

A ROSE BY ANY OTHER NAME: UTILIZING AND DRAFTING POWERS FOR TRUSTEES, TRUSTEE ADVISORS, AND TRUST PROTECTORS*

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I. INTRODUCTION

When designing trusts these days, practitioners often use such titles as “Trustee Advisor,” “Trust Consultant,” “Trust Committee,” and “Trust Protector,” and the terms are becoming more familiar to clients.¹ Many clients request—or their situations warrant—a division of authority between fiduciaries.² At other times, an unusual power is sought to go to the sole fiduciary.³ Whatever the reason, the trend is to share and divide the trust administration and corresponding duties in various ways among co-trustees, directed trustees, special trustees, and protectors.⁴

So what’s in a name? Not much, by way of statutory authority.⁵ The Internal Revenue Code (the Code) does not offer a definition of an “independent trustee.”⁶ Until recently, Texas law did not provide specific duties or liabilities as they relate to any specialized trustees.⁷ One prior exception is that the Texas Property Code defines the phrase “discretionary power holder” as “a person who has the sole power or power shared with another person to make discretionary decisions on behalf of a trustee with respect to distributions from a trust.”⁸

Other exceptions include the Texas Property Code provision sanctioning ancillary trustees and addressing co-trustees.⁹ Though specifi-

1. See Thomas D. Begley, Jr., *Trustee Advisor, Trust Advisory Committee or Trust Protector in a Special Needs Trust Situation*, BEGLEY L. GROUP (Sept. 4, 2010), <http://www.begleylawyer.com/2010/09/trustee-advisor-trust-advisory-committee-or-trust-protector-in-a-special-needs-trust-situation/> [<http://perma.cc/NV2E-9A8N>].

2. See Note, *Trust Advisors*, 78 HARV. L. REV. 1230, 1230–32 (1965). There is some disagreement among practitioners as to whether a protector is a fiduciary. See *infra* Part IV.A.

3. See Note, *supra* note 2.

4. See Ronald D. Aucutt, *When Is a Trust a Trust?*, in IT SLICES; IT DICES; IT MAKES JULIENNE FRIES: CUTTING-EDGE TRUST TOOLS 16 (Ronald D. Aucutt, et al., eds., 2014), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=162608&t=PDF&e=12843&p=1> [<http://perma.cc/XCJ2-4VPU>].

5. See generally *What is an Independent Trustee?*, LIPPMAN, SEMSKER, & SALB, LLC, <http://www.lsslawyers.com/resource-center/resources/what-independent-trustee> [<http://perma.cc/J5GX-8LYR>] (last visited Oct. 12, 2015) (discussing independent trustees).

6. See generally *id.* (explaining that independent trustees generally have no beneficial interest in a trust).

7. See TEX. PROP. CODE ANN. §§ 114.003–.0031 (West 2015).

8. See *id.* § 113.029(e).

9. See *infra* Part II.D.4 (relating to ancillary trustees). “Co-trustees may act by majority decision.” PROP. § 113.085(a). “If a vacancy occurs in a co-trusteeship, the remaining co-trustees may act for the trust.” *Id.* § 113.085(b). “A co-trustee shall participate in the performance of a trustee’s function unless the co-trustee: (1) is unavailable to perform the function because of absence, illness, suspension under this code or other law, disqualification, if any, under this code, disqualification under other law, or other temporary incapacity; or (2) has delegated the performance of the function to another trustee in accordance with the terms of the trust or applicable law, has communicated the delegation to all other co-trustees, and has filed the delegation in the records of the trust.” *Id.* § 113.085(c). “If a co-trustee is unavailable to

cally described in the Property Code, a client may assume a different meaning for the term “co-trustee.”¹⁰ For example, it could mean someone the settlor wants to watch over the trustee on behalf of a minor beneficiary or someone the client wants to advise the trustee.¹¹ Likewise, non-statutory terms can have many different connotations even among attorneys.¹²

Thus, the trust agreement not only specifies the name of the power holder but also determines the powers and duties granted.¹³ One common theme among drafters is that many use the Code’s definition of “related or subordinate party” as a negative requirement to describe an independent trustee.¹⁴

The bottom line is that any specialized power holder can be given any name; the key is in the powers given.¹⁵ Some powers are taxable, so it matters to whom they are given.¹⁶ Other powers are not taxable, but rather, provide desired controls and oversight infrastructure.¹⁷ Because almost every power granted in a trust agreement is indeed “powerful,” structuring who can exercise them, relinquish them or reacquire them provides for the best assurance of carrying out the settlor’s intent, and providing checks and balances to avoid the misuse of the powers.¹⁸

The focus of this article is to explore the various powers granted to an appointee in special circumstances and to examine the applications of several such powers.¹⁹ This article is not intended to encompass drafting for

participate in the performance of a trustee’s function for a reason described by Subsection (c)(1) and prompt action is necessary to achieve the efficient administration or purposes of the trust or to avoid injury to the trust property or a beneficiary, the remaining co-trustee or a majority of the remaining co-trustees may act for the trust.” *Id.* § 113.085(d). “A trustee may delegate to a co-trustee the performance of a trustee’s function unless the settlor specifically directs that the function be performed jointly.” *Id.* § 113.085(e). “Unless a co-trustee’s delegation under this subsection is irrevocable, the co-trustee making the delegation may revoke the delegation.” *Id.*

10. See generally *id.* § 113.085 (discussing the definition of a co-trustee).

11. See *id.*

12. See *id.*

13. See *infra* Part II.B.

14. I.R.C. § 672(c) (West 2015). A person related or subordinate to the settlor includes the settlor’s spouse if living with the settlor, and the settlor’s parents, issue, or sibling. *Id.*

15. See *infra* Part III (discussing powers).

16. See *infra* Part II.C.

17. See *infra* Part II.D.

18. See *infra* Part III.

19. See Marjorie J. Stephens, *The Malleable Trust: Carrying Out the Grantor’s Intent as Individuals, Families and Societies Change and Evolve*, ST. B. TEX. (2010), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=125558&t=PDF&e=9568&p=1> [<http://perma.cc/ERY7-L3TT>]; Philip M. Lindquist, *Drafting Fiduciary Powers for Trust Protectors and Independent Trustees*, ST. B. TEX. (2013), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=157008&t=PDF&e=12460&p=1> [<http://perma.cc/TJ53-M7W6>]; Michael W. Johnson, *Drafting for Beneficiaries Acting as Trustees*, ST. B. TEX. (2013), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=157026&t=PDF&e=12460&p=1> [<http://perma.cc/V7FD-4WB6>].

flexibility per se, nor is it intended to cover the various ways to draft trust distribution standards, although the topics are related and overlap.²⁰

II. SITUATIONS WARRANTING MORE THAN A BOILERPLATE TRUSTEE

Certain situations warrant naming an additional power holder or giving the regular trustee atypical powers.²¹ Section III below addresses the powers themselves and who should and should not possess them.²²

A. Longevity

Clients who create trusts for their family also opt more frequently for longer lasting trusts over the once conventional trust that ended when the primary beneficiary reached a certain age.²³ Whether dynastic (within Texas' rule against perpetuities), perpetual (under another state's laws), or simply longer-term, the odds of facing unanticipated circumstances increase with the longevity of the trust.²⁴ An additional trustee or power holder can provide flexibility and even cost savings.²⁵

One example is where the settlor wants to grant someone the power to remove a non-responsive corporate trustee without going to court or otherwise establishing a for-cause standard.²⁶ Without estate tax inclusion, even the settlor can have the removal power as long as he or she is prohibited from naming someone related or subordinate to himself.²⁷

Giving someone the power to terminate a trust early under more liberal provisions than a judicial termination, or that of the non-economic termination statute under the Texas Property Code, can be very desirable in a multi-generational trust.²⁸

A settlor also may desire to give someone the power to address and modify a trust in reaction to future legislative changes dealing with tax laws,

20. See John F. Bergner, *The Beneficiary Flexible Trust*, ST. B. TEX. (2014), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=170720&t=PDF&e=13284&p=1> [http://perma.cc/ZZ7Q-EKV4]; Leslie Kiefer Amann, *Distribution Provisions: Say What You Mean – Mean What You Say*, ST. B. TEX. (2014), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=167809&t=PDF&e=13284&p=1> [http://perma.cc/BJ2A-CL8V].

21. See Amann, *supra* note 20.

22. See *infra* Part III.

23. See Amann, *supra* note 20.

24. See *id.*

25. See *id.*

26. See *id.*

27. I.R.C. § 672(c) (West 2015). See also Rev. Rul. 95-58, 1995-2 C.B. 191 (ruling that even if the settlor possessed the “power to remove [the] trustee and appoint an individual or corporate successor trustee that [was] not related or subordinate to the [settlor] within the meaning of Code § 672(c),” the settlor would not have retained a trustee’s discretionary control over the trust).

28. TEX. PROP. CODE ANN. § 112.059 (West 2015) (permitting a trust with a value of less than \$50,000 to be terminated because of its uneconomic feasibility. See *infra* Part III.Q).

a beneficiary's change of circumstances, or perhaps items such as same-sex marital relationships, paternity, and reproductive issues.²⁹

B. Division of Responsibilities and Powers

Instead of generically naming co-trustees who have the same powers, clients may want or need to customize the trust as to who holds each power.³⁰ A client may, for example, want to divide the powers between those that are administrative and those that more directly affect distributions.³¹ The impetus to do this may be driven by the client's desire to utilize one trusted person's investment talents to be the investment trustee and another trusted person's interpersonal skills to be the distribution trustee.³² The client should base the division of powers on the appointees' personal attributes, expertise, and ability to act impartially, particularly when beneficiaries have conflicting interests or when family tensions are high.³³ By way of example, assume the surviving spouse (who is the second wife and not the mother of the settlor's children) is the trustee. She may face great pressure when responding to requests or demands from her stepchildren for distributions from the trust that may damage an already tenuous relationship.

Other ways to divide responsibilities can be through a trust committee that is in charge of certain trust administration aspects, such as investment decisions, trustee appointments and removals, distribution decisions, early trust terminations, or conflict resolutions between trustees and beneficiaries.³⁴

The combinations of responsibilities are practically endless, and who the client should name as a trustee depends on the powers given.³⁵ In any event, and especially if no fiduciary duty is attributable to the separate role, the nominee should be someone implicitly trusted by the settlor.³⁶

What is most essential is to draft the respective roles clearly in the document.³⁷ Nominating someone by simply using terms such as investment trustee, distribution trustee, or trustee advisor may have certain connotations,

29. Richard P. Trumpler, *12 Reasons Why One Should Not Appoint an Individual as Trustee*, N. Y. PRIV. TR. (Apr. 2013), <http://www.nyptrust.com/white-papers/12-reasons-why-one-should-not-appoint-an-individual-as-trustee/> [http://perma.cc/Z67A-UJFQ].

30. See Amann, *supra* note 20.

31. See *id.*

32. See Sharon L. Klein, *Ethical Considerations for Trustees and Their Advisors*, A.B.A. 2-3 (2009), http://www.americanbar.org/content/dam/aba/publications/rpte_ereport/2009/june/sharon_klein_42_121_aba5_4_09.authcheckdam.pdf [http://perma.cc/3L57-KNZ9] (describing the ability to delegate investment powers).

33. See *id.*

34. See *id.*

35. See N.Y. EST. POWERS & TRUSTS LAW § 11-2.3 (Consol. 2015).

36. *Id.* § 11-2.3(b)(5).

37. See Klein, *supra* note 32, at 29.

but without more explanation, fails to provide a clear legal definition of the division of responsibilities or powers granted.³⁸

C. Avoiding Unfavorable Tax Consequences

While a client might be motivated to divide powers among different trustees in order to best use their respective talents, practitioners should address whether a division of powers is necessary (or even effective) in order to avoid an unintended tax result to the power holder.³⁹

As discussed in this article, many powers may cause inadvertent tax consequences when granted to certain parties.⁴⁰ To avoid any unintentional adverse tax consequences, these authors advise including a savings clause in the trust agreement, such as the following:

All powers given to the trustee hereunder are exercisable by the trustee only in a fiduciary capacity. An individual trustee of any trust created by this trust agreement shall not have any power whatsoever in the determination of accumulation of income, or of distribution (including but not limited to distributions to such individual and distributions in discharge of any legal obligation of such individual) of income or principal, or in the apportionment of receipts and expenses between principal and income, or in the establishment and maintenance of reserves in the trust or any power in any other determination or distribution that would cause undistributed trust principal to be includible in such individual's estate for tax purposes, that would cause such individual to make a gift for tax purposes (whether by reason of a prior disclaimer by such individual, by reason of the making of such determination or distribution, or otherwise), or that would cause trust income to be taxed to such individual (except to the extent such individual receives or is deemed to receive distributable net income as a result of an actual or deemed trust distribution), but such determinations and distributions shall be made in the sole discretion of the other trustee then serving. If there is no other trustee then serving, such power shall not be exercised.⁴¹

1. Settlor as Trustee

a. Estate Tax Considerations

A settlor can include the trust, or a portion of the trust, in his or her gross estate if: (a) the trust agreement provides the trustee with discretion over either income or corpus, and (b) the settlor is a trustee or co-trustee who can:

38. *See id.*

39. *See infra* Part II.C.

40. *See infra* Part II.C.

41. *See* Johnson, *supra* note 19, at 6–7.

- name or change beneficiaries;
- change beneficiaries' shares of income or principal;
- decide whether income should be distributed immediately or accumulated and added to trust principal;
- apply a "sprinkling power" to determine which beneficiaries are to receive income;
- directly invade principal other than by following fixed and ascertainable standards;
- vote shares of stock in a controlled corporation; or
- retain incidents of ownership over life insurance on settlor's life, whether exercisable alone or in conjunction with any other person.⁴²

The same holds true if the settlor retains the power to direct how the trustee should exercise such powers, or if the settlor has the power to appoint himself or herself as trustee.⁴³

If the settlor is merely a co-trustee, it is irrelevant under Code sections 2036(a)(2) and 2038 whether the other trustee has a substantial adverse interest.⁴⁴ Even if the joint power holder can veto the settlor's decision (e.g., where majority vote controls), Code sections 2036(a)(2) and 2038 still may apply.⁴⁵

b. Gift Tax Considerations

For a settlor to make a completed gift to a trust for gift tax purposes, the most simple and conservative approach is for the settlor to serve as trustee only if the trustee's sole discretion is to accelerate or delay distributions to a single beneficiary with no ability to shift benefits to any other person.⁴⁶ Alternatively, the settlor may serve jointly with a trustee who has a "substantial adverse interest."⁴⁷ Although the Treasury Regulations do not define substantial adverse interest, most practitioners presume that the

42. I.R.C. §§ 2036(a)(2), 2036(b), 2038, 2042 (West 2015). If the settlor is not a trustee and does not retain the power to change trustees, then the trustee's power to change beneficial interests in the manner described above does not cause inclusion of the trust property in the settlor's gross estate, even if the trustee does not have an interest adverse to the settlor or is in fact subservient to the settlor. *Id.* § 2036(a). Conceivably, a settlor could control who would enjoy the beneficial interest of the irrevocable trust he creates by appointing an individual or corporate trustee who he is confident will adhere to his wishes and direction; however, this control, cannot be written into the trust agreement. *See generally* Amman, *supra* note 20 (discussing drafting).

43. *See* Treas. Reg. §§ 20.2036-1(b)(3) (as amended in 2011), 20.2038-1(a)(3) (as amended in 1962).

44. *See* I.R.C. §§ 2036(a)(2), 2038. This is not the case when analyzing the gift tax treatment of powers held by a settlor (i.e., when determining whether a gift is complete or incomplete). *See infra* Part II.C.1.B.

45. Treas. Reg. § 20.2036-1(b)(3).

46. *See* Santo Bisignano, Jr., *When the Only One You Trust Is Yourself: Drafting and Planning with Self-Trusteed Irrevocable Nongrantor Trusts*, ST. B. TEX. (2008), available at <http://www.texasbar.org/cle/OLViewArticle.aspx?a=99004&t=PDF&e=6708&p=1> [<http://perma.cc/LH29-L6WS>].

47. *See id.*

principles related to adverse parties for income tax purposes and powers of appointment apply.⁴⁸

2. Beneficiary as Trustee

a. Estate Tax Considerations

It is often a settlor's express desire that the primary beneficiary be the trustee, however, if a person is both a beneficiary and the trustee of the same trust, there is a risk that the trust assets will either be included in the beneficiary's estate or the exercise or non-exercise of a power held as trustee will be treated as a gift by the beneficiary.⁴⁹ These results are avoided if none of the powers granted to the beneficiary (who is a trustee) qualify as a general power of appointment.⁵⁰ For a beneficiary who is also a trustee, the following powers are some that cause estate tax inclusion:

- distribution power to oneself that is not limited to an ascertainable standard;
- distribution power that can satisfy the beneficiary/trustee's legal obligations or that allows his or her creditors to reach as much as he could distribute to himself or herself;
- ability to terminate the trust;
- power to allocate gains to trust income (i.e., power to shift more in distributions to a mandatory income beneficiary); and
- any administrative powers that can be indirectly used to modify or shift beneficial interests in the trust.⁵¹

b. Gift Tax Considerations

Gift tax consequences can arise for the beneficiary acting as trustee who has a general power of appointment over the trust assets, meaning an unfettered distribution power in favor of himself, his estate, his creditors, or

48. See I.R.C. § 672(a). For income tax purposes, an adverse party is defined as a person who has "a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of the power [in question]." *Id.* By way of example, a current trust beneficiary is an adverse party. See *id.* With relation to powers of appointment, an adverse party is defined as "a person who, after the death of the possessor, may be possessed of a power of appointment (with respect to the property subject to the possessor's power) which he or she may exercise in his [or her] own favor." *Id.* § 2514(c)(3)(B).

