2014 Cannon Estate Planning Teleconference Series

PARTICIPANT PACKET

August 19, 2014

WHO WANTS THIS JOB? SELECTION OF TRUSTEES AND OTHER FIDUCIARIES

Presented By:

CANNON FINANCIAL INSTITUTE

20905

Who Wants This Job? Selection of Trustees and Other Fiduciaries

Cannon Financial Institute, Inc.

Presents

The 2014 Estate Planning Teleconference Series

Featuring

Charles A. Redd

Tuesday, August 19, 2014

CHARLES A. REDD, PARTNER
STINSON LEONARD STREET LLP
7700 FORSYTH BOULEVARD, SUITE 1100
ST. LOUIS, MISSOURI 63105-1821
314-259-4534 - TELEPHONE
314-259-3952 - FAX
charles.redd@stinsonleonard.com

www.stinsonleonard.com

The seminar materials and the seminar presentation are intended to stimulate thought and discussion, and to provide those attending the seminar with useful ideas and guidance in the areas of estate planning and administration. The materials and the comments made by the presenter during the seminar or otherwise do not constitute and should not be treated as legal advice regarding the use of any particular estate planning or other technique, device or suggestion or any of the tax or other consequences associated with them. Although we have made every effort to ensure the accuracy of these materials and the seminar presentation, neither Cannon Financial Institute, Inc. nor the attorneys presenting the program assume any responsibility for any individual's reliance on the written or oral information presented in association with the seminar. Each seminar attendee should verify independently all statements made in the materials and in association with the seminar before applying them to a particular fact pattern and should determine independently the tax and other consequences of using any particular device, technique or suggestion before recommending the same to a client or implementing the same on a client's or his or her own behalf.

CHARLES A. REDD

CHARLES A. REDD is a partner in the firm of Stinson Leonard Street LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group of SNR Denton US LLP. Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company, (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now U.S. Trust Bank of America Private Wealth Management).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, pre-nuptial agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects each involving assets valued at several hundred million dollars and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements and other types of cases involving estates and trusts.

Mr. Redd is a member of the American Bar Association (Section of Taxation and Section of Real Property, Probate and Trust Law), the State Bar of Wisconsin, The Missouri Bar (Probate and Trust Committee), the Illinois State Bar Association (Section on Trusts and Estates), The Bar Association of Metropolitan St. Louis (Probate and Trust Section, member and past chairman) and the Estate Planning Council of St. Louis.

Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award.

Mr. Redd is an elected member of The American Law Institute, a Fellow of The American College of Trust and Estate Counsel (Board of Regents; Missouri State Chair; Communications Committee (Chair); Estate and Gift Tax Committee; and Fiduciary Litigation Committee) and an Adjunct Professor of Law (Estate Planning) at Northwestern University School of Law. He also serves as Co-Chair of the Editorial Advisory Board of Trusts & Estates magazine. Mr. Redd is listed in Who's Who in the World, Who's Who in America, Who's Who in American Law and The Best Lawyers in America. He has been designated as Best Lawyers' 2012 St. Louis Trusts and Estates Lawyer of the Year and 2012-2013 and 2013-2014 St. Louis Litigation-Trusts and Estates Lawyer of the Year. He is also nationally ranked by Chambers USA in its "Wealth Management" category. He speaks and writes frequently on topics in the trusts and estates field.

* * * * * * * * *

TABLE OF CONTENTS

Page

Who Wants This Job? Selection of Trustees and Other Fiduciaries

By: Charles A. Redd
Stinson Leonard Street LLP
St. Louis, Missouri

A. Introduction

Among the aspects of designing an estate plan that deserve the most attention, although often relegated to the status of an after-thought, is carefully identifying who would be most qualified and effective in various fiduciary roles, probably the most important of which are the roles of Trustee and successor Trustees. Even with estate planning documents of superb technical quality, if the fiduciaries entrusted to implement the directives in those documents are inappropriate, the client's estate planning goals will likely fail to be achieved, and they could blow up entirely.

Who is best suited to serve as a Trustee or other fiduciary depends, of course, on the circumstances, which can vary dramatically. There are numerous factors that should be taken into account and analyzed in selecting a fiduciary.

