



# The Wealth Counselor

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## Trustee Selection for Irrevocable Trusts

Most professionals who work with trusts have plenty of “nightmare stories” about trustees chosen by clients for their irrevocable trusts. No doubt this is because trustees are often chosen without careful consideration of the qualifications required.

In this issue of *The Wealth Counselor*, we will examine who can, who should, and who should not serve as trustee; non-tax and tax factors that should be considered when selecting a trustee; who can, and should, be given the right to remove and replace a trustee; and using a team approach to segregate duties among lay and professional trustees.



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### Background

Irrevocable trusts are created in two ways:

1. A revocable trust becomes irrevocable after the grantor has died.
2. An irrevocable trust is established while the grantor is living to save estate taxes (by removing assets from the grantor's estate) and/or for asset protection or Medicaid (Medi-Cal in California) planning.

While a grantor may technically be allowed to serve as the trustee of an irrevocable trust he creates, it is not a good idea at best. That is because if the grantor has any discretion with trust asset distributions, it could lead to inclusion of the trust assets in his estate for tax, Medicaid and other purposes, which could frustrate the trust's objectives.

Often there is someone the grantor knows who the grantor suggests to be the trustee. Typical choices are the grantor's spouse, sibling, child, or friend. Any of these may be an acceptable choice from a legal perspective, but may be a poor choice for other reasons. For example, some families would be torn apart if one sibling had to ask another for a distribution.

Left to their own devices, clients trustee appointments will frequently be made (out of ignorance) with little consideration of the qualifications the trustee should have. Likewise, those who agree to be trustees typically have no idea what they are getting into. Non-professional trustees often are overworked, underpaid, unappreciated, find they are dealing with unhappy and unappreciative beneficiaries, and may even wind up being sued by the beneficiaries.

With this in mind, let's look at some factors (non-tax and tax) that *should* be considered when selecting a trustee.

### **Non-Tax Considerations for Selecting a Trustee**

Here are some of the characteristics that the client should consider in choosing an individual trustee:

*Judgment:* Clients typically want their trustee to make the same decisions they would. Someone who shares the grantor's values, virtues, spending habits and faith is more likely to do this. Also, consider whether the trustee candidate will be aware of his own capabilities and weaknesses. If the trustee candidate does not have accounting or investment experience, would she have the judgment to admit this and engage an appropriate qualified professional?

*Availability/Location:* Does this trustee candidate have the time required to be a trustee? Will he be available when needed or will work and/or family demands leave too little time for trust responsibilities? Where does the candidate live? If the trustee lives in a place different than the trust situs, different laws may apply. Is living near the beneficiary important?

*Longevity:* How long will the trustee be needed? Many grantors are most comfortable with friends who share their values and have gained wisdom from life experiences, but someone near the grantor's age may not live long enough to fulfill the job. A trust established for the grantor's child will likely need a trustee for many years to come. Thus, for trusts that may last a long time, a corporate trustee is often the preferred choice.

*Impartiality:* The trustee must be capable of being impartial among the beneficiaries. This is especially difficult to do if the trustee *is* one of several beneficiaries. Corporate trustees, because they *can* be impartial, are often chosen to prevent a sibling or relative from being placed in an uncomfortable (and often unfair) position.

*Interpersonal Skills:* The trustee needs to be able to communicate well and effectively to the beneficiaries and to professionals who may be involved with the trust. Some people may be good record keepers or investors, but lousy at diplomacy or feel intimidated or even be offended if a beneficiary gets an attorney. A good trustee will need to be able to work calmly and well with all involved.

*Attention to Detail:* Does the trustee understand the serious duties that come with the job and is she willing to be accountable for her actions? Fiduciaries are often thought by the beneficiaries to be guilty until proven innocent. While it may not happen, the trustee should assume he will be sued at some point and keep meticulous records as a ready defense. A trustee who expects to be sued will be much better prepared than one who doesn't think it will happen and, as a result, does not take the record keeping requirement seriously.

*Investment Experience:* While it is helpful to have investment experience, the trustee can certainly get by without it, as long as he/she recognizes this is an area for which to secure professional help. Also, if the trustee lives in a place different than the trust situs, different investment laws may apply, making it especially prudent or even essential to seek professional assistance.

**Planning Tip:** CPAs can make good trustees, but often are unwilling or unable (because of insurance

considerations) to serve. Sometimes, the best choice would be a corporate trustee. Seldom will the unguided grantor even think of using a team, which can include both various professionals and friends and family members.

*Fees:* The non-professional trustee rarely discusses fees with the beneficiaries. Often, family members and friends will not charge a fee for their services out of a sense of family duty or respect for the grantor. But trustees *should* be paid and, more often than not, an unpaid trustee will eventually come to that conclusion or fail to diligently carry out his duties. From the outset, a trustee should keep close track of time and expenses so that a reasonable fee can be substantiated. Generally, a reasonable fee is what a corporate trustee would charge, so thinking that a non-corporate trustee will do the same necessary work for less is false economy.

**Planning Tip:** Become knowledgeable about the fees charged by corporate trustees in your area as a guideline. Talk about trustee fees when establishing the trust to avoid problems and misunderstandings later.

*Insurance:* Anyone serving as a trustee needs to have plenty of insurance (errors and omissions or liability). Some of the laws that govern trustees are absolute standards, so a trustee needs to have adequate insurance for protection in the event of a mistake or an innocent error. The amount of insurance needed can depend on the degree to which a trustee is indemnified. However, legal defense costs in trustee litigation can be very large and are typically borne by the insurer.

*Indemnification:* This often comes up when family members or friends are serving as trustee. Grantors want to indemnify family members and their friends; they do not want them to be sued. It is possible to reduce or eliminate the prudent investor rule for such trustees. However, indemnification is a two-edged sword because it may result in the non-professional trustee not taking the job seriously.

