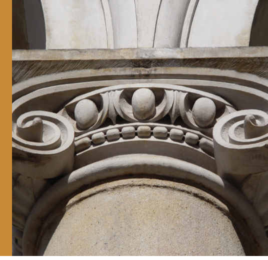

COMMITTEE REPORT:
FIDUCIARY PROFESSIONS

By **Martin M. Shenkman, Gail E. Cohen** & **Gerard F. Joyce, Jr.**

Considerations for Non-Professional Fiduciaries

A checklist of responsibilities

When family members, friends and other nonprofessionals assume the role of fiduciary—whether it be for a trust or an estate—there are many considerations that advisors should address with them to assure that they fulfill their responsibilities properly. These considerations fall into four broad categories—carrying out administrative responsibilities; making legal judgments; exercising discretion; and complying with and maximizing tax laws. Many, perhaps most, non-professional fiduciaries don't have the knowledge and training of their professional counterparts to appreciate the potential liability associated with these various actions. They frequently act in a manner motivated by emotional or personal views rather than by experience with difficult family dynamics compounded by the technicalities of the law, and they fail to appreciate not only the incredible complexity of the broad categories of responsibilities but also how intertwined any specific issue is with an array of other trust matters.

Here's a checklist of some of those considerations, presented by category, although as mentioned above, these categories are often intertwined. See "Trust Administration Checklist," p. 51. While we acknowledge that nonprofessionals who assume non-fiduciary positions also need professional legal and tax advice in fulfilling their duties, we're limiting our focus to those considerations applicable to trustees and personal representatives, as well as to investment advisors to whom fiduciary responsibility is delegated. Practitioners may wish to adapt this checklist as a handout for lay fiduciaries to educate them on the importance of regular meetings with professional advisors to carry out their duties.

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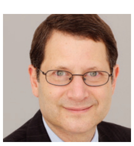


Administrative Matters

Notice of trust to beneficiaries. The Uniform Trust Code (UTC) requires that trustees provide notice of the trust to the beneficiaries—both current and future.[1] In states that haven't enacted the UTC, there are still numerous instances in which trustees should endeavor to give notice to individuals serving in various capacities under a trust instrument. Notice may be advisable even if not required. Modern trust drafting has resulted in the proliferation of various types of powers of appointment, as well as fiduciary and non-fiduciary positions in the trust instrument. For example, under common planning strategies, many individuals possess a general power of appointment (GPOA) to effectuate inclusion in the estate for income tax cost basis step-up. While most assume that it isn't necessary to give notice to an individual holding a GPOA for that GPOA to result in basis inclusion, the law isn't quite as certain as some might think.[2] Thus, it may be advisable for a powerholder to receive notice of the trust instrument. Practitioners should help fiduciaries identify powerholders and recommend whether notice or other actions should be taken with respect to those powers.

Notice of non-fiduciary appointment. Similar to notice to qualified beneficiaries, notice to individuals holding non-fiduciary positions in the trust may be advisable or even required.

Trust protector actions. What ongoing duties may a trust protector have under a trust instrument? The answer necessarily depends on the terms of the trust instrument and what specific powers and

responsibilities the particular protector has been given under the instrument, as well as applicable state law. Is there any duty of ongoing monitoring of trust activities? Should the protector communicate periodically with the trustees? Should the trustees send the protector statements and other communications? While there remains uncertainty concerning many of these issues, it seems clear that giving the protector notice of the trust may prove protective for the trustees and for the protector, and doing so might enhance the likelihood of the protector's attention. Counsel might communicate that the protector should retain an independent attorney and that the counsel for the trustees isn't counsel for the protector.

Ideally, all prior direction letters and other formal actions should be collected for a trust administered by lay trustees, put in chronological order and evaluated for appropriateness.