B. Checklist of Fiduciary Duties

A prerequisite to making informed decisions as to who would be the most appropriate fiduciary is comprehensive knowledge of what duties a given fiduciary must be prepared to fulfill. What follows is a list of responsibilities that a prospective Trustee should anticipate and have the ability and willingness to carry out:

- Establish possession and/or control of and conserve and safeguard assets to which the Trustee is entrusted. *See, e.g.,* UTC §§ 809 and 812.

- Except where unreasonable under the circumstances, prosecute claims belonging to the trust and defend against claims against the trust. *See, e.g.,* UTC § 811.

- Make appropriate investment decisions consistent with the purposes of the trust. A Trustee has a duty to make trust property productive. The Trustee must prudently invest trust property to assure both sufficient income for the current income beneficiaries and appropriate capital preservation and appreciation for the remainder beneficiaries. *See, e.g.,* UTC § 804. The settlor or testator may instruct the Trustee in the governing instrument that, in making investment decisions, the Trustee should emphasize either current income or underlying asset appreciation. If the principal is invested so that the principal does not appreciate, the impact of inflation could significantly erode the value of the remainder interest. If the trust's governing instrument or applicable state law is up-to-date, the Trustee may be permitted, or even encouraged, to implement a style of investing promoting total return. RESTATEMENT (THIRD) OF THE LAW – TRUSTS ("Restatement Third") § 90. In addition, the Trustee may have a duty to diversify trust investments unless the trust instrument waives the requirement or it would be prudent under the circumstances not to diversify. Uniform Prudent Investor Act § 3; Restatement Third § 227(b).

- Actively manage non-standard trust assets that require active management, *e.g.*, farm, ranch or commercial real estate, closely held business interests, mineral interests.

- Make mandatory distributions as required by the trust instrument and appropriate discretionary distribution decisions consistent with the purposes of the trust. *See, e.g.,* UTC § 814. This will often require the prudent exercise of discretion to sprinkle income and, possibly, principal to one or more beneficiaries in accordance with the trust instrument. The Trustee must be impartial and fair to all beneficiaries, both current and remainder. *See, e.g.,* UTC § 803. Discretionary distribution decisions may become contentious particularly when the Trustee is also a beneficiary. Restatement Third § 50. Query whether a Trustee should take into account the income tax posture of beneficiaries in an effort to assure that the overall income tax liabilities of the trust and its beneficiaries will be minimized to the extent consistent with the settlor or testator's objectives.

- Prepare and render to beneficiaries informative and accurate accountings and, generally, provide to beneficiaries that which is sufficient to keep them reasonably apprised about trust administration and enable them to protect their interests. *See, e.g.,* UTC §§ 810 and 813. Not only is compliance with these duties conducive to a good relationship between the Trustee and the beneficiaries, but these disclosures will often start the running of the statute of limitations on claims related to the disclosure. *See, e.g.*, UTC § 1005; Restatement Third § 82; *McNeil v. McNeil*, 798 A.2d 503 (Del. 2002) ("A Trustee has a duty to furnish information to a beneficiary upon reasonable request. Furthermore, even in the absence of a request for information, a Trustee must communicate essential facts, such as the existence of the basic terms of a trust.").

- Keep trust assets segregated from the Trustee's own assets and from the assets of other trusts. *See, e.g.,* UTC § 810.

- File tax returns and pay taxes and assessments for which the trust is responsible.

- Incur only costs that are reasonable in connection with trust administration. *See, e.g.,* UTC § 805.

- Refrain from delegating the entire administration of the trust to a non-Trustee. *See, e.g.,* UTC § 807.

- Upon the event of trust termination, expeditiously make termination distributions to the beneficiaries entitled to receive such distributions. *See, e.g.,* UTC § 817.

- Administer the trust solely in the interests of the beneficiaries and refrain from self-dealing. A Trustee must not make decisions that further or promote the Trustee's own interests to the detriment of the beneficiaries. Generally, any transaction in which the Trustee has a personal interest may be questioned unless there is specific authorization for such transaction in the trust instrument, consent by all interested parties or court approval. 3 Scott and Ascher on Trusts, 5th ed. § 17.2; UTC § 802; *Boyce Family Trust v. Snyder*, 128 S.W.3d 630 (Mo.App. 2004) (Trustee liable for damages resulting from entering into an agreement to buy a supermarket that the Trustee owned individually without disclosing the Trustee's personal interest in the transaction).

