



# WRMarketplace

## An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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### **TOPIC: The Use of Trust Protectors in Estate Planning.**

**MARKET TREND:** As the use of dynasty trusts increases, the use of Trust Protectors is gaining momentum as a way to provide oversight of the trustee's actions and ensure the settlor's goals are fulfilled.

**SYNOPSIS:** Trust Protectors of discretionary trusts can provide support in the exercise of the trustee's discretionary powers. The authority granted to the Trust Protector can include any power the settlor believes will assist in the administration of the trust, including the authority to remove and replace the trustee, approve distributions to beneficiaries, approve investments and consent to selling specific family assets (such as a family company or a family compound). When selecting the appropriate person to serve as Trust Protector, careful consideration must be given to the powers granted and the skill set required to exercise those powers. Laws regarding the use of Trust Protectors are evolving, and the settlor will need to determine whether the Trust Protector will serve in a fiduciary or non-fiduciary capacity.

**TAKE-AWAYS:** The office of Trust Protector can be a valuable tool to ensure the settlor's aspirations in creating the trust are fulfilled. The family should decide if and in what circumstances such a role is necessary, and the trust agreement should clearly define the Trust Protector's powers. The hardest questions for the family, however, likely will be who should be named initially as Trust Protector and as successors, and how subsequent successors should be appointed over the long term.

With the increase in the federal estate and generation-skipping transfer ("GST") tax exemptions and the extension or elimination by many states of their perpetuities periods, many clients are creating trusts (including life insurance trusts) which may hold assets for the benefit of numerous generations. Such trusts frequently give the trustees broad discretion over the application of income and principal for the beneficiaries and management of the trusts' assets. Over time (particularly if the client is deceased), the trustee may lose sight of the client's goals in setting up the trust, or the irrevocable nature of the trust may make it difficult for the trust to adapt to changing laws or situations.

In these cases, a "Trust Protector" (also sometimes referred to as a "Trust Advisor" or a "Trust Enforcer") can be used to ensure the client's goals and objectives in creating the trust are followed. A Trust Protector also can be used to add flexibility, enabling the trust to adapt to

fluctuating tax laws and changes in beneficiaries' personal needs and circumstances. While Trust Protectors have long been used in offshore trust planning, their use in U.S. domestic trusts is more recent - but gaining momentum.

### ***WHAT IS A TRUST PROTECTOR***

A Trust Protector is a person, separate from the trustee, the settlor, or a beneficiary, who is designated in the trust instrument to have certain specific powers or authority over the trust or the trustee. The Trust Protector can be a single individual, a group of individuals or an entity (although it is unlikely that a bank or trust company will be willing to serve in this capacity). A Trust Protector's role is much like a guardian for the trust – a person who can monitor the activities of the trust and change or redirect the course of those activities in order to fulfill the client's objectives over time.

### ***WHAT POWERS CAN BE GIVEN TO A TRUST PROTECTOR***

The Trust Protector can be granted any power or authority deemed necessary or advisable to fulfill the settlor's intentions in establishing the trust. Depending upon the needs of the trust and the identity of the Trust Protector, the Trust Protector may be granted only a few limited powers or may be given broad powers to direct the trustee and/or trust activities. The Trust Protector's authority can relate to administrative and/or distribution matters, and can be active (i.e., the Trust Protector has the power to direct the trustee to take certain actions) or passive (i.e., the Trust Protector acts only on the request of a beneficiary or the trustee). The following are examples of powers that could be given to a Trust Protector.

- Remove the trustee. This is the power most frequently granted to a Trust Protector. Over time, a trustee may not devote the necessary time and attention to trust matters, or tensions may develop among the trustee and the beneficiaries. The ability to remove a trustee (with or without cause) allows a transition to a new trustee without the time and expense of judicial intervention. The authority to remove the trustee can be structured so that the power can be exercised only at the request of the beneficiaries, or allow the power to be exercised by the Trust Protector on his or her own initiative.
- Appoint additional and successor trustees. The power to appoint additional and successor trustees is usually coupled with the authority to remove the trustee. As discussed below, however, if the settlor or a beneficiary is serving as the Trust Protector and a trustee is removed, then for tax reasons the replacement trustee should only be a person who is not related or subordinate to the Trust Protector.
- Approve investment strategies. For example, if the settlor has directed that the trust invest primarily in environmentally-friendly companies or blue-chip stocks, or that investments be structured for growth rather than income, the Trust Protector can monitor and approve the investment strategy structured to meet these objectives.
- Approve the purchase/sale of certain investments/assets. For example, the Trust Protector may be required to approve a corporate trustee's investment of the trust in its proprietary funds or a trustee's sale of certain family assets, such as a family or closely held business, a family residence or vacation home, copyrights, patents, artwork, or valuable collections.
- Review and approve trust accountings. A few states (Delaware for example) allow "silent trusts," which direct that trust information is not to be disclosed to beneficiaries

until they reach a designated age or until the occurrence of a specific event (such as the settlor's death). In such states or where beneficiaries are minors, a Trust Protector could receive and approve trust accountings on behalf of the beneficiaries.

