Putting Our Trust in Trusts

By Charlie Douglas and Susan P. Rounds

From trust owned businesses to trusts as beneficiaries of Roth IRAs, Charlie Douglas and Susan P. Rounds explore some of the practical uses and issues surrounding trusts today. More importantly, they examine what estate planners should be doing now to help clients and their families avoid the common pitfalls and problems found in trust administration later on.

Estate planning is more than just saving taxes or simply passing on assets to our loved ones. At its core, estate planning seeks to both protect and empower the existing family unit and the next generation. Though it strives to pass on property in a tax-efficient manner, the essence of estate planning is more about positively impacting people than it is simply passing on property.

Effective and enduring estate plans are built upon trusts. For wealthy clients, trusts are the heart and soul of estate planning and the fundamental vehicles for transferring assets and leaving an intended legacy. Advisors and their clients alike routinely put their trust in trusts to support their passions and the people they care about, while they are living, and long after they are gone.

Trusts are not stagnant, they respond to the economic climate around them. For example, charitable lead annuity trusts, which do well in a low interest rate environment, have seen a surge in recent activity, while the use of qualified personal residence trusts, which perform better in a high interest rate setting, have noticeably declined. Trusts tender a unique combination of flexibility and control as they continue to evolve.

Current trust law in the United States developed under the common law of England and has roots that date back to at least the 12th century. Dusty trust tomes tell of Crusaders heading off to war, needing someone to oversee the business of their estates and to make the inevitable payments due under the feudal system of land ownership existing at the time.

Thereafter, innovative English landowners used trusts to get themselves free of creditors

Charlie Douglas, JD, CFP®, AEP is a Senior Vice President for a leading wealth management institution, where he specializes in comprehensive planning solutions and fiduciary trust services for business owners, high–net-worth individuals and their families. A member of the Board of the National Association of Estate Planning Councils (NAEPC), Charlie is the current Editor of the NAEPC Journal of Estate and Tax Planning.

Susan P. Rounds, JD, CPA, LLM is a Senior Vice President and Senior Director of Planning for a global wealth management institution. Susan has been advising high–net-worth individuals and business owners for over 20 years. Susan also taught tax, accounting and business law courses at the University of Georgia School of Law and the Terry College of Business.

and feudal obligations. As such, trust administration typically required little experience or authority by the trustee, who was in essence a mere stakeholder. At that time, the trustee simply held the land for the use and benefit of the current generation and arranged for the land to be passed on to the next generation.

In our time, trusts have become much more comprehensive and complex. Instead of merely holding land for the current generation, today's intricate trusts often hold thriving family businesses and interface with sophisticated investment vehicles in an intricate global marketplace, often balancing the needs of current and future generations simultaneously.

Clients Can Trust Their Family Members, But Still Need Trusts to Protect Them

Recently, a prominent speaker in the wealth management industry advocated that you should not leave your assets in trust for your family, opining that doing so was a sign of not trusting your family. The speaker further stated that a trust was a poor substitute for instilling the notion of stewardship in the next generation. Although trusts do have their limitations and cannot replace the need for healthy family communication and sound fiscal values, using trusts in no way means that you do not “trust” your family.

Trusts obviously are essential for protecting the interests of heirs with disabilities, special needs children and the interests of minors. Moreover, they are indispensable for saving on income, gift, estate and generation skipping transfer (GST) taxes and avoiding probate.

For example, clients can save on income taxes through the use of a “spray trust” with a discretionary spray power to allocate income and principal to shift income to those in lower income tax brackets. Clients can also leverage their gift tax exemptions and pass on considerable wealth by making lifetime gifts to grantor retained annuity trusts (GRATs) and gifts/sales to intentionally defective grantor trusts (IDGTs). Estate and GST taxes can be greatly reduced with a credit shelter trust to which the decedent's GST tax exemption is applied. And unwarranted probate procedures, particularly ancillary probate, can be avoided by the funding of a living trust with assets during the client's lifetime.

Query: Can one adequately provide for the needs of their family while preserving those assets for future generations through an estate plan that consists solely of outright distributions?

What about clients who say, “I have a great relationship with my children and they can manage their own money responsibly. A simple outright distribution will do just fine.” Well, outright distributions can be fine and they do have their place in the planning process, but they also thwart the ability to provide loved ones with asset, creditor and divorce protection during their lifetimes.