- Administer the trust in conformity with the terms of the governing instrument and applicable state law. *See, e.g.,* Uniform Trust Code ("UTC") § 801. Moreover, if there is an ambiguity in the governing instrument, the Trustee may need to request a court to give instructions regarding what the instrument means. *See, e.g.,* UTC § 202. Alternatively, the Trustee could endeavor to reach an agreement with the interested parties regarding the interpretation of the ambiguous terms. *See, e.g.,* UTC § 111. A fiduciary is usually protected from liability for breaches of trust that arise from reasonable reliance on the terms of the trust document. *See, e.g.,* UTC § 1006.

C. Criteria to be Considered When Selecting a Trustee

1. Trust Characteristics

What are the primary and secondary purposes of the trust? Such purposes might include providing professional investment management, asset protection, tax minimization, protection of beneficiaries from their own financial improvidence, preservation of assets for the enjoyment of multiple generations and encouraging beneficiaries' positive behaviors and choices and discouraging negative ones.

Who will be the beneficiaries of the trust? The beneficiaries may consist of individuals who, because of mental or physical disability, or because they are not adults, would be unable to manage assets for their own benefit. A beneficiary could have a difficult personality or could be a spendthrift. A beneficiary's age, health status, position in his family, personal financial situation and other characteristics will likely impact trust administration decisions.

What are the dispositive provisions of the trust? There are myriad alternatives. The dispositive provisions could be relatively easy to administer to the extent they do not involve the exercise of discretion, *e.g.*, mandated periodic payments of income or a unitrust amount, powers of appointment or withdrawal held by beneficiaries, etc. On the other hand, it will be more challenging to administer a trust where income and/or principal may be distributed to or for the benefit of one or more beneficiaries either pursuant to an objective standard or in the Trustee's sole and absolute discretion.

What is the anticipated duration of the trust? It could be expected to remain in place for a relatively short time, *i.e.*, a few years, or to last for decades or longer.

What types of assets are anticipated to be held in the trust? The trust might consist of relatively easy-to-administer assets such as financial instruments and cash, or perhaps it will hold trust property that will be more challenging to administer such as residential property, farm or ranch property, valuable tangibles, mineral interests or equity in a closely held business.

What will be the aggregate value of the trust? A person that might be a good choice as Trustee of a trust holding thousands of dollars' worth of assets might be very inappropriate as Trustee of a trust worth millions of dollars.

2. Trust Characteristics

Does the person under consideration as Trustee possess sufficient expertise and the necessary experience to do the job? While it is true that a Trustee may usually engage agents and assistants to provide expertise in an area of trust administration in which the Trustee may be lacking in expertise, *e.g.*, investments, the Trustee is ultimately responsible for exercising prudence in selecting the agent, establishing the scope of the delegation and periodically reviewing the agent's actions.[1]

Is the proposed Trustee independent, or does the proposed Trustee have an inherent conflict of interest? Such a conflict could arise in at least two ways. First, the proposed Trustee could have a beneficial interest in the trust.[2] Second, the proposed Trustee could have a personal economic interest in the trust assets.

---

1 *See* Section 9 of the Uniform Prudent Investor Act.

2 For a recent example of the results of seemingly horrible Trustee selection, *see Carter v. Carter*, 965 N.E.2d 1146 (Ill.App. 1st Dist. 2012), *appeal denied* 968 N.E.2d 1064 (2012), wherein the Trustee, who was also the sole income beneficiary of the trust as well as the stepmother of the remainder beneficiary, invested the entire trust property in tax-free municipal bonds and, amazingly, was held not to have breached her fiduciary duties to the remainder beneficiary.

Does the Trustee have an appropriate fiduciary demeanor? Trustees often must make difficult choices. Whether a resolution may be right or wrong is rarely objectively certain. In addition, a conclusion may please one or more beneficiaries while causing distress to others. To be successful, a Trustee must possess the judgment to make prudent assessments and have the resolve to make and defend decisions in the face of possibly aggressive opposition.

Will the Trustee being considered be around long enough to see the job through? Unless the Trustee under consideration is a corporate fiduciary, the age and health of a proposed Trustee is important to take into account.

Where is the proposed Trustee located? Having a Trustee in close geographical proximity to the beneficiaries, while not necessarily indispensable, may be conducive to smooth trust administration. In some cases, a Trustee's location may be important for purposes of conducting in-person meetings with beneficiaries, as well as minimizing the trust's state income tax burden[3] or taking advantage of certain trust laws, such as the ability to modify or decant the trust.

