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SUBJECT: TRUSTEE SELECTION

TITLE: Choosing the Right Trustee to Achieve **Specific** Tax **Objectives**

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HIGHLIGHT:
To avoid causing either the grantor or the trustee to be taxed on a trust's income, the trustee must be chosen carefully, and the powers retained by the grantor or given to the trustee must be analyzed thoroughly, as this article explains.

CORE TERMS: grantor, beneficiary, adverse party, trust property, partnership, circle, spouse, income tax, co-trustee, subordinate, ownership, estate tax, distribute, fiduciary, definite, planning, lackey, inner circle, nonadverse, disability, attributed, continuum, appointed, shelter, manage, reversionary interest, transferred property, income beneficiary, economic interest, husband and wife

TEXT:
Trusts play an important role in most financial and estate plans. Even the simplest plan usually calls for a child's money to be held in trust if the parents die while the child is a minor. Frequent use is also made of credit shelter trusts, QTIP trusts, and life insurance trusts. Increasingly, individuals are planning for their own disability by placing their assets in trust, and so ensuring qualified and seamless management. Medicaid planning involves trusts, as does gift giving to grandchildren. These are some common reasons for using trusts, and there are several more unique reasons as well.

A trust consists of a legal arrangement between a grantor and a trustee, which divides legal and beneficial interests in property among two or more individuals. The trust has been well-named because "trust," in the non-technical sense of the word, is the common denominator every time such a structure is used. At the most fundamental level, a trust is one person entrusting another with property for a specific purpose. One would therefore assume that the person to be chosen for this faithful position as trustee would be someone related to the grantor--a spouse, parent, brother, adult child, or even the grantor himself.

But therein lies the problem. The Internal Revenue Code generally provides that appointing those closely related to you means that the trust property (in terms of its tax liabilities) is still yours, and that giving trusted individuals too much power means that the property becomes theirs. Because a reason for many trusts is to remove the assets from the grantor's dominion and control for income tax and estate tax purposes, the deemed "return" of the property is most unwelcome. Similarly, having the tax burden of the trust property shifted personally to the trustee is not the result most grantors--not to mention most trustees--desire. Accordingly, selecting the proper trustee is a critical part of establishing a trust.

Background

The rules regarding trustee selection are found in two broad portions of the Code: Sections 2031-2038, governing what property is included in the gross estate; and Sections 672-678, the grantor trust rules dealing with income tax. The rationale underlying these statutory provisions is surprisingly cogent, and may be stated as a simple question: "Who *really* owns the assets in trust?". If the grantor continues to make all the important decisions regarding the trust property, the tax consequence *should* be that it is still his property. This is illustrated most clearly by Section 2038. No matter how elaborate a trust scheme is, if the grantor could revoke it all, then the property never left his "ownership," and all tax obligations of the property remain rightfully imposed upon him. Hence, a revocable trust (or living trust) provides no income tax or estate tax advantage.

Keefover *<1> illustrates this point. In that case, the taxpayers--a husband and wife--created a trust for retirement and estate planning purposes using stocks, bonds and other personal assets. The wife was the original trustee, but she soon appointed their adult children as trustees. The trustees were given "unlimited power to hold, manage and distribute the income and corpus of trust." Despite this, the taxpayers retained signing authority over trust checks along with the trustees, and they kept the trust checkbook in their possession. When funds were used to build a new residence, the taxpayers were hired as "caretakers" of the property. This position allowed them to live in the house for no rent.

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*<1> TCM 1993-276.
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The court held that the trust created by the taxpayers was not valid, as the formation of the trust did not substantially restrict their use of and benefit from the assets purportedly transferred to the trust. Because the property never truly left the ownership of the taxpayers, the trust was not valid and was disregarded for tax purposes.

At the other extreme, if neither the grantor nor anyone he knows has any control over the property (e.g., a trust for the benefit of Bosnian orphans, administered by Kofi Annan), then indisputably, the property is no longer owned by the grantor and the tax burdens must shift elsewhere. Unlike *Keefover*, *Broide* *<2> exemplifies a case in which the taxpayers gave up all rights to the trust assets, thereby creating a valid trust. In *Broide*, the taxpayers--a husband and wife--each set up two trusts for the benefit of each of their two children. Mr. Broide called upon his wife's sister to be the trustee of his trusts, and Mrs. Broide named as the trustee of her trusts an employee of a business partnership in which the Broides were partners.