Put another away, I may trust my family completely during my lifetime to use my property, but I still have door locks, intruder alarms, property and casualty insurance and other safeguards in place because I recognize that accidents happen and the world is oftentimes an unsafe place. Even if my family is 100 percent trustworthy in every respect, the world is not. Similarly, keeping assets in trust for my family, particularly after I am gone, is a prudent way of extending protection to them.

Jeff Pennell, Professor at Emory University School of Law, who specializes in trusts, wealth transfer taxation and estate planning often talks about the “gift” of keeping assets in trust for family. Pennell says, “Donors could use trusts to insulate wealth from creditors, as well as protect it from a grandchild's misadventures. Trusts are really useful devices because they provide a level of protection that's not available with an outright gift.”[1]

The reality is that most wealth transfer plans break down because of lack of communication and because families have left the next generation unprepared to manage the wealth they will inherit. As such, leaving assets in trust can help provide a meaningful buffer for family members.

Oftentimes, we read about lottery winners who lose their sudden wealth through excessive spending, silly investments and divorce. Well, what is the difference between a lottery winner and an inheritor? In the former case the lottery winner gained sudden wealth by purchasing a winning ticket. In the latter case, an inheritor gained sudden wealth because someone they loved died. In each case, however, sudden wealth presents recipients with a similar set of challenges.

All of us are susceptible to our emotions and they do affect our ability to think with financial clarity. Warren Buffett recently commented on the housing bubble, “We are all a bunch of junkies and history shows that markets always oblige us with a fix. Rising prices are a narcotic that affects the reasoning power of people up and down the line. The entire American public, myself included, was caught up in the belief that housing prices could not fall dramatically.”[2] Moreover, there need not be a bubble in place, real estate, technology or otherwise, to play havoc with our investment returns.

DALBAR, Inc. recently updated its Quantitative Analysis of Investor Behavior (QAIB) study and found that while the S&P 500 returned 8.35 percent over a 20-year period ending in 2008, the average equity investor earned just 1.87 percent, which was less than the inflation rate of 2.89 percent. Bond investors fared no better. They earned just .77 percent compared to 7.43 percent for the index.

The DALBAR update underscores that the QAIB has consistently shown a large gap between returns investors actually earn and the returns they could have earned with a buy-and-hold strategy. Whether mutual funds, index funds or ETFs, when buyers and sellers hope to profit from short-term market movements, they likely will end up getting burned.

In a real sense, trusts and professional money management can help protect beneficiaries from themselves and their emotions. In contrast, outright distributions are unconstrained and significant outright distributions tend to leave family members exposed.

Forced Trust Distributions: Age, Markers of Maturity or a Multifaceted Approach?

Twenty five years ago, drafting trusts seemed relatively straightforward when it came to making mandatory trust distributions. Often, a typical trust distribution for a client's children might be income and principal at the trustee's discretion and mandatory distributions of principal in equal thirds at the ages of 21, 25 and 30. In many cases, it was perceived that around 30 or one's early to mid-thirties, children were considered "mature" enough to handle their inheritance.

But as the Silent Generation continued to age and Baby Boomers began to "mature" a funny thing started happening to mandatory distributions. As life expectancies increased and adult children showed more appetite for possessing and consuming during the go-go days of the 1980s and 1990s, mandatory distributions became more staggered out later in life. Now, mandatory distributions in equal thirds are typically staggered over the ages of 30, 35 and 40, or a continuing right of withdrawal given to the beneficiaries in like fashion.

While acknowledging that with age each of us becomes more mature, questions still remain. Does reaching a certain age necessarily mean that we are now suddenly more fiscally responsible? Should age be the primary litmus test for making a mandatory trust distribution and/or terminating a trust? Are children or grandchildren necessarily more or less capable of handling wealth just because the time clock has ticked on? Or is it more likely that, as we age, we carry many of the same struggles along with us?

More often than not, those who struggled with handling money at age 21 still struggle with many of the same issues age 40. On the other hand, just because someone may be in their mid-20s doesn't always mean that they are not capable of stewarding the wealth entrusted to them.

In more recent times, people have increasingly embraced the notion of "markers of maturity" for making trust distributions. Graduating from a four-year accredited college, getting married and raising children, buying a first car or home, writing a well crafted business plan in need of funding, career success, living free of destructive or addictive behavior, and having the trust match or multiply a beneficiary's financial skin-in-the-game efforts may all be perfectly appropriate ways of incentivizing and making trust distributions in accordance with markers in life as one matures.