Will the Trustee expect to be paid? The cost of trust administration is an important factor. However, trust administration is never "free." Even if a non-professional Trustee is not compensated, he will have to pay to engage third parties to render services in administrative areas in which he lacks competence.

Is the Trustee accountable? If the trust experiences losses caused by the Trustee's malfeasance, can the trust and its beneficiaries be made whole? If a corporate fiduciary is serving or if an individual Trustee is bonded (which is exceedingly difficult to accomplish), the answer is "yes." Otherwise, depending on the amounts of the losses, the answer could easily be "no."

D. Individual Trustee vs. Corporate Trustee

1. Advantages of an Individual Trustee

- An individual Trustee who is a family member or friend of the family may have a better understanding of the family dynamics and be more familiar with the family members.
- If a family business is to be held and managed in the trust, an individual Trustee may be more knowledgeable regarding such business operations.
- The costs associated with an individual Trustee are sometimes less than those associated with a corporate Trustee.
- The trust assets remain in "control" of a family member.

[3] *See, e.g.*, Cal. Rev. & Tax. Code § 17743 (providing that a California Trustee causes trust income to be subject to California income tax).

2. Disadvantages of an Individual Trustee

- Typically, an individual Trustee lacks sophisticated financial knowledge and detailed knowledge about trust administration. Even though usually authorized to retain agents and investment counsel to assist him or her in these matters, an individual acting as sole Trustee might find that the burdens of investment and administration are too complex and stressful.
- The time commitment necessary to be a responsible Trustee may be greater than a given individual has available; most individuals have another "full-time" job, but, with a corporate Trustee, trust administration is its "full-time" job.
- An individual Trustee may be unduly influenced by the trust beneficiaries.
- An individual may have a real or perceived conflict of interest between his or her duties as Trustee and his or her personal interest as a beneficiary or otherwise.
- An individual may die, become disabled or become unsuitable to act while serving as Trustee.
- To serve as Trustee, an individual Trustee may need to be a resident or otherwise be qualified to do business within a given state or be able to act in other states where trust assets would be located. Unless adequate provisions are made in the trust instrument for removal and replacement of Trustees, there may be an element of inflexibility in the selection of the Trustee. Furthermore, an individual Trustee in one state may have to pay state and/or local fiduciary income taxes that would not have to be paid if the trust were administered in another state. A corporate Trustee is more likely to be able to extend its operations into multiple states.

3. Advantages of a Corporate Trustee

- Where the trust is likely to be of substantial size or hold complex assets - such as closely held business interests or real estate - administration of the trust may require special competence and expertise beyond the ability of any individual, whether a relative, friend or business colleague. A corporate Trustee provides professional handling of investment, tax, accounting and other aspects of trust administration, as opposed to individual Trustees, who may not have the time or expertise to perform an adequate job. Although an individual named as Trustee might be willing to serve without compensation, the resulting savings is often offset by the need to retain and compensate attorneys, accountants, investment advisors and other agents.

- A corporate Trustee is intuitively knowledgeable concerning the laws and regulations that impose and relate to the duties of a Trustee. Moreover, because they are considered experts in trust administration, corporate Trustees are generally held to a higher standard of care than individual Trustees. *See, e.g.,* UTC § 806.
- As mentioned above, a corporate Trustee is also appropriate in situations in which a Trustee situated in a particular state is needed so that the trust and its beneficiaries can benefit from flexible trust laws, low or no state income tax, a high degree of protection from creditors and/or absence of a rule against perpetuities.
- A corporate Trustee's business is audited internally and by state and federal authorities.
- A corporate Trustee, unlike an individual Trustee, does not die or become incapacitated.
- Appointing a corporate Trustee usually eliminates most adverse tax consequences associated with a spouse or a child serving as Trustee because a corporate Trustee is independent and is never a beneficiary of the trust.
- A corporate Trustee is a neutral party. A corporate Trustee's neutrality helps minimize or eliminate potential conflicts among beneficiaries, especially those who are family members. Should family disharmony appear, a corporate Trustee can serve as a liaison between the quarreling family members. Moreover, a corporate Trustee is unlikely to show favoritism to one or more beneficiaries while making decisions regarding distributions or investments.

