

ANALYSIS AND PLANNING FOR USE OF THE TRUST PROTECTOR

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The rapid evolution of modern trust law has made use of trusts more valuable and important as a means to control taxation, property, and rights and powers of creditors. However, the purposes of trusts and legal and tax issues have become more numerous and complicated. Consequently there are more areas where the relevant law is not settled. As a result, more trust drafting practitioners have determined that there is a need for the ability to modify the trust agreement. The modifications are desired in order to alter the powers and duties of the trustee and the rights of the beneficiaries to address changes in the law, either due to case law development or legislation. In addition, many trusts are drafted to exist a long time. Many states' rules against perpetuities have been extended for hundreds of years¹, or are infinite. In that period there will likely be facts that dictate the need for change of the trust and its function.

For either or both tax and creditor protection purposes the beneficiaries should not be empowered to make these changes. Likewise, the settlor and the trustee should not possess such powers. The settlor may have estate tax inclusion issues and perhaps creditor issues. The trustee, if a beneficiary, may have the same concerns.

Unique Role and Status of Trust Protector

Therefore there is a need for another to be able to act to fix things. That person is not intended to be responsible for the day to day functioning of the trust. Traditionally a person having powers to act for the trust has fiduciary responsibility. Therefore such person either acts at his peril or is spending his time following the activities of the trust and would have fees commensurate with those of a trustee. This is an unnecessary burden upon the trust. To avoid either result there had to be certainty that the person would be available, but not subject to fiduciary liability. For these purposes many states have enacted legislation to provide for this ability.²

¹ E.g., the current Arizona Rule Against Perpetuities permits vesting to be deferred for 500 years. ARS Section 14-2901, et.seq.

² E.g., Arizona's ARS Section 14-10818. Subsection D thereof provides in part: Any provision of this title to the contrary, but except to the extent otherwise provided by the trust instrument, a trust protector is not a trustee or fiduciary and is not liable or accountable as a trustee or

Other provisions of the Model Uniform Trust Code (“UTC”) support the settlor’s ability to draft a trust agreement to provide for the fiduciary free status of a Trust Protector. UTC Section 808(c) provides:

C. The terms of a trust may confer on a trustee or other person a power to direct the modification or termination of the trust.

D. Unless the trust instrument provides otherwise, a person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty.

The drafters of the UTC, the National Conference of Commissioner of Uniform State Laws, comment to UTC Section 808 further evidences the right of the settlor to eliminate the fiduciary duty of a Trust Protector (see **bolded** text below), even in absence of Trust Protector statutes, unless those statutes indicate fiduciary duties:

Subsections (b)-(d) ratify the use of trust protectors and advisers. Subsections (b) and (d) are based in part on Restatement (Second) of Trusts § 185 (1959). Subsection (c) is similar to Restatement (Third) of Trusts § 64(2) (Tentative Draft No. 3, 2001). “Advisers” have long been used for certain trustee functions, such as the power to direct investments or manage a closely-held business. “Trust protector,” a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust. Subsection (c) ratifies the recent trend to grant third persons such broader powers.

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The provisions of this section may be altered in the terms of the trust. See Section 105. A settlor can provide that the trustee must accept the decision of the power holder without question. **Or a settlor could provide that the holder of the power is not to be held to the standards of a fiduciary.** A common technique for assuring that a settlor continues to be taxed on all of the income of an irrevocable trust is for the settlor to **retain a nonfiduciary power** of administration. See I.R.C. § 675(4).

A recent New Hampshire Supreme Court decision confirmed the power of a settlor to provide for division of responsibility under New Hampshire’s version of UTC Section 808: *Shelton v Tamposi*, 2013 WL 132721 (N.H. S.Ct, 2013).

fiduciary because of an act or omission of the trust protector when performing or failing to perform the duties of a trust protector under the trust instrument.

However if the Trust Protector is not a fiduciary, then it could follow that the Trust Protector has no typical ancillary powers of a fiduciary. **Not being a fiduciary may mean the Trust Protector has no right to information or compensation as a fiduciary without providing for such specifically in the trust instrument.** Having been granted that pristine status means that a clean slate can be written upon to craft the precisely desired attributes of the Trust Protector. On the other hand, the Trust Protector may have been given the power to give itself the rights described above, or perhaps the trust could be decanted to so do.

