvious that an individual may not possess all the required knowledge and experience to serve as trustee for a particular sophisticated client. A corporate trustee can provide the benefits that an individual cannot. For example, an individual living in New York may want to create an asset protection trust. Assume the individual trustor selects Delaware for the jurisdiction. Delaware asset protection trusts require a Delaware trustee (co-trustees permitted). The trustor can select a Delaware corporate trustee to serve that can provide the experience and knowledge required of a professional trustee, as well as the asset protection trust the client set out to create.

It may also be important to find a corporate trustee willing to work with outside investment advisors and financial planners as this structure can provides the maximum flexibility to complete the entire wealth management team. Many individuals use investment management firms or registered investment advisors to manage their personal portfolios of intangible assets such as stocks and bonds. These individuals often use those assets to fund their family trusts and would like to retain those same investment advisors to continue to manage the family trust assets. The trust document should include language permitting the use of third-party investment advisors to manage the trust assets. Some states have "delegation" statutes where the trustee can delegate the investment management of the trust to those third-party investment advisors. However, since trustees may still be responsible for the investments, they are often hesitant to delegate to third-party managers. Other states, such as Delaware, have a bifurcation statute where the investment manager can manage the assets of the trust and the trustee does not have to review the investment selection or performance of that advisor.[iv]

Corporate trustees who work with third-party investment advisors, distribution advisors, and trust protectors can provide added benefits to the client and his or her family. The corporate trustee provides another "set of eyes" looking after the client's family wealth needs and generally can provide external services otherwise not readily available to an individual trustee. For example, if a beneficiary needs a mortgage or loan, the trust administrator can provide that service or make the contacts to get the service started. The corporate trustee would have access to many extra services, whereas an individual trustee would have to contract out those services.

Many individuals who create trusts do so because they want professional asset management and growth for their family for generations to come. With state trust law changes, many individuals can now keep their desired investment managers and utilize corporate trustees who are willing to work with those advisors. These individuals are not forced into the corporate trustee's own mutual funds, common trust funds, etc., but can have any investment their advisor wishes to invest in. If the trust is in a state which permits bifurcation of investment responsibility, then the corporate trustee administrative fee is generally lower since the trustee does not provide investment oversight. The financial planner or investment advisor can control the family relationship and use a corporate trustee to provide everything except for investment expertise.

All trust documents should be flexible and provide provisions for current adult beneficiaries to remove any trustee and appoint a successor trustee, including corporate trustees. Trust documents should also be flexible and not restricted to the administrative laws of the state of residence of the trustor. The clients can then appoint an advisor-friendly successor trustee in a trust-friendly jurisdiction to administer their family trusts while they continue to use their trusted investment advisor.

Potential Benefits for Selecting a Corporate Trustee

The potential benefits of selecting a corporate trustee are that the trustee

- provides years of experience in administering trusts
- specialize in trust administration, custody, and fiduciary tax reporting services
- keeps abreast of changes that may affect the trust through the use of specialized professionals
- assumes fiduciary responsibility
- maintains fiduciary errors and omissions insurance coverage
- offers continuity – staff is available every day
- is generally examined by internal auditors and external regulators
- acts with best interest in mind of all beneficiaries, both current and future, while implementing trust provisions
- provides state-of-the-art technology or have access to superior systems otherwise not available
- provides a partnership relationship with multiple team members

In addition to these reasons, a corporate trustee could also assist family members for generations with issues such as 1) how to educate the next generation, 2) estate planning concerns, 3) Providing explanations of the terms of the trust and fiduciary accounting to each generation, 4) tax planning as a result of the beneficiaries' interest in the trust, and 5) modeling the investment portfolio to meet their income and risk needs.

Summary

A corporate trustee can work with a financial planner, individual co-trustee, or investment management firm. Together, they can provide a well-balanced service team to meet a client's goals and objectives. The advisor can recommend planning strategies utilizing asset protection trusts, dynasty trusts, or state income tax savings which otherwise may not be available to a client and his or her selected individual trustee's home state. By coordinating with a corporate trustee in a trust law-friendly state (such as Alaska, Delaware, South Dakota or Nevada to name a few), the financial planner or advisor could have a competitive advantage over his or her local corporate trustee competitors, since those trustees may not have offices in such jurisdictions. A corporate trustee should be considered in the very beginning so the team can meet the family members and everyone can become comfortable with the trust terms and the team in place. When family, friends and client's approach me about naming a trustee, I always tell them to explore all of the advantages a corporate trustee can offer!

Footnotes

i 12 Del. Code §3527

ii 12 Del.Code §3313

iii 12 Del. Code §3303(a).

iv 12 Del. Code §3313