4. Disadvantages of a Corporate Trustee

- A corporate Trustee is sometimes viewed as an insensitive, distant entity that is too rigid and inflexible. Some have the perception that a beneficiary will have to "beg for money" if a corporate Trustee is involved. Beneficiaries of smaller trusts sometimes believe that corporate Trustees pay less attention to them so they can favor their larger clients.
- The fees charged by corporate Trustees can be higher than compensation to be paid to an individual Trustee. Furthermore, the fees charged by a corporate Trustee for administering a trust may increase at a rate that is irreconcilable with the increase (if any) in value of the trust portfolio. While a corporate Trustee can usually do a better job of handling administrative details, investment decisions and accounting matters than an individual Trustee, an individual Trustee may usually retain accountants, investment advisors, attorneys and others who may be able to

provide the trust with essentially the same services that are available from a corporate Trustee.

- A corporate Trustee usually charges additional fees for managing a closely-held business. A corporate Trustee's management of a family business may be less effective than management of that business by a knowledgeable family member.
- A corporate Trustee may be quite unfamiliar with a given family's dynamics.
- Clients may perceive a loss of control when designating a corporate Trustee as opposed to an individual Trustee.
- A corporate Trustee is more likely than an individual Trustee to reject the administration of a trust if there are provisions in the trust instrument that it finds unacceptable. These provisions may deal with the amount of the discretion given to the Trustee to make distributions, the extent of liability to which a Trustee may be subject for the actions of a predecessor Trustee, for a loss of value or for otherwise mishandling trust property or restrictions on the types of actions for which the corporate Trustee can charge a fee. Rather than rejecting the administration altogether, the corporate Trustee may demand that the trust instrument be amended to remove the provisions that are unacceptable, which may be to the disadvantage to the beneficiaries.

E. Tax Aspects of Trustee Selection

1. Trustees' Activities Constitute Material Participation Under Passive Activity Rules

Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (March 27, 2014)

a. <u>Facts</u>. Frank Aragona ("Frank") established a trust (the "Trust") that owned rental real estate and also engaged in other real estate activities such as holding real estate and developing real estate. Frank was the initial Trustee and the beneficiaries of the Trust were Frank's five children. Frank died in 1981. The successor Trustees were an independent Trustee and the five children. One of Trustees was Paul V. Aragona ("Paul"), who handled the daily business operations. All the Trustees acted as a management board for the Trust and made all major decisions regarding the Trust's property.

The Trust was the sole owner of Holiday Enterprises, LLC ("Holiday"), which managed most of the Trust's rental real estate properties. Three of the Trustees, including Paul, worked full-time for this entity. Holiday was a disregarded entity for federal income tax purposes. The other Trustees had only limited involvement in the Trust's business activities beyond their service on the management board. The Trust also conducted its rental real estate, real estate holding and real estate development activities directly and through other entities as well.

For the 2005 and 2006 tax years, the Trust incurred losses from its rental real estate activities, which it treated as non-passive activities for purposes of IRC § 469 and deducted such losses in full on the Trust's income tax returns for those years. The IRS determined that those losses should have been treated as passive activity losses. Consequently, the IRS reduced the Trust's allowable deductions for those years by the amount of such losses. Treas. Reg. § 1.469-1T(a)(1)(i).

b. <u>Analysis</u>. The general rule is that rental real estate activities are considered passive activities under IRC § 469(c)(2) unless the taxpayer qualifies for the exception under IRC § 469(c)(7)(B). The exception provides that rental real estate activities are not passive activities if more than one-half of the personal services performed in trades or businesses by the taxpayer are performed in real property trades or businesses in which the taxpayer material participates. In addition, to meet this exception, the taxpayer must perform more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates. "Personal services" is defined as any work performed by an individual in connection with a trade or business. Treas. Reg. § 1.469-9(b)(4). A taxpayer is treated as materially participating in a real property trade or business only if the taxpayer is involved in the operation of the activity on a basis which is regular, continuous and substantial. IRC § 469(h).

The Tax Court had to determine whether IRC § 469(c)(7) applied to the Trust. The IRS focused on the definition of "personal services" above, which states that work constitutes personal services only if it is work performed by "an individual." The IRS also pointed to legislative history which discussed how the IRC § 469(c)(7) exception can be met, but only in the context of an individual or a corporation.

