Estate Planning Insights

A Quarterly Publication of

Karen S. Gerstner & Associates, P.C.

Attorneys At Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
(713) 520-5205

Vol. 3, No. 4 October 31, 2006

A TRUSTEE'S DUTIES–PART ONE

In 2004, two sweeping new pieces of trust law were added to the Texas Trust Code: the Uniform Principal and Income Act and the Uniform Prudent Investor Act (sometimes referred to as the "UPIA" twins). We will highlight and discuss certain provisions of the UPIA twins in the second part of this series. Because so many of our clients are still very confused about trusts, however, the first part of this series will review the fundamentals of trusts.

PART ONE: SOME TRUST FUNDAMENTALS.

Many of our clients are already serving as the Trustee of a trust that is both "effective" and "funded". Some of our clients have been *appointed* as the Trustee of a trust but are not currently serving as the Trustee–they will serve as the Trustee of the trust some time in the future, when the trust becomes effective or is funded.

Serving as the Trustee of a trust is a very serious responsibility and should not be undertaken lightly. Clients who are appointing Trustees in their documents should consider whether the intended Trustees are capable of carrying out their duties. In addition, Trustees should hire competent advisors and agents to assist them in their duties if they are not fully knowledgeable about their duties and/or if they are not fully capable of performing all required duties on their own.

What is a Trust? A trust is a legal arrangement in which the ownership of "property" (meaning, in the legal sense, ***any type of asset***, not just real estate) is split into two parts: (1) the legal owner, which is the Trustee, and (2) the true or "equitable" owner, which is the beneficiary (or beneficiaries) of the trust. The Trustee holds legal title to the assets in the trust, but must manage those assets for the benefit of the beneficiary (or beneficiaries). The assets that "are held in" or "belong to" the trust are called the "principal" or "corpus" of the trust.

A trust is also a split of ownership among beneficiaries in terms of the time period of the beneficiaries' respective interests. All trusts have at least two beneficiaries from a "time" standpoint: at least one current beneficiary and at least one "remainder" (future) beneficiary. The current beneficiary is usually entitled to current distributions from the trust (which can be specified or unspecified amounts out of the income and/or principal of the trust, as necessary or advisable for certain purposes). The remainder beneficiary (who may also be a current beneficiary) of the trust is entitled to receive what remains in the trust when the trust terminates. A trust will terminate at a specified time, such as when the current beneficiary of the trust reaches a certain age or after a certain number of years have passed or upon the death of a specified current beneficiary. When the trust terminates, its assets are then distributed to the remainder beneficiary or beneficiaries of the trust (which can include new trusts).

A person can be both the Trustee (or one of the Trustees) of the trust and the current beneficiary (or one of the current beneficiaries) of the trust. That same person can also be the remainder beneficiary (or one of the remainder beneficiaries) of the trust. Such a person wears "different hats" with respect to the trust at different times, depending on what he/she is doing at the time. Just because it is permissible for a person to be both the Trustee and a beneficiary of the trust, however, does not mean that, when wearing his Trustee hat, he can act solely for his own benefit and ignore the interests of the other beneficiaries of the trust (this "problem" will be discussed in Part Two of this series).

When is a Trust Really Effective? Although many of our clients have provisions creating trusts in their Wills, these trusts are only "on paper" at the moment and are not yet effective. Some clients have chosen to place their estate plan in a Joint (or Individual) Revocable Trust ("Living Trust"), rather than in a Will. While the Living Trust itself is "in existence" once the trust instrument has been executed, it may be totally "unfunded" at this time (i.e., it may not have any assets in it yet), which means that there is no need for the Trustee to administer the trust yet. Further, the instrument creating the Living Trust may also create trusts for other people that are not yet effective (just like the trusts "set up" in Wills) because these other trusts are not scheduled to "take effect" until the creator of the Trust (called the "Trustor") dies.

