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Twenty-five Things You *Have* to Know About Appointing Trustees

By Steve R. Akers

CLIENT: OK, I'll make gifts to save estate taxes, but only if my two children can't get at the money while I'm alive and as long as I can stay in control.
ATTORNEY: Well, there are limits . . . .
CLIENT: Name me as the trustee, or executor, or whatever it's called. My daughter's disastrous with money, and my son's a dope head we all fight with all the time.
ATTORNEY: There are tax rules we need to consider . . . .
CLIENT: Oh yeah, and after I die, name my daughter as trustee.

This conversation is at the front-line of what practitioners deal with on a daily basis in planning trusts for their clients. Invariably, clients want to retain control. The estate planner must

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carefully wrestle with what control can be given to the clients and the clients' family members as trustee. Here are twenty-five things the attorney must consider in making these decisions.

1. Legal Capacity

Although competent adults can serve as trustee, most states restrict what entities can serve as trustee. Typically, only specified financial institutions or other entities recognized under state law can act as a fiduciary. In some states, charities may serve as the trustee of a trust benefiting that charity or another charitable organization. Many states prohibit or restrict a financial institution domiciled in another state. Other states have reciprocity rules, permitting a corporate fiduciary from another state to serve if the other state recognizes corporate fiduciaries from the first state. Even if a foreign entity meets that requirement, it must make the necessary filings to qualify to do business in the state, which usually entail an information filing and designating a resident agent for service of process. The Office of the Comptroller of the Currency takes the position that under the Supremacy Clause of the U.S. Constitution, a national association can serve in any state without meeting any state requirements, including the modest filing requirements. OCC Interpretation Ltr. No. 872 (Dec. 1999).

2. Personal and Business Skills

The personal attributes of the trustee should be of paramount importance in the selection process. A trust that works for tax purposes will be of little benefit if an imprudently selected trustee dissipates the trust assets through poor administration. The planner and client should consider these characteristics: judgment, experience, impartiality, investment sophistication and track record, availability, accounting and record-keeping ability, and potential conflicts of interest. The Uniform Prudent Investor Act, which is being passed in many states, may increase the level of investment sophistication required of trustees. Often a client's "knee-jerk" reaction is to avoid corporate fiduciaries because of the fear of losing control and the reluctance to pay fees. The use of appropriate co-trustee and removal provisions can resolve the family control issue. As to fees, attorneys are all too aware (often on a personal basis) that paying matters take precedence and that volunteer activities get placed on the back burner: "You get what you pay for."

3. Deal with Family Tension

Throwing a family member in the middle of family hostilities by naming him or her as trustee is a ticking time bomb that eventually may explode. Saying no to one beneficiary and yes to another may result in family feelings ranging from resentment to outright hatred and cause a split in the family that can never be healed. Are family members likely to be susceptible to influence by other family members? Will placing one sibling in the role of parent over the financial affairs of another sibling result in strained relationships (or war) between the siblings? One commentator observes, "The choice between no and yes may be one of the most important duties of a trustee." S. Leimberg, The Tools and Techniques of Estate Planning 480 (11th ed. 1998).

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4. Power to Allocate Gains

Many states have adopted Section 104 of the new Uniform Principal and Income Act. This section gives the trustee the ability to allocate some or all capital gains in a particular year to trust income. If the trust provides for mandatory distribution of income, this decision directly affects (sometimes dramatically) the amount to be distributed to the income beneficiary. Therefore, most states adopting the provision stipulate that the discretion may only be exercised only by a trustee who is not also a beneficiary of the trust.

5. The Spendthrift Beneficiary

If standards for distribution are listed in the trust agreement, the beneficiary may go to court to force the trustee to make distributions within the prescribed standards. Giving a trustee the absolute, unlimited, sole, or uncontrolled discretion, perhaps even stating specifically that the trustee's exercise of discretion over distributions is not subject to a reasonableness standard, makes it more difficult for a spendthrift beneficiary to go to court to force a trustee to make distributions. Restatement (Second) of Trusts § 187, cmts. i–j (1959). Giving a family member-beneficiary (or the donor) of the trust that broad discretion will result in tax issues for the beneficiary (or the donor), as discussed more fully below. Moreover, giving a trustee no guidance in making distributions may make the client—and the trustee—very uncomfortable.

