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TRAPS FOR THE UNWARY:

SOME ESTATE PLANNERS' DUTIES, PROSCRIPTIONS AND CONUNDRUMS IN WEALTH TRANSMISSION*

BY

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By

Richard A. Oshins, AEP (Distinguished)[1]

I. INTRODUCTION

A. <u>Planning Dilemma</u> – Many modern trusts are created for tax and creditor protection purposes not to protect the primary beneficiary(ies) from their shortcomings. For competent, capable, mature adult inheritor, the goal is to give them all powers, controls, and beneficial enjoyment over the trust property that they would have over individually-owned property, reduced only to preserve all of the shelters from creditors (including divorcing or dissident spouses) and taxes that the trust wrapper can provide.

B. <u>Third Essential Component</u> – In addition to maximizing controls and protections, there is a third element must be factored into the equation – compliance with trust fiduciary standards in both design and implementation. The general fiduciary standards are the default rules and may be altered, or abrogated, except that certain restrictions such as good faith, fairness, honesty, and candor may not be waived.

C. <u>Navigating Fiduciary Constraints</u> - These results are produced only by navigating the thin line between giving maximum controls and beneficial enjoyment on the one hand, and compliance with the fiduciary rules mandated for trustees on the other hand. The former would permit the trust to engage in every conceivable action that an outright owner might consider. With proper amendment of the default rules, the limitations appear to be only those actions that are illegal or against public policy, except (as previously mentioned) certain fiduciary restraints cannot be waived. I refer to this trust design pattern as a "Beneficiary Controlled Trust."

D. <u>General Fiduciary Standards</u> - There are three primary duties that are imposed by trust fiduciary laws. They are:

1. **<u>Duty of Loyalty</u> – no conflicted action or self-dealing is permissible;**
2. **<u>Duty of Prudence</u> – reasonableness; and**
3. **<u>Duty of Impartiality</u> – fairness between beneficiaries.**

E. <u>The Duty of Loyalty</u> is considered to be the most fundamental duty that a trustee owes to the beneficiary(s). Unless waived, or modified, the default laws will apply to all three of the duties. Not adequately modifying or eliminating these rules will prevent the use of a Beneficiary Controlled Trust and expose the

[1] I would like to thank Professor Jeffrey Schoenblum for his helpful suggestions on this outline.

preferred inheritors to potential attack by secondary recipients. Over-modification will often create exposure to claimants or tax collectors.

F. Favorable Jurisdiction - To obtain maximum permissible controls and protections it is essential to select a trust-friendly situs that favors the trust beneficiaries. The two most compelling enhancements obtained by the selection of a preferred jurisdiction to govern a trust are protections from potential creditors and shelter from certain state/local taxes. Many advisors do not adequately take the consequences of situs selection into account during the estate planning design process. The disparities between desirable and inferior domiciles are massive.

G. Beneficiary Controls – Beneficiary Controls can be separated into three categories: (i) managerial control; (ii) access control; and (iii) dispositive control. The transferor can place limits on any or all of these controls.

1. **Managerial control - Who invests the trust assets**
2. **Access control - Who determines the use and beneficial enjoyment of the trust assets. Enhanced protections are achieved where distributions, use and access are in the hands of an independent trustee. Maximum protection occurs only if the independent trustee is sitused in a trust-friendly jurisdiction to prevent or minimize interference from potential judicial over-reaching. The primary beneficiary is typically given the "adequate access control" through the broad ability to determine the identity of the independent trustee. I acknowledge that this is a form of "dispositive" control.**
3. **Dispositive Control – Control to modify and amend the trust. This is generally given to the primary beneficiary through a special power of appointment. It can be broad (e.g., anyone other than the beneficiary, his estate or the creditors of either) or narrow (e.g., blood descendants).**

Note – I use the terms "full control" and "adequate control" interchangeably. In general, it is the maximum control that may be given to a beneficiary without exposing the trust to creditors and/or unnecessary taxes. The two "control" components that are "key" for most inheritors are managerial control and access control. They impact the inheritor directly. The authority to alter the provisions for others is generally a distant third.

H. Default Rules – The three fiduciary duties - loyalty, prudence, and impartiality - are default rules. They may be expanded, restricted, eliminated, or otherwise altered by the provisions of the trust. A trustee is not liable to the extent he/she/it acted in reasonable reliance on the provisions of the trust indenture.

II. MODERN ESTATE PLANNING FOR THE COMPETENT INHERITOR

A. What is Best - What is the best way to transfer wealth?

1. Improving the inheritance.

a. Assets transferred in a properly designed, situsedand managed trust are *always* more valuable to the recipient than those same assets would be if they were transferred outright.[2]

b. Beneficiaries will be happier receiving gifts and inheritances in trust, rather than outright, only if (i) they are given adequate control; and (ii) understand the virtues of the trust "wrapper."

B. Similar Trust Design - Virtually all trusts should be similarly designed, with minimal alterations. The dispositive scheme should be similar irrespective of the profile disparities of the recipients.

1. Maximum benefits – tax and asset protection - inure to trusts (and beneficiary(ies)) where the dispositive scheme is fully discretionary and the distribution (and use) discretion is in the hands of an "independent" trustee.

2. The variances are made with respect to the allocation of controls ranging from - (i) full control for the competent inheritor; (ii) to reduced/modified/shared/evolving control for primary beneficiaries who should not receive maximum control; to (iii) no control at all.

Best Trust Design

Dynastic; Discretionary *(with distribution discretion in the hands of an Independent Party who can be fired and replaced);* ***Beneficiary Controlled Trust*** *(unless (i) controls are undesirable or (ii) impermissible under law to avoid the taxing authorities and other claimants);* ***where the use of trust assets rather than distributions are encouraged*** *(unless distributions are beneficial or desirable);* ***sitused*** *in a trust-friendly jurisdiction.*

C. Impact of Beneficiary Profile - The profile of the inheritor is not meaningful in the trust design if the desire is to do what is "best" for the beneficiary. It is, however, extremely relevant in determining and designing the controls the beneficiaries should have, if any.