49. See *id.* §§ 2041, 2514.

50. See *id.*

51. TEX. PROP. CODE ANN. § 116.005(a) (West 2015). Note, however, Texas' Uniform Principal and Income Act does not permit a beneficiary who is serving as trustee to allocate gains to income under the statute. See *id.* § 116.005(c)(6).

creditors of his estate.⁵² If the beneficiary exercises or releases the general power, he or she makes a taxable gift.⁵³

The beneficiary's exercise of an *inter vivos* limited power of appointment over trust property may result in a gift if it reduces the pool of assets that might eventually distribute to the beneficiary, particularly if the power holder also has a mandatory income interest in the trust.⁵⁴ If the power holder does not have a mandatory income interest and is only a discretionary beneficiary, it is not clear that a gift would result from an *inter vivos* exercise of a limited power of appointment.⁵⁵ An example in the Regulations concludes that there is no taxable gift under Code section 2514 if the power holder is entitled to receive distributions under an ascertainable standard and exercises a limited power of appointment in favor of his children.⁵⁶ However, the Regulations do not address whether the power holder has made a gift under the general gift principles of Code section 2511.⁵⁷ Note that the issue of exercising a limited power of appointment may not directly impact the selection of trustees because the holder of the limited power of appointment has the same potential gift tax consequences whether or not the holder is the trustee.⁵⁸

In contrast, the Regulations indicate that a trustee with a beneficial interest in the trust does not make a gift if he distributes trust property to another beneficiary under a fiduciary power limited by a "reasonably fixed or ascertainable standard."⁵⁹ The implication is that if a beneficiary acting as trustee makes a distribution that is not subject to an ascertainable standard to another beneficiary, a gift results.⁶⁰ Additionally, if a beneficiary has an ascertainable interest under the trust and fails to enforce those rights, a taxable gift may result.⁶¹

D. Other Warranted Situations

The following section outlines several situations that may warrant a special trustee, whether it is an entity or an individual.⁶² The examples presented are non-exhaustive and focus mostly on ensuring the fulfillment of the trust's purposes.⁶³

52. I.R.C. § 2514(c).

53. *Id.* § 2514(b).

54. Treas. Reg. § 25.2514-1(b)(2) (as amended in 1981).

55. *See id.*

56. *Id.* § 25.2514-3(e).

57. *Id.* § 25.2514-1.

58. *See id.*

59. *Id.* § 25.2511-1(g)(2).

60. *See id.*

61. *See Akers, infra* note 68.

62. *See id.*

63. *See id.*

1. Self-Dealing

In situations that call for a trustee to act in more than one capacity, practical and legal self-dealing issues arise.⁶⁴ The Texas Property Code prohibits a loan of trust funds to the trustee or an affiliate; a director, officer, or employee of the trustee or an affiliate; a relative of the trustee; or the trustee's employer, employee, partner, or other business associate.⁶⁵ Similarly, it prohibits a purchase or sale of property by, or to, this same class, with a few specified exceptions; a sale of property from one trust to another having the same trustee unless the property is sold for its current market price and fully guaranteed, as well as the purchase of the trustee's securities.⁶⁶ While the trust agreement can waive these restrictions, a settlor may find it more palatable to give another person the authority to approve an otherwise prohibited self-dealing transaction.⁶⁷

2. Creditor Concerns and Forced Distributions

Separate and apart from being includable in a beneficiary's estate when trust assets can satisfy creditors (e.g., under a general power of appointment), a settlor may worry that a beneficiary who is a trustee could become insolvent (or near that point) and distribute to himself over and above what the settlor had intended.⁶⁸ In such a situation, a settlor may want to appoint another person to have the ability to turn off a beneficiary/trustee's ability to distribute to himself (even under otherwise ascertainable standards), or to change beneficiaries.⁶⁹

Similarly, a settlor may want an independent trustee to be able to make distributions with absolute discretion to avoid giving a beneficiary (or the beneficiary's creditors) the ability to compel distributions.⁷⁰ This power is more protective if there is more than one beneficiary.⁷¹

64. See TEX. PROP. CODE. ANN. § 111.004 (West 2015). An example would be a trustee who is purchasing assets from related or affiliated parties. See *id.*

65. See *id.* § 113.052. An "affiliate" is: "(A) a person who directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with another person; or (B) any officer, director, partner, employee, or relative of a person, and any corporation or partnership of which a person is an officer, director, or partner." *Id.* § 111.004(1). "Relative" includes "a spouse or, whether by blood or adoption, an ancestor, descendant, brother, sister, or spouse of any of them." *Id.* § 111.004(13).

66. *Id.* § 113.053-.055.

67. *Id.* § 113.053.

68. See Steve Akers, *Trustee Selection; Retaining Strings Without Getting "Strung Up"*, ST. B. TEX. (2002), available at <http://www.texasbarcollege.com/reports/akers.pdf> [<http://perma.cc/Z8HE-AWGQ>].

69. See *id.*

70. See *id.*

71. See *id.*

3. Provide Permanence and Availability of Trustees

Often, the settlor is most comfortable naming his or her trusted friends and advisors who belong to the same generation as the trustee and successor trustees.⁷² In order to provide for the continuity of trustees without the need for court action, one approach is to designate a trustee appointer or give an outgoing trustee the power to name his or her own successor or successors.⁷³ The planner can use these provisions in lieu of another specified succession method, but if it is in addition to another succession provision, the planner should clearly specify the hierarchy of appointments.⁷⁴

The settlor can be the trustee appointer (and remover) without estate tax inclusion.⁷⁵ Of course, to fully achieve continuity of trusteeship without a vacancy, the trust agreement should grant the appointment power to someone after the settlor's death or incapacity.⁷⁶

4. Out-of-State Trustee

If the client wants a dynastic asset protection trust that is not subject to the rule against perpetuities and is generally protected from creditor claims, it may be necessary to require that sufficient trustees always reside in the state of the applicable law.⁷⁷ The various states allowing for such trusts have differing laws regarding trustee selection.⁷⁸

Texas law permits a Texas trustee to “name in writing an individual or corporation qualified to act in a foreign jurisdiction [in which] trust property is situated to serve as an ancillary trustee.”⁷⁹ The Texas trustee has the power (within the limits given to the Texas trustee in the trust agreement) to delegate to the ancillary trustee those rights, powers, discretions, and duties as specified in the instrument appointing the ancillary trustee.⁸⁰ “If the law of

72. *See id.*

73. *See id.* Under the Texas Property Code, the court may appoint a successor trustee as a result, and the court shall appoint a successor trustee on the petition of an interested party. TEX. PROP. CODE ANN. § 113.083(a) (West 2015).

74. *See Akers, supra* note 68.

75. Rev. Rul. 95-58, 1995-2 C.B. 191. “[E]ven if [a settlor] possesses[s] the power to remove [a] trustee and appoint an individual or corporate successor trustee [(other than himself) who is] not related or subordinate to [him] (within the meaning of Code § 672(c)), [the settlor has] not retained a trustee’s discretionary control over trust income [so as to cause estate tax inclusion].” *Id.*

76. *See id.*

77. *See, e.g.,* Laura G. Mauel & David A. Diamond, *Delaware Trusts Safeguarding Personal Wealth*, NORTHERN TR. (2015), <https://www.northerntrust.com/documents/white-papers/wealth-management/delaware-trusts-navigable-Q15081.pdf> [<http://perma.cc/K82L-JSK9>].

78. *See id.* For example, Rhode Island requires all trustees to be a resident or authorized to do business in the state, while Delaware and Alaska require only one trustee to be a resident. *See id.*

79. TEX. PROP. CODE ANN. § 113.023(a) (West 2015). “The Texas trustee may remove an ancillary trustee and appoint a successor at any time as to all or part of the trust assets.” *Id.* § 113.023(c). Additionally, “the Texas trustee may require security of the ancillary trustee.” *Id.* § 113.023(d).

80. *Id.* § 113.023(b).

the foreign jurisdiction requires a certain procedure or a judicial order for the appointment of an ancillary trustee or to authorize an ancillary trustee to act, the Texas trustee and the ancillary trustee must satisfy [those] requirements.”⁸¹

5. Foreign Trust Treatment

A trust is a foreign trust unless a U.S. court “is able to exercise primary supervision over the [trust administration] and one or more [U.S.] persons have the authority to control all substantial decisions of the trust.”⁸² Accordingly, the selection of a non-U.S. trustee can implicate foreign tax treatment.⁸³ Unless the client purposefully wants the trust to be a foreign trust, no foreign person (anyone other than a U.S. citizen or a U.S. resident or a U.S. domestic corporation) should be appointed as the trustee with the power to control any substantial decisions.⁸⁴ Likewise, any non-U.S. persons should comprise fewer than half of the trustees, and the trust agreement should leave no decisions specifically in their control.⁸⁵

6. Qualified Domestic Trust (QDOT)

The estate tax marital deduction generally is not available to a decedent if his or her surviving spouse is not a U.S. citizen unless property passes to the non-U.S. spouse in a QDOT.⁸⁶ To qualify as a QDOT, the trust agreement must provide that at least one trustee “be an individual citizen of the [U.S.] or a domestic corporation.”⁸⁷ That trustee must also have the right to withhold from principal distributions the tax imposed on the trust under the Code.⁸⁸

Additionally, QDOTs with assets in excess of \$2 million must (1) have a bank as the U.S. trustee, (2) “furnish a bond [to the IRS] in an amount equal to 65% of the fair market value of the trust assets,” or (3) furnish an irrevocable letter of credit “in an amount equal to 65% of the fair market value of the trust assets.”⁸⁹ QDOTs with assets of \$2 million or less must

81. *Id.* § 113.023(e).

82. I.R.C. § 7701(a)(30)(E), (a)(31)(B) (West 2015).

83. See Ellen K. Harrison, et al., *U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*, PILLSBURY L. at 2 (2003), <http://www.pillsburylaw.com/siteFiles/Publications/2CC76D4DD096EED81A322AB82922C05B.pdf> [<http://perma.cc/24XD-3P3H>].

84. See Treas. Reg. § 301.7701-7 (as amended in 2001).

85. See *id.*

86. I.R.C. § 2056A.

87. *Id.* § 2056A(a)(1)(A). This is true unless waived by the IRS under its regulatory authority granted for estates of decedents dying after August 5, 1997. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

88. I.R.C. § 2056A(a)(1)(B).

89. Treas. Reg. § 20.2056A-2(d)(1)(i). The QDOT may alternate among any of those three arrangements “provided that, at any given time, one of the arrangements must be operative.” *Id.*

either meet the requirements that apply to QDOTs with assets in excess of \$2 million, or provide that “no more than 35% of the fair market value of the trust assets . . . [may] consist of real property located outside the [U.S.]”⁹⁰

7. Grantor Trust Rules

A trust is a grantor trust for income tax purposes if the settlor or a nonadverse party holds a power of disposition over trust assets.⁹¹ While various statutory exceptions can negate grantor trust treatment, the general rule will not apply if no more than half of the trustees are “related or subordinate parties who are subservient to the wishes of the [settlor],” and have the power to distribute or accumulate income or corpus for a class of beneficiaries.⁹²

A client may desire grantor trust status for income tax purposes but not want retained powers that could also risk estate tax inclusion.⁹³ Although there is guidance as to avoiding the inclusion of the trust assets for estate tax purposes when allowing the settlor to retain powers in trusts holding life insurance on the settlor’s life, giving a third party the power to substitute property of equivalent value in a nonfiduciary capacity may appear desirable when the trust owns stock in a controlled corporation.⁹⁴

A trust that is initially a grantor trust but can be “toggled off” may be desirable when the settlor initially wants grantor trust status, but remains concerned about indefinite liability for the trust’s income and capital gains taxes.⁹⁵ In that situation, the trust agreement can couple giving the settlor the authority to relinquish the power that causes grantor trust status with a third party’s authority to reinstate the power.⁹⁶

90. *Id.* § 20.2056A-2(d)(1)(ii).

91. I.R.C. § 674(a). A “nonadverse party” is “any person who is not an adverse party.” *Id.* § 672(b); Treas. Reg. § 1.672(b)-1. For purposes of the grantor trust rules, an “adverse party is a person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.” I.R.C. § 672(a).

92. *Id.* § 674(c).

93. *See supra* Part II.C.A.

94. *See, e.g.*, Rev. Rul. 2008-22, 2008-1 C.B. 796 (ruling that the settlor’s power to substitute assets, held in a nonfiduciary capacity, would not result in estate tax inclusion under either Code § 2036 or Code § 2038 of the trust assets in the settlor’s estate); Rev. Rul. 2011-28, 2011-49 I.R.B. 830 (ruling that the settlor’s power to substitute assets in a life insurance trust, held in a nonfiduciary capacity, is not an incident of ownership that could cause estate tax inclusion of the policy proceeds in the settlor’s estate). *See also infra* Parts III.H, III.L.

95. *See infra* Part III.E.

96. *See infra* Part III.E.

III. A CLOSER LOOK AT THOSE SPECIAL POWERS (AND JUST WHAT'S SO SPECIAL ABOUT THEM?)

Some powers that the settlor may grant supplement those automatically granted by the Texas Trust Code or by common law, unless the trust agreement specifically states otherwise.⁹⁷ Other powers are merely a division of power between the main trustee or trustees, and a special power holder or committee.⁹⁸ This section discusses several of such supplemental and bifurcated powers.⁹⁹

When granting any power, the drafter should consider (a) what the power is, (b) why the power is being granted, and (c) who should and should not be given the power for tax and non-tax reasons.¹⁰⁰

A. Power to Demand Trust Accountings and Records

1. What Is the Power?

Though the Texas statute giving beneficiaries the right to demand accountings is fairly extensive, it still has its limits, particularly for mere interested persons who are not trustees or beneficiaries, and for those beneficiaries who may need additional assistance with their affairs.¹⁰¹

A beneficiary can make a written demand to the trustee to deliver to each trust beneficiary within ninety days "a written statement of accounts covering all transactions since the last accounting or since the creation of the trust, whichever is later."¹⁰² The Property Code further provides that:

[a]n interested person may file suit to compel the trustee to account to the interested person . . . on finding that the nature of the interest in the trust of, the claim against the trust by, or the effect of the administration of the trust on the interested person is sufficient to require an accounting by the trustee.¹⁰³

97. See *infra* Parts III.A–R.

98. See *infra* Parts III.A–R.

99. See *infra* Part III.

100. See *infra* Part III.

101. See TEX. PROP. CODE ANN. § 113.151 (West 2015).

102. *Id.* § 113.151(a). "‘Beneficiary’ means a person for whose benefit property is held in trust, regardless of the nature of the interest." *Id.* § 111.004(2).

103. *Id.* § 113.151(b). "‘Interested’ person means a trustee, beneficiary, or any other person having an interest in or a claim against the trust or any person who is affected by the administration of the trust. Whether a person, excluding a trustee or named beneficiary, is an interested person may vary from time to time and must be determined according to the particular purposes of and matter involved in any proceeding." *Id.* § 111.004(7).

A trust agreement cannot limit a trustee's duty to respond to an accounting demand if it is from a beneficiary of an irrevocable trust who is entitled or permitted to receive distributions from the trust, or would receive a distribution from the trust if the trust terminated at the time of the demand.¹⁰⁴

2. *Why Grant the Power?*

Giving a third person the power to demand accountings and information from a trustee is helpful in many cases, but primarily adds clarity for everyone involved as it eliminates the concern and inquiry into whether the person is "interested" enough to make the demand.¹⁰⁵ One common instance may be to name someone to make accounting demands on behalf of a beneficiary who cannot oversee a trustee on his or her own, such as an incapacitated adult trust beneficiary who may not have a legal guardian or an attorney-in-fact.¹⁰⁶ Anyone holding a removal power, especially if the person can only exercise the power for cause, should also have this power.¹⁰⁷ Further, a settlor may only be comfortable making an *inter vivos* gift to a trust if he or she can demand an accounting, or a settlor may want this power to judge whether he or she should appoint the trustee as a fiduciary for future trusts or as an executor of the settlor's estate.¹⁰⁸ The trust agreement could also grant the power to demand accountings among co-trustees who handle different aspects of the trust administration (e.g., a trustee who is managing an active business may be keeping separate accounts).¹⁰⁹

Whether the trust agreement grants the power to a beneficiary or a third party, the trust agreement should also clarify:

- what information the demanding party is entitled to receive;
- whether a demand can be made more often than annually and whether the accounting must be provided sooner than the statutory ninety days;
- how the demand can be made (e.g., by email);
- whether the trust pays for any costs related to complying with the demand or whether the demanding party is required to pay;
- whether the demanding party can delegate his or her demand power to another or appoint a successor;
- when and whether a failure to timely respond to the demand is tantamount to a breach of trust and a removal for cause of the trustee;

104. *See id.* § 113.151.

105. *See infra* Part III.A.2.

106. *See infra* Part III.R.

107. *See infra* Part III.C.

108. *See infra* Part III.A.2.