6. Ascertainable Standards

Any power of the donor to shift benefits among beneficiaries (such as having a power to "sprinkle" distributions among multiple beneficiaries, add or remove beneficiaries, or accumulate income and thereby shift benefits to a remainderman) will generally result in the transfer being an "incomplete gift" for gift tax purposes and cause trust assets to be included in the grantor's estate for estate tax purposes. Code §§ 2036(a)(2), 2038. There is an exception to this treatment for gift and estate tax purposes if the power is lim-

ited by an ascertainable standard. Treas. Reg. § 25.2511–2(c) (gift tax); *Jennings v. Smith,* 161 F.2d 74 (2d Cir. 1947) (estate tax). An analogous gift regulation gives some examples of ascertainable standards. To be cautious, any dispositive powers reserved for the grantor should be limited by a strict "health, education, support and maintenance" standard. See Treas. Reg. § 25.2511–1(g)(2). The courts have generally recognized other reasonable standards as being ascertainable, but why risk an IRS argument and a possibly adverse court decision?

7. Avoid Retained Interests

Section 2036(a)(1) includes trust assets in the grantor's estate if the grantor makes a gift and retains the possession or enjoyment of, or the right to the income from, the property. If an independent trustee has the discretion to make distributions to the grantor, without any standard that the grantor could use to force distributions, it might seem that estate inclusion should be avoided because the grantor would not have "retained" the right to receive distributions. If the grantor's creditors can reach trust assets, however, there is no completed gift, and the assets will be included in the grantor's estate. Rev. Rul. 76–103, 1976–1 C.B. 293. A handful of states (including Alaska, Colorado, Delaware, Missouri, Nevada, Rhode Island, and Utah) have passed laws to provide that the grantor's creditors cannot reach trust assets merely because the trustee may, in its discretion, make distributions to the grantor. If the trust is created under the laws of one of those states and the requirements under that state's law are satisfied (for example, that there are trustees located in that state or that trust assets are administered in that state), one could argue that the grantor can be a discretionary beneficiary without causing estate inclusion. Otherwise, having the grantor as a potential trust beneficiary will cause estate inclusion.

A possible corollary to this rule is that the grantor may be able to purchase or rent assets from a trust for a fair value. On occasion, the IRS has won an argument that Section 2036(a)(1) applied when the grantor could rent assets, particularly if the rental that was paid was not adequate. *Estate of Du Pont v. Comm'r,* 63 T.C. 746 (1975). Most of the cases, however, have not applied Section 2036 when adequate rental is paid for the use of property by the grantor. *Estate of Giselman v. Comm'r,* T.C. Memo 1988–391; PLR 199931028 (grantor retained right to lease residence from qualified personal residence trust following end of QPRT term).

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8. Avoid Supporting the Grantor's Dependents

A trust may authorize a trustee other than the donor to make distributions to dependents of the donor without causing estate inclusion in the donor's estate, as long as there is no standard for distribution tied to support or maintenance of the donor's dependents. Rev. Rul. 77–60, 1977–1 C.B. 282. The more conservative approach, however, is to prohibit any distributions from a trust that would satisfy the donor's legal obligation of support, regardless of who is the trustee.

9. Prohibit the Donor from Becoming Trustee If No Ascertainable Standards

If the trustee can make distributions not limited by an ascertainable standard, estate inclusion will result for the donor even if the donor is merely a co-trustee, the other co-trustees can override the donor's decision, or the donor merely holds a veto power over distributions. Treas. Reg. § 20.2036–1(b)(3); *Estate of Grossman v. Comm'r,* 27 T.C. 707 (1957). Furthermore, estate inclusion results if the donor may name himself or herself as trustee if a triggering event occurs (such as, for example, the death, resignation, or removal of the current trustee, or the death of Aunt Mary, or when the Dallas Cowboys next (if ever) win another Super Bowl), even though the triggering event is outside the donor's control. Treas. Reg. § 20.2036–1(b)(3); *Estate of Farrel v. United States,* 553 F.2d 637 (Ct. Cl. 1977). The trust instrument may permit the donor to be a trustee if the power to make distributions that are not limited to an ascertainable standard may be exercised only by trustees other than the donor.

10. Make Broad Administrative Powers Subject to Fiduciary Standards

A grantor's or beneficiary's broad management powers as trustee will not cause estate inclusion if the trustee's actions are subject to review by a court of equity (for example, if the exercise of the power is subject to fiduciary standards). The U.S. Supreme Court held that the retention of retained rights to vote stock of a closely held corporation does not require the inclusion of the trust assets in the donor-trustee's estate. *United States v. Byrum,* 408 U.S. 125 (1972). The Supreme Court reasoned that the mere retention of broad powers of management does not subject a trust to the federal estate tax. The Court emphasized that the fiduciary duty owed by majority shareholders or directors is entirely unrelated to the needs of the trust or the donor's desires. 408 U.S. at 136–38. (Congress overrode the precise holding of the *Byrum* case by the enactment of Code § 2036(b). The Supreme Court's analysis of broad management powers, however, still applies.)