The Tax Court rejected this argument and held that a trust is capable of performing personal services within the meaning of IRC § 469(c)(7). The reference to "individual" in the definition of personal services can be considered to be an individual acting as a Trustee. The Tax Court found that if Congress intended the reference to an "individual" in the definition of "personal services" to exclude Trustees, Congress would have used the term "any natural person," as it did in IRC § 469(i).

Therefore, the Tax Court held that a trust can qualify for the exception under IRC § 469(c)(7). The Tax Court then considered the requirements for this exception. The IRS conceded that the Trust's real estate operations qualified as real property trades or businesses. The Tax Court then analyzed the material participation requirement. The IRS argued, again based on legislative history, that only the activities of the Trustees can be considered and the activities of the trust's employees cannot be considered. The Tax Court specifically stated that it would not determine whether employees of the Trust should be considered in determining whether the trust materially participated.

Considering the activities of the Trustees, the Tax Court found that the Trust materially participated in real property trades or businesses under IRC § 469(c)(7). The Tax Court came to this conclusion despite the fact that two of the Trustees also owned minority interests in their individual capacity in the same entities through which the Trust operated its real estate businesses. The Tax Court also rejected the IRS's argument that the three Trustees who were full-time employees of Holiday should be disregarded for purposes of determining the trust's material participation.

The IRS did not argue the question of whether the Trust met the other requirements of IRC § 469(c)(7): (1) the Trust must perform 750 hours of personal services in the real property trades or businesses for each of the tax years at issue and (2) more than one-half of the personal services performed in trades or businesses by the Trust during the year are performed in real property trades or businesses.

2. Estate and Gift Tax Consequences of Identity of Trustee

a. **<u>Estate Tax</u>.** The value of property with respect to which a decedent held a general power of appointment is included in the decedent's estate. IRC § 2041(a). A "general power of appointment" is a power of appointment exercisable in favor of the holder, the holder's estate, the holder's creditors or the creditors of the holder's estate. IRC § 2041(b)(1); Treas. Reg. § 20.2041-1(c)(1).. A holder's power to appoint property to himself that is limited by an ascertainable standard relating to the holder's health, education, support or maintenance is not a general power of appointment. IRC § 2041(b)(1)(A); Treas. Reg. § 20.2041-1(c)(2). However, a power exercisable for the purpose of discharging a legal obligation of the decedent is considered a general power of appointment. Treas. Reg. § 20.2041-1(c)(1).

A retained right, exercisable by the decedent alone or in conjunction with another, to determine who will enjoy property or its income, will result in inclusion in the estate of the value of such property. IRC § 2036(a). However, such a retained right does not give rise to inclusion in the gross estate if the decedent is not a potential beneficiary and the right is limited by an external standard. *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

b. **<u>Gift Tax</u>.** If a Trustee has a beneficial interest in a trust, a transfer of property by the Trustee is not a gift by the Trustee ***if*** it is made under a fiduciary power whose exercise is limited by a reasonably fixed or ascertainable standard set forth in the trust instrument. Treas. Reg. § 25.2511-1(g)(2). A reasonably fixed or ascertainable standard includes a beneficiary's education, support, health, maintenance, reasonable comfort as well as meeting an emergency or maintaining an accustomed standard of living. Treas. Reg. § 25.2511-1(g)(2).

3. Rulings Illustrate Income and Gift Tax Consequences of Holding Certain Dispositive Powers

PLRs 201310002-201310006 (March 8, 2013)

These PLRs revived the utility of so-called Delaware Incomplete Non-Grantor ("DING") Trusts, which are designed so that, first, the transfer of property to the trust is an incomplete gift for gift tax purposes. Second, the trust's income avoids state income tax because the trust is structured as a non-grantor trust for income tax purposes and is administered or "resident" in a state without a trust income tax. A DING may be used to avoid high state income taxes in a state that taxes trust income (the state in which the grantor is domiciled) only if there is a clear nexus between the administration of the trust and the state in which it is claimed the trust "resides" for income tax purposes. Zaritsky, "The Year in Review, an Estate Planner's Perspective on Recent Tax Developments," 39 Estates, Gifts and Trusts Journal 11 (January 2014).