D. Competent Inheritor - Under modern trust design theory, a competent, mature, responsible recipient will be given full control, at the proper time(s).[3] A "competent" inheritor/recipient is used to define beneficiaries to whom the transferor would pass the wealth outright, "but for" the tax and creditor shelters that trusts provide.

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[2] **Richard A. Oshins and Steven J. Oshins** - "Protecting & Preserving Wealth into the Next Millennium – Parts 1 & 2," Trusts and Estates (Sept. & Oct. 1998); **Keydel and Wallace**, ACTEC Symposium (3/6/1999)**; Ronald D. Aucutt**, *Structuring Trust Arrangements for Flexibility,* 35 U. Miami Inst. Est. Plan., Ch. 9 (2001)**; Richard A. Oshins and Steven G. Siegel**, The Anatomy of the Perfect Modern Trust – Parts 1 & 2, Estate Planning (Jan and Feb 2016)**; "Innovative Trust Designs Better Serve Inheritors",** Richard A. Oshins and L. Paul Hood, 44 Estate Planning 6 (June 2017); **Richard A. Oshins,** Advanced Planning Strategies Using Grantor Trusts; Chapter 27, 60th N.Y.U. Institute (2002)

[3] At the proper time is the time or times of projected maturity.

1. **In the absence of adequate control, a beneficiary will not be happy.**

2. **Adequate control is "full control" with minimal restraints - those necessary to preserve the "in trust" protections.**

   <u>Planning note</u> – Advisors generally focus on tax avoidance rules. It is also essential to give similar attention to the creditor rights precepts. Just because the IRC and IRS say something is permissible does not make it binding in creditor rights forums. It is essential to shield the assets from both classes of potential claimants. Unnecessary exposure of wealth to the tax collector is often more tolerable than loss of a similar amount to creditors including a divorcing or dissident spouse.

3. **Beneficiary control is the opposite of the "dead hand" control design philosophy historically used to "protect immature and dysfunctional beneficiaries against themselves." Modern trust design has shifted the focus to expanding the powers of the competent inheritor/trustee by increasing permissible empowerments to the edge (but not over the cliff) of what is essential to have the trust wrapper respected.**

   <u>Planning note</u> – Many older trust forms reflect the historical philosophy of restricting beneficiary control through disempowerment clauses. That strategy is often simply included in many law firm documents and accepted as "boiler-plate" by the client without acceptable discussion or even addressing the question at all.

   I am often told by advisors – "My clients do not want the complexities of trusts"; "trusts are too complex/too expensive/too controlling" or "my clients want to stay local and not use the laws of a different situs"; etc. …

   My conclusion is that the cost/benefit and/or alternative design strategies were not adequately explained by the advisor(s). It is inconceivable that properly informed clients would reach those determinations. Certainly, they would not reach these conclusions with the present prevailing frequency. It is one thing to tell clients various options, and another to properly explain them so that the clients can arrive at a properly informed conclusion.

4. **If given all permissible controls, the inheritor is essentially placed in the same position that he or she would be in if they personally owned the assets, except they will have tax and asset protection benefits that do not, and cannot, exist with personally owned wealth. Restrictions placed on the primary beneficiary's control will not compress the beneficiary's real enjoyment of the property. The goal is to come as close to outright ownership as possible without compromising the "in trust" shelters. With proper design and drafting, controls that must be imposed are innocuous.**

Further, it is vital to the beneficiary's happiness and peace of mind that he or she understands that the controls imposed do not have adverse impacts. Frequently, the consequence of not properly explaining the trust operation and virtues to the beneficiary will result in the beneficiary seeking and receiving alternative advice, which unfortunately will be misplaced. As a consequence, the regrettable result is that the advisor and inheritor will seek to terminate the trust, thereby eliminating shelters that are best left in place.

> ***Planning note*** ***– In order to obtain full tax and creditor protection the restrictions must be "real." For example, the ability for the Independent Trustee "to distribute or not to distribute" is essential to safeguarding the trust owned assets. If a beneficiary can compel distributions, courts will increasingly be expected to require the beneficiary to exercise the right of compulsion. The best answer to complaining clients and beneficiaries is – "It is the very discretion placed in the hands of the Independent Trustee, with fiduciary duties, that enables the trust-owned assets to be imbued with the shelters that you desire."***
>
> ***In my experience, it is probable that a reasonably minded "controlled trustee" will not make a discretionary decision in favor of the primary beneficiary, which is the best result. The ability of an independent person or entity to say "no," is what blocks many adverse taxes and claimants.***

5. **The controls that can be given to someone who has the dual capacities of beneficiary and trustee are considerable. With proper design and situs, the powers operationally are the functional equivalent of owning the assets outright.**

> ***Planning note:*** ***Frequently distribution patterns provide for "force-outs" whereby the wealth is transferred out of the trust to beneficiaries at specified ages or events. Often, it is the age or ages of projected maturity, such as ½ at age 25; the remainder at 30, or alternatively, upon graduation from college. The advisor should counsel clients that this process is typically harmful. It is based on the false premise that since the inheritor is mature, just "give" them the wealth outright. That analysis fails to take into account that the elimination of the "trust wrapper" unnecessarily exposes the assets to taxes and creditors.***
>
> ***Most wealth advisors are hired to accomplish a dual purpose – protect the family wealth from unnecessary taxes and potential claimants. Would you really adopt a plan where the end result is the shift of a client's wealth (or inheritor's wealth) from a tax and creditor protected spot into an area that is unnecessarily exposed to loss? The preferable alternative of retaining (or at the inception, passing) the wealth "in trust" and shifting the control to the beneficiary achieves superior results. For a***

capable, mature inheritor, it is the best "built-in" estate and asset protection plan available under U.S. laws. Once someone receives the assets, or has a right to the assets, they will be unable to achieve the benefits and protections that they could be "given" by another party transferor if the assets are retained in trust.