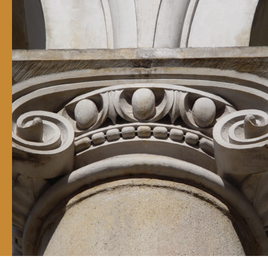
Trust assets. Create a trust balance sheet with underlying documents substantiating each item obtained. Lay trustees often don't appreciate the formalities of properly transferring and titling assets to a trust. Advisors should confirm the current balance sheet of the trust and that the underlying documentation supports those assets. It's not uncommon to find that a family merely had their accountant change the percentage interests on the K-1 each year to reflect purported gifts to a trust, forgoing the proper issuance of stock certificates or other formalities.[3] It's common to see a blank schedule of assets attached to an irrevocable trust, yet the trust instrument refers to those assets as constituting trust corpus. It's also important to obtain the tax basis of each asset as attempts years later to obtain the basis are typically more difficult and time consuming. It's also common to see assets listed on the schedule attached to a trust document for which no other documentation has been created that properly transfers that asset to the trust.

Property, casualty and liability insurance. Have an independent insurance consultant review all insurance coverage for trust assets. Lay trustees sometimes hold a home or vacation home whose insurance doesn't reflect the trust as an owner or the trustees' role. The limits of coverage should be reviewed against the values determined on the trust balance sheet noted above. While professional trustees may have a procedure for periodic insurance reviews, it's possible that lay trustees haven't modified coverage from whenever the asset was originally transferred to the trust.

Direction letters. When institutional directed trustees are asked to take a particular action, they're universally careful to obtain an appropriate direction letter. Lay trustees often don't understand this formality. Worse, some lay fiduciaries will take a direction letter or other formal action prepared by counsel for an unrelated matter concerning the trust and merely "doctor it up" to use in a completely different context. Ideally, all prior direction letters and other formal actions should be collected for a trust administered by lay trustees, put in chronological order and evaluated for appropriateness.

Compensation. Are the trustees entitled to compensation? Many instruments drafted with only family or other laypersons serving in all capacities may expressly prohibit compensation, remain silent or have mere boilerplate that's never really been thought through. If the lay trustee, lay trust protector or other individual serving under the trust instrument wants compensation, he should address it with counsel ideally before beginning to serve. Too often, nonprofessionals serving in these capacities only determine that they want compensation years later when there are fights or they view their role and efforts as not being appreciated. Is the failure to take compensation a deemed gift to the trust? If a lay trustee is going to receive compensation, a determination of what the trust instrument and applicable state law provide for should be made. These issues typically don't arise with professional trustees who generally negotiate a fee arrangement prior to serving.

Trustee insurance. Lay trustees rarely carry errors and omissions insurance, and thus their personal assets are potentially subject to claims of beneficiaries if there's



a dispute. Non-professional trustees should consider obtaining some form of insurance to protect against these potential claims. Professional trustees typically have insurance to cover their acts as trustee.

Legal Matters

Review of applicable trust terms. While this sounds so obvious perhaps it shouldn't seem to warrant mentioning in a checklist, the reality is that many non-professional fiduciaries have never read the governing instrument, or if they've read it, they did so years or decades ago, and they don't understand the implications of the instrument's terms or the role defined for them. Practitioners frequently see non-professional fiduciary clients show up with an old irrevocable life insurance trust that hasn't been dusted off in the decades since its creation. Thus, an important and productive step for most non-professional fiduciaries would be meeting with an advisory team to jointly review and annotate the governing instrument. It may be helpful to convert the PDF of an old trust document to Word and then annotate the agreement in track changes format (to differentiate the annotations from the terms of the instrument) with comments explaining provisions that will be critical to the role served by the particular nonprofessional. These annotations should also be tailored to address the specific assets and goals of the trust. Thus, annotating a life insurance trust for a trust protector might be quite different from annotating a dynastic trust holding family business interests to assist a named investment advisor. In many instances, a prerequisite to a review of the governing instrument is actually collecting all the documentation that comprises the trust. Especially for old trusts, it may become a challenge to identify a complete copy of the fully executed instrument and any actions subsequent to the initial signing that may have changed trustees or other terms of the trust. That compilation will be essential to a proper review. The compilation may also help the fiduciaries fulfill their fiduciary duties.

Trust modification. Advisors beginning representation of any trust with all non-professional fiduciaries should evaluate the trust terms to determine whether modification of the trust would be advisable. This may be feasible through trustee action, trust protector action, decanting or non-judicial modification. While their professional counterparts may periodically review a trust to determine whether changes are advisable, non-professional trustees likely don't do so. It may be appropriate to extend the term of the trust that has distributions to beneficiaries at a specified age, to change the situs and governing law for better asset protection or state income tax results, and so forth.