109. PROP. § 116.153.

- whether a failure forfeits the trustee's fee and whether a late response results in the trustee personally paying a fee for each late day to the trust;
- whether the acceptance (or the deemed acceptance) of an accounting is binding and conclusive on all persons who may currently or thereafter have an interest in the trust such that they cannot later contest a disclosed transaction; and
- whether responding in good faith to a request for information and records fulfills the trustee's duty of full disclosure.¹¹⁰

3. *Who Can Hold the Power?*

The settlor, any adult person, or any corporate fiduciary could have the power to demand an accounting and trust records.¹¹¹ If the instrument allows the power holder to delegate or appoint his or her successor, the settlor may want to specify those persons to whom the power holder cannot delegate the power or the instances such delegation would become void (e.g., a power delegated to a now ex-spouse).¹¹²

4. *Who Should Not Hold the Power?*

The power to obtain trust information does not cause estate tax inclusion in the power holder's estate because it is not a direct or indirect way to control beneficial enjoyment.¹¹³ Conceivably, therefore, anyone the settlor wishes, including himself, could hold this power.¹¹⁴

B. *Power to Appoint a Successor Trustee*

1. *What Is the Power?*

The Texas Property Code has its limits with regard to the appointment of successor trustees.¹¹⁵ The statute requires a petition to the court by an interested person to appoint a successor trustee in the event of the "death, resignation, incapacity, or removal of a sole or surviving trustee" where the

110. See, e.g., Jeffrey T. Knebel & Jason S. Scott, *The Fiduciary Duty of Full Disclosure: Knowing When and What to Disclose*, ST. B. TEX. (2012), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=147705&t=PDF&e=9220&p=1> [<http://perma.cc/P7AN-ZW5V>]; Frank N. Ikard, Jr., *Trustee's Duties to Disclose Information to Beneficiaries*, ST. B. TEX. (2008), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=46105&t=PDF&e=6708&p=1> [<http://perma.cc/A5ED-SF2E>].

111. See PROP. § 113.151(b).

112. See Ikard, *supra* note 110.

113. I.R.C. §§ 2036, 2038, 2041, 2042 (West 2015).

114. See *id.* § 2036(a).

115. See PROP. § 113.083.

trust agreement prescribes no method.¹¹⁶ As the statute explains, “[i]f for any reason a successor is not selected under the terms of the trust agreement, a court may and on petition of any interested person shall appoint a successor [trustee].”¹¹⁷ However, “[i]f a vacancy occurs in the number of trustees originally appointed under a valid charitable trust agreement [which] does not provide for filling the vacancy, the remaining trustees may fill the vacancy by majority vote.”¹¹⁸

2. *Why Grant the Power?*

In order to avoid any prolonged vacancy, the trust agreement should provide at least some method to perpetuate the appointment of a trustee.¹¹⁹ Such provisions become particularly useful with the prevalence of long-term trusts and the popularity of having a removal power.¹²⁰ Furthermore, if one trustee deems the trust problematic and decides to resign, the other listed trustees likely could follow suit and decline to serve, leaving no one named in the trust agreement.¹²¹ Similarly, if the agreement names only corporate trustees, and the trust becomes too small to justify their fees, the ability to name an individual trustee without court action becomes vital.¹²²

If someone is allowed (or required) to select a corporate trustee, it is common to include language in the trust that qualifies the corporate fiduciary.¹²³ For example, the settlor may require a minimum amount for the capital and surplus of the corporate fiduciary.¹²⁴ Except for the deliberate offshore trust, most clients prefer a trust situated in the U.S. to ensure that federal law and regulations clearly govern.¹²⁵

The settlor also should consider whether to waive any bond requirement for successor individual trustees, particularly when someone may appoint individuals or entities not known to the settlor.¹²⁶ Requiring a bond may provide a level of comfort to a settlor by ensuring compensation to the beneficiaries if the trustee makes errors.¹²⁷

116. *Id.* § 113.083(a).

117. *Id.*

118. *Id.* § 113.083(b).

119. *See id.*

120. *See infra* Part III.C.

121. *See infra* Part III.C.

122. *See infra* Part III.C.

123. *See infra* Part III.C.

124. *See infra* Part III.C.

125. *See supra* Part II.D.5.

126. *See* TEX. PROP. CODE ANN. § 113.058(a)–(b) (West 2015). Unless the trust agreement provides otherwise, a noncorporate trustee must give bond, but the statute does not require a corporate trustee to provide a bond. *Id.*

127. *See id.*

3. Who Can Hold the Power?

Under Texas law, there are no major constraints as to who can serve as a trustee and, therefore, who can hold the power to appoint a trustee.¹²⁸ “The trustee must have the legal capacity to take, hold, and transfer the trust property [and, if] the trustee is a corporation, it must have the power to act as a trustee in [Texas].”¹²⁹ Further, except when the same person holds legal and equitable titles, the fact that the person named as trustee is also a beneficiary does not disqualify the person from acting as trustee if otherwise qualified.¹³⁰ “The settlor of a trust may also be the trustee of the trust.”¹³¹

Thus, as a general rule, a settlor, resigning trustee, beneficiary, third person, or committee could have the power to appoint one or more successor trustees, including himself or herself.¹³² Nevertheless, the settlor needs to consider who will best utilize the power to give effect to the intent of the trust and maintain its integrity.¹³³ The drafter, in conjunction with the settlor, should next consider whether the trust agreement should specifically exclude any particular persons as possible appointees (e.g., the settlor himself or his spouse, a beneficiary, a beneficiary’s parent who is not a descendant of settlor, or a beneficiary’s spouse or significant other), and whether the trustee appointer may name successor trustees before the need arises.¹³⁴ Unless otherwise provided in the trust agreement, “the successor trustee has the rights, powers, authority, discretion, and title to trust property conferred on the [original] trustee.”¹³⁵

4. Who Should Not Hold the Power?

a. Estate Tax Considerations for the Settlor

The settlor should exercise great care to avoid creating an adverse tax effect when giving the settlor or certain beneficiaries the power to appoint a trustee.¹³⁶

The Code will treat a settlor as possessing the same dispositive and management powers as a trustee if a settlor may appoint himself or herself as

128. See *id.* § 112.008.

129. *Id.* § 112.008(a).

130. *Id.* § 112.034.

131. *Id.* § 112.008(c).

132. See *id.* § 113.083.

133. See John G. Steinkamp, *Estate and Gift Taxation of Powers of Appointment Limited by Ascertainable Standards*, 79 MARQ. L. REV. 195, 239 (1995).

134. See Alexander A. Bove, Jr., *The Trust Protector: Trust(y) Watchdog or Expensive Exotic Pet?*, 30 EST. PLAN. 390, 395–96 (2003).

135. PROP. § 113.084 (West 2015).

136. See Steinkamp, *supra* note 133, at 223.

a trustee at any time.¹³⁷ Even if a settlor has a contingent power to appoint himself as trustee upon the occurrence of an event that is out of the settlor's control, such power will cause the inclusion of the trust assets for estate tax purposes in the settlor's estate.¹³⁸ For instance, the trustee's right to designate beneficiaries is attributable to the settlor if the original trustee has the right to designate persons who can possess trust property and income, and the settlor can designate himself as a successor trustee.¹³⁹ Furthermore, the ability of the settlor to add oneself as a co-trustee would be just as damaging as being able to become the sole trustee, unless the trust agreement properly reserves the problematic power to the non-settlor co-trustee.¹⁴⁰ Alternatively, if the settlor merely has the power to add other persons as co-trustees, the Code generally does not treat the settlor as holding the powers of the trustee.¹⁴¹ Additionally, since 1995, a clear safe harbor provides that trust assets will not be includible in a settlor's estate if the settlor can remove a trustee, so long as he or she cannot appoint a successor trustee who is related or subordinate to him.¹⁴²

If the settlor decides to keep a more expansive ability to appoint others as successor trustees who would not come within the safe harbor rule (e.g., relatives), the drafter likely would include the following language: "A trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take."¹⁴³

When the trust is a self-trusteed irrevocable non-grantor trust (STINT), it is carefully crafted to permit the settlor to serve as the trustee without causing estate tax inclusion.¹⁴⁴ As a general rule then, the settlor of a STINT can retain a broad power to remove and appoint a trustee.¹⁴⁵ However, just as the settlor of a STINT should not be given certain tax sensitive powers, the settlor's otherwise limitless power to hire and fire trustees should not be exercisable over a special purpose trustee who holds sensitive powers, such as powers over life insurance, the power to vote stock of a closely held corporation, or the power to terminate a trust.¹⁴⁶

137. Treas. Reg. §§ 20.2036-1(b)(3) (as amended in 2011), 20.2038-1(a)(3) (as amended in 1962).

138. See I.R.C. § 2036(a) (West 2015).

139. Treas. Reg. § 20.2036-1(b)(3).

140. I.R.C. §§ 2036, 2038.

141. See Bove, *supra* note 134, at 395.

142. See Rev. Rul. 95-58, 1995-2 C.B. 191; I.R.C. §§ 2036, 2038. A related or subordinate party is any nonadverse party who is either: the grantor's spouse, if cohabitating; the grantor's father, mother, brother, or sister; issue of the grantor; an employee of the grantor; "a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; [or] a subordinate employee of a corporation in which the grantor is an executive." I.R.C. § 672(c).

143. See *Estate of Wall v. Comm'r*, 101 T.C. 300, 312 (1993). See also *Estate of Vak v. Comm'r*, 973 F.2d 1409 (8th Cir. 1992) (rejecting the argument that donor had the power to replace trustees with those who would do his bidding).

144. See Bisignano, *supra* note 46.

145. *Id.*

146. See *id.*

b. Income Tax Considerations for the Settlor

The settlor's power "to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee)" could cause the trust to receive treatment as a grantor trust for income tax purposes.¹⁴⁷ For example, if a settlor "has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify" as a non-grantor trust.¹⁴⁸

On the other hand, the planner could draft the trust agreement to prohibit the settlor from exercising the power to remove, substitute, or add trustees in a manner that would disqualify the trust from being a grantor trust under the grantor trust exceptions.¹⁴⁹ "[F]or example, a power in the grantor to remove or discharge an independent trustee on the condition that he [or she] substitute another independent trustee will not prevent a trust from qualifying" as a grantor trust under Code section 674(c).¹⁵⁰

c. Estate Tax Considerations for the Beneficiary

Commonly, the power to remove and replace the trustee is granted to the trust beneficiaries at some point in the trustee appointer succession.¹⁵¹ For a beneficiary to have the power to appoint a successor trustee, however, care must be given where the trustee's powers are akin to a general power of appointment if held by the beneficiary.¹⁵² When a beneficiary has the power at any time to appoint himself as trustee or co-trustee (unless the other co-trustee has a substantial adverse interest in the trust), the Code will treat the beneficiary as holding the powers of the trustee.¹⁵³ Therefore, if the trustee's power to make distributions to beneficiaries is limited to an ascertainable standard, and if the trustee is precluded from making distributions in satisfaction of the trustee's own obligation to support a beneficiary, there is no estate inclusion problem for the beneficiary, regardless of who serves as trustee.¹⁵⁴ On the other hand, if the trustee's distribution authority is not limited to an ascertainable standard, the ability of a beneficiary to remove and replace trustees can give the beneficiary a general power of

147. Treas. Reg. § 1.674(d)-2.

148. *Id.*; I.R.C. § 674(c)-(d) (West 2015).

149. Treas. Reg. § 1.674(d)-2(a).

150. *Id.*

151. See Steinkamp, *supra* note 133, at 227.

152. See *id.* at 226-27.

153. See *id.* at 227.

154. See *id.* at 205-06. The drafter should be mindful of necessary restrictions to avoid estate tax inclusion in the insured's estate if the trust owns an insurance policy on the beneficiary's life. See I.R.C. § 2042.

appointment.¹⁵⁵ However, the beneficiary is not deemed to hold “a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal.”¹⁵⁶ It is of note that Texas Property Code § 113.029 offers a savings provision by restricting a discretionary distribution power held by a beneficiary who is a trustee (other than the settlor) to an ascertainable standard.¹⁵⁷

C. Power to Remove a Trustee

1. What Is the Power?

Unless the terms of the trust agreement provide for a trustee’s removal, a removal requires court action.¹⁵⁸ An exception, mentioned above, is that a Texas trustee automatically has the authority to “remove an ancillary trustee and appoint a successor at any time as to all or part of the trust assets.”¹⁵⁹

Removal by the court, “on the petition of an interested person and after hearing”, requires a finding that: “(1) the trustee materially violated or attempted to violate the terms of the trust and the violation or attempted violation results in a material financial loss to the trust; (2) the trustee [became] incapacitated or insolvent; (3) the trustee fail[ed] to make an accounting that is required by law or by the terms of the trust; or (4) the court finds other cause for removal.”¹⁶⁰

2. Why Grant the Power?

The terms of a trust cannot limit the court’s power to remove a trustee.¹⁶¹ However, the terms of a trust can set forth removal procedures and ultimately grant someone the power to remove a trustee at any time, thereby avoiding the need for an expensive and prolonged court proceeding and the need to prove (or even allege) a trustee’s incapacity, insolvency, or breach.¹⁶² Avoiding a court proceeding also may temper the animosity created by a proceeding.¹⁶³

155. See Treas. Reg. § 20.2041-1(c)(1) (as amended in 1961).

156. *Id.* § 20.2041-1(b)(1).

157. TEX. PROP. CODE ANN. § 113.029(b) (West 2015).

158. *Id.* § 113.082(a).

159. *Id.* § 113.023(c).

160. *Id.* § 113.082(a).

161. *Id.* § 111.0035(b)(5)(B).

162. *Id.* § 113.082(a).

163. Robert A. Vigoda, *Powers to Replace Trustee: A Key Element of (and Risk to) Dynasty Trusts*, EST. PLAN. MAG., June 2008, at 22–23.

Most often, trust agreements grant the power to remove where corporate trustees are appointed or required.¹⁶⁴ Clients realize that corporate trustees often undergo changes over the lifetime of a trust, and therefore, want to give someone the flexibility to remove one and appoint another.¹⁶⁵ A settlor may also need the ability to protect an offshore trust against geopolitical events.¹⁶⁶

Removal of a trustee by an individual should not be tied to a termination for cause.¹⁶⁷ This creates a level of difficulty that the power is designed to avoid in the first place.¹⁶⁸ Cause is difficult to define and more difficult to enforce.¹⁶⁹ Frankly, the power holder may not have cause for the removal, but may simply not like the trustee for one reason or another.¹⁷⁰ That said, it is commonplace for a settlor to want to endow a special trustee or trust committee with the ability to remove an individual trustee upon the special trustee's or the committee's own finding of incapacity, or at least establish a simple, well-defined procedure to determine that the trustee is no longer fit to serve.¹⁷¹ When the power to remove remains unfettered, the settlor may want to consider limiting its exercise to once a year or some other specified time period.¹⁷²

3. *Who Can Hold the Power?*

Generally, a settlor, beneficiary, third person, or committee can hold the power to remove a trustee.¹⁷³ The settlor needs to consider who will best utilize the power to give effect to the intent of the trust and maintain its integrity.¹⁷⁴

4. *Who Should Not Hold the Power?*

Refer to the discussion above in Section III.B regarding removal powers when coupled with the power to appoint oneself.¹⁷⁵ Though there is no definite authority where the settlor or beneficiary holds only a power of removal (other than a smattering of private letter rulings bereft of factual information or containing peculiar facts), there should be no estate tax inclusion if:

164. *Id.* at 23.

165. *Id.*

166. *See infra* Part III.D. If a power to remove is used in such a situation, it is important to dovetail this power with the power to change the trust situs and governing law. *See infra* Part III.D.

167. *See Akers, supra* note 68.

168. *Id.*

169. *See generally id.* (discussing trustee selection and powers).

170. *See id.*

171. Robert Mack, *Insult After Injury*, PRIV. CLIENT PRAC., Mar. 2010, at 44, 45.

172. *Id.*

173. *See generally id.* (discussing the removal of trustees).

174. *Id.*

175. *See supra* Part III.B; Mack, *supra* note 171, at 45.

- the power to remove is only exercisable for cause;
- the trustee does not hold powers that would cause estate inclusion if the settlor (or beneficiary) held the powers directly; or
- the successor trustee (or the person with the power to choose the successor trustee) falls within the safe harbor of Revenue Ruling 95-58.¹⁷⁶

D. Power to Change Situs and Governing Law

1. What Is the Power?

When including the power to change the situs and the governing law, the planner must understand that simply moving the situs from one state (or country, in the case of offshore trusts) does not automatically result in a change in the governing law.¹⁷⁷ For example, trust agreements typically provide that the law of a specific state will govern “the validity, construction, and administration of the trust.”¹⁷⁸ If the trust so provides, moving the situs will not change the governing law.¹⁷⁹ Therefore, if one includes the ability to change the trust situs, the trust agreement should also include the corresponding power to change the governing law.¹⁸⁰ An alternative drafting choice is to include a provision that the law of the jurisdiction where the trust is administered or has situs will govern the trust.¹⁸¹ To ensure that the trust agreement provides the most flexibility, it may be best to include the power to change the situs and governing law, as well as the provision that the laws of the jurisdiction in which it has situs will govern.¹⁸²

2. Why Grant the Power?

The ability to change the governing law and trust situs provides flexibility to address unanticipated changes in the law of the trust’s jurisdiction, dissatisfaction with the current trustee (i.e., an expensive, non-responsive, or maleficent trustee), or economic or political unrest in the trust’s jurisdiction.¹⁸³ The latter issue generally is seen as more of a concern with offshore trusts, but given the recent economic troubles of many states in the United States, a trust could become subject to a higher state income tax which could prompt the desire to move the trust to a jurisdiction with a lower

176. See Mack, *supra* note 171; Richard W. Nenno, *The Trust from Hell: Can It Be Moved to a Celestial Jurisdiction?*, 22 PROBATE AND PROPERTY 60, 61 (2008).

