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## **Trust Flexibility, Trust Protectors** *And a Summary of the Pension Protection Act*

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In recent years, the concept of “trust protectors” has developed. Originally, the need was driven by complex offshore trusts that needed to be perpetually nimble. But the concept itself is not complex at all. The effective mechanism: empowering designated agents who can change trustees, trust situs, or investments.

Are trust protectors useful for garden-variety domestic trusts which are typically set up for family wealth management purposes?

The answer is a qualified “Yes.” There are, of course, existing means of creating flexibility in trusts, so the addition of a new approach has to be seen in context. And for modern trusts, flexibility may also entail a “total return” approach to investing, which is another key factor.

Let’s review traditional approaches to trust flexibility and see what trust protectors add to the equation.

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## ***What Is a “Trust Protector”?***

A trust protector is a specially empowered third party who can modify the trust. Typically, such a protector would be able to replace the trustee, change the trust situs, alter investments, and perhaps even alter the trust in certain ways.

A trust protector is like a super trustee in some ways, looking over the shoulder of the actual trustees. And that raises a number of sub-issues. Do they owe any enforceable duties to the trust beneficiaries? That's one of the unknowns of trust protectors which are identified by a recently published law review article.<sup>1</sup>

Or perhaps one should conceive of the Protector as an alter ego of the grantor, someone with insight into the grantor's objectives and philosophy who can act as the grantor would if direct ownership and control had been retained.

## ***Be My Protector?***

Selecting a Protector for a domestic wealth protection trust raises several issues. For many years, trust protectors were utilized in tax havens and in the United Kingdom. Articles began appearing in American estate-planning articles during the 1990s.<sup>2</sup>

No plan can foresee all possible ways in which life can play out, but every trust may carry within it the seeds of flexibility that enable it to adapt to new circumstances.

Trusts that were reliable become rigid. Trusts may be exhausted and become uneconomical to operate. The situs of a trust may become inconvenient. There may be reasons to change trustees. And the need to modify investments is a topic unto itself.

## ***Traditional Flexibility***

An irrevocable living trust can have a great deal of built-in flexibility. Consider the following approaches in a circumstance where Mr. A has set up a revocable living trust during his lifetime which has become irrevocable upon his death

**Power to Invade Principal:** If income is not adequate to accomplish trust purposes, the trustee can be authorized to distribute all or portions of trust corpus. But caution is needed in granting such power to beneficiaries directly. If such invasion power is not subject to an ascertainable standard, the net result for tax purposes becomes distribution of the entire trust.

**Power of Appointment:** Mr. A's trust will pay income to his daughter, Alexis, for her life. Where will the trust assets go when Alexis dies? To allow for flexibility, Mr. A has given Alexis the power to decide, in her will, where the assets will be distributed.

**Power to Amend the Trust:** Mr. A's trust can also give his trustees the power to modify the trust to save taxes or carry out Mr. A's objectives. For instance, if there is a major tax law, Mr. A's trustees will be able to change the trust terms to take advantage of any new tax breaks. This power might also be given to a separate fiduciary.

**Power to Terminate the Trust:** A modestly sized trust may become uneconomical to administer and may become irrelevant in the context of much larger family assets. A trustee with the power to terminate a trust meeting certain standards, either falling below a threshold such as \$50,000 or based on the trustee's assessment of the trust's viability.

**Other Powers:** Virtually any power can be granted to trustees along with appropriate guidelines. Here are a few examples of —

### **Powers to....**

- Change or remove trustees.
- Change trust situs.
- Divide trusts for GST purposes, to qualify company stock for S corporation purposes or so that assets can be invested in different ways to coordinate with beneficiary needs.
- Combine identical trusts.
- Substitute charitable beneficiaries.
- Correct a drafting error that defeats trust purposes.
- Allow early termination of the trust.

### **Investment powers to...**

- Retain stock in the grantor's family business.
- Invest in additional stock in the grantor's family business.
- Invest in non-income-producing assets.
- Accumulate income.
- Invest aggressively but using a diversified stock portfolio.
- Invest with the same style and philosophy exhibited by the grantor.

**Warning!** These strategies carry risks with them. Yes, the modern trustee has been greatly liberated from the restrictive bounds of the prudent-man standards of the past and this can be to the mutual benefit of grantors and beneficiaries. But in removing the restrictive safeguards, the potential exists for an estate to fall victim to a lack of diversification. A trustee who is permitted to invest in non-income-producing assets may build equity at the expense of current income beneficiaries.

### ***Enter Total Return Investing***

Once upon a time, in 1830, securities held in a trust fell in value from \$50,000 to \$30,000. The trustees were not held liable because they had invested in bank stock, which in 1830 met (and set) the standard of observing “how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”<sup>3</sup>

Flash forward to a time of diversified mutual funds and a stable market. As modern portfolio theory developed, the more restrictive prudent-man standard was replaced by the prudent-investor standard that is included in the Restatement (Third) of Trusts of 1992. The total return theory of investing is further reflected by the Uniform Principal and Income Act of 1997, which allowed for greater fiduciary leeway in allocating income and principal—even allowing the fiduciary to recharacterize principal as income. Note, however, that the IRS will only respect allocations of income to principal and vice versa that are authorized under state statute.<sup>4</sup>

But what is income or principal these days? Over time, the real world has blurred the lines of income and principal. A growing number of states are enacting or considering legislation that permits a trustee to exercise discretion in making equitable adjustments between income and principal, if necessary, to ensure that the income and remainder beneficiaries are being treated fairly.