Until a trust is both effective *and* funded, the Trustee of the trust has nothing to administer. The trusts that are

provided for in a Will, called "testamentary trusts", are *never effective* until the person who made the Will (called the "Testator" or "Testatrix") dies. It is permissible to name a trust that is created in a Will (i.e., a testamentary trust) as the beneficiary of assets that will be passing by beneficiary designation at the time of the Testator's death (such as life insurance, qualified retirement plans, IRAs and annuities), even though the testamentary trust is not yet effective, because it will *become effective* upon the Testator's death. Likewise, except for the Living Trust itself, which is currently effective if the trust instrument has been fully executed even if the trust has not yet been funded, the trusts created within the Living Trust document for persons other than the Trustor are not effective until the Trustor dies. Again, these trusts can be named as the beneficiary of assets that will be passing by beneficiary designation upon the Trustor's death even though they are not yet effective, because they will *become effective* at that time. However, **no assets should be titled in the name of these "effective after death" trusts now** because they technically do not yet exist.

Revocable and Irrevocable Trusts. Trusts that are created during the Trustor's lifetime can be called "inter vivos" trusts because they are valid trusts that are effective "during life" (to be distinguished from testamentary trusts that do not become effective until after the death of the Testator). Inter vivos trusts can either be revocable or irrevocable. A Living Trust is a revocable *inter vivos* trust because it can be completely revoked (and also just partially revoked and/or amended) by the Trustor while he/she is living. Almost all inter vivos trusts that are created to achieve tax benefits, however, are *irrevocable*, meaning that they cannot be revoked or changed once they are established. Some typical inter vivos trusts that are used for tax reasons and that are always irrevocable include Irrevocable Life Insurance Trusts (ILITs), Grantor Retained Annuity Trusts (GRATs), Charitable Remainder Unitrusts and Annuity Trusts (CRUTs and CRATs), "Crummey" Trusts or Gift Trusts, 2503(c) Trusts and "Intentionally Defective" Grantor Trusts (IDGTs). Trusts that are created in a Will (testamentary trusts) are always *revocable* while the Testator is still living and are always *irrevocable* once the Testator has died.

Provisions Adding Flexibility to Irrevocable Trusts. Provisions can be added to irrevocable trusts to make them more flexible. Flexibility is worth planning for when drafting a trust because many trusts will last for a long time (and it is hard to anticipate every possible change that might affect the trust when drafting the trust). Typical provisions included in irrevocable trusts to add flexibility include (1) Trustee appointment provisions and (2) "Powers of Appointment".

Trustee Appointment Provisions. Trusts often give someone (e.g., the current Trustee of the trust and/or the current trust beneficiary and/or a Trust Committee and/or the Trustee Appointer) the power to add, remove, change, appoint, and/or replace Trustees. A new Trustee may be needed due to the death, disability, or resignation of the prior Trustee. Certain trust beneficiaries may be given the right to become a Co-Trustee or the sole Trustee of their trust upon reaching a certain age. They may also be given the power to add additional Trustees to serve with them or with the other Trustee(s) of their trust. It is often a good idea to give someone the power to remove the Trustee so that a "bad" Trustee can be removed without court action. If the instrument creating the trust does not contain some "built in" mechanism for changing or appointing Trustees in the future, then the beneficiaries or acting Trustee of the trust may have to file a petition with the court, asking the court to appoint or remove a Trustee.

Powers of Appointment. Powers of Appointment are used to provide a particular beneficiary of a trust (the "power holder") with the means to make some substantive and/or administrative changes to an irrevocable trust. The Testator/Trustor includes these powers in the original instrument creating the trust. The power of appointment has to be exercised in the precise manner specified in the instrument that grants the power or it will not be effective.

The exercise of an *inter vivos* power of appointment results in changes to the trust that are effective immediately, while the exercise of a *testamentary* power of appointment results in changes to the trust that are effective upon the death of the power holder.