6. **For less competent, immature, irresponsible beneficiaries, managerial controls will be modified/reduced/delayed/refined or possibly not be given at all. The tax and creditor shields remain and are generally increasingly necessary for a beneficiary with that profile.**

7. **Restrictions may be placed on the use, beneficial enjoyment, and dispositive powers of beneficiaries if the transferor desires to impose them. However, generally compressed controls often are not desired by transferors who would transfer the wealth outright "but for" the improvements that trusts can provide.**

8. **Examples of controls that may be restricted even for mature, capable, adult inheritors include:**

   a. **Investment controls and/or limitations – there may be cascading managerial controls. The two or more step process is often a wonderful training tool prior to shifting into full control. The beneficiary might first become a co-trustee and then morph into a trustee who has full investment control as well as control over the identity of the independent/distribution trustee.**

   b. **Reduction in the beneficial enjoyment – "I don't want my child to be a trust baby."**

   c. **Dispositive controls – "I am willing to give a power of appointment, but I want to restrict the class of potential appointees." For instance, "to my blood relatives" rather than "anyone other than the beneficiary; the beneficiary's estate; or the creditors of either." Alternatively, the definition of "spouses" may only include those who have been married to a blood descendant for a specified period, or have children with the blood descendant.**

E. **<u>Goals</u> - What do most clients really want to achieve when passing/shifting wealth to competent beneficiaries?**

   1. **Trusts enhance the gift or inheritance.**

      a. **It is difficult to envision a gift or bequest that would <u>not</u> be improved if it is made in trust rather than made outright.**

      b. **Many advisors use an artificial threshold amount before considering the use of trusts. Often that number is based on the**

then-prevailing estate tax exemption. And, because of portability, some even double it!!! That figure is way too high. Estate planning is more than just the avoidance of transfer taxes. Too often even some very intelligent, well-respected advisors are much too dismissive of the multiple non-transfer tax benefits that well-crafted trusts provide, including powerful income tax advantages.

c. **Proponents of the credit shelter threshold minimum amount often argue that trusts are (i) too complex; (ii) too controlling; (iii) too inflexible; (iv) too expensive etc. I respectfully submit that this view fails to adequately take into account the laws of unintended consequences that many families will suffer due to the "substantial, unnecessary, and irretrievable loss" of family assets to taxes, divorce and creditors that trusts can avoid, even if the beneficiary was given expansive, but allowable, controls. The trust simply must be designed, funded, operated and sitused properly.**[4]

d. **In addition to the traditional reasons that trusts are recommended – management, transfer tax avoidance, creditor protection and divorce protection - income tax sheltering is extremely powerful. The two strategies that I find most persuasive, and not given adequate attention are:**

   i. **Avoidance of state and city income taxes; and**
   ii. **Basis planning by creating inclusion in beneficiary(s) estate using general powers of appointments and Delaware tax traps. Most people will die with unused applicable exemption amount which can be accessed to increase income tax basis of trust owned assets.**

2. **Many modern trusts are created for tax and creditor protection purposes primarily to increase the benefits of the primary beneficiary, not to protect the interests of the remaindermen, under the philosophy that:**

   "I would give it (the wealth) outright (to that beneficiary), except for the shelters (tax and creditor protection) that trusts provide."

3. **Control plus beneficial enjoyment equals outright ownership.**

4. **Often the desire is to give the primary beneficiary full control and beneficial enjoyment during his or her lifetime.**

   a. **The other beneficiaries receive whatever is left over, if anything.**

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[4] **Keydel and Wallace**, ACTEC Symposium (3/6/1999); **Richard A. Oshins,** Advanced Planning Strategies Using Grantor Trusts; Chapter 27, 60th N.Y.U. Institute (2002)

b. Subordinate beneficiaries are able to participate earlier, if, and to the extent, the "controlled" independent trustee determines is appropriate.

5. Therefore, in making an "informed decision," these transferors would desire to permit a trustee/primary beneficiary to engage any type of plausible transaction that might enhance the trust and/or make the beneficiary "happy." The only restrictions would be that the trust purposes and trustee/beneficiary could not do anything that was illegal or against public policy.

6. The corollary of that design feature is to protect the primary beneficiary/trustee with broad exculpatory provisions that would leave potential secondary beneficiaries with minimal (and preferably no) effective remedies.

7. <u>Desired Result</u> -

- **<u>Give</u> the competent preferred beneficiary as close to "all powers, controls and beneficial enjoyment" that an individual beneficiary might have;**
- **<u>Preserve</u> the tax and creditor shelters; plus**
- **<u>Comply</u> with the fiduciary disempowerment system that has been reduced, but not eliminated, over time.**

The superior draftsperson will design empowerment provisions to negate or compress conflict with the general rules of self-dealing, impartiality and prudence.

F. <u>The "Wish List"</u> - It is reasonable to conclude that all competent inheritors want the exact same six (6) components of a wealth transfer - no more no less – the "Wish List".

1. With proper design, efficient operation and selection of appropriate protective situs, trusts can provide all of the components of the "Wish List" without exposing the trust owned assets to unnecessary taxes, creditors or unhappy subordinate beneficiaries.

2. The transferor, however, can reduce or eliminate the controls given if desirable.

G. <u>Components of the "Wish List"</u> – The first three are reasonable "controls;" the next two are "shelters;" and the sixth attribute is avoidance or elimination of undue and unnecessary complexities.

1. <u>Control</u> – Investment/managerial control.

2. <u>Use and Enjoyment</u> - Beneficial enjoyment and use of the trust assets for any purpose.

3. **<u>Flexibility</u> - Ability to alter or modify the planning especially if the family dynamics or the laws change.**

4. **<u>Creditor Protection</u> - Including protection from divorcing or dissident spouses.**

5. **<u>Tax Avoidance</u> - Including both transfer taxes and income taxes.**

   - **The avoidance of unnecessary state income tax, over time (dynastic trusts), is massive.**
   - **The basis adjustment potential by using multiple general powers of appointments to secure basis step-ups is very powerful.**

     <u>Planning note</u>: Unfortunately, the probability in most instances is that theory and application will differ. Too often advisors will <u>know</u> about the benefits they can achieve with proper planning, but they will fail to adequately explain the choices to their clients – or, they will fail to address the planning opportunity at all. It is difficult to conclude that an "informed" client would reject avoiding state income tax by simply "renting" situs in a state that has no state income taxes, but that result occurs frequently. Similarly, even if the trust indenture is designed properly, often the planning is not monitored.