a. **Facts.** Grantor created an irrevocable trust for the benefit of himself and his issue, which consisted of four sons and their issue. A corporate fiduciary was the sole Trustee. During Grantor's lifetime, the Trustee was required to distribute income and principal to Grantor and his issue as directed by the Distribution Committee and/or Grantor. Distributions could be made in the following manner: (a) the Trustee, pursuant to the direction of a majority of the Distribution Committee members and with the written consent of Grantor, could distribute to Grantor or Grantor's issue such amounts of the net income or principal as directed by the Distribution Committee; (b) the Trustee, pursuant to the direction of all of the Distribution Committee members, other than Grantor, could distribute to Grantor or Grantor's issue such amounts of the net income or principal as directed by the Distribution Committee; and (c) Grantor, in a nonfiduciary capacity, could, but could not be required to, distribute to any one or more of Grantor's issue, such amounts of the principal as Grantor deemed advisable to provide for the health, maintenance, support and education of the Grantor's issue.

The Distribution Committee was initially composed of Grantor and his four sons. The Distribution Committee ceased to exist upon Grantor's death. The trust instrument provided that at least two "eligible individuals" must be members of the Distribution Committee. An "eligible individual" was a member of the class consisting of the adult issue of Grantor, the parent of a minor issue of Grantor and the legal guardian of a minor issue of Grantor.

Upon Grantor's death, the balance of the trust was required to be distributed to or for the benefit of one or more persons or entities, other than Grantor's estate, Grantor's creditors or the creditors of Grantor's estate, as Grantor appointed by Will. In default of the exercise of this limited power of appointment, the trust balance would be distributed, *per stirpes*, to Grantor's then living issue in further trust.

b. **Rulings.** The following rulings were requested: (a) during the period the Distribution Committee was serving, no portion of the income, deductions and credits of the trust would be included in computing the tax of the Grantor under IRC § 671; (b) the contribution of property to the trust by Grantor was not a completed gift subject to federal gift tax; (c) any distribution of property by the Distribution Committee from the trust to Grantor would not be a completed gift subject to federal gift tax by any member of the Distribution Committee; and (d) any distribution of property by the Distribution Committee from the trust to any beneficiary other than Grantor would not be a completed gift subject to federal gift tax by any member of the Distribution Committee.

With regard to the first issue, the IRS determined that none of the circumstances existed that would cause Grantor to be treated as the owner of any portion of the trust assets. The most likely reason for this conclusion is that the Distribution Committee members other than Grantor were considered adverse parties for income tax purposes. IRC § 672(a). In addition, none of the other Distribution Committee members would be treated as the owner of any portion of the trust under IRC § 678(a).

In the second and third rulings, the IRS concluded that the contribution of property to the trust by Grantor was not a completed gift subject to federal gift tax. In contrast to the income tax ruling described above, the IRS reasoned that the other Distribution Committee members did not have interests adverse to Grantor for gift tax purposes. Treas. Reg. § 25.2511-2(e). Any distribution from the trust to Grantor was merely a return of Grantor's property and would not be a completed gift subject to federal gift tax by any member of the Distribution Committee.

Regarding the fourth ruling requested, the IRS concluded that any distribution of property by the Distribution Committee from the trust to any beneficiary of the trust other than Grantor would not be a completed gift subject to federal gift tax by any member of the Distribution Committee. Instead, any distribution of property from the trust to a beneficiary other than Grantor would be a completed gift by Grantor.

F. Trustee Compensation

1. State Law Regarding Trustee Compensation

For some time a Trustee has been allowed compensation in the United States unless the Trustee voluntarily serves without compensation or waives his or her right to compensation. The amount of the compensation is fixed either by the terms of the trust instrument, by contract between settlor and Trustee, by statute or by court action.

In most states there are statutes that govern the allowance of a Trustee's compensation. By their terms these statutes apply only where the settlor has not fixed the Trustee's compensation by the terms of the trust instrument or by contract with the Trustee. *See, e.g.,* UTC § 708.

There are basically three types of Trustee compensation statutes in force. The first type of Trustee compensation statute authorizes the court in its discretion to allow the Trustee "reasonable compensation." *See, e.g.*, Cal. Prob. Code 15681. Under this type of statute the Trustee often requests a specific amount on one or more of the Trustee's accountings, and the court grants the Trustee a fee which it deems fair and reasonable under the circumstances. A second type of statute provides that the Trustee is "entitled" to compensation and authorizes the Trustee to collect the compensation from the trust estate without prior court authorization. *See, e.g.*, Section 456.7-708, RSMo.; 760 ILCS 5/7. The third basic type of compensation statute sets forth, in varying degrees of detail, a schedule or scale of commissions or fees that are permitted. Some of these schedules give the Trustee a percentage of trust income; *see, e.g.*, Md. Code 14-103; and often an annual commission based on the fair market value of trust principal. *See, e.g.*, N.Y. SCPA § 2309.