Including financial incentives in the trust to encourage heirs to become well-balanced, productive members of society is a worthy goal. However, there can be problems in trying to motivate heirs' behavior through markers of maturity. One issue involves how a trustee, corporate or individual, can routinely and effectively monitor these markers. Unless a marker is easily and objectively measurable, it can become subject to sporadic policing and subjectivity.

Of greater concern is that motivating external behavior through money may retard an heir's ability to get in touch with his or her own passions and internal motivations. Estate planners should exercise caution in drafting a trust which relies too heavily on external behavioral goals for heirs. A more effective way may be to have the heirs articulate their gifts, goals and passions and then design corresponding proper behavioral activities incentivized by the trust to empower them. In many cases, a multifaceted approach which includes some markers of maturity is a more effective and comprehensive way of making trust distributions.

A few years ago there was a memorable husband and wife, who not surprisingly, each looked at passing on their wealth differently. Notably, each possessed a Master's degree from an Ivy League school in accounting and finance, respectively.

For the wife's part, she wanted to share with her children their financial success while she and her husband were still living and wanted her children to know that their assets were available to them in case of need. She didn't want her children to have to wait until they were too old to receive their inheritance or to reward one child over the other should he or she choose to marry and raise children, climb the corporate ladder or simply be an artist who used their gifts to pursue their passion regardless of the level of income achieved.

The husband, for his part, was concerned with deadening his children's incentive to develop their gifts and talents by making money too available. Having achieved considerable financial success with a Horatio Alger, "pull-yourself-up-by-your-own-bootstraps mentality," the husband didn't want his children to join what he perceived to be a society of consumers who were increasingly losing touch with their ability and need to produce. He favored having most all of the trust distributions based on incentives in accordance with markers of maturity.

While seemingly at odds with each other regarding crafting an estate plan, this couple found common ground by using a multifaceted approach. Some assets were distributed in accordance with age, other assets were distributed in accordance with markers of maturity, while the bulk of the estate was held in trust for the children in accordance with an ascertainable standard and with each child being their own trustee of their respective sub-trust.

Deciding upon a distribution approach is a critical client decision. So, too, is naming the trustee(s) and successor trustee(s) to administer the trust documents.

Selecting a Proper Trustee and Avoiding, "Who Died and Made You Boss?"

Growing up, it was not uncommon for our siblings to jibe us from time to time with the quip, "who died and made you boss?" The underlying notion being, I don't know why you think you are in charge of me and my matters.

Too often, clients make the same mistake by appointing one child as trustee over a pot trust or a sibling's sub-trust specifically. What was once a childhood tease can become an unpleasant reality as an adult.

As a general rule, while it is often practical and prudent to have a child as co-trustee along with a corporate institution, or even to act as the sole trustee of his or her own sub-trust, having one child in charge of the another child's financial affairs is by and large a bad idea. Families have enough dysfunction trying to be a family and adding unnecessary fiduciary duties more often only adds fuel to the fire.

Still, estate planners routinely appoint family members and friends as trustees. Clients, after all, typically want individuals who know them, their family and their finances well. Moreover, corporate institutions come with their own baggage, and the fact is that family and friends can, at times, serve well as individual trustees.

Be that as it may, too many trusts mechanically name family and friends as fiduciaries. Asking someone to be a fiduciary is like asking someone to be a godparent, which is typically seen as position of honor. Feeling obliged to accept (assuming he or she knows about the appointment in the first place), little do these individuals understand the weight of the liability they are assuming, the varied skill set required and the time involved to discharge their duties properly.

For example, general trust law makes clear that, unless the trust instrument provides otherwise, a failure to extensively diversify a portfolio will be considered to be a breach of trust. As such, excessively conservative and/or aggressive investment strategies may violate the prudent investment standard.

The diversity of modern trust investments alone, among the various asset classes below, requires a level of skill and knowledge beyond that of most individual trustees.

- **Stocks—**Suitable holdings of domestic, developed international and emerging equities.
- **Bonds**—Appropriate mix of government, agency, corporate or municipal bonds, as well as high yield or foreign-debt.
- **Real assets—**Public or private real estate and commodities to provide inflation protection and low correlation.
- **Complementary strategies—**Conservative (fund of funds) and aggressive hedge funds, as well as private equity to provide low correlation and to buffer risk. Historically, alternative investments have shown little to no correlation to traditional investments such as stocks, bonds, or cash.
  - **Hedge funds—**Typically non-regulated investment vehicles designed to generate returns with less volatility than traditional investments utilizing long and short investment techniques, niche strategies and leverage. (Note: In this post-Madoff environment it is important for investors to be sure that the hedge funds they are invested in have addressed the concerns of liquidity, transparency, lower fees and on-time Schedule k-1s.)