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*<2> 156 F. Supp. 12, 52 AFTR 808 (DC Ill., 1957).

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On the date the trusts were created, the old business partnership was dissolved and a new one was organized, with Mr. and Mrs. Broide and the two trustees as the general partners. The trusts contributed all the trust funds to the partnership in exchange for partnership interests. Thus, the partnership interests were trust investments. While the taxpayers and the trustees were all involved in the partnership together, Mr. and Mrs. Broide reserved no right to participate in or receive any of the income or corpus of the trusts.

The IRS found that the partnership was not a bona fide partnership for tax purposes, and reallocated the trusts' share of partnership income to the taxpayers. The court, however, held that because the grantors did not reserve the right to direct the investments in the trust instruments, nor did they perform any personal services for the trusts in the making of an investment, there was no Code provision that would render the income of the trusts taxable to the grantors. As a result, the trusts were taxable on their share of the partnership's income.

Between the two ends of the spectrum represented by these two cases is a broad gray area where most individuals engaged in income tax or estate planning find themselves, and this is where a clear understanding of the trustee selection rules becomes essential.

Statutory scheme

To determine who really owns the trust assets, we must remember the definition of "ownership" as a collection of discrete powers, such as the power to sell, mortgage, or lease property. In trust, these discrete powers may be limited, broad, or divided among several people. Finding the real "owner" requires identifying exactly which persons hold exactly what powers, and this is the approach taken by the Code: *who* can do *what* with the property. Based on the above two cases, it is clear that courts look to who the trustees are and, more importantly, what power the grantors retain over the trust when it is created.

Understanding the way in which the Code makes use of these two tools--people and powers--is the key to proper trustee selection. The pertinent categories of "people" are set forth in Section 672. That section defines a continuum, ranging from those people most closely identified with the grantor in terms of blood-relation or economic interest, to those whose relationship with the grantor or whose economic interests are most distinct from him. These categories may be viewed as a series of concentric circles.

In the first circle, is the grantor. Clearly, *any* powers retained by the grantor are highly suspect and are likely to cause the trust property to remain "owned" by the grantor for tax reasons. The second circle consists of those people closest to the grantor: his spouse, parents, issue, and siblings. Also included in this circle are the grantor's employees and any entities he substantially controls. This second group consists of "related or subordinate parties" *<3> who are considered, in effect, the grantor's legal lackeys. What they control, he controls. If they control property he placed in trust, without restriction, then he still "owns" that property for tax purposes.

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*<3> Section 672(c).

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The third circle is composed of the rest of the world--virtually everyone who is not close family. They are "nonadverse" or independent parties, *<4> and they include those who often appear in the trust context: banks, professional managers, attorneys, accountants, and trusted friends. The fourth circle is the most interesting of all and consists of people wearing two hats. On one hand, they are beneficiaries of the trust and, on the other hand, they also either are trustees or hold some fiduciary power over the trust. These people are in an inherent conflict; by exercising their fiduciary powers in favor of another beneficiary, they reduce the amount of money or benefits they might receive themselves. These people are called "adverse parties," *<5> but far from being the grantor's enemies, they are frequrntly the very same people found in the second circle (e.g., the grantor's spouse or children), who have an interest in the trust as both a fiduciary and a beneficiary.

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<4> Section 672(b).<5> Section 672(a).

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The second main analytic tool used by the Code is "powers," and these fall into two main categories: (1) powers that directly benefit the grantor or his spouse, and (2) those that do not. The first category includes: a transfer with a retained life interest (Sections 2036, 677); a power to revoke (Sections 2038, 676); a substantial reversionary interest (Sections 673, 2037); a power of appointment (Sections 2041, 678); and a power to deal with the property at less than arm's length (Section 675). The second category includes all the other powers to control who will enjoy the benefits of the property, and how they will do so (Section 674). The Keefovers retained too much power for the court to recognize a valid trust. In contrast, the Broides retained no power over the trust assets, and were therefore not taxed on the trust income.