177. Nenno, *supra* note 176.

178. *Id.*

179. See *id.*

180. See *id.*

181. See *id.* at 61–62.

182. See *id.*

183. See Bergner, *supra* note 20, at 20.

income tax rate.¹⁸⁴ Additionally, some states impose a state income tax on trusts based on the residency of the trustee or the location of the trust administration.¹⁸⁵ Although a planner may advise on the initial administration of the trust, over time, an individual trustee may move to an unfavorable jurisdiction or a successor trustee may take office in an unfavorable jurisdiction.¹⁸⁶ Changing the governing law also may permit the trustee to take advantage of more favorable statutes in the new jurisdiction, such as providing decanting ability, reformation ability, better creditor or spendthrift protection, shortening (i.e., terminating) or extending the trust's duration, or avoiding the appointment of a guardian *ad litem* by choosing a jurisdiction that provides for virtual representation.¹⁸⁷ Changing the situs may allow the consolidation of multiple trusts in a single jurisdiction, or allow a trust to qualify for diversity jurisdiction so parties may litigate a matter in federal district court.¹⁸⁸

In short, moving a trust under provisions included in the trust agreement precludes the necessity of court action to move the trust and correspondingly remove and replace the trustee.¹⁸⁹ In many cases, not only does the original jurisdiction require a petition, but the new jurisdiction also may require a petition seeking the court's approval of the transfer of situs and acceptance of the trust.¹⁹⁰

3. *Who Should or Should Not Hold the Power?*

The transfer of the trust's situs and governing law often results in the need for a different trustee located in the new jurisdiction.¹⁹¹ Thus, if a

184. *Id.*

185. *Id.*

186. *Id.*

187. See *infra* Part III.N. Texas permits virtual representation of a minor by his or her parent, if there is no conflict of interest and no guardian of the estate or guardian ad litem has been appointed. TEX. PROP. CODE ANN. § 115.013(c)(3) (West 2015). Additionally, "an unborn or unascertained person who is not otherwise represented [can be] represented by another party having a substantially identical interest in the proceeding." *Id.* § 115.013(c)(4). While the Texas statute requires a parent to act on behalf of his or her children or another party with a substantially identical interest to act on behalf of an unborn or unascertained person, Texas case law is broader. See, e.g., *Mason v. Mason*, 366 S.W.2d 552 (Tex. 1963) (holding that a trustee properly virtually represented three minor unnamed beneficiaries because the beneficiaries' interest was not in conflict with the trustee's interest). The *Mason* case thus applies the doctrine of virtual representation outside the context of beneficiaries representing other beneficiaries. *Id.* The court ruled that the trustee virtually represented the beneficiaries in a suit challenging the validity of the trust. *Id.*

188. See *Nenno*, *supra* note 176.

189. See *id.*

190. See *id.*

191. See *Situs Selection and Change of Situs for Trusts*, AM. B. ASS'N (Dec. 2011), http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/nclcf/2011_12/rpte_nclcf_2011_dec_g_agenda_situs_selection_and_change_of_situs.authcheckdam.pdf [<http://perma.cc/3H6N-U35J>].

planner includes such powers in the trust agreement, it is wise to ensure that someone or some entity has the ability to remove and replace the trustee.¹⁹²

In many instances, a protector is given the power to change the situs and governing law, as well as the power to remove and replace the trustee.¹⁹³ Planners will recall that the trust agreements should not give a protector the power to remove a trustee and replace the trustee with someone related or subordinate to the settlor or a beneficiary to avoid unfavorable tax consequences.¹⁹⁴

E. Power to Re-grant Powers Held by Settlor

1. What Is the Power?

A planner may also want to grant a special trustee or protector the ability to re-grant a power the settlor has relinquished.¹⁹⁵ By way of example, if a planner drafts a trust agreement as a grantor trust, provisions allowing the grantor trust provisions to be toggled off in the future permits further flexibility if the grantor later decides that the income tax burden of the trust has or will become too great.¹⁹⁶ In this instance, the grantor could relinquish all powers that would otherwise trigger grantor trust status, such as any power held in a nonfiduciary capacity.¹⁹⁷ However, because most trusts are not drafted so that the powers, once toggled off, can be toggled back on, planners should not take the decision to toggle off grantor trust status lightly, but instead should make a decision only after analyzing the facts and circumstances.¹⁹⁸

2. Why Grant the Power?

To provide flexibility to trust agreements that allow certain powers to be toggled off and provide a solution when a party makes a misinformed decision to toggle off or inadvertently toggles off a power, some planners include provisions in their agreements giving a third party the power to re-grant (or toggle on again) the power.¹⁹⁹ That said, these authors advise exercising extreme caution when including such a provision, given the

192. *See id.*

193. *See* Nenno, *supra* note 176.

194. *See* I.R.C. § 672(c) (West 2015); *supra* Parts III.B–C.

195. *See* I.R.C. § 672(c).

196. *See* Philip Di Giorgio, *Grantor Trust Basics*, 42 TR. & EST. L. SEC. NEWSL. (2009) at 19, 23 <http://www.pierro-digiorgio.com/files/Grantor-Trust-Basics-PUBLISHED.pdf> [<http://perma.cc/47K5-Q6JK>].

197. *See id.*

198. *See id.*

199. *See id.*

Service's unfavorable view of the toggling on and off of grantor trust powers.²⁰⁰

3. *Who Should or Should Not Hold the Power?*

If a drafter decides to include a provision to re-grant the power, the agreement should not give the settlor the power, a settlor who has both the ability to relinquish the power and turn it back on results in the relinquishment having no effect for tax purposes.²⁰¹ Furthermore, the settlor's retention of the ability to toggle on and off grantor trust status might result in an incomplete gift or cause inclusion of the trust assets in the settlor's estate.²⁰²

Although a nonadverse party may hold the power to re-grant a power in certain instances, the drafter should carefully analyze the grantor trust rules to determine when to use a nonadverse power holder.²⁰³ The most conservative approach, however, is to not grant the power to a nonadverse party.²⁰⁴

F. *Power Relating to Dispute Resolution*

1. *What Is the Power?*

A dispute resolution power entails giving a third person or a committee the authority to resolve disputes between trustees and beneficiaries, or to resolve differences of opinion between co-trustees.²⁰⁵

The trust agreement might define dispute openly.²⁰⁶ A dispute could be a difference in opinion relating to whether to make a distribution; how much should be distributed; whether to allocate a receipt or disbursement to income or principal (when the statute or trust agreement allows for such discretion);

200. See I.R.S. Announcement 2007-73, 2007-34 I.R.B. 435; I.R.S. Notice 2009-55, 2009-31 I.R.B. 170. The 2007 Announcement identifies a type of transaction involving the toggling on and off of grantor trust status, and substantially similar transactions, as transactions of interest. I.R.S. Announcement 2007-73, 2007-34 I.R.B. 435. Specifically, it describes three situations that allow the trust grantor to claim a tax loss greater than his or her actual economic loss, or to avoid the recognition of capital gain. *Id.* The 2009 Notice includes a warning that the toggling on and off of grantor trust status continues to be considered a transaction of interest subject to penalties for non-compliance. I.R.S. Notice 2009-55, 2009-31 I.R.B. 170.

201. Treas. Reg. § 1.675-1(a) (as amended in 1960).

202. See Jeanne Newlon, *Developments Involving Grantor Trusts*, ALI-ABA EST. PLAN. COURSE MATERIALS J. (2010), https://www.venable.com/files/Publication/0f37c6db-cc39-43b5-ba43-77d1ebfc7895/Presentation/PublicationAttachment/4f223214-65ad-4c44-97ab-86f51d4731d7/Newlon--Grantor_Trusts.pdf [http://perma.cc/V9WW-Z8GG].

203. See *id.*

204. See *id.*

205. See *Rachal v. Reitz*, 403 S.W.3d 840, 850-51 (Tex. 2013) (discussing an arbitration provision under the Texas Arbitration Act where an *inter vivos* trust was enforceable against a trust beneficiary).

206. See *id.* at 850.

investment decisions; lease, purchase, or sale terms; or setting the amount of the trustee's fee.²⁰⁷

2. *Why Grant the Power?*

Granting powers to resolve disputes between trustees and beneficiaries is generally beneficial in avoiding the alternatives of either court action (assuming the dispute is justiciable) or putting the trustee in an unenviable position where his or her own judgment will create discord regardless of his or her decision.²⁰⁸ The power holder could serve as a tiebreaker between two co-trustees who differ in opinion, and could act when the trustee has a conflict of interest.²⁰⁹ Both scenarios commonly arise in a marital trust for a second spouse when the spouse and her stepchild serve as co-trustees, or when either of them serve as a sole trustee.²¹⁰

Planners should consider whether the power holder will receive compensation, whether an exoneration clause will apply, or whether he or she is to be considered a fiduciary.²¹¹ The provisions also should state how the issue is to be brought to the power holder's attention and whether he or she can decline to act on a case-by-case basis.²¹²

3. *Who Can Hold the Power?*

The better question here is who *should* hold the power.²¹³ There is no restriction or limit as to whom or how many individuals the settlor can grant this power.²¹⁴ The initial appointment and provisions for successors should be clear.²¹⁵ Ultimately, the settlor needs to be comfortable with the role he or she is creating, and the power holders need to be comfortable with the role they are accepting.²¹⁶ The settlor should consider candidates who, among other traits, have or can gain knowledge of the settlor's family affairs (both the economics and personal dynamics); show a history of being able to analyze the issues at hand and make informed decisions with good results;

207. *See id.*

208. *See generally* Doggett v. Robinson, 345 S.W.3d 94, 99 (Tex. App.—Houston [14th Dist.] 2011, no pet.) (discussing a suit filed by family trust beneficiaries against an attorney trustee's estate).

209. *See generally* Kappus v. Kappus, 284 S.W.3d 831, 838–39 (Tex. 2009) (holding that a good-faith disagreement is not enough to warrant removal of an independent executor and trustee).

210. *See id.*

211. *See* TEX. PROP. CODE ANN. § 112.087 (West 2015).

212. *See* Rachal, 403 S.W.3d at 847.

213. *See generally* KENNETH MCLAUGHLIN, JR., TEX. EST. PLANNING § 32.05 (Matthew Bender, ed., 2014) (discussing the trustee's requirements).

214. *See id.*

215. *See id.*

216. *See id.*

and have a good personal investment history and sound business background.²¹⁷

4. *Who Should Not Hold the Power?*

It is impractical to name the settlor or a person who is (or could be) a beneficiary when the role naturally calls for independent, unbiased judgment.²¹⁸ Further, the power could cause estate tax inclusion for a settlor or a beneficiary if it is deemed broad enough to change beneficial interests or qualify as a general power of appointment.²¹⁹

G. *Power to Value Unmarketable Assets*

1. *What Is the Power?*

Granting the power to value unmarketable assets may include the power to appoint a third person or a committee to assign a value to assets or to retain an independent, professional appraiser at the expense of the trust estate to value certain trust assets.²²⁰

2. *Why Grant the Power?*

In situations where values may not be readily available, giving a third person or a committee powers to value trust property saves the parties time and expense, and protects the trustee from liability.²²¹ The power benefits a trustee whenever the trustee's right to determine the value of property may be self-serving, produce a conflict of interest, or cause adverse tax issues.²²²

The need most often arises when the trust owns an interest in a closely held business, but could be utilized for real property interests and other assets if the settlor desires to provide for an informal evaluation by an unbiased person.²²³ For example, some clients and their families may desire a special trustee when the assets are sentimental but not technically unmarketable.²²⁴

217. *See id.*

218. *See id.*

219. *See generally id.* § 35.02[4][c] (discussing dispute resolution powers).

220. *See* Treas. Reg. § 1.664-1(a)(7)(ii)–(iii) (as amended 2011). “Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents.” *Id.* § 1.664-1(a)(7)(ii). “For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.” *Id.*

221. *See* McLaughlin, *supra* note 213, at § 45.01[D].

222. *See* Treas. Reg. § 1.664-1(a)(7).

223. *See id.* § 1.664-1(a)–(b).

224. *See id.*

Drafters can also utilize the power when the trustee has the power to divide the assets on a non-fractional basis among beneficiaries at the trust's termination.²²⁵ A different, weightier instance may be where an annual unitrust payment is to be calculated.²²⁶ Most notably, a charitable remainder trust (CRT) needs to contain provisions for the valuation of unmarketable assets to obtain a charitable contribution deduction for income, gift, and estate tax purposes.²²⁷ If unmarketable assets are transferred to or held by a CRT, the trust neither will be treated as a trust with respect to which a charitable contribution deduction is available for income, gift, and estate tax purposes, nor will it be treated as functioning exclusively as CRT, unless, whenever the trust is required to value these kind of assets, the valuation either is: (1) performed exclusively by an independent trustee; or (2) determined by a current qualified appraisal from a qualified appraiser.²²⁸ Thus, if the settlor, someone related or subordinate to the settlor, the settlor's spouse, or any noncharitable beneficiary is the sole trustee, he or she must value the unmarketable assets using a current qualified appraisal from a qualified appraiser.²²⁹ To avoid the expense, it may be worth appointing an independent trustee with valuation powers.²³⁰ The drafter should then consider giving the power holder the discretion to hire a professional appraiser, and charge the expense to the trust.²³¹

3. Who Should or Should Not Hold the Power?

If the power is one where the settlor desires to protect the trustee, the power holder should not be someone who is a beneficiary or has a conflict of interest with, or bias towards, a beneficiary.²³² A committee could be suitable to hold the power.²³³

If there are transfer tax concerns, particularly for a CRT, an independent person (or committee) should be appointed to hold the power to value unmarketable assets.²³⁴ To be an independent trustee, the person cannot be the trust settlor, a noncharitable beneficiary, or a party related or subordinate to the settlor, the settlor's spouse, or a noncharitable beneficiary.²³⁵

225. See TEX. PROP. CODE ANN. § 113.027 (West 2015).

226. See generally McLaughlin, *supra* note 213, at § 35.13[3] (discussing assets).

227. See Rev. Proc. 2005-52, 2005-2 C.B. 326 (providing safe harbor language).

228. See Treas. Reg. § 1.664-1(a)(7); Treas. Reg. § 1.170A-13(c)(3) (defining qualified appraisal); Treas. Reg. § 1.170A-13(c)(5) (defining qualified appraiser).

229. See Treas. Reg. § 1.664-1(a)(7)(iii).

230. See *id.*

231. See *id.* § 1.664-1(a)(7)(b).

232. See *id.* § 1.664-4(b)(1).

233. See *id.*

234. See Marc Hoffman, *The Charitable Remainder Trust*, PLANNED GIVING DESIGN CTR. (May 18, 2011), <http://www.pgdc.com/pgdc/charitable-remainder-trust/> [http://perma.cc/42KR-56KR].

235. Treas. Reg. § 1.664-1(a)(7)(iii).

H. Powers Relating to Life Insurance

1. What Are the Powers?

The powers at issue when dealing with life insurance are referred to as incidents of ownership.²³⁶ Broadly speaking, incidents of ownership include any economic interest in, or benefit from, the insurance policy.²³⁷ For example, the regulations state that it “includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy or revoke an assignment, to pledge the policy for a loan, or to borrow against the cash surrender value of the policy.”²³⁸

2. Why Grant the Powers?

An insured person possessing any incidents of ownership over life insurance, whether exercisable alone or in conjunction with any other person, will cause the gross estate to include the insurance proceeds.²³⁹ Furthermore, the value of a life insurance policy is included in the insured’s estate if the insured transferred incidents of ownership in the policy within three years of the insured’s death.²⁴⁰

A decedent is considered to have an “incident of ownership” in an insurance policy on his or her life held in trust if the decedent either alone or in conjunction with another person or persons has the power (*as trustee or otherwise*) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. . . . [S]uch a power may result in the inclusion in the decedent’s gross estate under [Code] section 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent created the trust, has the power to surrender the insurance policy, and the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.²⁴¹

If a trust may acquire insurance on the trustee’s life, the trust agreement should include provisions for a special life insurance trustee.²⁴² The insured trustee can serve as trustee for the rest of the trust, and can have powers over the non-insurance assets.²⁴³ The insured trustee also could have the right to

236. I.R.C. § 2042(2) (West 2015).

237. *See id.*

238. Treas. Reg. § 20.2042-1(c).

239. I.R.C. § 2042.

240. *Id.* § 2035.

241. Treas. Reg. § 20.2042-1(c)(4) (emphasis added).

242. *Id.*

243. *Id.* § 20.2042-1(c)(2).

remove and replace the special insurance trustee, provided the replacement power is limited to persons not related or subordinate under Code section 672(c).²⁴⁴

3. *Who Should or Should Not Hold the Powers?*

No insured, whether the settlor, a beneficiary, or a trustee, should hold a power that includes any incidents of ownership over the life insurance policy insuring his or her life owned by the trust.²⁴⁵ Further, if one of the foregoing individuals has the power to remove a special insurance trustee and appoint a successor, the safe harbor approach of limiting appointees to someone who is not related or subordinate is advisable.²⁴⁶ Moreover, the special insurance trustee should not be someone who plays a role in another trust such that the reciprocal trust doctrine could apply if the two trusts were uncrossed.²⁴⁷

I. *Power to Control Beneficial Enjoyment*

1. *What Is the Power?*

The grantor trust rules in the Code address the power to control beneficial enjoyment of the trust income or principal.²⁴⁸ In short, the rules provide that the settlor is treated as the income tax owner of any portion of a trust if the beneficial enjoyment of the corpus or the income is subject to a power of disposition exercisable by the settlor, a nonadverse party, or both, without the approval or consent of any adverse party.²⁴⁹ Because the grantor trust rules are particularly complex in this context, granting any of the various powers that control beneficial enjoyment to a special or independent trustee reduces the risk of the drafter inadvertently misapplying the rules.²⁵⁰

Powers that qualify as controlling the beneficial enjoyment of the trust property include the power to add or remove beneficiaries to the trust, and

244. Rev. Rul. 95-98, 1995-2 C.B. 191.

245. See Irrevocable Life Insurance Trust (ILIT), THE WEALTH COUNSELOR, http://www.thewealthcounselor.com/uploads/1_Irrevocable_Life_Insurance_Trust.pdf [<http://perma.cc/HV5U-KHTH>] at 1 (last visited Oct. 17, 2015).