- **Private investments**—Often illiquid and privately negotiated investments in private companies. These investments can include leveraged buyouts and venture capital, as well as private equity partnerships in real estate, energy, and other hard assets.

The goal of diversification under the Uniform Prudent Investor Act (UPIA) is more than just diversification within a single asset class; rather, it is diversification across numerous asset classes. In many cases, the investment goal of a trustee is to shoot for consistent total returns, not returns which are designed to blow away the indexes or favor income over growth or vice versa.

Many trustees under the UPIA strive for a total return trust, where investments are made in accordance with modern portfolio theory to balance the income interests of the income beneficiary with those of the remaindermen. Under the UPIA, no specific investment is inherently prudent or imprudent. Rather, suitability to the trust account's purposes and beneficiaries' needs is what is considered paramount.

As if designing a well diversified portfolio were not difficult enough, making adjustments with respect to amounts to be distributed to the current beneficiary, without regard to whether the distribution is composed of dividends, interest, rent, capital gain or otherwise, can be even more difficult as it causes the trustee to consider a laundry list of complicated factors.

Consider how a friend or family member as an individual trustee might meet the income needs of the current beneficiary in today's low interest rate environment. Under the UPIA, in deciding whether and to what extent to exercise the power to adjust, a trustee is to consider, among other items:

- the nature, purpose and expected duration of the trust;
- the trustor's intent;
- the identity and circumstances of the beneficiaries;
- the needs for liquidity, regularity of income, and preservation and appreciation of principal;
- the type of assets held in the trust;
- whether the trust gives the trustee the power to invade principal or accumulate income, and the extent to which the trustee has exercised these powers;
- the actual and anticipated impact of economic conditions on principal and income, and effects of inflation and deflation; and
- the anticipated tax consequences of an adjustment.

Estate planners would do well to ask their clients several key questions before perfunctorily naming a trustee(s), be it a corporate or individual trustee:

- Does the proposed trustee have the experience to administer the trust in view of the legal, fiduciary accounting and investment management needed?
- Can the proposed trustee truly act independently and impartially regarding family members?
- Will the proposed trustee be available as often as needed, on a daily basis or otherwise?
- Does the proposed trustee have the necessary systems in place for administration?
- Does the proposed trustee have the financial wherewithal to safeguard the assets?

Although these functions can certainly be hired out by an individual, can they be hired out on a cost-efficient basis? And even though an individual trustee may delegate their duties of administration to other professionals that does not necessarily relieve the individual trustee of liability.

Trusts As Beneficiaries for Roth IRAs

Roth IRA conversions have made a lot of headlines this year. When the modified adjusted gross income limitation of $100,000 was eliminated beginning in 2010, affluent clients began to seriously consider conversion. For wealthy clients who will likely have taxable estates, a Roth conversion often works well under the following factors:

- They do not need the IRA to live on and have monies outside of it to pay the income taxes on the conversion.
- They plan to leave their IRA assets to their heirs and not to charity.
- They believe that their income tax bracket will likely be higher after conversion than before.
- They feel that their IRA still has upside potential after having been beaten down from the 2008 market meltdown.

From an estate tax standpoint, one of the main advantages of a Roth conversion is that it shrinks the estate through the payment of income taxes that would have been paid by their heirs later on. In a sense, the payment of income taxes by the client is like a tax-free gift to their heirs. And from an economic standpoint, it is better to pay income taxes on the Roth IRA before estate taxes as compared to the income tax deduction obtained under Code Sec. 691 where a traditional IRA is subject to estate taxes.

While many have gone through considerable analysis in making the Roth IRA conversion, too few have given enough time and attention to naming the proper beneficiary. Consider the case where the client's goal is to stretch out the Roth IRA by leaving it to younger heirs and to have it protected from creditors.

Stretching the Roth. Generally, only an individual beneficiary can use the life expectancy payout method and "stretch out" the Roth's payment. The individual beneficiary's life expectancy then becomes the "applicable distribution period" (ADP) for the Roth's benefits.

Although the heirs of a Roth IRA will not owe any taxes on withdrawal, what about using a trust as a beneficiary for someone who wants to ensure that his or her beneficiaries do not withdraw the Roth IRA benefits more rapidly than the minimum required distribution (MRD) rules require?