11. Avoid Two Prohibited Administrative Powers

The donor may not be given the power, as trustee or co-trustee, to exercise either of two administrative powers. First, the donor cannot have the power, either directly or indirectly, to vote stock of a controlled corporation that the donor has given. Code § 2036(b). Second, the donor may not retain any "incidents of ownership" over a life insurance policy on the donor's life. This includes just about any powers over the policy. Code § 2042. Such powers cannot even be held in a fiduciary capacity by the donor-insured without risking estate inclusion. Treas. Reg. § 20.2042–1(c)(4); but see Rev. Rul. 84–179, 1984–2 C.B. 195 (powers held by insured as a fiduciary will not cause inclusion of policy in estate under Code § 2042 if the insured is not a beneficiary of the trust and never made a transfer to the trust of any funds used to purchase or maintain the policy).

12. Address Successor Trustee and Resignation of Trustee

If all persons named in a trust as trustee have declined to serve, and the document does not name a successor or procedure for appointing a successor, a court having jurisdiction over the trust will appoint the successor trustee. Similarly, if a trust instrument does not provide a procedure for resignation, a court must approve any resignation. Until a court has approved a trustee resignation, the trustee still has all of the responsibilities (and liabilities) of a fiduciary.

13. Retain the Power to Name Co-Trustees or Successors

The donor generally can retain the power to add co-trustees without causing the trust assets to be included in the donor's estate. *Durst v. United States,* 559 F.2d 910 (3d Cir. 1977). Nevertheless, there is concern if the donor can keep adding co-trustees indefinitely. Similarly, no case has held that a retained power to name successor trustees would cause estate inclusion (even though someone might argue that such a power is a power to "amend" the instrument). For example, the IRS did not even make an argument for estate inclusion in one case in which the donor had the power to appoint successor trustees and to specify the date or event upon which such appointment should take effect. *Estate of Budd v. Comm'r,* 49 T.C. 468 (1968).

14. Removal Permitted with Restrictions

Beginning with the now infamous Rev. Rul. 79–353, 1979–2 C.B. 325, the IRS took the position that the donor's right to remove a corporate trustee without cause would result in estate inclusion under Code §§ 2036 and 2038, even if the donor had to appoint another corporate fiduciary as successor trustee. After losing several cases, the IRS changed its position in Rev. Rul. 95–58, 1995–2 C.B. 1, to hold that the retained power to remove the trustee and appoint an individual or corporate successor trustee would not result in estate inclusion as long as the successor was not related or subordinate to the decedent (within the meaning of Code § 672(c)). If a donor wants to keep the power to remove the trustee and have the power to name a relative as successor trustee, the donor is not protected by the safe harbor rule in Rev. Rul. 95–58. Instead, the donor would have to rely on case law that has rejected the IRS's position. *Estate of Vak v. Comm'r,* 973 F.2d 1409 (8th Cir. 1992); *Estate of Wall v. Comm'r,* 101 T.C. 300 (1993).

15. Limit Foreign Persons as Trustees

If any non-U.S. person or persons constitute at least half of the trustees, or if any "substantial decision" (meaning any decision other than ministerial decisions) is left specifically to a non-U.S. person or persons, the trust will constitute a foreign trust for income tax purposes. Treas. Reg. § 301.7701–7(d)(1)(ii). Various complexities arise for foreign trusts. Foreign trusts must meet reporting requirements on Form 3520 for contributions to or distributions from the trust. Section 684 triggers gain recognition when there are no U.S. beneficiaries or when the grantor dies. Finally, a throwback rule applies with an interest charge for accumulated distributions. Code §§ 665(d), 667(a)(3), and 668.