The following factors have been considered in determining the reasonableness of a Trustee's appropriate compensation: (a) the size of the trust; (b) the responsibility involved; (c) the character of the work involved; (d) the results achieved; (e) the knowledge, skill, and judgment required and used; (f) the time and services required; (g) the manner and promptness in performing its duties and responsibilities; (h) any unusual skill or experience of the Trustee; (i) the fidelity or disloyalty of the Trustee; (j) the amount of risk; (k) the custom in the community for allowances to Trustees; (l) any estimate of the Trustee of the value of his services. *See, e.g.*, *Comerica Bank v. Adrian*, 446 N.W.2d 553 (Mich. App. 1989); *In re Estate of McDonald*, 525 N.Y.S.2d 503 (1988).

Many corporate Trustees publish schedules of fees for their services as Trustee under a will or a trust agreement. A corporate Trustee may, in practice, compute its fee by reference to its published fee schedule in effect from time to time as and when services are rendered, unless such arrangement has been modified by prior agreement or by a compensation provision in the trust's governing instrument. Of course, a corporate Trustee's fee schedule does not have the effect of law, and whether fees computed with reference to such a schedule are reasonable may be subject to question. Special rates are often quoted for inactive trusts, such as a title-holding land trust or a life insurance trust during the life of the insured. Corporate Trustees tend to avoid fixed fee arrangements and often insist, as a prerequisite to accepting appointment as Trustee, that the trust instrument include a clause granting them the contractual right to charge fees in accordance with their then prevailing fee schedule.

Notwithstanding provisions granting a Trustee specified compensation, the Trustee's fees may be subject to challenge as to reasonableness. "[T]he court may allow more or less compensation if: (a) the duties of the Trustee are substantially different from those contemplated when the trust was created; or (b) the compensation specified by the terms of the trust would be unreasonably low or high." UTC § 708(b). "A downward adjustment of fees may be appropriate if a Trustee has delegated significant duties to agents, such as the delegation of investment authority to outside managers . . . On the other hand, a Trustee with special skills, such as those of a real estate agent, may be entitled to extra compensation for performing services that would ordinarily be delegated." UTC § 708, Comment; *see also* Restatement Third § 38.

When a Trustee determines that it is appropriate to modify the compensation paid for services rendered by such Trustee, the Trustee must provide adequate prior notice of such change. "To provide a beneficiary with time to take action, and because of the importance of Trustee's fees to the beneficiaries' interests, Section 813(b)(4) of the Uniform Trust Code requires a Trustee to provide the qualified beneficiaries with advance notice of any change in the method or rate of the Trustee's compensation. Failure to provide such advance notice constitutes a breach of trust, which, if sufficiently serious, would justify the Trustee's removal under Section 706." UTC § 708, Comment.

2. Other Considerations in Corporate and Individual Trustee Compensation

Fees charged by a corporate Trustee, including minimums, can vary greatly. Frank discussion of fees and expenses in advance can also extinguish unrealistic expectations and potential problems. Acting as Trustee entails considerable responsibility, inconvenience and potential risk. Although it is often anticipated that an individual Trustee will not charge a fee, the Trustee should certainly understand what is involved before agreeing to serve without a fee. If it is anticipated that the individual Trustee will take a fee, it may avoid misunderstanding if the instrument specifies (or there is agreement) that a fee will be taken and, if possible, how it will be calculated.

The trust instrument should discuss compensation especially when the trust instrument appoints co-Trustees. Depending on the circumstances, each Trustee may receive a full fee, a single fee may be divided between two Trustees or the individual Trustee may forego receiving any compensation. However, it is generally unwise to set forth a rigid compensation schedule in the trust instrument because of the difficulty in anticipating the services that may be required of the Trustee and the difficulty of obtaining approval of any change in such schedule.

Thank you for attending this event.

Today’s event features an online, post-event evaluation form. To send us your feedback, please click on the link below, or type the URL into your web browser’s address bar.

http://eval.krm.com/eval.asp?id=20905

Your feedback and comments are very important to us. Thank you in advance for taking the time to complete this evaluation!