While trusts do not have "life expectancies," IRS regulations provide that if the trust is considered a "see-through trust," the IRS "looks through" the trust and uses the oldest trust beneficiary's life expectancy as the ADP.

For a trust to be treated as having a life expectancy, a "see-through" trust must meet the following four requirements under Reg. §1.401(a)(9)-4:

- The trust must be valid under state law;
- The trust must be irrevocable or become irrevocable at the death of the grantor;
- The trust beneficiaries must be identifiable; and
- Documentation must be provided to the custodian of the IRA by Oct. 31 the year after the owner dies.

Assuming a client's trust met the see-through requirements, what if the Roth IRA were left to a trust where the trust's beneficiaries varied widely in age? In such a case, the oldest beneficiary's life expectancy would need to be used for all other beneficiaries regarding MRD rules because all beneficiaries inherited through a trust. This is the case even if the trust divides into a sub-trust for each beneficiary.

Therefore, in order to protect the Roth IRA "stretch," a see-through trust would need to be established for each heir and be specifically designated as a beneficiary of the Roth. Thereafter, the MRD would be calculated based on each individual beneficiary's age and would go into his or her individual trust.

Protecting the Roth. With IRA assets, including Roth IRAs, becoming an increasingly significant portion of many clients' estates, estate planners should be aware of the potential asset protection issues presented by inherited IRAs. Specifically, there is a growing body of case law questioning whether or not inherited IRAs can be creditor protected as determined under state law.

In a recent Minnesota case, *In re Nessa*, a federal bankruptcy judge relied on new language in the 2005 federal bankruptcy law that protects $1M in IRA assets from creditors.[3] (The law also protects all assets rolled from an employer pension plan, such as a 401(k) or defined benefit plan, into an IRA, regardless of the amount.) The judge concluded that an inherited IRA is still a retirement account protected under that law, even though it has switched hands from the original owner to the beneficiary.

Conversely, a Texas judge in another recent bankruptcy case, *In re Chilton*, came to the opposite conclusion of the Minnesota judge.[4] The Texas judge ruled that inherited IRAs are not protected in bankruptcy because the funds in an inherited IRA "are not funds intended for retirement purposes."

Even if the state in which your client lives protects inherited IRAs, their beneficiaries could live in, or move to, a state such as Texas, which does not. Consequently, to protect the Roth IRA your clients should consider having their Roth IRA payable to a see-through trust that contains spendthrift provisions, thereby affording protection to the beneficiaries of the trust from their creditors.

Holding the Family Business in Trust

Protection is indeed a staple of trust design. By transferring property in trust, we can protect the beneficiaries from their inabilities, disabilities, creditors and predators. When the trust corpus consists primarily of a family business, protecting the trust can be equivalent to preserving the family legacy. If the trust provisions are contemplated and drafted properly, the trust can even act as a salve to preserve family harmony.

Certain types of trusts work well with integrating the planning for both the business and for the family owners of closely-held family businesses. In particular, GRATs and installments sales to IDGTs can provide a ready way to accomplish an estate freeze, shift appreciation downstream and provide an income stream to the grantor, all within a protective wrapper.

While preserving the legacy by preserving the family business in trust is an earnest goal for many closely-held business owners, this goal can be in direct conflict with a trustee's duty to diversify under the Uniform Prudent Investor Act (UPIA). Indeed, prudent investing, as earlier mentioned, ordinarily requires diversification on a total-portfolio basis. Let us examine the prudent investor rule as embodied in the UPIA and the concomitant effect on a trust established to hold interests in a closely-held family business.

Section 1(a) of the UPIA states that, "Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act]."

Section 1(b) provides that, "The prudent investor rule, *a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust*. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance of the provisions of the trust." (Emphasis added.)

Rather than providing an unusual exception, Section 1(b) is in keeping with the norm. Oftentimes, the rules of trust law are default rules, that is, rules that the settlor may alter or abrogate. Subsection (b) carries forward this traditional attribute of trust law.[5]

UPIA Section 3 defines and at the same time qualifies the duty to diversify: "A trustee shall diversify the investments of the trust *unless* the trustee reasonably determines that, *because of special circumstances the purposes of the trust are better served without diversifying*." (Emphasis added.)