The type of power of appointment used may have tax consequences for the power holder. For example, if the power holder is given a *general* power of appointment over the trust (which allows her to appoint the trust assets to *anyone)*, the trust assets will be subject to estate taxes in the power holder's estate when she dies (whether she exercises the power or not). Usually, this is done intentionally, to avoid a more onerous tax that would otherwise apply (such as the Generation-Skipping Transfer Tax).

Powers of appointment can be very limited or very broad in terms of the potential beneficiaries to whom the trust assets may be "appointed". A *limited* (or special) power of appointment allows the power holder to change the beneficiaries otherwise provided for in the trust instrument to any one or more persons who are members of certain defined groups, such as the beneficiary's own "descendants" (i.e., his children, grandchildren, great-grandchildren, and so on), the descendants of the Testator/Trustor, spouses of descendants, and charities. A limited power of appointment can be very, very broad, if the Testator/Trustor desires, without constituting a *general* power of appointment for tax purposes. The broadest possible *limited* power of appointment allows the power holder to appoint the trust assets to anyone other

than the power holder himself, his estate, his creditors and the creditors of his estate.

Powers of appointment add flexibility because they enable the power holder to make changes to a trust based on changed circumstances. Powers of appointment are often used as part of the estate plan for married couples in a "nuclear marriage" (defined as a marriage in which the only children are the children of both spouses from that marriage). In a nuclear marriage situation, each spouse usually trusts the other spouse to make appropriate decisions with respect to the couple's mutual children after the first spouse has died. (Please note, however, that powers of appointment should probably not be used by couples in a second marriage because there is bound to be some conflict between the surviving spouse and the children of the deceased spouse.)

As an example of the usefulness of powers of appointment granted to spouses in a nuclear marriage, suppose that the Bypass Trust created upon the first spouse's death is to terminate on the death of the surviving spouse, and, at that time, the trust assets are to be distributed in equal shares to the couple's two children. Suppose further that, after the death of the first spouse, one child wins the lottery and the other child develops a debilitating illness. The surviving spouse can change the shares of the Bypass Trust assets passing to each child upon its termination by exercising her power of appointment over the Bypass Trust.

Powers of Appointment can be useful for fixing technical "problems" with a trust. Suppose that the share of a trust that will be distributed to a particular remainder beneficiary should instead be placed into a Special Needs Trust for that beneficiary when the original trust terminates. If the power holder has a typical power of appointment over the original trust, he can make that change through the exercise of his power. In addition, certain tax problems resulting from the way a trust has been drafted can sometimes be fixed through the exercise of a power of appointment.

Granting a current beneficiary of a trust who is also the Trustee of the trust a power of appointment over the trust can also protect that beneficiary/Trustee from "frivolous" lawsuits filed against him/her by other current beneficiaries and/or remainder beneficiaries of the trust. That is because the power holder can exercise his/her power of appointment over the trust to eliminate the "trouble maker" as a beneficiary of the trust. Thus, for example, if a particular child is giving Dad a hard time with respect to the way Dad is handling the Trust (and Dad really has done nothing wrong), Dad can exercise (or threaten to exercise) the power of appointment to "cut out" or reduce the share passing to the "problem child".

Of course, powers of appointment, like any tool, can be abused. A power of appointment should not be held as a hammer over the heads of trust beneficiaries who have legitimate complaints about the way the Trustee (who happens to be the power holder) is administering the trust. As another example, one child, knowing that Mom possesses a power of appointment over the Bypass Trust, may "unduly influence" Mom to leave the entire trust to her, to the exclusion of her siblings (who have done nothing wrong). Thus, persons who create trusts and include powers of appointment should evaluate the advantages and disadvantages of this tool in light of their own particular family circumstances.

When does the Trustee Start Administering a Trust?