**Planning Tip:** A good alternative is to have a family member or friend serve with a corporate fiduciary that is assigned the administrative and investment responsibility. The family member or friend trustee could make or veto discretionary distributions, but having no oversight, administration, or investment obligations would be less likely to be sued if something goes wrong.

**Planning Tip:** Indemnification might be appropriate in a situation with obvious bad family dynamics, where the siblings are already fighting each other yet the grantor insists on naming one sibling as trustee. In such a situation, your recommendation to name a corporate fiduciary instead should be well documented.

**Planning Tip:** Waiving the prudent investor rule can also be helpful in other situations, depending on the use of the trust. For example, with the sale of an appreciated asset(s) to a grantor trust, the trustee is usually buying hard-to-value assets (real estate, wholesale business interest) from the client in order to shift future appreciation to the trust and away from the grantor. Rather than starting initially with a corporate fiduciary who is not familiar with the asset or situation, it may be more effective (saving both time and money) to have the initial trustee be someone close to the family who better understands the issues, and then change later to a corporate fiduciary. Waiving the prudent investor rule and providing indemnification for the initial trustee in this situation could make sense.

**Planning Tip:** Being able to waive all or part of the prudent investor rule when using an irrevocable life insurance trust (ILIT) gives greater latitude and peace of mind to make some of the transactions meet the

unique needs of the client. Beware, however, of the risk that the trustee, shielded from liability, may fail to do the appropriate work to make sure that the insurance held in the ILIT is appropriate as markets change.

*Note:* Florida is considering a statute that would relieve trustees of the duty to review the propriety of investments in life insurance policies, which would, in effect, waive the prudent investor rule for life insurance policies owned by ILITs. This would help to solve the problem of corporate trustees not wanting to serve as the trustee of ILITs due to the obligation to review policies that have not performed very well.

## **Tax Considerations**

### ***Estate Tax***

If a purpose of the trust is to remove assets from the grantor's estate, the grantor cannot have any role in determining who gets distributions or when they occur. However, the grantor can have the power to remove and replace the trustee or to control the investments of the trust. Neither of those will cause estate tax inclusion providing the grantor cannot appoint a trustee who is related or subordinate to the grantor (as would be a brother, employee or someone else who will capitulate to the grantor's wishes). Interestingly, there is no problem appointing, at the inception of the trust, an initial or successor trustee who is related or subordinate to the grantor.

**Planning Tip:** It is unclear if a grantor can have the right only to remove a trustee and allow the next named successor trustee to take over. While also unclear, it seems that a grantor can reserve the right to remove and replace someone who is not a fiduciary (for example, a trust protector).

### ***Income Tax***

A non-adverse trustee having certain powers may trigger grantor trust rules and cause the grantor to be taxed on the trust's income. In some instances the client may not want the tax to come back to the grantor and instead want a trust that is a separate tax-paying entity for which the income that is distributed to the beneficiaries is be taxed to the beneficiaries.

**Planning Tip:** Because the trustee's identity may affect state income tax as well, you may be able to shift the trust situs to a state with a lower income tax rate. Depending on the trust assets, this could be important as some investments (such as oil and gas) may be taxed significantly higher in some states than in others.

### **Beneficiary Removal and Replacement of Trustee**

This is an area that is customizable for each trust and can help maintain some downstream flexibility. Some grantors may not want the beneficiaries to be able to remove the trustee, especially if the grantor is aware of family quarreling. But if the corporate or individual trustee knows it cannot be replaced there is little need for responsiveness or careful attention to investments. Because there does need to be a way to have the trustee removed if things should deteriorate, the document can include that the trustee can only be removed for cause as determined by the court. On the other end, spendthrifts may want to "trustee shop" until they find one that will do whatever they want, so there will need to be some restraints on when a trustee can be replaced.

### **Team Approach**

There are times when a team can do a better job than a single trustee. Having more than one trustee, even with different duties and responsibilities, can work well for many situations. The trust can benefit from assigning the trustees specific duties based on their strengths and experience. Of course, the fewer people who are

involved, the less complicated the administration. Also, disagreements will have to be worked out. If there are two trustees or any even number, deadlocks are possible. With an odd number, a simple majority would be needed. If an agreement cannot be reached, the court can be allowed to intervene as a last resort.

Also, as mentioned earlier, family member trustees can work with professionals as paid advisors instead of as trustees. This would allow the advisors to provide valuable input and insight into both the grantor's desires and the personalities of the beneficiaries, without being so exposed to possible lawsuits.

**Planning Tip:** Ethical issues can arise if the attorney represents more than one trustee, so she should be sure to have a waiver of conflict or other plan in place.

**Planning Tip:** Naming someone as trustee is a nomination. The person named is under no obligation to accept the responsibility when the time comes, and it is not unusual for someone to refuse to serve or to step aside once he understands the duties and responsibilities involved. For this reason, it is important for the trust maker to name several successor trustees and to clearly communicate with each before finalizing the choices. Most drafting attorneys will also recommend naming a corporate trustee as trustee of last resort, especially if no procedure for appointing successors is provided to the beneficiaries, short of going to court.

### **The Trustee's Duties and Responsibilities**

- administer the trust
- be loyal
- be impartial
- be prudent
- control and protect trust property
- collect trust property
- inform and report to beneficiaries
- diversify investments
- keep records and no commingling
- enforce and defend claims

### **Conclusion**

A competent trustee is as important to the success of a trust as its being well-drafted. Naming a favorite family member as trustee may not be the smartest (or kindest) thing the grantor can do. As experienced professionals who have seen the consequences of unwise choices for trustee, we are in a unique position to counsel our clients with their and their beneficiaries' best interests in mind.

*To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.*