- Grant a beneficiary a power of appointment. The Trust Protector may have the authority to grant, modify, or revoke a power of appointment to adapt to the trust's circumstances (e.g., if a trust will be subject to GST taxes at the death of a beneficiary, the trustee may grant the beneficiary a general power of appointment over the trust to cause inclusion in the beneficiary's estate and taxation at a lower estate tax rate).
- Consent to a beneficiary's exercise of a power of appointment. For example, the exercise of a power of appointment in favor of a beneficiary's spouse could require the consent of the Trust Protector.
- Act as tie-breaker if co-trustees are at an impasse and cannot reach a majority decision.
- Amend the trust instrument. The power to amend the trust can be limited to correcting scrivener's errors or making technical modifications to deal with changing tax laws, or broad enough to change beneficial interests in the trust. Granting a Trust Protector the authority to amend the trust adds flexibility and can avoid the time and expense of a decanting or a judicial modification.
- Direct that the trust's assets be "decanted" to a new trust, or that any such decanting be subject to the consent of the Trust Protector.
- Change the trust's situs or place of administration, or change the trust's status as a domestic or foreign trust.
- Direct or consent to certain distributions to beneficiaries (such as distributions to help a beneficiary start a business).
- Direct or consent to withholding trust distributions to a beneficiary. If, for example, a beneficiary is unable to handle money, has a mental or physical impairment, has a drug or alcohol dependency or gambling addiction, is going through a divorce or separation, has asset protection needs, etc., a Trust Protector who is familiar with the beneficiary and his or her problems could direct the trustee to withhold distributions where a trustee may otherwise be reluctant to make such a decision.

Although the Trust Protector can be given the power to direct, approve, or consent to a variety of actions and administrative functions, if the Trust Protector is given too much authority, there is a risk that the Trust Protector could be viewed as a de facto co-trustee with all of the fiduciary duties and responsibilities (and potential liabilities) of a trustee. The powers granted to the Trust Protector should be tailored to the individual client's goals and objectives, taking into consideration the identity of the person the client would like to appoint as the Trust Protector.

### ***WHO CAN (OR SHOULD) SERVE AS THE TRUST PROTECTOR***

The most difficult part of utilizing a Trust Protector is identifying the right individual, and successor individuals, to serve.

First, in order to provide the most flexibility, ideally the Trust Protector will be an unrelated third party who is not subordinate to the settlor or the beneficiaries, and who has no interest in the trust, such as a friend, distant relative, accountant, attorney, or other trusted adviser.

Second, although the settlor of an irrevocable trust may serve as Trust Protector, the powers granted to the Trust Protector in that instance must be severely curtailed in order to avoid unintended income and estate tax consequences:

- The settlor cannot have any direct or indirect authority over distributions of income or principal or be able to change beneficial interests.
- The settlor cannot have an unrestricted power to remove and replace trustees. Rather, if the settlor removes a trustee, any replacement trustee must be a person who is not related or subordinate to the settlor; otherwise, the settlor will be deemed to hold the powers of the trustee, which will cause the assets to be pulled into the settlor's estate for estate tax purposes<sup>1</sup>.
- Similar considerations must be reviewed and addressed if a beneficiary is appointed as the Trust Protector.

Third, consideration also must be given to the authority to be granted to the Trust Protector and the skill set required to carry out that authority:

- If the Trust Protector is to approve certain distributions to the beneficiaries, the Trust Protector should be someone who is familiar with the beneficiaries and their needs and circumstances.
- If the Trust Protector is to direct the trustee regarding the management of a closely held business, the person selected should be someone who is familiar with the business or has experience managing a similar enterprise.
- If the Trust Protector will have authority to amend the trust to adapt to changes in tax laws, it may be advisable to appoint a person who has a knowledge and understanding of such laws and their potential impact on the trust and its beneficiaries.