The comments to Section 3 elaborate on the meaning of "special circumstances" that may overcome the duty to diversify. For example, if a tax sensitive trust owns an undiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding. Even more explicitly related to our discussion, the wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.[6]

Deference is given to the preference of a settlor to maintain certain assets in the trust. UPIA Section 2(a) defines the standard of care, portfolio strategy, and risk and return objectives as follows: "A trustee shall invest and manage trust assets as a prudent investor would, by considering the *purpose*, terms, distribution requirements, *and other circumstances* of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution." (Emphasis added.)

The circumstances that the trustee shall consider are an asset's special relationship or special value, if any, *to the purposes of the trust or to one or more of the beneficiaries*.[7] The comment to this section references the fact that the trustee is allowed to take into account any preference of the beneficiary respecting heirlooms or other prized assets.

The key to limiting the trustee's duty to diversify and thereby attaining the goal of preservation of the family business hinges on precise drafting of the purpose of the trust and specific direction to retain the closely held business interests in the trust. The settlor must specifically state that the purpose of the trust is to perpetuate the family business and include mandatory language directing retention of the closely held business assets.[8]

If the language regarding retention of the business interests can be construed to be merely permissive or only authorizes the trustee to hold onto these assets, the trustee's duty to diversify will not be vitiated.[9] Even with well drafted provisions, the risks are high and new cases come out from time to time testing a trustee's liability for failure to diversify. As such, a corporate trustee will most likely want to conduct due diligence before accepting trusteeship and will generally request a hold harmless agreement or other liability protection.

Practical Considerations in Administrating a Closely Held Business (CHB)

If you intend to appoint a corporate trustee to manage closely held business interests ("CHB interests") in trust, there are several issues to take into account. The nature of this asset, the level of concentration the CHB interests provide, and whether the ownership interest is controlling or represents a minority interest can all invoke significant risk and liability for the trustee. Accordingly, if the trust is accepted, the corporate trustee may want to take certain precautions. Be sure to discuss the institution's policies about accepting these assets in trust early in the planning process.

CHB interests held in trust under a corporate fiduciary arrangement will likely require annual reviews and special attention to ongoing administration. If a concentration of CHB interests is to be purchased by an IDGT or accepted by a GRAT, the corporate fiduciary may require prior agreement among all interested parties or court approval.

The corporate fiduciary will also have a level of due diligence to meet prior to accepting the asset. At a minimum, the trustee will likely make an initial review of financial statements, interview management and visit the company site. Thereafter, this may become an ongoing annual process. The corporate fiduciary will also want the appropriate language in the document directing the retention of the concentrated position. In addition, when representing a controlling interest, the corporate trustee may want a seat on the board and the ability to hire outside experts when circumstances dictate the need.

A CHB owner will generally commission a valuation pending a transfer of the interests to trusts like GRATs and IDGTS. In the typical scenario, the wealth creator would like to transfer the business interests at the lowest possible value, which translates to the lowest possible transfer tax cost. In addition, any appreciation in those assets is transferred to the next generation at no additional transfer tax cost.

The perspective of the corporate trustee may likely be different than that of the CHB owner. To monitor risk, the value of the business interest must be periodically updated; accordingly, annual valuations by a qualified business appraiser are a foreseeable element of ongoing administration with a corporate trustee. Unlike publicly held stock that has a new market value published daily, closely held businesses are often difficult to value because they are unique and can take significant time to liquidate.

On top of that, a trust will often include restrictions on the right to transfer the interests themselves or to have a say in control of the business. Such restrictions will give rise to valuation discounts that must be determined by an appropriately trained and certified appraiser. Corporate systems are frequently not designed to automatically pick up on changes in the value of these business interests, so adjustments must be made manually.

While there are many factors to consider in the trust administration of a CHB, the following are ten practical pointers to pay attention to:

Duty to diversify. State that any statutory law or duty to diversify is superseded by the trustee's duty to retain the family business. Old fashion "retention language" is typically not enough. State law can likely be superseded where the trustee is directed to retain the family business.

Potential liability of the trustee. Consider inserting language allowing the trustee to retain any interest in the closely held business without liability for nonproductivity, decline in value or lack of diversification; Moreover, if the trustee disposes of any such property, there should be no liability to the trustee for loss resulting from any increase in value of such property after such disposition.

Protecting business interests from outside threats. To secure asset protection benefits, the trust should contain a spendthrift clause, where distributions are discretionary and cannot be compelled. Distributions may need to be in the sole and absolute discretion of an independent trustee or co-trustee.