246. *Id.*

247. *Id.*

248. I.R.C. § 674(a) (West 2015). The cautious drafter should realize that relying on Code § 674(a) as a method of ensuring grantor trust status requires careful consideration and drafting around the various exceptions that negate grantor trust status and are enumerated in Code § 674, with particular attention to whether the power applies to and affects income or principal or both. See, e.g., *id.* § 674(b)–(d); Treas. Reg. § 1.674(b)-1.

249. I.R.C. § 672(a). An adverse party is defined as a person who has “a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power” in question. *Id.* By way of example, a current trust beneficiary is an adverse party. See *id.*

250. See *id.*

the power to allocate and distribute trust income and principal among a class of beneficiaries, effectively shifting the trust benefits among beneficiaries (i.e., a sprinkle power).²⁵¹

2. *Why Grant the Power?*

Settlors commonly use the power to control beneficial enjoyment to provide flexibility for unforeseen circumstances.²⁵² Assume the settlor creates a trust for his three minor children, one of whom later acquires a substance habit.²⁵³ A flexible trust agreement might provide the ability to remove the substance abuser child as a beneficiary, or to allocate and distribute the trust income and principal among the settlor's children, thereby shifting a greater benefit to the non-substance abusing children.²⁵⁴

Another manner of achieving a similar result is to grant a lifetime limited power of appointment to the independent trustee or trust protector.²⁵⁵ It is unlikely, however, that the power holder would exercise the power in a manner that benefits anyone other than the existing beneficiaries for fear of breaching his or her fiduciary duty.²⁵⁶

The ability to allocate and distribute trust income also provides a way to adjust the trust's income tax rate.²⁵⁷ For example, to combat the trust accumulating income on which it will pay income tax, a special trustee may be given the power to make distributions that allow the trust to reduce the taxes paid on its income.²⁵⁸

3. *Who Should or Should Not Hold the Power?*

a. *Income Tax Considerations*

The main consideration in determining who should serve as special trustee with the power to control beneficial enjoyment is income tax related.²⁵⁹ If the purpose of the trust agreement is to create a non-grantor trust (i.e., the settlor does not want the trust income to be reportable on his or her individual income tax return), then the most simplistic drafting technique is to not grant the settlor, or anyone related or subordinate to the settlor, the

251. Treas. Reg. § 20.2041-1 (as amended in 1961). *See also* I.R.S. Priv. Ltr. Rul. 95-43-050 (Aug. 3, 1995) (providing an example of trustees holding the power of beneficial enjoyment through the power of disposition).

252. *See* Treas. Reg. § 20.2041-1.

253. *See id.*

254. *See id.*

255. *See id.*

256. *See id.*

257. *Id.*

258. *See id.*

259. *See id.*

power to control the beneficial enjoyment of the trust.²⁶⁰ The trust should grant this power to a special trustee or committee, no more of half of whom are related or subordinate to the settlor.²⁶¹

In contrast, if the goal is to create a grantor trust for income tax purposes, then the settlor may grant full discretion over distributions to a related or subordinate trustee.²⁶² The effect is that the settlor now has the power to allocate among beneficiaries.²⁶³

The careful drafter will note, however, that certain powers may be held by anyone as a trustee or not as a trustee without creating a grantor trust under Code section 674.²⁶⁴ The planner should also note the Treasury Regulations that provide certain cutbacks to the general rule under Code section 674 that creates a grantor trust.²⁶⁵ Moreover, a trust is not a grantor trust for income tax purposes simply because a person, including a trustee or the settlor acting as a trustee or co-trustee, has the power to apply or distribute income for the support of a beneficiary (other than the settlor's spouse) whom the settlor has the legal obligation to support or maintain, unless the income is actually applied or distributed for that purpose.²⁶⁶ When this rule applies, Code section 674 is not applicable, and the trust is not a grantor trust for income tax purposes.²⁶⁷

In the beneficiary context, if the trust is a non-grantor trust as to the settlor for income tax purposes, then the beneficiary should not serve as a special trustee with the discretion to make distributions (whether subject to an ascertainable standard or not) to himself to avoid the trust income being taxed to the beneficiary.²⁶⁸

260. See I.R.C. § 672(c) (West 2015). A person related or subordinate to the settlor includes the settlor's spouse if living with the settlor, and the settlor's parents, issue, or sibling. *Id.*

261. *Id.* §§ 679, 675. Even if the special trustee or committee is not related or subordinate to the settlor, the trust cannot qualify as a foreign trust under Code section 679 and the trustee cannot have one of the proscribed administrative powers in Code section 675. See *supra* Part II.D.5.

262. See Treas. Reg. § 20.2041-1.

263. See *id.*

264. See I.R.C. § 674(b)(1)–(8).

265. See *id.* §§ 674(b)(1), 672(e). For example, the power to apply income to support a dependent exception set forth in Code § 674(b)(1) is available only to the settlor (and the settlor's spouse) under Code § 672(e) when the power is held as a trustee. See *id.*

266. See *id.* § 677(b).

267. See *id.* §§ 674(b)(1), 677(b).

268. See, e.g., *id.* § 678(a)(1) (providing that “[a] person other than the grantor shall be treated as the owner of any portion of the trust with respect to which . . . such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself”). An important exception to Code section 678(a)(1) is that if a grantor holds a power under Code sections 671-679 and the beneficiary holds a Code section 678 power, the beneficiary's power is disregarded, and the grantor is taxed as the owner of the trust income. *Id.* § 678(b) (emphasis added). It is of note that there is a disconnect under a strict reading of the rule in that the beneficiary is still deemed the owner for income tax purposes of the trust *principal*. See *id.* (emphasis added).

b. Gift Tax Considerations

The settlor should not hold the power to add beneficiaries unless the drafter desires that the settlor's gifts to the trust be incomplete gifts.²⁶⁹ Additionally, a settlor acting as trustee with the power to make distributions, even if limited by an ascertainable distribution standard, has made a completed gift in certain circumstances.²⁷⁰

A trust should not give an income beneficiary the power to accumulate income because such a power might cause the Code to treat the power holder as making a gift of the accumulated income.²⁷¹ Similarly, a beneficiary with a power to add beneficiaries may have, in some circumstances, a general power of appointment, thereby resulting in a completed gift by the beneficiary power holder if the power is exercised.²⁷²

To preclude a completed gift by the individual holding the power to add beneficiaries, he or she should not be given the power to add himself or herself as a trust beneficiary.²⁷³

Finally, the trust agreement should not name a person who has any obligation to support any trust beneficiary as special trustee or protector to preclude a deemed gift of the trust property.²⁷⁴ The power might be construed as a general power of appointment, and therefore, taxable for gift tax purposes.²⁷⁵

c. Generation-Skipping Transfer (GST) Tax Considerations

When granting a party the power to add beneficiaries or otherwise control the beneficial enjoyment of a trust, the planner also must ensure that the exercise of the power does not cause an unintended and unfavorable GST tax consequence.²⁷⁶

269. See Treas. Reg. § 25.2511-2(c), (f) (as amended in 1999); *Estate of Sanford v. Comm'r*, 308 U.S. 39 (1939).

270. See Treas. Reg. § 25.2511-2(c), (f).

271. See *id.* § 25.2511-1(b)-(d).

272. See *id.*; § 20.2041-1.

273. See I.R.C. § 674.

274. See *id.*; Treas. Reg. § 20.2041-1.

275. See I.R.C. § 2514.

276. Treas. Reg. § 26.2601-1(b)(1)(i). The planner should keep in mind the GST tax exempt status of the trust and whether it arises by way of qualifying as a grandfathered trust. See *id.* A grandfathered trust is one of the following: (1) "any generation-skipping transfer under a trust . . . that was irrevocable on September 25, 1985," (the day the House Ways and Means Committee began consideration of the bill containing the GST statutes) but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 or out of income attributable to such corpus; (2) any generation-skipping trust under a will or revocable trust executed before October 22, 1986 (the date Congress enacted the Tax Reform Act of 1986) if the decedent died before January 1, 1987; or (3) any trust made by a person who on October 22, 1986, and continuously thereafter was under a mental disability to change the disposition of his or her property and the trust was included in the gross estate of the incompetent person. *Id.*

d. Estate Tax Considerations

Generally, because most powers that would permit the settlor to control the beneficial enjoyment of the trust property also subject the trust assets to inclusion in the settlor's estate, it is best to give such a power to a special trustee or protector who is not the settlor.²⁷⁷ Specifically, Code section 2038(a) requires inclusion of trust assets in a decedent's estate when the decedent has the power, alone or in conjunction with any other person, to alter, amend, revoke, or terminate the enjoyment of the trust property.²⁷⁸ Therefore, the settlor should not serve as a special trustee or protector holding the power to make distributions if such power is not limited to an ascertainable standard.²⁷⁹

Another example where the power to control the beneficial enjoyment of a trust may be problematic is where a special trustee has the power to accumulate income, consequently resulting in a greater benefit to the remainder beneficiaries.²⁸⁰ An alternative manner of drafting is to grant such a power to a protector, or give the trustee the ability to exercise full discretion over distributions to the beneficiaries.²⁸¹

Additionally, the planner should consider granting the power to control the beneficial enjoyment of a trust to a special trustee when a beneficiary/trustee is serving to prevent the possibility that the beneficiary/trustee's creditors could thwart the spendthrift provisions of the trust.²⁸²

277. See I.R.C. § 2038. Another tripwire that can cause estate tax inclusion under Code section 2038 is if the settlor and power holder have any agreement that the power holder will distribute the trust property in accordance with the settlor's desires; thus, it is best to avoid any such arrangement. *See id.*

278. *Id.* § 2038(a).

279. See Rev. Rul. 77-73, 1977-1 C.B. 175. Even if trust distributions are limited to an ascertainable standard, the trust may be includible in the settlor's estate if trust distributions are mandatory and have the purpose of paying the settlor's support obligations. I.R.C. § 2036(a). Specifically, Code section 2036(a) requires the inclusion of property transferred by a decedent in the decedent's gross estate when the decedent retained "(1) the possession or enjoyment of, or the right to the income from, the property, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." *Id.* A trustee with the discretion to pay support obligations is less clear unless under state law, but if the trustee could be required to make payments to someone because of an ascertainable standard, then Code section 2036 will apply. *See Estate of Gokey v. Comm'r*, 72 T.C. 721 (1979) (holding irrevocable *inter vivos* trusts for children were support trusts and included in decedent's gross estate).

280. See I.R.C. § 674.

281. See *supra* Parts III.B–C; *infra* Part III.J. If the latter alternative is chosen, the planner must beware of the tax implications involved. See *supra* Parts III.B–C.; *infra* Part III.J.

282. TEX. PROP. CODE ANN. § 112.035(f) (West 2015). Texas law provides that a beneficiary is treated as a settlor of a trust in various instances, but specifically excludes those instances where a beneficiary merely holds or exercises: (1) "a presently exercisable benefit to consume, invade, appropriate, or distribute property to or for the power of the beneficiary if the power is:" (a) exercisable only with the consent of an adverse party or limited by an ascertainable standard, including a HEMS standard; (b) a limited power of appointment; (2) a testamentary power of appointment; or (3) a presently exercisable withdrawal right that does not exceed the greater of the five and five rule under Code sections 2041(b)(2) and 2514(e), or the gift tax annual exclusion amount under Code section 2503(b). *Id.*

The settlor's spouse, however, may hold the power to make discretionary distributions of income and principal without an estate tax inclusion issue, as long as he or she did not make any contributions to the trust, the spouse cannot distribute to himself or herself, and the spouse cannot distribute in satisfaction of his or her legal obligations.²⁸³

Similar to the gift tax implications discussed above, a beneficiary with a power to add beneficiaries could be deemed to hold a general power of appointment, thereby causing estate tax inclusion of the trust property by the beneficiary power holder.²⁸⁴ Additionally, to preclude estate tax inclusion of the trust property by the special trustee or protector holding the power to add beneficiaries, he or she could not be given the power to add himself or herself as a trust beneficiary.²⁸⁵ Any person who has any obligation to support any trust beneficiary should not be named as special trustee or protector to preclude estate inclusion of the trust property.²⁸⁶ The power might be construed as a general power of appointment and, therefore, be estate taxable.²⁸⁷

e. Non-tax Considerations

Let us look at the power to add beneficiaries.²⁸⁸ The trustee's fiduciary duties could be construed to limit the trustee's exercise of the power, because a trustee has a fiduciary duty to act in the best interests of the trust's beneficiaries, and adding beneficiaries would dilute the current beneficiaries' interests in the trust.²⁸⁹ Thus, granting the power to a special trustee or protector may resolve the issue.²⁹⁰ However, the question then becomes whether a special trustee or protector is held to the same fiduciary duty, thereby negating his or her ability to add beneficiaries.²⁹¹ A protector likely can exercise the power, but another option is to provide a special trustee or protector with the authority to grant the power to add beneficiaries to a person who is not the settlor, trustee, special trustee, or protector.²⁹²

283. See I.R.C. §§ 2036(a)(2), 2038(a).

284. See *id.*

285. See *id.*

286. See *id.*

287. See I.R.C. § 2041.

288. See *id.* § 674.

289. See *id.*

290. See *id.*

291. See *id.*

292. See *id.*

J. Power to Direct or Veto Distributions (Also Known as a Distribution Trustee)

1. What Is the Power?

Separate and apart from the power to control beneficial enjoyment addressed in Section III.I above, the settlor may grant a third party the extraordinary power to direct a distribution without the need to satisfy a standard, veto a distribution, or both.²⁹³

2. Why Grant the Power?

When the trustee is required to make distributions based upon an ascertainable standard, either by deliberate design or by default, it can be desirable to grant a third party or a committee an unlimited power to direct the trustee to make a distribution to one or more beneficiaries.²⁹⁴ A distribution trustee often appeals to a settlor who anticipates difficult beneficiaries and who desires more distribution flexibility in the hands of a trusted confidant.²⁹⁵

Likewise, a settlor may grant that same confidant the ability to prohibit a distribution, even one the trustee believes is within the distribution standard expressed in the trust agreement.²⁹⁶ This veto power provides the settlor with additional oversight to satisfy any of his or her apprehensions.²⁹⁷ It also provides an extra layer of protection for the trustee who, in a sense, receives implicit approval of his or her distribution decision if no veto is made.²⁹⁸

In another instance, the main trustee may hold no distribution powers whatsoever, with such distribution power completely isolated and held only by the distribution trustee.²⁹⁹ A similar option is to make the power to direct distributions springing so the trustee can renounce his or her distribution powers, thereby triggering provisions that call for a distribution trustee to commence serving.³⁰⁰

A hybrid of these powers can arise when the settlor wants a moral trustee to make unpopular decisions that may burden the main trustee or cause

293. See TEX. PROP. CODE ANN. § 113.029 (West 2015); *supra* Part III.I.

294. PROP. § 113.029(b)(1) (limiting distributions for health, education, maintenance, or support).

295. See *id.*

296. See *id.* § 112.035.

297. See *id.*

298. See *id.*

299. See *id.*

300. See Lindquist, *supra* note 19 (providing an example of such language). In 2014, the I.R.S. issued several related private letter rulings in which it concluded that membership on an “approval committee” was not tantamount to a general power of appointment under sections 2041 or 2514 when the committee has more than one member whose interests are adverse to one another. I.R.S. Priv. Ltr. Rul. 14-38-010 (Sept. 19, 2014); I.R.S. Priv. Ltr. Rul. 14-38-011 (Sept. 19, 2014); I.R.S. Priv. Ltr. Rul. 14-38-012 (Sept. 19, 2014); I.R.S. Priv. Ltr. Rul. 14-38-013 (Sept. 19, 2014).

conflict between the main trustee and the beneficiary.³⁰¹ For example, the settlor may want someone to monitor acts he or she believes should disqualify a beneficiary from receiving distributions, such as the beneficiary's living arrangements, school grades, employment situation, or drug use.³⁰²

3. *Who Should or Should Not Hold the Power?*

When the power is one of flexibility or decreases the main trustee's burden (i.e., non-taxable), any trusted confidant, whether related or not, or a committee can hold the power.³⁰³

When the trust agreement confers the power to distribute upon the special trustee without an ascertainable standard, the same care is necessary as when granting the power to remove a trustee and appoint a successor.³⁰⁴ To avoid any possible estate tax inclusion issues, the distribution trustee should be independent (i.e., not subordinate or related).³⁰⁵

K. Power to Control and Direct Trust Investments (Also Known as the Investment Trustee)

1. What Is the Power?

The trust agreement may grant the power to control and direct the trust investments or particular investments to the exclusion of the other trustee or trustees to an investment trustee.³⁰⁶ For example, a settlor may want to name a particular trusted family friend as trustee, but also want to provide for a situation where an investment trustee with specialized expertise in certain investments assists the trustee on the investment side.³⁰⁷

2. Why Grant the Power?

Compare the scenario above to the situation where a trustee merely delegates its investment responsibilities to an advisor.³⁰⁸ An investment trustee has a fiduciary duty to invest the trust assets for the beneficiaries' best interests, whereas it is less clear whether an investment manager to whom investment decisions are delegated is liable to anyone other than the

301. See I.R.C. § 2041 (West 2015).

302. See *id.*

303. See *id.*

304. See *supra* Parts III.B–C.

305. See *supra* Part I.

306. See JEFFERY A. SCHOENBLUM, ANDERSON'S ESTATE PLANNING FORMS & CLAUSES, Form 4.04 (Michael Bender, ed., 2d ed., 2014).