Fiduciary duties. Practitioners should explain to lay fiduciaries what "fiduciary duties" mean and specific steps they should consider to properly carry out those duties. Too many non-professional trustees don't understand the higher level of responsibility they have when serving in a fiduciary position versus other roles they may have in business or investment endeavors. With the proliferation of positions in modern trusts,

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practitioners should be alert to who may be characterized as a fiduciary. Some state laws mandate that a trust protector must serve in a fiduciary role. Other state laws defer to the provision of the governing instrument.[4]

Private entity interests held by the trust. Many trusts would have lay trustees own interests in a family business, real estate rental limited liability company, etc. What responsibilities and obligations do the trustees have for the management of the underlying entity? Most institutional trustees would have such a trust structured as a directed trust to minimize or eliminate their liability, unless they have expertise in the entity, agree to manage the entity and are paid for doing so. Many lay trustees don't understand the concept of a directed trust, and few old trusts were structured in this manner. The result is that the lay trustees may have a degree of liability that they don't comprehend. For example, the entity may be the only trust asset, and if it significantly declines in value, the trustees may be held liable for not reviewing and considering sale of the entity. Those same lay trustees may make no effort to look into the operations and distributions from

the underlying entity. What if the underlying entity is paying an egregiously unfair salary to one child who's purportedly managing the business or rental property while all children are equal beneficiaries of the trust that owns that entity?

Life insurance. While life insurance could be subsumed under the prior caption, the problems with life insurance held by an irrevocable trust with family or other non-professional trustees are so legion that it warrants its own caption. It's too common for an irrevocable trust to hold a life insurance policy that's never been reviewed. While professional trustees almost assuredly have procedures in place to periodically review insurance coverage, lay trustees rarely seem to do so. Practitioners have often seen the devastation of the policy that's not being monitored, is underfunded and is about to implode. In *In re Stuart Cochran Irrevocable Trust,*[5] the beneficiaries of an insurance trust sued the institutional trustee claiming violation of the Principal and Income Act and breach of trust. If a professional trustee can be sued, lay trustees without the expertise and procedures face even greater risk.

Each trust should have an investment plan that's designed to meet that trust's particular goals.

Trust formalities. Practitioners should educate lay trustees as to the requirements to adhere to trust formalities. Lay trustees often don't understand the need for independence and formality. While the list of many critical steps is obvious to practitioners, it's often not obvious to laypersons. All trust financial transactions should be handled solely through a separate trust account at a bank, brokerage or other institution. The trustees shouldn't be commingling the trust assets with any personal assets of the settlor or trustee or other individuals named in the instrument. The trust should file its own income tax return. Even grantor trust returns are advisable to corroborate the independence of the trust and to reinforce with lay trustees the importance of treating the trust as a separate entity. Accurate books and records should be maintained for all transactions. Practitioners frequently see lay trustees at the beginning of an engagement that have no organized copies of trust records to turn over for evaluation.

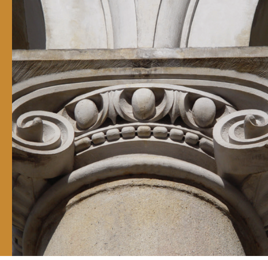
Powers clauses. Even lay trustees who read the trust agreement usually skip over the single-spaced, boiler plate powers clauses. But, these are potentially the most important clauses to understand. Can the trustees lend trust assets to a beneficiary? Can the trustees hypothecate assets to take out a loan? Can trustees invest in all assets classes, or are there limitations? What type of agents can trustees hire? These are provisions that are sometimes contained in state laws but can also be found in the powers clauses of the trust agreement.

Duty of impartiality. This is a difficult subject to broach with your trustee client. It often arises in the context of the wishes of the settlor. Perhaps the trustee was appointed by the settlor and, like the settlor, favors one beneficiary over another. The trustee may feel that this complies with the settlor's wishes. However, absent written instructions otherwise, a lay trustee must act in an impartial manner regardless of whether the trustee feels that he was empowered to act otherwise by the settlor.

Descendants. Often, the beneficiaries of a trust are described as "issue" or "descendants." Who's a "descendant" may be defined in the trust agreement or, if not, by state law. A lay trustee may not question an adopted child's right to become a beneficiary or a non-marital child's right, even though the trust may provide otherwise. Creating a family tree and understanding how the trust considers all of the members of that family are critical steps that many lay trustees may not understand.