6. **<u>Simplicity</u> – No one wants complexity.**

H. **<u>Everyone "Wants" all "Wish List" Components</u> - Although the priorities may differ, every one of the benefits in the "Wish List" would be desirable to all wealth transfer recipients, if achievable.**

   1. **The advisor's task is to obtain the "controls" (#1-#3) without compromising the "protections" (#4-#5) while reducing or avoiding "complexities" (#6).**

   2. **The goal is to give a competent beneficiary all controls, rights, powers and beneficial enjoyment over assets that an individual would have if he or she owned the property outright, but eliminating exposure to creditors or the taxing authorities.**

      <u>Planning note</u>: Frequently trusts are structured by "giving" beneficiaries the maximum benefits permissible under the IRC without exposing the trust assets to inclusion under the Estate Tax. Many "traditional trusts" are designed to "give" the beneficiary, some or all of the following "benefits:"

      i. ***income annually, or more frequently, for life;***
      ii. ***the right to withdraw corpus based on "an ascertainable standard for health, education, support, or maintenance" (IRC Sec. 2041 (b)(1)(A)); and***
      iii. ***the lapsing right to withdraw the greater of 5% or $5,000 annually (IRC Sec.2041 (b)(2)).***

I believe that the "unintended consequences" of these rights are not fully understood by most advisors and/or not adequately explained to clients. Paying

out the income reduces the income tax planning available and shifts the income from inside of the trust. A "5x5" withdrawal of power, even if exercisable only the last day of the year, exposes the withdrawal amount to creditors, including former spouses.

I. <u>Core Fiduciary Rules -</u> The default law of trusts imposes three important fiduciary duties on trustees – (i) loyalty; (ii) prudence; and (iii) impartiality. They conflict with the "Beneficiary Controlled Trust" concept. These are "default" rules and must be modified, reduced or eliminated in the trust instrument if the modern trust design strategies I encourage are adopted.

Professor Langbein states:

"The starting point is that each of the fiduciary duties is a default rule, including the core duties of loyalty (the duty to administer the trust solely in the interests of the beneficiaries), impartiality (the duty of due regard to the interests of all beneficiaries of a trust), and the duty of prudence in the conduct of trust administration (the care norm, requiring the exercise of reasonable care, skill and caution)."[5]

<u>Planning note</u>: It is permissible to modify all three of the core fiduciary obligations. In configuring the modern beneficiary controlled trust, the goal is to structure the instrument as close to, but not over, the fine line of compressing trustee duties of the preferred/primary beneficiary and not impacting his or her controls and enjoyment. It is the ability to avoid over-deterrence, but to negate exposure which would render the trust wrapper illusory, that separates the superior planner from those in the mainstream. This rule addresses not only the trust design, but also the situs selection and the implementation process. If the client and trustee do not respect the plan, they should not expect that the courts and/or taxing authorities will.

i. The settlor can alter, amend or negate any or all of the default rules with certain restrictions. "There are, however, some mandatory rules, which the settlor is forbidden to vary."[6]

a. The duties of good faith, fairness, candor and honesty cannot be extracted from the trustee's duties.
b. Negating these obligations would result in eliminating the trustee's fiduciary capacity.[7] **As a result the trust's existence will be ignored.**

J. <u>Reasonable Control</u> - Inheritors will not be happy unless they have "reasonable controls" - managerial control and dispositive (including "use") control.

1. Modern trust theory often gives the competent beneficiary:

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[5] Langbein, John H., "Questioning the Trust-Law Duty of Loyalty: Sole Interest or Best Interest?" (2005) Faculty Scholarship Series. Paper 495.

[6] See fn. 5

[7] UTC Sec. 105(b)(1) cmt.

"All powers over the trust property which an unmarried competent owner has over individually owned property."[8]

2. **Essentially, "all powers" is "reasonable controls," that is "full control" with minimal, non-impactful restrictions.**

3. **There has been a profound transformation in theory and law relating to trustee controls and trustee decision-making.**

   a. **Prior to the evolution, the laws and courts favored the use of disempowering trustee restraints. These restrictions were designed to protect trust beneficiaries from the perils of trustee misbehaver.**
   b. **Present laws allow trustees to be given broad decision-making capacity. As a result of this erosion of the draconian restrictions, trustees may be authorized "to engage in every conceivable transaction that might enhance the value of the trust assets…"[9]**

4. **The compression of the disempowerment system shifted to legislation allowing broad authorization of trustee powers enabling them essentially to do anything in the best interest of the trust, as long as it is not illegal or against public policy. That is consistent with the modern trust design approach – "I would give the assets outright but for the shelters that *in trust* transfers provide."**

5. **Certain controls, such as investment decision-making, are innocuous. Other controls, may present risks under some circumstances. To illustrate, the unfettered right to fire and replace a distribution trustee (even if the successor is limited to a party acceptable by the IRS under Rev. Rul. 95-58) concerns me. Even though the prevailing view does not result in tax exposure, it is easy for a cynical observer to project that there will be rogue judges who will apply what they believe the law "should be" and view too much control as essentially the equivalent of entitlements and owning the trust assets outright.**

6. **The greater the controls, the greater the wealth is exposed to taxes and potential claimants. The judicial trend is to attack trusts where too many controls are given to the beneficiary.**

   a. **How much is "too much" is a judgment decision.**
   b. **I recommend erring on the conservative side and avoiding the risk.**
   c. **The generally acceptable conservative controls should satisfy even the most demanding beneficiary, except proper situs is essential. Not selecting, and respecting, proper situs will enable more and more successful plaintiff attacks.**