307. *Id.*

308. See *supra* Part II.B.

trustee.³⁰⁹ Therefore, the claim against the investment manager, if any, would arise as a breach of contract, rather than as a breach of fiduciary duty.³¹⁰ Therefore, if the planner and settlor would like to ensure a higher standard for the individual or entity tasked with making investment decisions, the planner should consider bifurcating the responsibilities between a trustee and an investment trustee.³¹¹

3. *Who Should or Should Not Hold the Power?*

One potential downside to naming a specific investment trustee is that an individual investment trustee may die, or a corporate investment trustee may terminate.³¹² Thus, drafting for these two types of trustees requires some duplication in the successor and removal provisions.³¹³ Additionally, an individual or corporation who accepts the appointment as an investment trustee may charge more for the services rendered, given the higher standard of responsibility assumed.³¹⁴

Additionally, there are certain considerations relating to tax consequences.³¹⁵ Specifically, if the goal is to create a non-grantor trust, then neither the settlor, nor any related or subordinate party should be named as investment trustee, because the settlor would, as a result of the power to determine the trust investments, have the power to control the beneficial enjoyment of the trust assets (by controlling the income and principal of the trust), thereby causing the settlor to be the grantor for income tax purposes.³¹⁶

L. Powers Relating to Business Control

1. What Are the Powers?

The power to vote corporate stock warrants discussion when a trust will own business interests.³¹⁷ Voting rights include all decision-making authority that shareholders possess under state law or the corporate bylaws.³¹⁸ In 1972, the Supreme Court rejected the Service's argument that retaining

309. See Natalie B. Choate, *The Fiduciary's Guide to Retirement Benefits*, A.L.I. (July 2015).

310. See *id.*

311. See *supra* Part II.B.

312. *Id.*

313. See *id.*

314. See J. Daniel Schrauth, Attorney, Representing Estate & Trust Beneficiaries & Fiduciaries (July 2012).

315. See *id.*

316. See *supra* Part III.I.

317. See Brett Snider, *Should Your Business Be Held in Trust?*, FINDLAW (Aug. 9, 2013, 10:37 A.M.), http://blogs.findlaw.com/free_enterprise/2013/08/should-your-business-be-held-in-trust.html [<http://perma.cc/S6CY-7DY8>].

318. See Grygor Scott, *Shareholder Voting Rights*, CHRON, <http://smallbusiness.chron.com/shareholder-voting-rights-64241.html> [<http://perma.cc/6J8P-XMRN>] (last visited Oct. 12, 2015).

voting powers over stock transferred to a trust constituted a power causing estate tax inclusion under Code section 2036(a)(2).³¹⁹ In response, Congress passed the “anti-Byrum” amendment, enacting the predecessor to Code section 2036(b).³²⁰

2. *Why Grant the Powers?*

A settlor who retains the power, as trustee or otherwise, to vote the stock of a controlled corporation must include such stock in his or her estate for estate tax purposes.³²¹ Indirect retention of the right to vote stock can also trigger estate tax inclusion of the stock.³²² Indirect retention includes the right to vote in a fiduciary capacity as a trustee, co-trustee, or officer of a corporation.³²³

3. *Who Should or Should Not Hold the Powers?*

Given the discussion above, it generally is not advisable for a settlor to serve as the trustee or co-trustee of a trust that owns stock in a controlled corporation if the settlor wants to avoid inclusion of the trust’s assets in his or her estate.³²⁴ Likewise, the settlor (or anyone related or subordinate to the settlor) should not be granted the authority to vote controlled stock held by

319. U.S. v. Byrum, 408 U.S. 125 (1972) (holding that a decedent who transferred stock into an irrevocable trust for the benefit of others could retain the powers to vote the stock and veto its transfer by the trustee without having the value of the stock included in the decedent’s estate under Code section 2036).

320. Pub. L. No. 94-455, § 2009(a), 90 Stat. 1520, 1893 (1976). The original amendment in 1976 simply added the following language at the end of Code section 2036(a): “For purposes of paragraph (1), the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock.” *Id.*

321. I.R.C. § 2036(b)(2) (West 2015); Prop. Treas. Reg. § 20.2036-2(d), 48 Fed. Reg. 35143 (Aug. 3, 1983). A controlled corporation is defined as one in which the decedent, at any time after the transfer and during the three-year period before the decedent’s death, owned or had the right, alone or in conjunction with any person, to vote stock comprising “at least 20 percent of the total combined voting power of all classes of stock.” I.R.C. § 2036(b)(2). It is important to note that the attribution rules of Code section 318 apply to the determination of the 20% test. *Id.* Such power is deemed a transfer with a retained life estate. *Id.* § 2036(b)(1).

322. See Rev. Rul. 80-346, 1980-2 C.B. 271 (stating that informal strings on voting stock held in trust can bring it into the settlor’s estate). *Cf.* Rev. Rul. 81-15, 1981-1 C.B. 457; Prop. Treas. Reg. § 20.2036-2, 48 Fed. Reg. 35143 (Aug. 3, 1983) (saying the settlor’s retention of voting stock outside of a trust will not cause section 2036(b) inclusion of nonvoting stock transferred in trust).

323. See Prop. Treas. Reg. § 20.2036-2(c), 48 Fed. Reg. 35143 (Aug. 3, 1983).

324. See 49 C.F.R. § 1013.1 (2010). Beware of the situation where the settlor insists on retaining management control via management of a family limited partnership or other entity where interests in such entity are contributed to the trust. See, e.g., I.R.S. Tech. Adv. Memo 99-38-005 (Sept. 24, 1999) (providing an example of the Service pulling the voting stock back into the decedent’s estate under section 2036(b)). Instead, the planner might consider recapitalizing the company and transferring non-voting stock to the entity (which cannot have elected S corporation treatment), followed by gifts of non-managing entity interests. See generally *id.* (providing an example of the alternative).

the trust.³²⁵ Drafters should give further consideration to extending the prohibition to the donor's spouse if the controlled stock was community property when given to the trust.³²⁶ Instead, a special trustee should be appointed to vote the stock.³²⁷

Moreover, the Service deems voting power retained if there is any express or implied agreement with the settlor that the trust as shareholder (or other holder of the power to vote stock) either will vote the stock in a specified manner or will not vote the stock.³²⁸ Therefore, the appearance of an agreement should be avoided at all costs.³²⁹

M. Power to Convert a Power of Appointment

1. What Is the Power?

In order to provide additional flexibility to the beneficiary with regard to his or her planning, a special trustee or protector may be given the power to convert a beneficiary's limited power of appointment to a general power of appointment.³³⁰

2. Why Grant the Power?

Powers of appointment can provide tremendous flexibility to a multi-generational trust agreement by allowing the power holders to exercise the judgment that the settlor would have exercised if he or she had known the future facts, circumstances, and law applicable to the trust.³³¹

There are two types of powers of appointment: the general power of appointment and the limited (or special) power of appointment.³³² When a general power of appointment is given to a beneficiary, the trust settlor has effectively relinquished all dominion and control over the trust assets.³³³

325. See I.R.S. Tech. Adv. Memo 99-38-005 (Sept. 24, 1999).

326. See *id.*

327. See *id.*

328. Prop. Treas. Reg. § 20.2036-2(c), 48 Fed. Reg. 35143, 35144 (Aug. 3, 1983).

329. *Id.*

330. See *supra* Part II.C.2.a.

331. Steinkamp, *supra* note 133, at 196. See also W. Barton Leach, *Powers of Appointment*, 24 A.B.A.J. 807 (1938) (proclaiming the common law power of appointment to be "the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out").

332. I.R.C. § 2041(b)(1) (West 2015). A "general power of appointment means a power which is exercisable in favor of the [power holder], his estate, his creditors, or the creditors of his estate", subject to certain exceptions. *Id.* Pursuant to the Treasury Regulations, a general power of appointment includes: a power "exercisable to meet the estate tax, or any other taxes, debts, or charges that are enforceable against the estate" and a power "exercisable for the purpose of discharging a legal obligation of the possessor or for his pecuniary benefit." Treas. Regs. §§ 25.2514-1(c) (as amended in 1981), 20.2041-1(c) (as amended in 1961).

333. See Treas. Reg. § 25.2514-1. This is true unless the settlor retains a concurrent general power over the trust assets. See *id.*

Therefore, the settlor has made a completed gift to the beneficiary granted the general power of appointment.³³⁴ Consequently, any assets subject to the general power of appointment are includible in the beneficiary's estate for estate tax purposes, unless the power falls under one of the exceptions to the general power.³³⁵

In contrast, granting a limited power of appointment does not by itself result in a completed gift by the settlor.³³⁶ Therefore, when drafting a trust agreement, planners often include a limited power of appointment to achieve three goals.³³⁷ First, the trust agreement can grant a limited power of appointment to a trust beneficiary while preserving the creditor protection of the trust assets from the beneficiary's creditors.³³⁸ Second, planners grant a limited power of appointment to beneficiaries to provide estate tax and GST tax benefits to the beneficiaries.³³⁹ Specifically, if a beneficiary holds only a limited power of appointment, the property subject to the power (e.g., the trust assets) will not be includible in the beneficiary's estate for estate tax purposes.³⁴⁰ Additionally, an exercise or release of such a power does not constitute a taxable gift by the beneficiary.³⁴¹ The result is that the trust property (assuming the remainder of the trust agreement is drafted properly) is passed to successive generations free of transfer tax, while at the same time providing flexibility as to the ultimate disposition of the trust property.³⁴²

Converting a limited power to a general power may be desirable for several reasons, most of which are tax driven.³⁴³ By way of example, suppose the planner represents a beneficiary of a GST tax non-exempt trust, created by her grandparents, that owns assets that have significantly appreciated in value since they entered the trust.³⁴⁴ Because the trust is non-exempt for GST tax purposes, any distributions made to the beneficiary are subject to GST tax at the time of distribution.³⁴⁵ Moreover, the rule of perpetuities will require the trust to terminate during the lifetime of the beneficiary's children, forcing the trust assets out of trust and into the estates of the beneficiary's children.³⁴⁶ Suppose also that the beneficiary and her spouse do not

334. See I.R.C. § 2514(a).

335. *Id.* § 2041(a)-(b).

336. See Steinkamp, *supra* note 133, at 195.

337. See *id.*

338. See *id.*

339. See *id.*

340. See *id.*

341. See *id.*

342. See *id.*

343. See *supra* Part III.I.3.

344. See *supra* Part II.A. Planners recently have become more concerned about the fact that the assets in dynastic trusts, such as the one described, do not receive a step-up in basis at the death of the settlor (as they would if the settlor held the assets individually outside of trust). See *supra* Part II.A. Instead, because the assets were gifted to the trust, the assets retain a carryover basis. See *supra* Part II.A.

345. I.R.C. §§ 2601, 2621 (West 2015).

346. See *generally supra* Part II.A (discussing trust longevity).

anticipate that their joint estates will exceed the estate tax exemption amount after considering portability.³⁴⁷ In this instance, it would be helpful if a third party had the ability to convert the beneficiary's limited power of appointment to a general power of appointment in order to force the inclusion of the trust assets in the beneficiary's estate.³⁴⁸ Doing so would permit the beneficiary to allocate some or all of her (and her spouse's, should he choose to split gifts with her) GST tax exemption amount to the trust assets and provide a step-up in basis of all of the trust assets for income tax purposes at the beneficiary's death.³⁴⁹ The results are two-fold.³⁵⁰ First, the beneficiary, at her death, could appoint the assets in trust for the benefit of her children by appointing the trust assets to another trust for which she is the transferor for GST tax purposes, thereby deferring the GST tax for several more generations.³⁵¹ Second, the inclusion in the beneficiary's estate would effectuate a step-up in basis for the trust assets at her death, providing the trust with an income tax benefit.³⁵²

3. *Who Should or Should Not Hold the Power?*

To preclude estate tax inclusion of the trust assets in the settlor's estate, the settlor never should be given the ability to convert a limited power of appointment to a general power of appointment.³⁵³

A beneficiary also should not be given a general power of appointment so as to preserve the asset protection of the trust as to the beneficiary and to preclude estate tax inclusion of the trust assets in the beneficiary's estate (at least not unless it is determined that it would be advisable from a transfer tax standpoint for the beneficiary to hold such power).³⁵⁴

Consequently, the power to grant a beneficiary of a trust a general power of appointment, or to expand an existing limited power to a general power of appointment, should be held by a third party not related or subordinate to the settlor or the beneficiary.³⁵⁵

347. See Amy Kincaid, *What Does Portability of the Estate and Gift Tax Exemption Mean for You?*, SCHELL BRAY (June 2014), <http://www.schellbray.com/news/entry/what-does-portability-of-the-estate-and-gift-tax-exemption-mean-for-you/> [<http://perma.cc/X7EE-3T33>].

348. See *id.*

349. See *id.*

350. See *id.*

351. See *id.*; *supra* Part III.N (discussing the Delaware Tax Trap).

352. See Kincaid, *supra* note 347.

353. See *supra* Part II.C.1.b.

354. See *supra* Parts II.A, II.D.4.

355. See generally I.R.C. § 2514 (West 2015) (discussing powers of appointment).

N. More on Powers of Appointment and the Delaware Tax Trap

1. What Is the Power?

The power to grant a beneficiary of a trust a general power of appointment, or to expand an existing limited power to a general power of appointment, can be beneficial not only to provide general flexibility as discussed above, but also as an alternative when springing the Delaware tax trap is desired but cannot be achieved.³⁵⁶ Congress enacted Code sections 2041(a)(3) and 2514(d) to prevent the tax-free passing of property from generation to generation by the use of successive powers of appointment when applicable state law allows a power of appointment to be exercised without regard to the common law portability against perpetuities (RAP).³⁵⁷ Referred to as “the Delaware tax trap,” the Code sections provide that the exercise of a limited power of appointment results in the imposition of estate or gift taxes if the power is exercised in a manner that starts a new perpetuities period.³⁵⁸ In other words, a limited power of appointment will be taxed as a general power of appointment if the holder exercises it to create another power of appointment that, under applicable local law (e.g., Delaware), can be used in a manner that extends the RAP period.³⁵⁹

In contrast, the Texas Property Code codified the common law RAP.³⁶⁰ In Texas, where one limited power of appointment is exercised to create another limited power of appointment, the date of creation of the second power is deemed to be the date of creation of the first power.³⁶¹ Therefore, property subject to both limited powers of appointment will have the same perpetuities period, and there is no trap for the unwary.³⁶²

One way to spring the trap is to exercise a limited power of appointment and create a presently exercisable (i.e., *inter vivos*) general power of appointment.³⁶³ The second way is to exercise a limited power of appointment and create a second limited power of appointment where the date of creation of the second power re-starts the applicable perpetuities period.³⁶⁴ In Texas, the first method of springing the trap is possible, but exposes the assets to the power holder’s creditors and may raise concerns

356. See *supra* Part III.M.

357. See I.R.C. §§ 2041(a)(3), 2514(d).

358. See *id.*

359. See *id.*

360. TEX. PROP. CODE ANN. § 112.036 (West 2015). “The rule against perpetuities applies to trusts other than charitable trusts. Accordingly, an interest is not good unless it must vest, if at all, not later than 21 years after some life in being at the time of the creation of the interest, plus a period of gestation. Any interest in a trust may, however, be reformed or construed to the extent and as provided by section 5.043.” *Id.*

361. See I.R.C. § 2514.

362. See *id.*

363. See *id.*

364. See *id.*

within the family that the power holder will exercise it in an undesirable manner.³⁶⁵ Under Texas law, it is currently not possible to spring the trap by the second method.³⁶⁶ Therefore, the planner must find other possibilities that would accomplish the same results as springing the Delaware tax trap.³⁶⁷

As discussed in Section III.M above, another method with the same result is to give a power to a third party to grant a trust beneficiary a general power of appointment, or to expand an existing limited power of appointment into a general one over all or part of the trust assets.³⁶⁸ If the power is implemented, it causes inclusion of those assets in the beneficiary's gross estate, and therefore, the assets receive a stepped-up basis equal to their value on the date of the beneficiary's death.³⁶⁹

2. *Why Grant the Power?*

In this new era of increased federal estate tax exemption amounts, one may see a trap where another may see an opportunity.³⁷⁰ Opportunities caused by springing the Delaware tax trap can include:

- achieving a step-up in basis (when values have appreciated) for income tax purposes;
- avoiding GST tax by making assets subject to an estate tax; and
- changing the transferor for GST purposes to use the new transferor's available GST tax exemption.³⁷¹

The power would be used by the third party only if he or she believes that the beneficiary's estate is sufficiently smaller than his or her remaining exemption amount, and that including these additional assets in the beneficiary's gross estate would not generate additional estate taxes.³⁷²

3. *Who Should or Should Not Hold the Power?*

The power to bestow a general power of appointment should be held only by an independent trustee.³⁷³ There are two somewhat contradictory reasons why.³⁷⁴ First, if a trustee who is also a beneficiary has an interest adverse to the exercise of this power, it would arguably render the power a limited power of appointment for estate tax purposes.³⁷⁵ Second, the Service

365. See PROP. § 181.083.

366. See *id.*

367. See *supra* Part III.M.

368. See *supra* Part III.M.

369. See *supra* Part III.N.2.

370. See *supra* Part III.M.

371. See *supra* Part III.M.

372. See *supra* Part III.N.3.

373. See *supra* Part III.M.

374. See *supra* Part III.M.

375. See I.R.C. § 2041(b)(1)(C)(ii) (West 2015).

may argue that a trustee who is a close relative of the beneficiary has indirect control over the grant of the general power, causing inclusion of the entire trust in the beneficiary's estate even without a specific grant of the general power of appointment.³⁷⁶

O. Broader Decanting Power

1. What Is the Power?

As with most of the powers discussed in this article, drafters generally include the power to decant the trust into another trust or trusts to provide flexibility to the trust agreement over time as circumstances and laws change.³⁷⁷ Effective September 1, 2013, Texas permits decanting under statutory law.³⁷⁸ The statute distinguishes between full discretion trusts and limited discretion trusts.³⁷⁹ To qualify as a full discretion trust, the trustee's distribution power must not be limited in any way.³⁸⁰ If the trust is a full discretion trust, the trustee may distribute principal from a full discretion trust to another trust for the benefit of one or more of the current beneficiaries of the first trust, and give a wholly discretionary beneficiary a power of appointment (i.e., the trustee may decant the original trust).³⁸¹ For tax and non-tax reasons, few trust agreements are drafted as full discretion trusts.³⁸² To address this commonality, the Texas statute also provides that a limited discretion trust may be decanted.³⁸³ A limited discretion trust is one in which the trustee's power to distribute is limited.³⁸⁴ For example, the common language permitting distributions for a beneficiary's health, education, support, and maintenance qualifies a trust as a limited discretion trust under Texas law.³⁸⁵ To decant a limited discretion trust under the Texas decanting statute, the current beneficiaries, the successor beneficiaries, and the remainder beneficiaries of both the original and the new trust, as well as the distribution standard in both trusts must be the same.³⁸⁶ In essence, the decanting statute as applied to a limited discretion trust has limited applicability, and is most useful upon the desire for strictly administrative changes.³⁸⁷

376. *See id.*

377. *See supra* Part III.O. For example, a trust may be decanted to separate the beneficial interests of different beneficiaries and to modify certain provisions of the original trust. *See supra* Part III.O.