16. Avoid (or Trigger) the Grantor Trust Rules

If the planner wants to avoid grantor trust status (which treats the grantor as the owner of—and taxable on the income of—the trust for income tax purposes), one of the following sets of circumstances must exist:

- Use independent trustees (no more than half of whom are related or subordinate parties) and give them the authority to distribute assets among a designated class of beneficiaries.
- Use a trustee other than the grantor or grantor's spouse, whose distribution powers are limited by a reasonably definite external standard.
- Use a reasonably definite distribution standard for principal distribution (or have separate shares for the beneficiaries), and as to income, either
  - —have a vested trust for a single beneficiary,
  - —provide that the income must ultimately pass to current income beneficiaries in irrevocably specified shares, or
  - —provide that on termination the assets may be appointed to appointees (other than the grantor or grantor's estate) *if* the trust is reasonably expected to terminate during the current beneficiary's lifetime.
- Use an adverse party as trustee.

Even if one of those exceptions is satisfied, the trust cannot qualify as a foreign trust and the trustee cannot have one of the proscribed administrative powers in Code § 675.

Of course, there are times when a planner wants a trust to be a grantor trust. To trigger grantor trust status, use one (or more) of the following.

- Select trustees and dispositive powers to flunk all of the exceptions in Code § 674—generally, more than one-half of the trustees are related or subordinate parties and there is no reasonably definite external standard for distributions.
- Give a non-adverse party the power to add beneficiaries. Code §§ 674(b), 674(c), 674(d).
- Give a non-adverse trustee the power to make a loan to the grantor and not have to require adequate security for the loan. Code § 675(2).
- Give the grantor a substitution power in a nonfiduciary capacity (realizing that the IRS takes the position that whether it is exercisable in a nonfiduciary capacity is a fact question, to be determined in every case). Code § 675(4)(C).

17. A Beneficiary-Trustee's Power to Make Distributions to Self Must Be Limited by an Ascertainable Standard

A beneficiary who has the power to withdraw assets from the trust, not limited by an ascertainable standard (in tax-speak, this is a "general power of appointment"), will have to include the assets in the beneficiary's estate for estate tax purposes under Code § 2041. Furthermore, the release of a general power of appointment is a taxable gift by the beneficiary under Code § 2514(b). Once a beneficiary becomes trustee or otherwise acquires a power that constitutes a general power of appointment, there is a permanent taint that ultimately will result in a gift or estate inclusion. Section 2041 applies if the beneficiary is merely a co-trustee, unless the other co-trustee is an adverse party. Section 2041 includes an ascertainable standard exception for a power that is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent. Any deviation from those terms, or other example standards listed in Section 20.2041-1(c)(2) of the reg-

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ulations, invites danger. For example, an invasion power "for the reasonable support, care and comfort" of the beneficiary was held to be an ascertainable standard in *Whelan v. United States*, 81–1 U.S. Tax Cas. (CCH) ¶ 13,393 (S.D. Cal. 1981). Seven years earlier, the very same court held that a standard permitting distributions for "reasonable care, comfort and support" was not an ascertainable standard. *Tucker v. United States*, 74–2 U.S. Tax Cas. (CCH) ¶ 13,026 (S.D. Cal. 1974).

18. Can Give a Third-Party Trustee Broad Powers

The fact that a beneficiary might be able to go to court and force a trustee to make distributions within a broad standard does not mean that the beneficiary has a general power of appointment. The IRS lost that argument in *Security-Peoples Trust Co. v. United States*, 238 F. Supp. 40 (W.D. Pa. 1965), and agreed that it would not pursue that argument in the future. Rev. Rul. 76–368, 1976–2 C.B. 271.

19. Avoid the Trustee's Legal Support Obligations

If a trustee has the power to make a distribution that satisfies the trustee's legal obligations, the trustee is deemed to have a power to distribute to the trustee. Although the trustee may not otherwise be a beneficiary of the trust, power of appointment problems for the trustee can still arise if any person to whom the trustee owes legal obligations is a beneficiary. Treas. Reg. § 20.2041–1(c)(1). Observe the dichotomy—the authority to make distributions for the support of the trustee as a beneficiary is allowed, but the authority to make distributions for the support of a dependent of the trustee results in the trustee having a general power of appointment. This issue has become known by the name of a case involving Code § 2503(c) that does not address this precise Code § 2041 issue at all. *Upjohn v. United States*, 72–2 U.S. Tax Cas. (CCH) ¶ 12,888 (W.D. Mich. 1972). To cure any possible argument, planners insert what has become known as the *Upjohn* clause: a clause prohibiting the trustee from making any distribution that would have the effect of discharging that trustee's legal obligations.