Trustee removal and replacement. Consider using an independent co-trustee and giving the beneficiaries the right to remove and replace one corporate trustee with another. Insiders within the CHB and corporate trustees likewise may want language within the trust where the corporate trustee has legal title only as a shareholder and little or no management duties or management voice.

Pay attention to which trust(s) will likely own the CHB. The family businesses may be allocated at death to a certain trust or a number of trusts (marital deduction, credit shelter, GST). Pay attention to the collective impact if more than one trust is involved. Are active members in the family business being partnered with non-active family members to form an accidental partnership?

Holding subchapter "S" stock. To retain "S" corporation status, the trust at some point must typically qualify to be a qualified Subchapter S trust (QSST), where all income must be distributed to the income beneficiary annually, or be an electing small business trust (ESBT), where the trust itself must pay the highest applicable income tax rate for trusts. Note, the "S" election is lost after two years if the trust is not qualified as a QSST or ESBT.

Retaining the CHB and paying estate taxes. Consider how the need for liquidity to pay estate taxes may impact the family business. Are there sufficient liquid resources, or can an election under Code Sec. 6166 to defer the taxes with respect to the business be made, or will the business need to be sold?

Coordinate any interplay between trust and buy/sell agreements. Even if the business is owned by a trust, is there a current, binding buy-sell agreement that takes precedence? Remember that contractual obligations in a Buy/Sell still apply and the estate could be taxed at a higher value, while the mandatory contract purchase price may be much lower. The buyout price in the agreement is not binding on the IRS unless it complies with IRC 2703. Consider including a provision in the Buy/Sell that requires, in all events, the buy-out price at the death of the business owner be no less than the value of the owner's business equity as finally determined for federal estate tax purposes.

Communication concerning the CHB. One of the issues that should be addressed is whether or not a given beneficiary is entitled to receive certain information regarding the CHB. Note, that the Uniform Trust Code

(UTC) is intended to provide a default position that may kick in only if the document is silent, so it is incumbent upon trust drafters to include communicative direction before state law does it for them. For example, under the UTC, certain notices need to be given only to the "qualified beneficiaries" (vested and first-line remainder contingent beneficiaries). Other beneficiaries who do not fall under the definition of a qualified beneficiary, such as beneficiaries with remote remainder interests must receive certain information only when they file a specific request with the trustee.

Trusts are not business succession plans. According to the Small Business Administration, roughly 90 percent of America's businesses are family owned, yet only 30 percent are successfully transferred to the next generation, and a mere 15 percent survive into the third.[10] According to experts, the primary reason that businesses fail to continue in successive generations is that there is not a properly structured succession plan. Even if the trust is expertly crafted regarding to whom and how the client's CHB will be held, administered and distributed to upon the owner's demise, business succession planning must also ensure that the family business will continue to thrive with successive managers. Trusts are only part of the succession plan process but never the succession plan itself.

Help Clients Be More Intentional About Their Intentions

Let's face it: As practical as trusts are, they can be the most boring, boilerplate ridden and cold documents known to humankind. Full of legalese and often devoid of any personal touch, they can represent a distant and final exchange between a grantor and his or her loved ones.

This need not be the case. While it is important not to tinker with the legal and tax aspects of these critical documents, it is not unlawful for clients to insert more of themselves into their trusts and to take the time to clarify the purpose of the trust and their intentions. Clients often say that they have it covered under their will or trust, but the reality is they have little idea regarding how these documents will work in practice when the time comes and whether or not their true intentions will be honored.

Consider these suggestions about having the clients be more intentional:

Preamble. Although not intended to be as expansive as an ethical will, which is designed to pass on wisdom and love to future generations, a short personal overture at the beginning of the trust may be all that is needed to connect with heirs, explain discrepancies and give them needed context. For example:

> The words that follow this brief introduction may have more legal significance, but they cannot possibly express my love and hopefulness for each of you. The purpose of my estate plan is to save on wealth transfer costs and to protect and empower you. I have decided to keep the bulk of my estate in trust and to have each of you be a co-trustee of your own sub-trust along with a corporate fiduciary. Please know that I trust each of you, but I also believe that keeping assets in trust can provide safeguards that outright distributions cannot. Moreover, I believe that you are all responsible adults whom I am proud of. Still, I decided to pair you with a corporate trustee to help provide professional guidance and management and to serve as a prudent check and balance regarding making financial decisions. Emotions can cloud our best judgments and each of us can make foolish investment decisions when left to our own devices. I know I did. Above all, my hope is that you will use the assets left to you wisely in accordance with the trust provisions to empower your unique gifts and passions, to take care of your own family and each other, and to assist those throughout our world who are truly in need.