Protect the Trust Protector or you won't get any knowledgeable ones. But consider giving the Trust Protector at least one restriction.

Sample for discussion of a Trust Protector exculpation clause:

To the greatest extent permitted by applicable law, the Trust Protector has no fiduciary or other duties, and has no duty or obligation to any settlor, trustee or beneficiary of a trust created under this instrument. No Trust Protector shall incur any liability by reason of any error of judgment, mistake of law, or action of any kind taken or omitted to be taken hereunder. In addition, the Trust Protector shall have no duty to supervise the actions (or inactivity) of any Trustee who serves hereunder. Each Trustee who acts under the provisions of this instrument shall serve subject any power of the Trust Protector to remove the Trustee if and to the extent as provided herein and each Trustee covenants not to sue the Trust Protector for any damages at law or to seek any injunctive or other equitable relief as a consequence of its removal by the Trust Protector. The Trust Protector is indemnified and held harmless by the trusts created under or pursuant to this trust instrument from and against all claims for all acts and failures to act as Trust Protector, including all costs and expenses and attorneys' fees incurred to defend against same. **Any provision in this Agreement and this paragraph to the contrary notwithstanding, the Trust Protector shall not, and shall not agree to, exercise or decline to exercise any power for consideration to or for the benefit of the Trust Protector or any person or entity**

Consider giving the Trust Protector at least two express rights and powers.

Sample for discussion of a Trust Protector rights clause:

The Trust Protector of a trust created under or pursuant to this Trust Agreement has the following powers and rights with respect to such trust:

- (a) To receive all information concerning any trust created under or pursuant to this Trust Agreement from the trustee or any other person as requested by the Trust Protector, provided that the Trust Protector shall have no duty to so do.

(b) To be compensated from a trust under the same standard as a corporate Trustee would be so compensated from the trust, and to be reimbursed from a trust under the same standard as a corporate Trustee would be so reimbursed from the trust.

Provide for Trust Protector Succession and Integrity.

None of the settlor, the trustee, or the beneficiaries should generally have authority to remove or appoint the Trust Protector. It is possible to give a Settlor a power to remove a Trust Protector and appoint a successor if the settlor is not and cannot become a beneficiary. To avoid retaining a power that could cause estate tax inclusion under Code Section 2036, the settlor cannot appoint a person who is related or subordinate to him under Code 672(c). Revenue Ruling 95-58, 1995-2 CB 191. Note that the ruling does not specifically address whether that power will not cause inclusion of the trust in the gross estate of the settlor under Code Section 2042 if the trust holds insurance on the life of the settlor. However the broad consensus, based upon some authority, is that the Settlor having that power with respect to an irrevocable life insurance trust will not alone cause a serious risk of estate tax inclusion.

Some clients are of a nature to worry about the power being held by someone with no fiduciary responsibility, although they are aware that such may be the requirement for one to act as the Trust Protector. Consider asking the client whether he or she wants a second system of Trust Protector who can fire and hire the Trust Protector, the “TP Protector.”

Reasons for a Trust Protector Statute are Numerous.

The primary purpose of a Trust Protector is to be able to make changes to an irrevocable trust without the need for extraordinary activity, such as court proceedings, or actions requiring the written consent of parties, sometimes many parties. However, the particular actions that a Trust Protector may take should be spelled out unambiguously. There are at least three significant reasons: income tax, asset protection for beneficiaries, and estate tax issues.

If the Trust Protector powers are intended to assist in asset protection of the trust against the creditors of a beneficiary, the Trust Protector may exercise powers to amend the trust to remove and replace a trustee. A purpose of the power is to address the situation of a trustee who may become subject to a court order constraining its actions, Another purpose of the power is to eliminate the right of a beneficiary to distributions that a trustee may otherwise become compelled to divert to others. These possible situations are reviewed in another written discussion by the author, “Creditor Protection Planning Techniques.”

Sample Trust Provision for Trust Protector.