Discretionary Matters

GPOAs. Does a trust instrument allow the trustees to confer on a beneficiary a GPOA for basis step-up purposes, for generation-skipping transfer tax purposes or other reasons on the death of the powerholder? The trustee should review these provisions to determine the status of the powerholders, whether powers have been appropriately circumscribed to prevent inappropriate exercise (for example, requiring the consent of the non-adverse party) or whether the trustee should take action to achieve the desired result (for example, conferring



the power of appointment or taking it away). Often, lay trustees aren't aware that they have this power, and if they're aware, haven't considered whether to use it. In all events, the practitioner should assist the trustees with documenting that they're aware of the power and the reasons they've taken whatever action is appropriate.

Investment plan. Few lay trustees, unless they've hired professional investment advisors, have addressed the appropriateness of investments for the trust. Holding whatever assets the settlor initially funded the trust with may be a comfortable old shoe but one potentially fraught with liability for the trustee.[6] The investment plan should comport with the governing state law's Prudent Investor Act (PIA), which requires the plan to assess the assets of the trust, the goals of the trust, income tax status of the trust and its beneficiaries, anticipated distributions to beneficiaries and other factors. It should all be memorialized in an investment policy statement (IPS) for the particular trust. Even in the few instances in which lay trustees have an IPS, it's often prepared for the settlor or family generally and isn't unique to the specific trust. Each trust should have its own IPS, and that IPS should be periodically updated to reflect any relevant changes. The PIA requires that an appropriate process be adhered to, not that particular investment results be achieved. Many lay trustees simply don't understand this and don't implement a process that would protect them in the event of a challenge. Also, each trust should have an investment plan that's designed to meet that trust's particular goals. Lay trustees may not understand that a simple "one-size-fits-all" approach may not work when there are qualified terminable interest property trusts for elderly spouses and dynasty trusts for future generations that have vastly differing time horizons, among other key differences.

Distributions. Have the lay trustees prepared financial models of trust corpus, investment returns under various scenarios (for example, Monte Carlo simulations), documented the needs of beneficiaries and evaluated the trust terms that govern this? The trust may require consideration of a beneficiary's other resources, merely suggest beneficiary resources be considered, or say nothing at all. What has the trustee done to document whatever is appropriate under the terms of the instrument before making distributions? A heightened responsibility may be warranted for professional trustees who inevitably will have a formal trust distribution committee evaluate and document the decision process for each distribution. Too many lay trustees presume with respect to distributions that "it's family" and don't have a process that can be memorialized regarding distributions—which may be one of the most sensitive trust administrative matters. While practitioners know the fallacy of that dangerous assumption, many lay trustees don't comprehend it until after a problem arises. Distributions should be reviewed annually, as otherwise a distributive pattern created in Year 1 may not be appropriate in later years.

Swap power. The swap or substitution power not only can be used to bring assets back into the grantor's estate for basis step-up purposes but also to effectively rewrite a dispositive scheme. For example, a grantor may have transferred an interest in the family business to an irrevocable trust that benefits a particular heir who was intended to be the successor for the business. If those circumstances change during the grantor's lifetime, swapping the business interests back into the grantor's estate can facilitate an alternate distribution for those interests. The reality is that few lay trustees monitor trusts periodically to determine whether a swap power should be exercised. They should be counseled to do so and to document their decisions. If significant trust assets are comprised of marketable securities, then perhaps the wealth manager may monitor those to alert the lay trustee as to when a swap may be advisable. When trust corpus is comprised of closely held business or real estate entity interests, who'll monitor that?

Naming successors. Lay trustees may be granted the right to name their successors, but often no such designation has been completed. This could create a vacancy in the office that needs to be filled by an expensive court proceeding.

Tax Matters

Tax identification number (TIN). Practitioners should confirm that a TIN for a particular trust instrument has been obtained. In some cases, non-professional trustees may be operating a grantor trust under the settlor's Social Security number when in fact a separate TIN might be advisable. Also, confirm that the TIN is associated with the correct trust. It's not uncommon for lay trustees to inappropriately use a TIN from a different trust, compounding the confusion and tax compliance problems.