The relationship between these two conceptual tools, "people" and "powers," is inverse. The closer a person is to the grantor, the fewer powers to directly benefit the grantor he may have if continued grantor "ownership" of the trust is to be avoided. The farther one is from the grantor, in terms of family or economic interest, the greater one's powers to benefit the grantor may be.

The concept is simple. Someone who is considered a lackey of the grantor will be ignored, and the powers he holds to benefit the grantor will be attributed back to the grantor. Conversely, someone who is truly detached from the grantor, or whose own economic interests run counter to the grantor's, can be expected to act independently. Hence, that person's powers will not be attributed back to the grantor, and consequently, that person can possess significant powers over the property. In the previous example, Mr. Kofi Annan, who is independent from the grantor, may hold great power over the management and distribution of the trust property, without the fear that the property will be attributed back to the grantor. Instead of Mr. Annan, suppose that the grantor had appointed his wife as trustee and that the grantor was himself a Bosnian orphan. In such a case, it is easy to see how the remaining terms of the trust could be disregarded, and the grantor could be deemed never to have parted with the incidents of ownership.

The inverse relationship between people and power means that within the first circle (the grantor's circle), the greatest restrictions apply. Powers or rights that can *directly* benefit the grantor can be held only by an adverse party. Section 2036 deals with any transfer made by the grantor, including a transfer to a trust, in which the grantor retains any possession, enjoyment, or right to income from the transferred property. The language is quite broad and, if found to apply, mandates inclusion of the trust property in the grantor's estate. Sections 673 and 2037 state that if the grantor has more than a de minimis reversionary interest, the shifting of tax obligations is not effective.

Section 677 provides that if the grantor or his spouse can receive or benefit from the income produced by the trust property, the grantor is still considered the owner of the property. Section 676 declares that any transfer that can be revoked by anyone but an adverse party is not effective to transfer the income tax obligations away from the grantor. Similarly, under Section 2038, a power to revoke a transfer, exercisable by the decedent alone or with any other person, causes inclusion of the transferred property in the decedent's estate.

Section 675, entitled "Administrative Powers," states that if the grantor can deal with the trust property on less than arm's-length terms (such as by borrowing the property without adequate interest or security), he is treated as the owner. These Code sections all deal with the grantor directly or potentially retaining some benefit in the property himself. These powers to directly benefit the grantor are so significant that generally, if anyone who is not an adverse party holds these powers, it is enough to preclude shifting the tax obligations.

Powers that do not directly benefit the grantor or his spouse are less suspect, and can be held by people closer to the grantor--or even by the grantor himself--without causing the grantor to be deemed the owner of the property. These types of powers are addressed in Section 674. This section starts with a broad catch-all proposition: If anyone other than an adverse party has the power to "dispose" of the "beneficial enjoyment" of the principal or income from the property, the grantor is still treated as the owner of the property.

The purpose of this rule is to "catch" any scenarios that benefit the grantor but are not dealt with specifically by other Code sections. But due to the underlying interplay of "people" and "powers" (as discussed earlier), this rule is riddled with caveats and exceptions so that certain powers, which do not directly benefit the grantor, may be held by nonadverse parties. Thus, under one exception, the power to determine the ultimate beneficiaries of a trust, *exercisable only by will*, will not cause the property to be treated as owned by the grantor. *<6> Similarly, a power to allocate among only charitable beneficiaries does not benefit the grantor directly, and so is a power that can be held by him or his inner circle. The power to withhold income during the minority or disability of an income beneficiary does not benefit the grantor directly and so is permissible. Numerous other expectations are contained in Section 674, and this section must be studied carefully whenever specialized powers are to be granted.

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*<6> Section 674(b)(3).
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The most significant aspect of Section 674, however, is the creation of a safe harbor: the reasonably definite standard. This concept holds that a member of the grantor's inner circle can hold a power--even a power to benefit the grantor directly--provided it can be exercised only in accordance with an external standard. If so, then it is not considered broad enough to trigger the grantor's "ownership" of the trust assets.