Sample for discussion of a Trust Protector powers clause:

The Trust Protector of a trust created under or pursuant to this Trust Agreement has the following powers and rights with respect to such trust:

(a) To prevent a Beneficiary from acting as a Trustee of a Beneficiary Trust for the benefit of the Beneficiary and to prevent a Beneficiary from removing or appointing a Trustee of a Beneficiary Trust for the benefit of the Beneficiary.

(b) To remove and appoint Trustees of the trust, and to amend the Trust agreement to prevent or prohibit appointment of one or more persons or entities, or one or more classes of persons or entities, as Trustee.

(c) To terminate the trust if the Trust Protector determines in the Trust Protector's reasonable and not unlimited discretion that it is in the best interests of the beneficiaries of the trust to terminate the trust due to the political, economic, and social order, legislative and legal climate and factors, and the available suitable trust investments, and thereupon distribute the trust property as provided in [the applicable rule against perpetuities statute], as if required to be distributed by that Paragraph, such that the power to terminate is not unlimited.

(d) To amend this Trust Agreement to the extent necessary to cause one or more trust created hereunder to be or not be a trust taxable to a Settlor for purposes of Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of the Code.

(e) To amend this Trust Agreement to either or both (i) limit or expand the rights of parties to enter into nonjudicial settlement agreements binding upon the agreeing parties and (ii) to provide, in whole or in part as determined by the Trust Protector, that part or all of in [applicable nonjudicial settlement agreement statute] shall not govern, control, or apply to, this Trust Agreement and interested persons with respect to the trusts created under or pursuant to this Trust Agreement.

(f) To amend this Trust Agreement to require, or if required, to eliminate the requirement of, alternative disputes resolutions to provide mandatory, exclusive and reasonable procedures to resolve issues with regard to such matters of the administration or distribution of the applicable trust in accordance with and as provided in [applicable required arbitration statute] among such interested persons or trustees or both as the Trust Protector shall determine.

(g) To amend this Trust Agreement to permit, or if permitted to deny, the Trustee of a trust created under this Trust Agreement, in the Trustee's sole discretion, to reimburse a Settlor for income tax attributable to taxable income of the trust includable in the taxable income of the Settlor to the extent that the possession of such power by the Trustee will not alone (i) cause creditors of the Settlor to have any right to reach the trust

for satisfaction of claims against the Settlor or the Settlor's estate, or (ii) cause the assets of the trust to be includable in the Gross Estate of the Settlor for federal estate tax purposes.

(h) To amend this Trust Agreement to change the standard or right of distribution to one or more beneficiaries to provide that such distribution shall be further limited or reduced or eliminated for such period or periods as the Trust Protector shall determine in the sole unfettered uncontrolled discretion of the Trust Protector.

(i) To amend this Trust Agreement to limit, suspend, or eliminate a general or limited power of appointment.

(j) To amend this Trust Agreement to reduce or eliminate the power of the Settlor to acquire property of a trust by substituting property.

(k) To amend this Trust Agreement to reduce or eliminate the power of the Trustee to apply income to the payment of premiums of policies of insurance on the life or lives of one or more of the Settlers or spouses of the Settlers.

(l) To amend this Trust Agreement to reduce or eliminate one or more of the powers of the Settlor to remove, replace, or appoint Trustees.

(m) To act to revoke, modify or undo, in whole or in part, one or more actions of the Trust Protector, except to the extent the Trust Protector has expressly provided that this power shall not apply to an action of the Trust Protector.

Care and Feeding of a Trust Protector.

It is critical to have a person acting as Trust Protector be someone who is trusted, but who doesn't have to be on the clock keeping up with the activities of the trustee and the trust, without the risk of liability as a trustee for negligence or other actionable claims for not paying attention. It is typically envisioned that the Trust Protector is as a relief pitcher, not even in the bullpen, or even in the ballpark, but who can be called upon at a point when his judgment and power may be needed. It is possible that the Trust Protector is not even aware of his status, and in fact is not clothed with that title until acceptance. Some trust agreements provide for the office, but have not provided for a specific party. In those instruments the initial power to appoint the Trust Protector may be a third party or, in a pinch, a trustee or the settlor, with Revenue Ruling 95-13 in mind.

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