Fourth, the laws of the state in which the proposed Trust Protector resides should be analyzed to determine whether the appointment could cause the trust to be subject to income tax in that state.

Finally, in all events, the Trust Protector should be someone the settlor trusts.

### ***IS THE TRUST PROTECTOR A FIDUCIARY?***

Whether a Trust Protector is deemed to be a fiduciary will impact the standard of care the Trust Protector is required to use in exercising his or her powers. At a minimum, fiduciary standards would require that the Trust Protector act in good faith, and in the best interests of the beneficiaries and the purposes of the trust. The status of the Trust Protector as a fiduciary will also impact the liability exposure for the person serving as Trust Protector and could even impact whether the trust will be subject to income taxes in the Trust Protector's home state<sup>2</sup>.

The law regarding Trust Protectors is still developing in the United States. A few states (such as Idaho, South Dakota, Tennessee, and Wyoming) have enacted statutes defining a Trust Protector

as a fiduciary. States that have adopted the Uniform Trust Code (“UTC”) also are likely to treat a Trust Protector as a fiduciary<sup>3</sup>. Other states, such as Alaska and Arizona, specifically provide that a Trust Protector is not a fiduciary. Many states, however, do not have a statutory or common law basis for the role of a Trust Protector or an established method for determining whether a Trust Protector is subject to fiduciary standards<sup>4</sup>. Advisors in these states frequently struggle with whether the Trust Protector is a fiduciary or acts in a non-fiduciary capacity.

Although the settlor can direct in the trust instrument that the Trust Protector is not a fiduciary and that the powers are personal to the Trust Protector, it is unclear whether such direction will be honored by a court, particularly where the Trust Protector holds considerable authority over the trust. If neither the settlor nor a beneficiary is to serve as the Trust Protector, the better path may be to provide that the Trust Protector is a fiduciary and relieve the Trust Protector of liability except for fraud, willful misconduct, bad faith and/or gross negligence.

### ***FINAL CONSIDERATIONS***

In addition to defining the specific powers granted to the Trust Protector and whether the Trust Protector is a fiduciary, the trust instrument should provide a mechanism for the appointment of additional and successor Trust Protectors and their removal.

Other administrative matters that the Trust Protector provisions should address include:

- Will the office of Trust Protector be held only by independent third parties?
- Who should have the power to remove a Trust Protector?
- Should the Trust Protector receive compensation and if so, how is compensation determined?
- If there are multiple Trust Protectors, will decisions be made unanimously or by majority vote?
- May the Trust Protector delegate his or her authority?
- What actions may a trustee take in the event of a vacancy in the office of Trust Protector?
- To what extent should the Trust Protector be relieved from liability for his or her actions or inaction?
- May the Trust Protector seek independent advice or counsel in the exercise of his or her authority at the expense of the trust?

### ***TAKE-AWAYS***

- The office of Trust Protector can be a valuable tool to ensure the settlor’s aspirations in creating the trust are fulfilled.
- The family should decide if and in what circumstances such a role is necessary, and the trust agreement should clearly define the Trust Protector’s powers.

- The hardest questions for the family, however, likely will be who should be named initially as Trust Protector and as successors, and how subsequent successors should be appointed over the long term.

## **NOTES**

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<sup>1</sup> See, Rev. Rul. 95-58, 1995-2 C.B. 191.

<sup>2</sup> Under California law, for example, if the Trust Protector is deemed to be a fiduciary, the trust will be subject to California income taxes, even though the trust is administered in another state, and the trustee and beneficiaries all reside outside of California. See, Ca. Rev. & Tax Code §§ 17006, 17742, 17743.

<sup>3</sup> The UTC does not specifically authorize the use of a Trust Protector but provides that a person, other than a beneficiary, who holds the power to direct trustee actions is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from a breach of a fiduciary duty. See, UTC § 808.

<sup>4</sup> For a general discussion regarding whether a Trust Protector is a fiduciary, see Bove, “The Case Against the Trust Protector,” *ACTEC Law Journal*, Vol. 37:77 (Summer 2011).

## **DISCLAIMER**

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### **WRM #15-14 was written by Greenberg Traurig, LLP**

Jonathan M. Forster  
Martin Kalb  
Richard A. Sirus  
Steven B. Lapidus  
Rebecca Manicone

### ***Counsel Emeritus***

Gerald H. Sherman 1932-2012  
Stuart Lewis 1945-2012