A person who has been named as the Trustee of a trust begins to administer the trust once it is both *effective and funded* (even if only partially funded). If the trust is a *testamentary* trust, the Trustee will begin administering (handling) the trust once (1) the Testator's Will has been probated, (2) all Estate administration matters (including estate tax and related estate income tax matters) have been concluded, and (3) the Executor of the Estate has distributed to the Trustee the assets of the Estate passing to the trust per the terms of the Will (*see* our prior newsletters outlining the three parts of the post-death process, dated 7/31/04, 10/31/04, and 1/31/05). Thus, while testamentary trusts are effective upon death, it is usually quite awhile after death before they are funded.

If the Trustor of a Living Trust dies, assuming the Trustor was serving as the Trustee of his trust until his death, the issue of when the successor Trustee (the person appointed to take over as Trustee of the Living Trust when the Trustor dies) begins to act depends on whether the Living Trust was funded (i.e., had any assets in it) at the time of the Trustor's death. If the Living Trust was completely unfunded (i.e., it was just an empty "vessel", waiting to be filled with the Trustor's [probate] assets when he died [via his "pour-over Will"]), then the Trustee of the Living Trust will not have any assets to administer until the Executor is finished administering the Estate and the Estate assets are distributed to the Trustee for further handling in accordance with the terms of the Living Trust instrument (this is just like the testamentary trust case described in the previous paragraph).

If the Living Trust was "fully funded" prior to the Trustor's death (i.e., every single asset was already titled in the name of the Trust before the Trustor died), so that the Trustor's pour-over Will does not have to be probated to transfer his (probate) assets to the Trust, then the successor Trustee of the Living Trust must first administer the Living Trust as a post-death entity, exactly like an Executor administers an Estate, prior to distributing any assets to the post-death beneficiaries of the Living Trust (including any new trusts created in the Living Trust instrument, to be effective upon the Trustor's death).

In other cases, a Living Trust may be *partially* funded prior to death and/or the Living Trust may not have been funded prior to death but certain assets may be

passing directly to the Trustee of the Living Trust by beneficiary designation as a result of the Trustor's death. In these cases, the successor Trustee of the Living Trust must work with the Executor administering the Trustor's probate Estate (often the same person) to handle the post-death matters in a coordinated way prior to distributing the Living Trust assets to the beneficiaries (including new trusts created to be effective upon the Trustor's death). Only when the post-death matters have been concluded will the Living Trust assets be distributed to the beneficiaries, including any new trusts that were "set up" in the Living Trust instrument to be effective upon the Trustor's death. Once those trusts have been funded, the Trustee begins administering them per the document.

If the trust is an *irrevocable* inter vivos trust, as soon as the trust is established, the initial Trustee who is appointed in the instrument has duties with respect to that trust. If the trust is a *revocable* inter vivos trust, as soon as the trust is effective *and funded* with any assets, the Trustee's duty to administer the trust commences.

HOLIDAY SCHEDULE: The law firm will be closed on the following dates: 11/23, 11/24, 12/25-12/29, 1/1/07.

A LETTER TO ALL CLIENTS will be going out in early January to explain some new procedures and billing practices required by the firm's professional liability insurance carrier and/or required by new Texas law.

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

You can also reach us by e-mail addressed to:

Karen S. Gerstner*	karen@gerstnerlaw.com
Kathryn Miller Connelly	kathryn@gerstnerlaw.com
Nan Darby	nan@gerstnerlaw.com
Biljana Salamunovic	biljana@gerstnerlaw.com
General delivery	gerstnerlaw@yahoo.com

**Board Certified, Estate Planning & Probate Law, Texas Board of Legal Specialization*

KAREN S. GERSTNER & ASSOCIATES, P.C.
A Professional Corporation
Attorneys At Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448

Telephone (713) 520-5205
Fax (713) 520-5235

www.gerstnerlaw.com

PRSRT STD
U.S. POSTAGE
PAID
PERMIT NO. 600
HOUSTON, TX

CHANGE SERVICE REQUESTED

PRINTED ON RECYCLED PAPER

To download back issues and learn more about estate planning, visit our web site at www.gerstnerlaw.com