K. <u>The Proper Approach</u> - "Control it; don't own it."[10]

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[8] UTC Sec. (2000) 815

[9] Langbein fn. 5

[10] Attributed to John D. Rockefeller

1. **Full control, plus use and enjoyment equals outright ownership**

2. **Legal title is harmful – It does not shield the assets from:**

   a. **Creditors**
   b. **Taxes**

3. **Investment/managerial control will not expose the trust-owned assets to taxes or creditors with one exception: life insurance on the life of the trustee.**

   a. **Controls over life insurance on a Trustee's own life will expose the proceeds to estate tax inclusion. IRC Sec. 2042.**
   b. **Control over life insurance on the life of someone else is outside of the scope of IRC Sec. 2042.**

4. **It is difficult for me to conclude that an intelligent, <u>informed</u> person would not want to inherit their wealth in trust if they were given all components of the "Wish List".**

   a. **Full control; use and enjoyment; protections; simplicity.**
   b. **If they were completely candid, no inheritor would really elect to compromise the trust shelters from unnecessary taxes, creditors and divorces if they truly understood the consequences of the alternative. A byproduct of that thesis is that the informed transferor or inheritor would want to "rent" the laws of a favorable trust situs if the value/cost/complexity proposition was adequately addressed.**
   c. **For instance, simply because the assets are owned by a trust they are shielded even though they are used for any legal purposes. Because some state's creditor laws are inferior and/or some have state income tax, situs planning is integral to proper advice.**

L. <u>Operational Efficiency</u>

a. **Use it; don't lose it.**

b. **Operate the trust efficiently but follow the rules.**

c. **Remember that any assets distributed from the trust have at least some adverse consequences. The protective shelter of the trust entity is removed.**

d. **Certain distributions should be made, for example to achieve income tax savings, but it should be done after consideration of other factors, including creditor shelter implications.**

e. **Resist the temptation that many trustees fall into of simply distributing current trust income. For some reason many trustees will distinguish income from corpus and feel compelled to distribute the income. Of course, sometimes income should be distributed. However, it should not be disbursed just because distributing current income seems**

appropriate.[11] Income retained in the trust often has favorable income tax, transfer tax and creditor shelter benefits.

M. <u>Use a "Use" Trust</u>

1. **Keep assets inside of the trust wrapper and simply "use" the assets.**

2. **Under the philosophy that "the more control that you possess, the greater the risk you have," consider using an Independent Trustee to determine which beneficiary(s) may use the trust-owned assets.**

3. **Current law does not appear to impose the foregoing restraint, however, I am concerned with the judicial and administrative trend of expanding the rights of claimants.**

4. **The ability to "use" trust assets may be for any purpose, including "happiness." The ascertainable standard restrictions of IRC Sec. 2041 (b)(1)(A) do not apply to the use of trust owned assets. For example, a life estate will not result in estate tax inclusion even though the owner may use the asset for any purpose whatsoever.**

5. **Distributions can be made (i) if beneficiaries need the money; (ii) it is tax beneficial (after consideration of the other consequences); or (iii) in many instances if the beneficiary(ies) simply wants the money, even if the money will be spent to satisfy the beneficiary(ies) champagne and caviar tastes. The later would apply if the transferor was using the trust vehicle rather than an outright transfer principally for shelter purposes.**

6. **The "Use" Trust is essentially as simple to operate as a Revocable Trust. In fact, a compelling argument can be made that it is simpler!!!!**

    a. **It can be operated in the same manner as a Revocable Trust, except the beneficiaries cannot make gratuitous transfers to the trust.**

    b. **If the trust is a grantor trust for income tax purposes there isn't even a need to file an income tax return.**

    c. **If the trust is not a grantor trust, an income tax return must be filed. However, there are many income tax sheltering opportunities to improve overall tax consequences. They include sprinkling income to lower bracket beneficiaries, avoiding state income taxes, and basis adjustment planning using IRC Sec. 2041.**

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[11] Often a trustee will distribute all annual income to current beneficiaries under the belief that approach reflects a fair and impartial allocation between current beneficiaries and remainder beneficiaries.

7. **For maximum tax and creditor shelter, give an independent trustee the uncontrolled right to pay to; pay for the benefit of; or permit the use of trust assets, to or for, more than one beneficiary. The independent trustee can also elect to not pay, or permit the use of the trust assets. Preferential treatment guidance is not harmful. The decision should, however, be made only if it will carry out the intention of the trust purposes.**

   <u>Planning note</u> – Typically many advisors seek to "enhance" the planning process by telling the client/transferor what he or she <u>can</u> "give" to the donee or other transferee. "More is not always better." I recommend reversing the process. Using the "Wish List," ask the donor, or other transferor, "Which of these do you want the beneficiary to receive?" and, "Which of these do you not want to beneficiary to have?" It is difficult to envision an "informed" transferor not electing to provide every one of the "Wish List" options, if they otherwise desired to transfer the wealth outright.

N. <u>Duration</u> - If you conclude, as I have, that "inheriting in trust is <u>always</u> better than inheriting the same assets outright," then it should naturally follow that trusts should continue for as long as is permissible under state law.

1. **It is difficult for me to envision a circumstance where an earlier termination date is defensible.**
2. **Would you terminate a business entity status at the death of the owner? Of course not.**
3. **Then why would you consider exterminating the trust wrapper and the sheltering it provides before it must be terminated?**

O. <u>Modify or Eliminate Default Rule</u> - Essential to the Modern Trust Planning strategy is the use of a "Beneficiary Controlled Trust" whereby the primary beneficiary has all controls (Wish List items #1 - #3) and shelters (Wish List #4 - #5) with minimal, if any, unnecessary complexity (Wish List #6). The trust design must deal with and conform to all fiduciary governance rules. In the absence of proper drafting, fiduciary standards imposed on trustees generally restrict, or eliminate "full control."The primary issues that the trust scrivener must address are:

1. **The "Duty of Loyalty" rule – Outline Sec. III**
2. **The "Prudent Person" rule – Outline Sec. IV**
3. **The "Duty of Impartiality" rule – Outline Sec. V**

<u>Planning note</u>: Most of the discussion below (referencing the foregoing three fiduciary duties relate to the "default" rules that are applicable unless altered by agreement of the parties. The default rules can, and in most instances should, be modified in the trust agreement. In such instance, if there was informed consent, they will yield to the express agreement of the parties.