Concentration issues. If a client wants a concentrated position of 10 percent or more to be retained in his or her portfolio, then specific retention and indemnification directing the trustee must be inserted.

Funds for a wedding, first home and starting a business. In addition to ascertainable standards, clients may want to flesh out the parameters for funding these often named rights of withdrawals under the "similar purpose" language accompanying each. For example, does paying down the mortgage of an existing home for a beneficiary qualify as a permissible distribution for a first home or similar purpose?

Trustee fees. Recommend staying away from frozen fee language. Corporate trustees would like to see language within the document where fees are set in accordance with their published fee schedule.

Breaking deadlocks between co-trustees. If the client is concerned with how to break ties, consider adding a third trustee, committee structure or trust protector to break the deadlock, should one occur.

Favoring particular beneficiaries. If one beneficiary (for example, the surviving spouse) should really take priority over other beneficiaries (children) in a pot or credit shelter trust, then make that clear.

Closely held business interests. See prior discussion.

Special trustees and closely held business interests. In addition to the comments in the aforementioned section dealing with CHBs, consider using a directed trust where a special trustee or trust protector can allow insiders to stay in charge of running the family business, while a third-party corporate trustee manages the remaining trust assets. For liability purposes, setting up the trust in states like South Dakota or Delaware, where the corporate trustee has statutory protection against imprudent decisions made by the special trustee or trust protector, may be both prudent and practical.

Flexibility with irrevocable trusts. Consider naming a special trustee or trust protector, particularly in long-term dynasty trusts, who is familiar with the grantor's personal and financial goals and who can modify the terms of the trust when necessary to carry out the grantor's intent as tax, business, economic and a beneficiary's circumstances may change.

Having access and asset protection. For maximum asset protection for a grantor who still wants access to trust assets, think about establishing a domestic self-settled spendthrift trust in favorable states like Alaska, Delaware, South Dakota and Nevada, or an offshore self-settled spendthrift trust in places like Bermuda, the Bahamas or the Cook Islands.

Which trust to encroach upon first. Suggest having language that allows the trustee to encroach upon non-exempt GST assets before encroaching upon exempt GST assets.

Spendthrifts and preservation. Insert language to have the trustee consider outside resources and other sources of income of a spendthrift beneficiary and/or to preserve the trust corpus. Note, by adding this language, budgets and tax returns will need to be submitted by the beneficiary prior to a distribution being made.

Destructive behaviors. Before the trustee makes a distribution, language regarding mandatory drug testing may be appropriate, if the client has concerns regarding a child's addictive behavior.

Remove and replace. Always give beneficiaries the unconditional right to remove one corporate trustee and replace it with another corporate trustee.

Conclusion

The same concerns that made the innovations giving rise to the trust system so valuable from its inception, still apply today. When considered carefully and drafted properly, trusts can accomplish many goals of estate planning, including most importantly, the preservation of the family legacy.

Endnotes

1 Northern Trust, *Educating the Next Generation: Managing Inherited Wealth*, available online at *www.northerntrust.com/wealth/10-spring/managing-inherited-wealth.html*.

2 Dan Burrows, *Warren Buffett on Who's Responsible for the Financial Crisis: Everyone*, available online at *www.dailyfinance.com/story/investing/warren-buffett-on-whos-at-fault-for-the-financial-crisis-every/19500152/*.

3 *In re Nessa*, 105 A.F.T.R.2d 2010-609 (Bankr. D. Minn. Jan. 11, 2010),), aff'd, 426 B.R. 312 (B.A.P. 8th Cir. April 9, 2010).

4 *In re Chilton*, 105 A.F.T.R.2d 2010-1271 (Bankr. E.D. Tex. March 5, 2010).

5 UPIA Section 1 Comment.

6 UPIA Section 3 Comment.

7 UPIA Section 2(c)(8).

8 *Wood v. US Bank, N.A.*, 828 N.E.2d 1072 (Ohio App.2005).

9 *See* generally Restatement 3rd Section 91.

10 Nancy Bowman-Upton, *Transferring Management in the Family-Owned Business*, available online at *www.sba.gov/idc/groups/public/documents/sba_homepage/serv_pubs_eb_pdf_eb1.pdf*.