THE USE OF TRUSTS

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for

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A "Trust" (Restatement (3d) of Trusts §2) [p. 1*]

"**A trust** … is a **fiduciary relationship** with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who **holds** title to the property to **duties** to deal with it **for** the benefit of charity or **for** one or more persons, at least one of whom is not the sole trustee."

- Thus, a trust is administered **by** the trustee (or trustees) **for** the beneficiaries.

* Page numbers [in square brackets] refer to "The Use of Trusts," the written outline for the Institute.

Trusts in England [pp. 1-2]

Franciscan Friars of the 13th Century [p. 1]

- Were prohibited from owning land.
- A “feoffee” could **hold** title to land “**for** the **use** of” a Friar as the “cestui que use.”
- The Chancellor, as “the keeper of the King’s conscience,” enforced a feoffee’s loyalty and **duties** to the “cestui que use.”

The Developing Uses of Uses [pp. 1-2]

- Use for noncharitable successors could avoid “feudal incidents” upon transfer at death.
  – Crops.
  – Service of knights.

- And provide donative freedom and bypass primogeniture.

- A “committee” of feoffees could ensure continuity.

The Statute of Uses (1535) [p. 2]

HENRY THE EIGHTH

(Reigned 1509-1547)

- The Statute of Uses "executed" (collapsed) uses.
  - Like the property had never been in trust at all!
- Lawyers found workarounds.
  - *E.g.*, "active uses."
  - The Chancellor supported them.

Legacy [p. 2]

ELIZABETH THE FIRST

(Reigned 1558-1609)

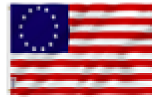
- The Statute of Charitable Uses (1601).
- Foreshadowed section 501(c)(3) of the Internal Revenue Code.

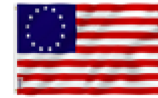
Trusts in America [pp. 2-3]

Origins and Distinctions

GEORGE THE THIRD

(1760-1820)





FREE AND INDEPENDENT STATES

- But the law remained English.
- Rugged Individualism and Donative Freedom thrived.
- And so did the modern "feudal incidents" of taxation!
- And property became more than land.

Queen Charlotte of Mecklenburg-Strelitz

The Modern "Feudal Incidents" of Taxation

- Federal estate tax (1916).
- Federal gift tax (1932).
- Federal estate tax and gift tax integrated (1976).
- Federal GST tax (1976 and 1986).
  - Like the property had never been in trust at all!

“A Quiet Revolution” [pp. 3-21]

Uniform Prudent Investor Act (UPIA) (1994) [pp. 4-5]

- Standard of prudence applied to entire portfolio ("modern portfolio theory" – "total return" – "balance").
- No categorically prohibited investments.
- Diversification integrated into prudent investing.
- Delegation of investment and management functions permitted.
- **Expanded discretion … Expanded responsibility.**

Revised Uniform Principal and Income Act (RUPIA) (1997) [pp. 5-6]

- Addresses the tension between total return investing and distribution standards.
- Section 104 allows “adjustments” between income and principal **if**:
  - The trustee invests as a prudent investor.
  - Distributions are limited with reference to “income.”
  - Impartiality is therefore **impossible**.
- Provides a list of nine “factors” to consider.

Uniform Fiduciary Income and Principal Act (UFIPA) (2018) [pp. 6-9]

- Section 203 detaches the power to adjust from distribution standards.
  - If the adjustment "will **assist** the fiduciary to administer the trust or estate impartially."
  - With 11 factors to consider.
- Article 3 permits conversion to a "unitrust" [pp. 7-9]
  - Current **"income"** is defined as a percentage of the value of the trust assets.
  - Thus current and successive beneficiaries have a "**unity** of interest" in a "**unified** fund."
  - Respected by the IRS, with limitations (*e.g.*, 3-5% unitrust rate), in Reg. §1.643(b)-1 (2003).

Uniform Trust Code (UTC) (2000) [pp. 9-11]

- Court supervision as the exception, not the norm.

- "Virtual representation" of minors, etc. (Section 304).

- Nonjudicial settlement agreements (Section 111).
  - Must not "violate a material purpose of the trust."
  - A "spendthrift" provision is not a "material purpose of the trust" (Section 411(c)).

- Hint of role for a "trust director," without using the term (Section 808).

Uniform Directed Trust Act (UDTA) (2017) [pp. 11-12]

- Formalizes the role of a “trust director.”
- Confirms the **duty** and **liability** of a trust director, matching those of a trustee (Section 8).
- Requires a directed trustee to comply with a trust director’s direction, unless compliance would be **willful misconduct** (Section 9).

Trust Decanting [pp. 12-21]

- *Phipps v. Palm Beach Trust Co.* (Fla. 1940) [p. 12]:
  - "[T]he power vested in a trustee **to create an estate in fee** includes the power to create or appoint **any estate less than a fee** unless the donor clearly indicates a contrary intent."