File Form 56. Many non-professional trustees fail to file Form 56 with the Internal Revenue Service to notify the IRS of their beginning to serve as trustee or their resignation or termination as trustee. This is a simple matter but important so that the IRS has the correct address for sending notifications.

Tax reimbursement. If the grantor is taxable on the trust's income, should a trustee reimburse the grantor? The answer depends on several factors, such as what does the trust instrument provide, and what does state law provide? When a tax reimbursement clause is permissible, some lay trustees will make a tax reimbursement payment on a regular basis. Some have even so much as paid the grantor's quarterly tax estimates. Trustees need to be advised on how a tax reimbursement clause should be properly administered and how to avoid an appearance of an implied agreement with the grantor. In some instances, a trust instrument may not provide for a tax reimbursement or may expressly provide that there shall be none. Too often that doesn't suffice to prevent a lay trustee from making an impermissible tax reimbursement.

Adverse party. In some trusts, distributions to a spouse, for example, may require the consent of an adverse party. This may be done to characterize the trust as a non-grantor trust. This is all incredibly complex, and it's likely that a lay trustee won't address this prerequisite. Practitioners should review prior distributions to ascertain what documentation should have been prepared.

Situs and governing law. Lay trustees rarely understand the legal and state income tax ramifications of the situs where the trust is administered and the interplay between that situs and the governing law provision in the trust agreement. Practitioners should review this and help determine what changes or modifications may be warranted. For example, it may be advisable to divide a trust pursuant to its terms to have a trust's passive assets (assets that aren't source income to a high tax state or located in that state) bifurcated and the subsequent subtrust moved to a different state to effectuate significant state income tax savings.

***Crummey* powers.** These nearly ubiquitous demand powers are often required to be documented by a formal written notice given by the trustee to those holding these powers.[7] It's far too common to find that *Crummey* letters have never been issued or perhaps were only issued decades ago in the first year of the trust when counsel who created the trust was permitted to assist. Even in the instances in which laypersons prepare these notices, they may be prepared incorrectly. With the availability of forms on the Internet, some self-help lay trustees prepare notices that can create a host of problems. While there are arguments that written notices may not be required to qualify for the annual gift exclusion,[8] what if the terms of the governing instrument require notice be given? Would it suffice for beneficiaries to sign a formal waiver of any future notices? The critical issue for lay trustees is to have this addressed in some rational fashion and documented, which too often isn't done.

Non-grantor trust status. Non-grantor trusts are used in a variety of circumstances, perhaps to maximize an Internal Revenue Code Section 199A deduction, salvage charitable contribution deductions and so forth. It's not merely enough for a trust to contain the appropriate language to qualify as a non-grantor trust, but it must be administered as such. For example, if a non-professional trustee makes a loan to the settlor, might that characterize the trust inadvertently as a grantor trust? These aspects of trust administration need to be reviewed with the lay trustee to assure compliance with what might be a principal purpose of the trust.

Endnotes

1. The Uniform Trust Code (UTC) Section 813 requires keeping qualified beneficiaries reasonably informed, and UTC Section 105(b)(8) prohibits waiving the duty to inform qualified beneficiaries over 25 years of age.
2. *Finley v. United States,* 404 F. Supp. 200 (S.D. Fla. 1975), vacated on jurisdictional grounds, 612 F.2d 166 (5th Cir. 1980).
3. *Knop v. Knop,* 830 S.E.2d 723 (Va. 2019).
4. *See* 12 Del. C. Section 3313(a), providing that fiduciary advisors "shall be considered to be advisers and fiduciaries when exercising such authority provided, however, that the governing instrument may provide that any such adviser (including a protector) shall act in a nonfiduciary capacity."
5. *See In re Stuart Cochran Irrevocable Trust,* 901 N.E.2d 1128 (Indiana Court of Appeals, March 2, 2009).
6. *Erlich v. First Nat'l Bank of Princeton,* 208 N.J. Super. 264 (Law Div. 1984); *Merrill Lynch Trust Company, FSB v. Mary F.C. Campbell, et al.,* C.A. 1803-VCN, V.C. Noble (Delaware Court of Chancery, Sept. 2, 2009).
7. *Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968).
8. *Estate of Turner v. Comm'r,* T.C. Memo. 2011-209.