The starting point in designing a Beneficiary Controlled Trust is to eliminate, to the largest extent possible, all three duties. That assumes the intention is to pass the wealth with the maximum beneficiary controls. In such instance, to the extent it does not expose the trust assets to unnecessary taxes or creditors, the favored beneficiary should be permitted to transact (buy/sell/lend/borrow), with himself (or other "conflicted party") subject only to the mandatory, non-waiverable fiduciary mandates.

III. DUTY OF LOYALTY

A. ***"The most fundamental duty owed by a trustee to the beneficiary is the duty of loyalty."***[12]

B. ***"The most fundamental principal of the fiduciary obligation in trust law is the duty of undivided loyalty to the beneficiary. A trustee must administer the trust solely in the interests of the beneficiary." (Emphasis the authors)***[13] **Note the "key" phrases:**

1. **Most fundamental principal**
2. **"Undivided" loyalty**
3. **"Solely" in the interest**

C. **If asked if they knew what the "Duty of Loyalty" is, most advisors believe that they could easily describe it with reasonable precision. I believe that the majority would substantially understate both the duties imposed and the strict rigidity that the courts use to enforce the duty.**

D. ***"It is generally, if not always, humanly impossible for the same person to act fairly in two capacities and on behalf of two interests in the same transaction."***[14]

1. **The "impossibility" standard is especially apparent when the trustee's own interests are involved.**
2. **Professor Langbein**[15] **correctly points out that this is an overstatement and that conflicts often occur in the real world that are resolved equitably.**
3. **Nevertheless, Professor Bogert's famous statement as to the standard of behavior (although the implementation is quite draconian) is the prevailing view of the courts.**
4. **See, for example, Judge Benjamin Cardozo's famous quote, in *Meinhard v. Salmon.***

"Not honesty alone, but the punctilio of honesty is the standard of behavior."[16]

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[12] Scott, "The Law of Trusts"; Bogert & Bogert, "The Law of Trusts and Trustees"
[13] Dukeminier and Sitkoff," Wills, Trusts, and Estates", p 588
[14] Bogert & Bogert, "The Law of Trusts and Trustees"
[15] Langbein fn. 5
[16] 164 N.E. 545, 546 (N.Y. (1928)

5. **The proscription against self-dealing is a strict rule resulting in a conclusive presumption against the breaching party. There are no exceptions. It is imposed with "uncompromising rigidity" unless one of the defenses apply.[17] Defenses are listed in Sec. III. L., below.**

E. The "Duty of Loyalty"/"Prohibition against self-dealing" is discussed by the leading textbook covering the subject as follows:

"If a trustee undertakes a transaction that involves self-dealing or a conflict between the trustee's fiduciary capacity and personal interests, good faith and fairness are not enough to save the trustee from liability. In such a case <u>no further inquiry</u> is made; the trustee's good faith and reasonableness of the transaction are irrelevant." (Emphasis the authors)[18]

F. The "Duty of Loyalty" key concepts

1. **<u>Sole</u> interest**
2. **Any <u>possibility</u> of self-dealing results in liability.**
3. **<u>No further inquiry</u> – good faith and favorable outcome will not be enough to save the trustee from liability.**

G. "Sole" interest; not "best" interest

"A trustee shall administer the trust solely in the interests of the beneficiaries."[19]

"(T)he duty of loyalty requires a trustee to act in the <u>"sole interest"</u> of the beneficiaries, not just in the <u>best interests</u> of the beneficiaries. For example, the duty of loyalty prevents a trustee from engaging in a transaction that involves a <u>potential</u> conflict of interest, even if the transaction is in good faith and maximizes the interests of the beneficiaries (e.g., the conflicted party is offering the highest price). A court will not evaluate the good faith of the trustee or the fairness of the transaction. Instead, if the transaction violates the sole interest rule, the court will make "<u>no further inquiry</u>" and find that the trustee has breached its duty of loyalty." (Emphasis added) [20]

H. "Sole" interest of the trust beneficiaries

1. **Default rule - "Undivided" loyalty**

2. **Unless one of the exceptions (defenses) apply, the self-dealing prohibition can compromise the best interests of the beneficiaries. The often-cited illustration of a harmful economic result is "the auction" rule.[21] A trustee is prohibited from making a higher bid at an auction without breaching his/her/its duty of loyalty, *unless* an exception is applicable. As a consequence, the sole interest rule result, in certain factual situations, is that the beneficiaries are harmed. For example, in an auction in order for the trustee's bid to prevail, it must be higher than the**

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[17] *Meinhard v. Salmon* Id
[18] Dukeminier & Sitkoff, p 591
[19] UTC Sec. 802
[20] Daniel B. Kelly, "Remedies for Breach of Trust" p. 20
[21] Langbein fn. 5

current highest bid, but it is impermissible without the trustee running afoul of the sole interest rule.

> ***<u>Planning note</u>: Ideally, the trust document will have modified, or eliminated the self-dealing rules. If not, the cure would be for the trustee to obtain an exception to the general rule either by securing prior beneficiary consent after disclosure of all material facts or obtaining prior court authorization. That solution is simple and sensible, but is often not considered.***

I. The mere "possibility" of self-dealing results in a breach.

"(T)he duty of loyalty prevents a trustee from engaging in a transaction that involves a <u>potential</u> conflict of interest, even if the transaction is in good faith and maximizes the interests of the beneficiaries." (Emphasis supplied) [22]

"Not because there <u>is</u> fraud, but there <u>may</u> be fraud." (Emphasis supplied) [23]

"(L)oyalty can be preserved only if the relationship is stripped of the <u>possibility</u> of such conflicts. The duty of loyalty is, therefore, not the duty to <u>resist</u> temptation, but to <u>eliminate</u> temptation, as the former is assumed to be impossible." according to Professor Bogert. (Emphasis supplied)

"(T)he beneficiary only need show that the fiduciary allowed himself to be placed in a position where his personal interest <u>might</u> conflict with the beneficiary." (Emphasis the Court's) [24]