Through the use of this technique, the grantor himself may be appointed trustee, manage property, and distribute principal to a defined and fixed class of beneficiaries (not including himself). *<7> A related or subordinate party, such as a sibling or parent, can allocate and distribute both income and principal to a fixed class of beneficiaries. *<8> The standard must be enunciated in the trust and must be specific enough to be enforced by a court. Accordingly, a power to distribute corpus for a beneficiary's "reasonable support and comfort," or for "education, support, maintenance or health," is sufficiently definite. On the other hand, distributions to achieve the beneficiary's "happiness" are not. *<9>

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<7> Section 674 (b)(5)(A).<8> Section 674(d).*<9> Reg. 1.674(b)-1(b)(5)(i).
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Further along the continuum of "people" and "powers," Section 674 (c) permits independent trustees (i.e., those who are nonadverse but not "related or subordinate") even greater powers. These individuals may deal with income and principal for the benefit of the trust beneficiaries, even without a definite standard.

The last group on the continuum--those who are allowed the most powers without causing the grantor to be treated as the owner of the trust--are "adverse" parties. An adverse party is someone who is a beneficiary of the trust and who also holds fiduciary powers regarding it. Any exercise of power by an adverse party in her fiduciary capacity to benefit another beneficiary, necessarily reduces the power holder's own stake in the trust assets. This inherent conflict of interest, according to the Code, prevents an adverse party from ever being the grantor's "legal lackey." As a result, an adverse party can possess virtually unlimited powers over the trust property, even to the extent of revoking the trust and returning the property to the grantor. *<10>

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*<10> Section 676(a).
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Planning opportunities

In real life, however, children and other close family members can often be depended upon to subordinate their own self-interest in favor of an intimate relative. This creates many planning opportunities to name a close family member as trustee, if this person is also made adverse by virtue of being named a beneficiary of the trust. Credit shelter trusts use this device regularly; for example, the spouse is the income beneficiary and the child is the trustee and remainder beneficiary. Similarly, QTIP trusts may be established this way as well as insurance trusts that benefit the spouse.

This same device is used when the grantor establishes a trust to protect against his or her own disability. Often, these trusts also incorporate a "reasonably definite standard," both to provide further protection against treating the grantor as owner of the trust and to ensure that the "adverse" trustee, in fact, is held to a fair standard in her dealings with the other beneficiaries. The careful use of these two devices--adverse parties and definite standards--allows a grantor to choose someone from his inner circle to be the trustee of his property, and yet achieve the goal of removing property from his income tax and estate tax picture.

One last concern regarding trustee selection is the issue of giving the trustee too much power. The question "who really owns the property?" can be answered "the trustee," if that person has broad powers to use the property for her *own* benefit. This problem generally arises in the case of an adverse party, where the trustee is also a beneficiary. In this instance, as much of the property as the adverse party/trustee has the *power* to give to herself will be considered her property, even if she never uses the power that way. This could wreak havoc in a sprinkling credit shelter trust, where the surviving spouse and two children are beneficiaries and one child is also the trustee. In that situation, all the trust property could be considered as owned by the trustee for income or estate tax purposes, even if the trustee has made absolutely no distribution to herself.

The safest method to avoid this problem is to appoint a co-trustee to serve together with the adverse party/trustee. The co-trustee must not be "related or subordinate" to the adverse party/trustee, or once again, the co-trustee will be considered a legal lackey, blindly carrying out the wishes of the adverse party/trustee. The need for concurrence of the co-trustees will prevent the adverse party from being treated as the "owner" of the property. *<11>

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*<11> Section 678(a)(1).
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A trustee or co-trustee owes several fiduciary duties to the trust and its beneficiaries, including the duty to exercise due care, the duty to account, and the duty to separate and earmark trust property. In addition, trustees and co-trustees have the duty to preserve trust property and make it productive. Trustees must be counseled that the majority of states have recently adopted the Uniform Prudent Investor Act, requiring them to manage trust assets as a prudent investor would, using reasonable care, skill and caution, and taking into account the purpose, term and distribution requirements provided in the trust document.

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