378. TEX. PROP. CODE ANN. §§ 112.071–087.

379. *See id.*

380. *See* PROP. §§ 112.071–087.

381. *See id.* §§ 112.071–087.

382. *See id.* §§ 112.071–087.

383. *See id.* § 112.073.

384. *See id.* § 112.071.

385. *See id.* § 113.029.

386. *See id.*

387. *See id.*

2. *Why Grant the Power?*

Given the limitations of the Texas decanting statute, including a power to decant in the trust agreement can be helpful if a change later needs to be made, and one wants to avoid the requirement of going to court or obtaining consent from all of the trust beneficiaries.³⁸⁸ When including such a provision, however, one must analyze the tax implications of granting such a power.³⁸⁹

An alternative to achieve decanting via another power is to permit a change of governing law and situs.³⁹⁰

3. *Who Should or Should Not Hold the Power?*

If the trust is fully discretionary (i.e., the trustee has the power to decant the trust under Texas law), the Texas decanting statute contains a tax savings provision to preclude an unintended or undesirable tax consequence to the trustee.³⁹¹ Rather than relying on the statute, it may be more effective to grant the power to decant the trust in the trust agreement to an independent, third-party trustee who is not related or subordinate to the settlor.³⁹² First, doing so removes the requirement that the trustee must have full discretion over distributions, a power with which many settlors are uncomfortable.³⁹³ Second, it ensures that the settlor will not be deemed to hold a general power of appointment over the trust assets, which would make the assets includible in the settlor's estate for estate tax purposes.³⁹⁴ The beneficiary should not hold the power for the same reason.³⁹⁵ Similarly, if the trust is a limited discretion trust, then someone other than the trustee should be given the power to decant the trust assets into another trust.³⁹⁶

388. *See id.* §§ 113.071–.073.

389. *See* Michael M. Gordon, et al., *The Tax Consequences of Decanting: An Overview of the Gift, Estate, Income and Generation-Skipping Transfer Tax Issues to Consider When Contemplating a Trust Decanting*, ST. B. TEX. (2013), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=156443&t=PDF&e=11842&p=1> [<http://perma.cc/WL3H-3SPK>].

390. *See supra* Part III.D.

391. PROP. § 113.029(b). The Texas decanting statute provides the following tax savings clause: “Subject to Subsection (d), and unless the terms of the trust expressly indicate that a requirement provided by this subsection does not apply: (1) a person, other than a settlor, who is a beneficiary and trustee, trustee affiliate, or discretionary power holder of a trust that confers on the trustee a power to make discretionary distributions to or for the trustee’s, the trustee affiliate’s, or the discretionary power holder’s personal benefit may exercise the power only in accordance with an ascertainable standard relating to the trustee’s, the trustee affiliate’s, or the discretionary power holder’s individual health, education, support, or maintenance within the meaning of Section 2041(b)(1)(A) or 2514(c)(1), Internal Revenue Code of 1986; and (2) a trustee may not exercise a power to make discretionary distributions to satisfy a legal obligation of support that the trustee personally owes another person.” *Id.*

392. *Id.*

393. *Id.* § 113.029.

394. *Id.* § 113.002.

395. *Id.*

396. *Id.* § 112.073.

Some drafters instead include provisions in their trust agreements that permit all of the current and remainder beneficiaries, if they are not related or subordinate to the settlor, to appoint an independent trustee to decant the trust.³⁹⁷

Finally, the planner must be cautious when decanting a trust that is grandfathered for GST tax purposes, so as to not jeopardize the exempt status of the trust.³⁹⁸ A distribution of trust principal from a grandfathered trust to a new trust will not cause a loss of exempt status if the following two requirements are satisfied: (1) the distribution is pursuant to the trust agreement or pre-effective date state law and (2) the new trust does not violate the perpetuities period measured by the original trust.³⁹⁹ If the trust cannot be decanted because the trust cannot meet the above requirements, there is the possibility it might be decantable under one of the safe harbors set forth in the Treasury Regulations.⁴⁰⁰

P. Reformation Power for S Corporation Purposes

I. What Is the Power?

The shareholders of a corporation may elect to have net profits and losses taxed directly to them without a separate federal income tax on the corporation.⁴⁰¹ These corporations are known as S corporations.⁴⁰² However, only certain specified trusts qualify to hold stock in an S corporation.⁴⁰³ Grantor and beneficiary-controlled trusts, voting trusts, qualified Subchapter

397. See *What is an Independent Trustee?*, *supra* note 5.

398. See I.R.S. Priv. Ltr. Rul. 08-22-008 (May 30, 2008); I.R.S. Priv. Ltr. Rul. 07-43-028 (May 29, 2007); I.R.S. Priv. Ltr. Rul. 07-14-016 (Apr. 6, 2007). There are no Code sections or Treasury Regulations that deal directly with the decanting or modification of non-grandfathered trusts; however, several private letter rulings (which cannot be used as precedent or relied upon) suggest that the Treasury Regulations for grandfathered trusts should apply to non-grandfathered trusts. See *id.*

399. Treas. Reg. § 26.2601-1(b)(4)(i)(A)(1) (as amended in 2004). The first prong of the test requires that either (1) the terms of the governing instrument of the grandfathered trust authorize distributions to other trusts, “without the consent or approval of any beneficiary or court” or (2) at the time the grandfathered trust became irrevocable, state law authorized distributions to other trusts, “without the consent or approval of any beneficiary or court.” *Id.* Because Texas did not enact a decanting statute prior to 1985, it is not possible to satisfy the factor that requires the state law to authorize distributions, so the terms of the governing instrument must permit distributions to other trusts without the consent or approval of any beneficiary or court. See *id.* The second prong of the test requires that the terms of the governing instrument of the receiving trust cannot “extend the time for vesting of any beneficial interest [in a] manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property” beyond a period measured by 21 years after the death of any life in being at the time the original trust became irrevocable. *Id.* § 26.2601-1(b)(4)(i)(A)(2).

400. See Treas. Reg. § 26.2601-1(b)(4)(i)(A), (D).

401. See *S Corporation*, U.S. SMALL BUS. ADMIN., <https://www.sba.gov/contents/s-corporation> [<http://perma.cc/Q3HK-N4CQ>] (last visited Oct. 11, 2015).

402. See *id.*

403. See *id.*

S trusts (QSSTs), and electing small business trusts (ESBTs), along with a few other trusts, may be shareholders.⁴⁰⁴

2. *Why Grant the Power?*

Practitioners typically include language authorizing the trustee or special power holder to reform a trust to ensure it qualifies as a QSST or an ESBT (when it is not—or is no longer—a grantor trust or voting trust, or is past the two-year grace period) in anticipation of the trust owning S corporation stock.⁴⁰⁵

3. *Who Should or Should Not Hold the Power?*

There is concern among practitioners that some modification and election powers are often too broad, creating other tax concerns if the trustee is not independent.⁴⁰⁶ Cautious drafting could include language that limits who can exercise the modification power (typically to an independent trustee or protector).⁴⁰⁷

404. Treas. Reg. § 1.1361-1(h)(1). The regulations refer to such trusts as “qualified Subpart E trusts” because the grantor or other person owns the trust under subpart E of Subchapter J of Chapter 1 of the Code. *Id.* It does not matter under which section of the grantor trust rules the trust is deemed owned by the grantor or another person, as long as that person owns all of the trust while the trust holds S corporation shares. *Id.* A beneficiary owns a trust if he has a power to withdraw the income and principal from the trust and the settlor has not retained any grantor trust powers. I.R.C. § 678(a) (West 2015). Therefore, a trust that can be terminated by the beneficiary at any time, with the trust funds distributed immediately to the terminating beneficiary, is an eligible S corporation shareholder under Code section 1361(a)(1). *See id.* Furthermore, a beneficiary may own a trust by reason of a combination of a temporary withdrawal power and certain continuing interests in the trust. *Id.* § 678(b). A trust is an eligible S corporation shareholder if it is “created primarily to exercise the voting power of stock transferred to it.” *Id.* § 1361(c)(2)(A)(iv). The beneficiaries of a voting trust are treated as S corporation shareholders, so each beneficiary must be a U.S. individual or eligible trust. *Id.* § 1361(c)(2)(B)(iv). A QSST is a special type of trust allowed to own S corporation stock, provided that the benefits of its S corporation stock are almost entirely dedicated to one individual beneficiary who agrees to be treated as the deemed owner of the trust. *Id.* § 1361(d)(3). A separate share of a trust that meets the requirements of Code section 663(c) will constitute a separate trust for purposes of the QSST rules. Treas. Reg. § 1.1361-1(j)(3) (as amended in 2008). Therefore, a trust may include a power to create subtrusts to hold the S corporation stock. *Id.* Generally, a trust may elect to be treated as an ESBT if: (1) the trust has as beneficiaries only individuals, estates, charitable organizations described in paragraphs two through five of section 170(c)(1), and governmental organizations if they hold only contingent interests in the trust and are not potential current beneficiaries, and (2) no interest in the trust was acquired by purchase. *See* I.R.C. § 1361(c)(2), (e)(1).

405. *See* I.R.C. § 1361(c)(2).

406. *See* Glenn Karisch, *Modifying and Terminating Irrevocable Trusts*, TEX. PROB. 1, 18–19 (2008), <http://www.texasprobate.net/articles/modifyingorterminatingtrusts.pdf> [http://perma.cc/9DVA-ANVP].

407. *See id.* at 19.

Q. Power to Terminate the Trust

1. What Is the Power?

Although Texas statutory law permits the termination of an uneconomic trust (i.e., a trust with a value of less than \$50,000), most drafters would contend that the administration of a trust becomes uneconomic at some dollar value well above \$50,000.⁴⁰⁸ Texas statutory law also permits the termination of a trust for several other reasons, including when the purpose of the trust has been fulfilled or when circumstances not known at the time of drafting warrant termination of the trust.⁴⁰⁹

2. Why Grant the Power?

To avoid the cost and time commitment associated with initiating a statutory court action to terminate the trust, many drafters instead prefer to include a provision permitting the termination of the trust by either the trustee or a special power holder.⁴¹⁰

3. Who Should or Should Not Hold the Power?

A settlor acting as trustee should never be given the power to terminate the trust.⁴¹¹ Such a power likely would be deemed a retained power to affect the beneficial enjoyment of the trust that is not limited by an ascertainable standard, thereby causing estate tax inclusion of the trust property in the settlor's estate.⁴¹² However, several drafting options will preclude this result.⁴¹³ First, the trustee could be barred from receiving a distribution for his or her benefit or to discharge his or her legal obligation, or could be found predeceased in this event.⁴¹⁴ Second, the trustee could resign prior to the termination.⁴¹⁵ Third, the power could be held jointly with or held by an

408. TEX. PROP. CODE ANN. § 112.059(a) (West 2015).

409. *Id.* § 112.054(a). Under Texas statute, a court may order the termination of a trust upon a petition by a trustee or a beneficiary if: "(1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill; (2) because of circumstances not known to or by the settlor, the order will further the purposes of the trust; (3) modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration; (4) the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or (5) continuance of the trust is not necessary to achieve any material purpose of the trust, or the order is not inconsistent with a material purpose of the trust." *Id.*

410. *See id.*

411. *See supra* Part Q.III.

412. *See, e.g.,* Commissioner v. Holmes' Estate, 326 U.S. 480 (1946); Lober v. U.S., 346 U.S. 335 (1953).

413. *See* Karisch, *supra* note 406, at 14

414. *Id.*

415. *Id.*

adverse party.⁴¹⁶ Finally, the trust agreement can set a value (e.g., \$25,000) to limit the value included in the beneficiary's estate for estate tax purposes to that amount.⁴¹⁷

Additionally, the power to terminate the trust should only be given to an independent trustee or special power holder if the trustee is related or subordinate to the settlor (e.g., the settlor's spouse is named trustee of a nonmarital testamentary trust).⁴¹⁸

If the trustee is given the power to terminate the trust at any time and distribute the trust property to the beneficiaries then entitled to receive the net income of the trust, then the trustee also should not be a beneficiary or the only trust beneficiary.⁴¹⁹ The power of a beneficiary/trustee to make distributions to himself or herself must be limited to an ascertainable standard to preclude the beneficiary/trustee having a general power of appointment.⁴²⁰ A beneficiary who holds a general power of appointment must include all of the trust assets in his or her estate for estate tax purposes.⁴²¹ Furthermore, if a beneficiary/trustee makes a distribution to another beneficiary under a non-ascertainable standard, the beneficiary/trustee is treated as making a gift.⁴²² In short, the beneficiary/trustee will be deemed to have either made a gift or have the trust assets included in his or her estate for estate tax purposes.⁴²³ Thus, careful planners draft around this issue.⁴²⁴

416. *Id.*

417. *Id.*

418. See Sebastian V. Grassi, *Tax Changes Put Premium on Drafting Flexible Estate Plans*, 71 PRAC. TAX STRATEGIES 140, 140-43 (Sept. 2003).

419. See *supra* Part Q.III.

420. I.R.C. § 2041 (West 2015). Code section 2041 applies if the beneficiary is a co-trustee unless the other party is an adverse party. *Id.* Code section 2041 also includes an exception for a power limited by an ascertainable standard relating to the health, education, maintenance, or support (HEMS) of the decedent. *Id.* Therefore, the drafter must exercise caution when including the ability of the beneficiary who is trustee to make distributions to himself. *Id.* If the trust agreement deviates from the HEMS standard or the standards set forth in Treasury Regulations § 20.2041-1(c)(2), the beneficiary as trustee will be deemed to hold a general power of appointment. Treas. Reg. § 20.2041-1 (as amended in 1961). The courts, however, have ruled differently over time on the same standard. See, e.g., *Whelan v. United States*, 81-1 U.S. Tax Cas. (CCH) ¶ 13,393 (S.D. Cal. 1981) (holding that a distribution power "for the reasonable support, care, and comfort" of a beneficiary was an ascertainable standard); *Tucker v. United States*, 74-2 U.S. Tax Cas. (CCH) ¶ 13,026 (S.D. Cal. 1974) (holding that a distribution power for the "reasonable care, comfort, and support," of a beneficiary was *not* an ascertainable standard).

421. I.R.C. § 2041(a).

422. *Id.* § 2514(b). A release of a general power of appointment is deemed a taxable gift by the beneficiary who is trustee under Code section 2514(b). *Id.*

423. See *id.*

424. See *infra* Part Q.III.

R. Considerations When Drafting Special Needs Trusts

1. Why Grant Special Powers?

One particular difficulty with drafting a special needs trust is that the drafter wants the document to change and flex with the special needs beneficiary, and the situation of the special needs beneficiary may change incrementally or drastically over time.⁴²⁵ Because many special needs trust beneficiaries are incapable of monitoring the actions of the trustee, a protector or other power holder may be given this role.⁴²⁶ Some drafters include a requirement in the trust agreement that the trustee engage a professional to conduct an annual evaluation and make recommendations regarding the special needs beneficiary's care.⁴²⁷ This professional might be called a special trustee, case manager, or trust protector (to avoid confusion with the concept of a trust protector, special trustee will be used in this context).⁴²⁸

The special trustee might be given the ability to: (1) toggle distributions on or off or otherwise exercise discretion so as not to prevent benefits for which the beneficiary might otherwise be eligible; (2) amend the trust in the event of the beneficiary's changed circumstances or to maximize government benefits; (3) move the trust to a different jurisdiction to obtain greater benefits for the beneficiary; or (4) monitor the trustee's investment decisions.⁴²⁹ The drafter can provide additional flexibility by including provisions allowing the trustee to: (1) purchase life insurance on a parent or caregiver's life to provide additional funds in the event of a parent or caregiver's untimely death; (2) pay funeral and attendant expenses after reimbursing the state for Medicaid expenditures; and (3) transfer trust assets to a pooled trust (if the assets are too complex for an individual trustee to manage or too small for a corporate trustee to cost-efficiently manage).⁴³⁰

One cautionary note to planners is to consider the potential effect that naming a protector or special trustee can have in the special needs context. For example, public benefit agencies reviewing the trust agreement may be unfamiliar with the protector or special trustee role, and, therefore, they may view the trust agreement with a skeptical eye.⁴³¹ As a precaution, the planner

425. See Donovan Waters, *The Protector: New Wine in Old Bottles?*, in TRENDS IN CONTEMPORARY TRUST LAW 63, 70 (A. J. Oakley ed., 1996).