J. "No further inquiry" rule.

1. **The Conflicted Trustee is automatically liable.**
2. **The Court will not evaluate the good faith or the fairness of the transaction. They are not relevant. Honest and dishonest trustees are treated the same.**
3. **The trustee is irrefutably presumed disloyal and the only issue is the measure of the damages.**

K. Measure of Damages – Protection against trustee opportunism – Plaintiff can elect damage option

1. **Optimal remedy election**

    a. **Profits – disgorgement of profits**

    i. **Goal – Offset the incentive to breach by providing for optimal deterrence.**

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[22] Daniel B. Kelly, "Remedies for Breach of Trust" p. 20

[23] Piatt v. Longworth's Devisees, 27 Ohio St. 159, 195-196 (1875)

[24] Fulton Nat'l Bank v. Tate, 363 F2d 562,571 (5th Cir. 1966)

ii. **Professor Kelly's paper discusses in detail the burdens that trust beneficiaries have in detecting and proving trustee breaches and the rationale of the courts imposing "optimal" deterrence remedies. He states that *"an election of remedies eliminates a trustee's incentive to breach."*[25]**

iii. **Kelly also states – *"Similarly, if an election of remedies is optimal, there is an economic justification for punitive disgorgement. Under this novel remedy, a court would not only strip ill-gotten gains but also impose a multiplier that would force a trustee to disgorge any benefits by paying expected disgorgement equal to the gain."*[26]**

iv. **The disgorgement remedy is to *"impose some element of punishment that helps overcome any remaining errors in detecting wrongdoing."*[27]**

b. **Consequential damages - harm to the Plaintiff**

c. **Rescission**

2. **Possible punitive damages[28]**

a. **To prevent "efficient fiduciary breach"**

i. **If breach does not have punitive effect, trustees' incentive to breach will not be diminished.**

There is minimal or no risk to a trustee who violates his or her duties, and simply unwinds advantageous personal violations. He or she is not punished if caught, but benefits if not caught. Coupled with the difficulty of detection, the rule is necessary to disincentivise efficient fiduciary breaches.

ii. **The election of remedies and potential punitive damages raise the stakes and reduces or eliminates a trustee's incentive to breach.**

b. **Meaningful for deterrence by increasing the stakes. Contract law damages do not act as a deterrent.**

c. **To offset difficulty of detecting and proving wrongdoing. The consistent theme of the "sole interest rule" is to prohibit conflicted trustees from using their administrative control of the trust to conceal their wrongdoing and prevent detection.**

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[25] Kelly, p.5.
[26] Kelly, P.7.
[27] **Cooter & Freedman**, "The Fiduciary Relationship: Its Economic Character and Legal Consequences, 66 NYU Law Review 1045, 1074 (1991)
[28] **Daniel B. Kelly**, "Remedies for Breach of Trust" p. 20

L. Defenses

1. **<u>Settlor authorization</u> – Can be Express or Implied**

    a. **Express - Stated in the trust indenture**
    b. **Implied – e.g., settlor appoints a "conflicted person" to act as trustee in the document. For example, a child is selected to be trustee of his or her parent's credit shelter trust: the child would be a "conflicted person" at the inception of the trust, but the exception would apply. The court will infer waiver of the sole interest rule.**

    ***"It is well established that a trustee may occupy conflicting positions in handling the trust where the trust instrument contemplates, creates, or sanctions the conflict of interest."*[29]**

2. **<u>Beneficiary Consent</u> – After full disclosure of all material facts, a beneficiary cannot hold a trustee liable for breach of trust if the beneficiary consented to an act or omission of an act if the beneficiary gave informed consent.**

3. **<u>Prior judicial approval</u> – Must be in advance.**

M. Even if there is a defense, the requirements of "good faith", "honesty", "candor" and "fairness" continue. They cannot be waived.

N. Over-deterrence concern

1. **Paralysis by analysis - trustee does nothing due to fear of liability.**
2. **Costs of compliance.**
3. **Time to obtain approval.**
4. **Missed opportunities.**
5. **Often disingenuous results – Even if trustee can improve the trust's economic outcome, it still is a breach and the "conflicted" trustee is liable.**
6. **For example, the trustee outbids the highest bidder at an auction. [30]**
    a. **The fact that the auction is conducted by a legitimate independent auction house is irrelevant.**
    b. **The fact that the trust benefits is irrelevant. The beneficiaries receive less if the trustee cannot bid. i.e., in order to win the auction, the trustee's bid must exceed all other bids.**
7. **Consider this issue outside of the trust context.**
    a. **Prof. Langbein illustrates the absurdity of the result using a dentist. If the dentist discovers that a patient needs a crown, does the dentist have to refer the patient to another dentist?**
    b. **That course of action is harmful to the dentist who loses business and to the patient who has to pay two dentists.**
    c. **The need to protect beneficiaries is similar. The dentist has the financial incentive to provide additional services; not fewer.**

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[29] Estate of McCredy, 470 A.2d 585, at 600 (1983)

[30] Langbein fn. 5, "This outcome is value impairing; it harms the beneficiary by successfully deterring what would have been the high bid." P.52

d. Similar to honest v. dishonest trustees, there are honest and dishonest dentists. The analysis of duties, however, differ.

8. For estate planners, consider the following:

a. Trustee is the lawyer for the trust. Does he/she have to refer a decanting or amendment to another law firm?

b. Trustee is the CPA for the family. Does he/she have to refer the accounting and tax return to another CPA firm?

c. A life insurance advisor's opportunity to profit, by selling more rather than less, or higher commissioned products is especially apparent.

d. Surely, these advisors have the financial incentive to do more work; not less work.

e. Although the regularity is more recognizable with advisors on commissions, the frequency of other conflicted service providers is common.

O. Self-dealing is not inherently wrong especially with trusts created under the "if not for taxes and creditor protection I would have passed the wealth outright" thesis.

P. Drafting suggestions.

1. Permit self-dealing in the instrument – Exception #1. "*Notwithstanding any rule of law relating to self-dealing ….*"

2. Require good faith

a. That is not waivable

b. Cosmetically stating the requirement in the document looks good in both tax and creditor's rights contexts.