And for the ultimate blurring of the lines, the “total return” concept represents a historic truce between lifetime-income beneficiaries and remaindermen. A total-return unitrust trust can be invested to maximize returns, and yet the interests of both current and future beneficiaries can be balanced to reasonable and realistic extent.<sup>5</sup>

### ***Trust Protectors Arrive***

Considering all the ways of making an irrevocable trust more flexible, having a trust protector might be overkill. It might even make an otherwise flexible trust more cumbersome to have another layer of compliance and interaction.

Although the trust protector concept arose in the context of offshore trusts, there are aspects of the trust protector concept that are applicable to garden-variety domestic trusts. A trust protector is a way of empowering beneficiaries who might be at odds with the trust and would otherwise have to seek judicial reformation involving time, expense, effort, and uncertainty.

### ***Don't Judge a Trust...***

Revocability of the living trust has been the epitome of flexibility, but don't judge the flexibility of a trust by its revocability alone. Isn't it ironic that the individual who insists on keeping trusts revocable for the sake of flexibility would needlessly allow the same trust to become an inflexible irrevocable trust after his death? By comparison, a long-term dynasty-style trust can offer great flexibility over time.

The better test of flexibility is whether the right provisions have been included to help a particular trust adapt to the most likely range of potential issues it will face.

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## **TECHNICAL REFERENCES**

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1. Sterk, Stewart E., *Trust Protectors, Agency Costs, and Fiduciary Duty*. Cardozo Law Review, Vol. 27, 2006. This is 35 pages and is available online.
2. Our list of traditional approaches for making trusts flexible is taken from, Moshman, *Making irrevocable trusts flexible*, The Estate Analyst (June, 1997). At that time, the paragraph on the power to amend trusts noted that “this power might also be given to a separate fiduciary called a trust protector,” and cited Hodgman, *Drafting flexible irrevocable trusts—whom do you trust?*, 23 EP 5, p. 221 (June, 1996).
3. *Harvard College v. Amory*, 26 Mass.; Moshman, *What is “trust income” in 2001?* The Estate Analyst (April, 2001).
4. Kline and Anderson, *Using Total Return Trusts*, Trusts & Estates (Feb., 2005, p. 30).
5. Pittsburgh attorney Robert Wolf used computer modeling to demonstrate the viability of total return unitrusts during the 1990s. Moshman, *The total return unitrust*, The Estate Analyst (August, 2001).

## Highlights of the Pension Protection Act of 2006

The Pension Protection Act of 2006, H.R. 4, which President Bush signed on August 17, 2006, was the culmination of more than four years of efforts to reform the retirement system upon which 44 million Americans rely.

Most of the new law focuses on the funding standards for corporate pension plans. Companies have seven years to shore up the 30,000 employer-run plans which are currently underfunded by \$450 billion. A new formula controls plan contributions. Airlines in bankruptcy proceeds have an extra 10 years (17 years total) to fully fund pension plans.

“Americans who spent a lifetime working hard should be confident that their pension will be there when they retire,” said President Bush in signing the law, which comes in the wake of corporate scandals in which employees with their nest eggs in company stock lost their life savings.

The new law requires employers to provide additional investment options and information for workers. Companies with seriously underfunded plans will not be able to promise their workers bigger benefits. However, the defined benefit system, which has shrunk from 112,000 plans in 1985 to 30,000, is being replaced by a system of individual accounts.

Other provisions allow employers to automatically enroll workers in 401(k) plans. There is a mechanism to increase savings and employers are encouraged to match savings. When in effect, the change could generate an additional \$10 billion or more of annual investments in 401(k) accounts. Several other noteworthy tax changes are included in the new law.

**HIGHER CONTRIBUTION LIMITS:** Higher contribution limits that would have expired in the next decade were made permanent.

**NON-SPOUSE BENEFICIARIES:** In the past, only a surviving spouse was afforded favorable treatment for rolling over retirement plan distributions. Under the new law, non-spouse beneficiaries of qualified retirement plans will now be treated as if they were receiving distributions under a qualified pension plan and will be able to make the distribution over a five-year period or over the life expectancy of the non-spousal beneficiary.

**RELIEF FOR RESERVISTS:** In, *IR-2006-152*, the IRS notes that under PPA 06, military reservists called to active duty can receive payments from their individual retirement accounts, 401(k) plans, and 403(b) tax-sheltered annuities, without having to pay the 10% early-distribution tax that normally applies to most retirement distributions received before age 59½. Distributions would, however, be subject to income tax when distributed. Reservists can choose to re-contribute all or part of distributions to an IRA.

**RELIEF FOR PUBLIC SAFETY EMPLOYEES:** Members of police, fire, EMT, and other public safety employees who separate from service after age 50 will not be subject to the 10% early-withdrawal tax on distributions from governmental defined-benefit pension plans.

**DIRECT DEPOSITS:** Tax refunds can now be directly deposited into an IRA.

**CHARITABLE DONATIONS:** Up to \$100,000 per year per taxpayer can be donated directly from an IRA (traditional or Roth) to a qualified charity without taxes. Cash donations will not be deductible without a receipt or cancelled check. Non-cash donations must be in “good condition” which may make it prudent to retain photographic documentation of the condition of donated materials.

**INVESTMENT ADVICE:** A qualified investment advisor can be paid out of an IRA or other retirement account without incurring a penalty for distribution from the plan if the advisor's fee doesn't vary based on the investment choices that participants make or if recommendations are based on a computer model certified by an independent third party.

**CONSERVATION EASEMENTS:** Conservation easement reforms hitched a ride on PPA 06. Under previous law, there was a 30% limit on contributions of capital gain property by individuals. Now, for 2006 and 2007 only, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in §170(b)(1)(A) to the extent of the excess of 50% of the contribution base over the amount of all other allowable charitable contributions. For coverage, see Moshman, *New Deductions for Conservation Easements*, The Estate Analyst (Sept., 2006).