20. Do Not Give a Beneficiary-Trustee the Authority to Make Distributions to Other Beneficiaries Without an Ascertainable Standard

Section 25.2511–1(g)(2) of the regulations provides that if a trustee who is a beneficiary makes a distribution to another person under an ascertainable standard, the beneficiary-trustee is not treated as having made a gift. The regulation also states that an ascertainable standard does not exist if the trustee's determination is conclusive. The clear implication is that if a beneficiary-trustee makes a distribution to another beneficiary under a standard that is not ascertainable, the beneficiary-trustee is treated as making a gift. No rulings or cases have addressed this regulation, but careful planners draft around its possible application by the IRS.

21. A Beneficiary May Have the Power to Appoint Successors or to Remove Trustees

If a beneficiary has the power to appoint himself or herself as trustee, with distribution powers not limited by an ascertainable standard, the beneficiary is treated as having a general power of appointment (unless a co-trustee has a substantial interest in the trust that is adverse). This problem does not exist if the beneficiary's power

to appoint exists under conditions that have not yet occurred. Treas. Reg. § 20.2041–1(b)(1). Giving a beneficiary the power to remove a trustee without cause does not cause the beneficiary to have a Section 2041 power of appointment if the conditions of Rev. Rul. 95–58 are met (in other words, a successor trustee must be appointed who is not a related or subordinate party). PLR 9746007. One favorable letter ruling was more expansive, in that the beneficiary could, in effect, appoint anyone as successor; reliance on that ruling at the planning stage would seem unwarranted. PLR 200024007.

22. Having a Beneficiary as Sole Trustee May Result in Grantor Trust Treatment to Beneficiary

If a beneficiary serves as sole trustee and has the authority to make distributions to himself or herself, there is the possibility (perhaps remote if the distribution power is limited by an ascertainable standard) that the trust income will be taxed to the beneficiary under a grantor trust rule. Code § 678(a)(1). There is no ascertainable standard exception in the statute. Case law recognized such an exception under the predecessor to Section 678. *Funk v. Comm'r*, 185 F.2d 127 (3d Cir. 1950). One reported case after the adoption of Section 678, which dealt with the power of a life tenant under a legal life estate, adopted an ascertainable standard exception. *United States v. DeBonchamps*, 278 F.2d 127, 130 (9th Cir. 1960). Letter rulings have been inconsistent, but the more recent rulings also recognize an ascertainable standard exception. PLR 9227037. Under this approach, a beneficiary could serve as sole trustee and not be taxed on the trust income under Section 678 if there is an ascertainable standard for distributions.

23. Determine Whether Appointment of a Trustee in Another State Causes the Trust to Be Subject to Income Tax in That State

Some states determine domicile of a trust for purposes of state income taxation based on the residency of the trustee or where the administration of the trust occurs. John A. Warnick & Sergio Pareja, *Selecting a Trust Situs in the 21st Century*, PROB. & PROP. 53, 57–58 (Mar./Apr. 2002). Appointing a trustee who lives in one of those states could subject the trust to state income taxation that might not otherwise exist.

24. Use a Savings Clause

To avoid inadvertent adverse tax effects, consider using a "savings clause" in every trust to limit automatically any retained powers of the grantor or of the beneficiary. Give a great deal of thought to drafting such a clause, and include it in every trust. For examples of such clauses, see Jerold I. Horn, *Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts*, 20th Univ. of Miami Philip E. Heckerling Inst. on Est. Planning ¶ 502.2 (1986).

25. Be Wary of Having Beneficiary as Trustee If There Are Creditor Concerns for the Beneficiary

"Blackletter" trust law would suggest that the beneficiary-trustee's creditors cannot reach the trust assets when the trustee is not the only beneficiary of the trust. 2A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, SCOTT ON TRUSTS § 99.3; RESTATEMENT (SECOND) OF TRUSTS § 154. But there is little in the way of strong authority saying that a trust beneficiary may also serve as trustee and still be assured absolutely of relying on strong spendthrift protection. The *Restatement (Third) of Trusts* (Tentative Draft No. 2, 1999) takes the position in § 60, Comment g, that a creditor of a beneficiary-trustee can reach as much as the beneficiary-trustee could properly distribute to himself or herself under the terms of the trust instrument. In a recent bankruptcy case, the creditor of a beneficiary-trustee could reach the trust assets when the instrument allowed distributions the trustees determined to be required or *desirable* for his health, maintenance, and support, and provided that the trustee *need not consider the interests of any other beneficiary. Johnson v. McCoy (In re McCoy)*, 274 B.R. 751 (N.D. Ill. 2002). ■