3. Require "adequate and full consideration"

a. Protects against attacks under IRC Secs. 2036 and 2038

b. Creditor protection preserved

IV. PRUDENT PERSON RULE

A. General rule - a trustee must act prudently in administrating, investing and distributing trust property

B. The Prudent Investor Rule provides:

"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 on the provisions of the trust." Sec. 1 (b).

C. Duty of loyalty and duty of prudence compared

1. Duty of loyalty – absolute standard; no further inquiry

2. Duty of prudence

a. Common sense, objective standard

b. **Prudent management and care**
c. **No hard and fast rule**
   i. **Facts and circumstances**
   ii. **As determined by Settlor's goals; beneficiary(s) profile; and the governing document**

d. **Determined at the time of the decision or action**
   i. **Not outcome**
   ii. **Good results are not mandated**
   iii. ***"The law holds fiduciaries to a high standard of care, but does not mandate good results."*[31]**
   iv. **There is a very real fear of "hindsight bias". Judges and juries will give weight to what the result was after the fact rather than analyzing the decision based solely on the facts existing at the time the decision was made.**
e. **Intention of the transferor and the instrument**

3. **Guidance**

"… a standard of conduct, not outcome or performance. … determined in light of the facts and circumstances <u>prevailing at the time of the decision or action</u> of a trustee" NYEP&T Law 11-2(b)(1) defining the "prudent investor rule" in N.Y. (Emphasis added)

   a. **In making these decisions, the trust should consider all reasonable factors, to the extent relevant.**
   b. **The trustee should take into account the intention of the transferor as expressed, or implied, in the governing trust indenture.**
   c. **The trustee should take into account the design strategy of the trust.**

4. **Modern trust analysis has abrogated categoric restrictions. No particular type of investment is considered inherently prudent or imprudent. The UPIA implicitly disavows the emphasis in older law on avoiding risky investments.**

5. **Modern trust guidance emphasizes a consolidated portfolio standard rather than each individual asset.**

6. **Do we want to impose unnecessary standards for the inheritor to whom we were going to pass wealth outright but for the shelters that trusts offer?**

   a. **Why impose restrictions?**
   b. **If the transferor would pass the wealth outright "but for" the "in trust" shelters, presumptively the transferor would want to permit the trustee to engage in any conceivable transaction which may augment or improve the trust.**
   c. **Often certain investments, including many that would be forbidden by the "prudent person" rule, are desirable**

[31] Randy Roth. Liability Issues for Lawyers and Other Fiduciaries", 44 U. Miami Heckerling Inst. on Est. Plan., Ch. 16 (2010) p. 16-30

i. **Family business – especially a non-controlling interests that do not have a ready market**
ii. **Artwork**
iii. **Low or no interest loans to beneficiaries, even without adequate collateral or none at all**

d. **Generally we want minimal restraints. The restrictions imposed are the minimum necessary to achieve the twin goals of avoiding exposure to unnecessary taxes and creditors.**

***Planning note**: Under the common law, certain investments, such as start-up ventures are viewed as inherently risky. Modern estate planning recognizes the fundamental fact that many start-up ventures are often the best asset to plan with in the wealth shifting process. The concept is called "opportunity shifting." Shifting a favorable business or investment opportunity to a child, grandchild, or preferably a trust, is an essential tool in the estate planner's arsenal and is generally accepted as a superior planning strategy.*

An opportunity shift is not a "gift" subject to the transfer tax system because the gift tax only applies if there is a gratuitous transfer of property. Powerful benefits will accrue if the "seed" money for the start-up venture is transferred by someone who is not a trust beneficiary and the favorable opportunity is acquired by the trust. All growth will be outside of the transfer tax system and not be subject to creditors, if sitused correctly. The benefits will be magnified if the trust is a "grantor trust" for income tax purposes either as an IDGT or a BDIT. The planner must be sure to empower the trustees to engage in these activities. In general, that means modification or elimination of the self-dealing rules and the duties of prudence and impartiality. Properly drafted trusts contain these adjustments.

Q. Drafting

1. **Negate "prudent person rule" in the trust instrument**

2. **Goal is to "…authorize trustees to engage in every conceivable transaction that might enhance the value of the trust assets."** [32]

3. **The trustee may disregard:**

   a. **Whether a particular investment will produce a reasonable rate of return**
   b. **Whether a particular investment will result in the preservation of principal**
   c. **Whether a particular investment is consistent with the duty of impartiality**
   d. **Whether the trust is diversified**
   e. **Whether the investments are risky or speculative**

4. **Exculpatory language**

   a. **The trustee is not liable merely due to the nature of the investments**

[32] Langbein fn. 5

b. The trustee is not liable merely due to the degree of risk of the investments
c. The trust instrument cannot waive liability in certain circumstances. The trustee is liable for
i. Willful misconduct
ii. Clear negligence

5. Give the beneficiary a broad special power of appointment

a. Can eliminate any complaining beneficiary – "A power of appointment, is a power of disappointment." [33]
b. Shows the intention of the settlor to give all permissible controls to the primary beneficiary to the exclusion of others.

V. DUTY OF IMPARTIALTY

A. The general rule is that the trustee must act impartially in investing, managing and distributing the trust, giving due regard to the respective interests of the beneficiaries.[34]

B. This guidance does not mandate equality, rather it means that the trustee should take into account the respective interests of all beneficiaries as set out in the trust indenture.

C. Trusts are often designed to prefer one beneficiary, or class of beneficiaries over others. There is no proscription to favoring a single beneficiary, or a class of beneficiaries, even if it results in the exclusion of the others. In such instance, the default rule should be amended or eliminated to reflect this attitude.

D. The "Beneficiary Controlled Trust" design strategy gives the favored inheritor all allowable controls and enjoyment of trust owned assets; i.e., the functional equivalent of outright ownership, without compromising the "in trust" shelters. In such instance, the beneficiary is given what amounts to "full control." One of the "controls" is the ability to control the identity of, or influence the person who controls or enjoys the trust assets. The desire is to eliminate all interference from others to the extent permissible – i.e., preserving all trust protections.

[33] Attributable to Prof. Ed Halbach.
[34] UTC Sec. 803 (2000)