426. See *id.*

427. See Patricia F. Stichler & Kathy Lynch, *And How Are the Children? Planning for Children with Special Needs Trusts*, ST. B. TEX. (2011), available at <http://www.texasbarcle.com/cle/OLViewArticle.asp?a=130234&t=PDF&e=9946&p=1> [<http://perma.cc/HC8L-YZLR>].

428. See *infra* Part IV.A.

429. See Stichler & Lynch, *supra* note 427, at 33.

430. See *id.* at 46–47.

431. See *id.*

may consider including a provision prohibiting any violation of agency trust requirements by the protector or special trustee.⁴³²

2. *Who Should or Should Not Act as Trustee or Special Trustee?*

The Texas Estates Code prohibits an individual from serving as trustee of a court-created management trust unless: (1) the trust corpus is less than \$150,000; or (2) the trust corpus was greater than \$150,000 and no corporate trustee in the geographic area will accept trusteeship.⁴³³ The Texas Estates Code also addresses the potential requirement of a bond for an individual trustee.⁴³⁴ Even if an individual qualifies, he or she may not have sufficient experience or time to devote to the fiduciary role requiring attention to distributions, investing, accounting, and tax returns.⁴³⁵

Trusts that are settled by third parties (such as a family member) are not subject to the same statutory prohibitions on who can serve as trustee.⁴³⁶ If using an individual trustee, however, it may be best to name an unrelated trustee because a related party may not have time to handle ongoing distributions or may not have the necessary skills to manage the large investments held by a special needs trust.⁴³⁷

Even if the family member does not have the time or experience to serve as trustee, a family member can act as the special trustee to monitor the trustee's activities and amend the trust or approve specific distributions.⁴³⁸ This system of checks and balances can be particularly helpful when a corporate trustee is acting.⁴³⁹

IV. PRACTICAL CONSIDERATIONS

A. *Comparing Trustees and Protectors*

1. *What Is a Protector?*

Following the discussion of the various types of powers that can be carved out and allocated to a special-purpose trustee or other trusted

432. *See id.*

433. TEX. EST. CODE ANN. § 1301.057 (West 2015). For trusts created by the court to hold property recovered in a suit by a next friend or guardian ad litem that will be settled with assets greater than \$50,000, an individual may serve as trustee only if no financial institution is willing to act as trustee. TEX. PROP. CODE ANN. § 142.005(m)–(n).

434. EST. §§ 1301.058, 1301.101.

435. *See* Sitchler & Lynch, *supra* note 427, at 48.

436. *See* EST. § 1301.053.

437. *See id.*

438. *See* Sitchler & Lynch, *supra* note 427, at 63. Drafters should exercise caution when naming a family member, especially in a third-party settled special needs trust, to avoid any unintended tax consequences. *Id.*

439. *Id.*

individual, we turn now to the concept of a protector.⁴⁴⁰ The role of a protector, although not used often in the United States until the 1990s, is not novel.⁴⁴¹ One commentator attributes the protector to three origins: (1) non-trustee fiduciaries in England and other Commonwealth countries; (2) similar individuals and financial institutions acting with respect to offshore and domestic asset protection trusts; and (3) trust advisors in American trusts.⁴⁴²

The first use of the specific term “protector,” however, was made in a 1989 amendment to the Cook Islands International Trusts Act 1984.⁴⁴³ The term was defined as “the holder of a power which when invoked is capable of directing the trustee in matters relating to the trust in respect of which matters the trustee has discretion and includes a person who is the holder of a power of appointment or dismissal of trustees.”⁴⁴⁴ Today, the Cook Islands International Trusts Act of 1984 (as amended, most recently in 1999) provides that a protector is one who: (1) has the power to appoint or remove a trustee; (2) directly or indirectly controls, whether by power of veto or otherwise, the trustees’ exercise of one or more of their powers, functions or discretions under the trust; or (3) holds the office of protector in accordance with the Act.⁴⁴⁵

In essence, a protector is the holder of one or more powers capable of affecting what the trustee is to do with the trust property.⁴⁴⁶ A protector is not a trustee and should have no beneficial interest in the trust.⁴⁴⁷ Instead, the role of a protector provides flexibility within the trust document to allow it to grow or change over time.⁴⁴⁸ Because there is no statutory provision made for a protector as such under Texas law, a protector of a Texas trust derives its powers, rights, and authority solely from the trust agreement.⁴⁴⁹

440. See *supra* Part IV.A.

441. Richard C. Ausness, *When Is a Trust Protector a Fiduciary?*, 27 QUINN. PROB. L. J. 277, 289 (2014).

442. See *id.* “A trust adviser is a person who has power to exercise control over a trustee.” *Id.*

443. INT’L TR. AMENDMENT ACT 1989 § 3(2) (Cook Is.), available at http://www.pacii.org/ck/legis/num_act/itaa1989351/index.html [<http://perma.cc/374R-3CVE>].

444. See *id.*

445. INT’L TR. AMENDMENT ACT 1999 § 20 (Cook Is.), available at http://www.pacii.org/ck/legis/num_act/itaa1999351/ [<http://perma.cc/3MKB-7Z8T>].

446. See Waters, *supra* note 425, at 64.

447. Robert C. Lawrence III, *The Role of the Trust Protector or Protective Committee*, Practicing Law Institute, § 7:2.4, Nov. 2001.

448. *Id.*

449. UNIF. TRUST CODE § 808(c) (amended in 2010). Several states, excluding Texas (which has used several Uniform Trust Code provisions, but adopted its own comprehensive Trust Code), have adopted the Uniform Trust Code. *Id.* Section 808(c) of the Uniform Trust Code permits a trust agreement to “confer upon a trustee or other person a power to direct the modification or termination of the trust.” *Id.*

2. What Powers Should the Protector Hold?

The powers granted to a protector by the drafter should be carefully considered and based on the specific facts and circumstances of the client's situation and intent.⁴⁵⁰ For instance, the grantor might give the protector the power to remove and replace a trustee; add new beneficiaries or remove existing beneficiaries; amend the trust for tax or other reasons; terminate the trust; convert a limited power of appointment to a testamentary general power of appointment; change the situs and governing law of the trust; or resolve disputes between trustees or between beneficiaries and the trustee.⁴⁵¹ Some commentators mention the inclusion of the power to veto or direct trust distributions, or monitor the trustee's investment decisions, but the drafter granting such powers should be aware that these powers put the protector into a fiduciary realm.⁴⁵²

In any event, Texas law provides that the terms of a trust prevail over the Texas Trust Code, except that the terms of a trust may not limit the following: (1) requirements that the trust cannot require a trustee to commit an act that is criminal, tortious, or contrary to public policy; (2) the duties and liabilities of and restrictions placed on a corporate trustee; (3) the statute addressing exculpation of a trustee; (4) the period of limitations for commencing a judicial proceeding; (5) certain trustee duties; and (6) "the power of a court . . . to take action or exercise jurisdiction."⁴⁵³

3. What Powers Should the Protector Not Hold?

There are certain powers the grantor should not give to a protector to preclude an unfavorable tax situation for the protector.⁴⁵⁴ The drafter should not give the protector a general power of appointment because such a power could cause the inclusion of the trust assets in his or her estate.⁴⁵⁵ For example, the protector should not be given a power to appoint as trustee himself or herself or anyone related or subordinate to him or her; should not be permitted to exercise the powers in favor of himself, his creditors, his or her estate, or the creditors of his or her estate or discharge his or her legal obligation of support; or allowed to determine his compensation (as this last issue should be given to the trustee).⁴⁵⁶

450. See *supra* Part IV.A.2.

451. See *infra* Part III.D.

452. See Bove, *supra* note 134, at 390; *Supra* Part III.J.

453. TEX. PROP. CODE ANN. §§ 111.035(b)(1)-(b)(6), 112.031, 113.052-.053, 114.007 (West 2015).

454. See Jay Adkisson, *Trust Protectors -- What They Are and Why Probably Every Trust Should Have One*, FORBES (Aug. 25, 2012, 1:03 PM), <http://www.forbes.com/sites/jayadkisson/2012/08/25/trust-protectors-what-they-are-and-why-probably-every-trust-should-have-one/> [http://perma.cc/N7S6-7DKT].

455. See *id.*

456. See *id.*

4. *Who Should Act as Protector?*

The ideal candidate acts exactly as the trust settlor would to protect the purpose of the trust and trust property.⁴⁵⁷ Whatever the powers given to the protector, neither the settlor nor anyone related or subordinate to the settlor or the beneficiaries should be named as the protector.⁴⁵⁸ Otherwise, the asset protection and the tax purposes of the trust may be compromised.⁴⁵⁹

5. *Is a Protector a Fiduciary?*

Another issue is whether a protector is a fiduciary (i.e., does a protector owe a duty, and if so, to whom?), which is a topic of much debate among the American estate planning bar.⁴⁶⁰ While an exhaustive discussion of the issue is not appropriate here given the broad topic and the space limitations, it bears some mention.⁴⁶¹ . . . Most notably, Texas law validated the practice of giving a non-trustee the power to direct certain actions of the trustee but specified that such a person presumptively owes fiduciary duties to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries.⁴⁶² However, the statute was amended in 2015 to apply only to charitable trusts. New legislation was enacted in 2015 to apply only to noncharitable trusts.⁴⁶³ It provides that a person who is given authority to direct, consent to, or disapprove the trustee's investment, distribution, or other decisions is considered a fiduciary in exercising that authority, except to the extent the trust provides otherwise.⁴⁶⁴ It further provides a trustee who acts in accordance with those directions is not liable for doing so, except in cases of the trustee's willful misconduct or gross negligence.⁴⁶⁵ Although legislation is developing in this area, few American cases address the question of whether a protector is a fiduciary.⁴⁶⁶

A 2002 federal bankruptcy case makes the statement: "Plaintiff correctly points out that a fiduciary position such as Protector of the Trust

457. *See id.*

458. *See id.*

459. *See id.*

460. *See* William D. Pargaman & Craig Hopper, *2015 Texas Estate and Trust Legislative Update*, TEX. ASS'N CNTYS 1, 20 (May 8, 2015), <http://county.org/member-services/education-and-training/presentations/Documents/2015%20Probate%20Academy/Legislative%20Update.pdf> [<http://perma.cc/RV4-CN5T>].

461. *See, e.g.,* Bove, *supra* note 134, at 390; Alexander A. Bove, Jr., *The Case Against the Trust Protector*, 37 ACTEC L. J. 77 (Summer 2011); John T. Brooks & Gregory F. Monday, *Do We Need Protection from Trust Protectors?*, TR. & EST. (Mar. 28, 2012) <http://wealthmanagement.com/financial-planning/do-we-need-protection-trust-protectors> [<http://perma.cc/5SRQ-U8GT>]; Ausness, *supra* note 441; Aucutt, *supra* note 4.

462. TEX. PROP. CODE ANN. § 114.003 (West 2015).

463. TEX. PROP. CODE ANN. § 114.0031 (West 2015).

464. *Id.* § 114.0031(e).

465. *Id.* § 114.0031(f).

466. *See infra* Part IV.A.5.

... ” without further analysis.⁴⁶⁷ Subsequently, the Missouri Court of Appeals decided a case in 2009 that addressed the issue (in dicta) in a case where the trust agreement explicitly provided that the “[p]rotector’s authority . . . is conferred in a fiduciary capacity and shall be so exercised,” then in a later provision provided that the “[p]rotector shall not be liable for any action taken in good faith.”⁴⁶⁸ The case was remanded to the trial court in 2011, and in 2013, the case again was before the Missouri Court of Appeals for decision.⁴⁶⁹ The court, however, did not rule on whether the protector was a fiduciary or, if there was a fiduciary duty, whether it arose as a matter of law or simply under the trust agreement.⁴⁷⁰

In contrast, however, dicta in a 2013 federal case states that “[c]ommentators agree, however, that the trust protector is, at [his] core, an agent.”⁴⁷¹

If the planner takes the position that a duty exists, the next question becomes whether it can be drafted away.⁴⁷² When drafting, the planner should consider the possible consequences of doing so and what recourse, if any, the settlor and the beneficiaries will have against the protector if the protector decides to become a bad actor.⁴⁷³ One option is to grant a combination of fiduciary and non-fiduciary (i.e., personal) powers to the protector, with the likely result being that the protector would be held to a fiduciary standard in those actions which are non-personal, but not with regard to the exercise of any personal powers.⁴⁷⁴ Another option is to include language stating that the protector is not liable for any action or inaction unless recklessness, fraud, or willful misconduct is found.⁴⁷⁵

B. Comparing a Single Appointee to a Committee

After determining that the settlor needs or simply wants to appoint a special-purpose power holder in the trust agreement, the next step is to decide

467. Walker v. Weese, 286 B.R. 294, 299 (D. Md. 2002).

468. Robert T. McLean Irrevocable Tr. v. Patrick Davis, P.C., 283 S.W.3d 786, 789–90 (Mo. Ct. App. 2009). A special needs trust was created for Mr. Robert McLean from the settlement proceeds of a personal injury case and the trust agreement named a protector who was given the power to remove the trustee and appoint a successor trustee. *Id.*

469. Robert T. McLean Irrevocable Trust v. Ponder, 418 S.W.3d 482 (Mo. Ct. App. 2013). *See* Ausness, *supra* note 441, at 295–301.

470. Ponder, 418 S.W.3d at 490–94.

471. PHL Variable Ins. Co. v. 2008 Christa Joseph Irrevocable Trust, 970 F. Supp. 2d 932, 943 (2013) (quoting Philip J. Rice, *The Trustee and the Trust Protector: A Question of Fiduciary Power. Should a Trust Protector Be Held to a Fiduciary Standard?*, 59 DRAKE L. REV. 67, 68 (2010)).

472. *See* Philip J. Rice, *The Trustee and the Trust Protector: A Question of Fiduciary Power. Should a Trust Protector Be Held to a Fiduciary Standard?*, 59 DRAKE L. REV. 67 (2010).

473. PHL Variable Ins. Co., 970 F. Supp. 2d at 940 (explaining that the settlor likely will have no or little recourse, as a settlor generally does not have standing to bring suit with regard to an irrevocable trust).

474. Rice, *supra* note 472, at 79–83.

475. *See id.*

whether a single appointee or a committee will implement the powers granted.⁴⁷⁶

Decision-making by committee precludes any one person from being solely responsible for the decision and may avoid emotional aspects that can be evoked when one individual is making the decision.⁴⁷⁷ Generally, provisions for a committee initially appoint specified individuals who then can select their own successors.⁴⁷⁸ Provisions also may require that the group consist of persons with specific qualifications or, if the powers are not sensitive ones from a tax or personal standpoint, the group can include family members.⁴⁷⁹

Some items to consider when comparing the two options with the client include the following:

- the settlor's desire to include his family in the decisions without bestowing total control or responsibility (oftentimes, one member of the trust committee is required to be the settlor's spouse or issue, giving them a formal platform for input which can be overruled by the majority;
- the settlor's desire to have a certain type of professional serve on the committee (e.g., attorney, accountant, or financial advisor));
- the availability and willingness of multiple persons to serve;
- whether the majority will rule or some actions will require unanimity;
- the settlor understanding that appointment of a committee can lead to delays in action to be taken on behalf of the trust, as well as slower responses to a beneficiary's or trustee's questions or concerns;
- increased complexity and cost concerns, especially when the committee members are entitled to fees, in addition to out-of-pocket costs, perhaps for meeting and travel expenses;
- the settlor's need for a greater system of checks and balances; and
- whether having a committee would better manage or curtail the litigation risks of all the appointed fiduciaries.⁴⁸⁰

476. See generally Gregory Wilcox, *Trust Protectors: The Underground Planning Technique*, NEALA NEWS (April/May 2014), https://www.naela.org/Public/Library/Publications/Publications_Main/NAELA_News_Archive/NAELA_News_2014/AprMay/TrustProtectors.aspx [http://perma.cc/2JFQ-8QKQ] (discussing the tax issues of a trust protector and explaining which individuals should serve as a trust protector).

477. See *id.*

478. See *id.*

479. See *id.*

480. See *id.*

V. CONCLUSION

Although the name given to a special purpose power holder may have a certain meaning to practitioners and another meaning to clients, what remains critical is providing clarity within the trust agreement as to the powers, duties, and liabilities for those appointed.⁴⁸¹ Equally essential is understanding the tax and non-tax advantages and pitfalls when sharing or dividing the trust's administration roles among the parties.⁴⁸²

481. *See supra* Parts III.A–B.

482. *See supra* Parts III.A–D.