- **Compare** *Wiedenmayer v. Johnson* (N.J. 1969) [p. 12]:
  - "If [trustees] could make [a] distribution to the end, as the trust indenture expressly stated, that the trust property would be the son's '**absolutely, outright and forever**,' it seems logical to conclude that the trustees could, to safeguard the son's best interests, **condition the distribution upon his setting up a substituted trust**."

Decanting (continued)

- *Morse v. Kraft* (Mass. 2013) [pp. 13-14]:
  - Authority to make distributions "**for the benefit of**" beneficiaries is "evidence of the settlor's intent that the disinterested trustee have the authority to distribute assets **in further trust** for the beneficiaries' benefit").
- **Contrast** *In re Estate of Spencer* (Iowa 1975):
  - A testamentary power of appointment authorized to be exercised by **life estates for children** with the remainders to children's surviving issue could **not** be exercised in favor of **a multi-generation trust that vested later than the children's deaths**).
- New York enacted the first decanting **statute** in 1992.

Decanting and the IRS

- The IRS ruled on decanting, without necessarily calling it that, in rulings from 1993 to 2011 [pp. 15-18].
- Since 2011, decanting has been on a no-rule list [p. 18].
- IRS Notice 2011-101 asked for comments on decanting [pp. 18-19].
  - Also asked for a "definition" of decanting [p. 19].
- Section 19 of the **Uniform Trust Decanting Act (UTDA) (2015)** specifically guards against jeopardizing tax benefits through a decanting [pp. 19-20].
- IRS disallowed an estate tax deduction for transfers to charities under a power of appointment enlarged by a decanting. *Horvitz v. Commissioner* (2023) [pp. 20-21].

Talking to Families About Trusts

Views of Wealth Can Reflect Views of Life [pp. 21-22]

- Someone who is **self-centered** may be concerned with possession, enjoyment, and **control**.
- Someone who is **others-centered** may be concerned with stewardship, service, charity, and **values**.

- Put another way:
  - **Creating** wealth involves entrepreneurship and innovation.
  - **Sharing** wealth involves values, gratitude, and generosity.
    - All anyone has is a life estate!

- **So talking to families about wealth necessarily involves (or should involve) discussion of all these concepts, including transferable family values.**

And Views of Wealth Can Influence Views of Trusts [pp. 22-23]

- **Control** begs to be **kept**; **values** beg to be **shared**.
- **Sharing** involves roles for younger generations:
  - Co-trustees.
  - Trust directors.
  - Family "governance" and meetings.
  - Officers of a private foundation.
  - Even donees of outright gifts.

Core Elements of a Modern Trust

The Ability to Change

The Ability to Challenge

The First Core Element:
The Ability to Change [pp. 23-26]

Challenges for a Long-Term Trust from Changes in Family and Legal Environments

- Repeal or relaxation of the Rule Against Perpetuities.

- Proliferation of the family line.
  - Dispersion, demographics, diversity, dissent.

- Evolving understandings of "issue" (*e.g.*, assisted reproductive technology), "spouse," etc.

- One constant: The grantor **chose** the **trust form**.
  - And **trust law** permits **change** – within limits.

The Second Core Element:
The Ability to Challenge [pp. 27-46]

Prelude and Reprise – Henry's Revenge: The Influence of Tax Law [p. 23]

- Income tax treatment of a trust requires that "the beneficiaries not, **qua beneficiaries**, control trust affairs."
  Bedell Trust v. Commissioner, 86 T.C. 1207, 1220 (1986)
- Or else the "trust" may be taxed as a partnership.
  Reg. §301.7701-3(b)(1)(i)
- A trust must be administered
  - **by** the trustee
  - **for** the beneficiaries.

A "Trust" (Restatement (3d) of Trusts §2) [p. 27]

"**A trust** … is a **fiduciary relationship** with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who **holds** title to the property to **duties** to deal with it **for** the benefit of charity or **for** one or more persons, at least one of whom is not the sole trustee."

- Thus, a trust is administered **by** the trustee (or trustees) **for** the beneficiaries.

Threats to Fiduciary Duty?

- Exculpation [p. 27]? UTC §1008(a) (2000):

  "A term of a trust relieving a trustee of liability for breach of trust is **unenforceable** to the extent that it (1) relieves the trustee of liability for breach of trust committed **in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries**; or (2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor."

  – **Not strict liability… But not total exculpation.**

- Dividing fiduciary roles [pp. 11-12, 28-29]?
  – Allocating fiduciary duty:
    - **Upstream** – in director, or
    - **Downstream** – in trustee.

From Judge Learned Hand [p. 30]

"[N]o language, however strong, will **entirely** remove any power held in trust from **the reach of a court of equity**. After allowance has been made for every possible factor which could rationally enter into the trustee's decision, if it appears that he has **utterly disregarded** the interests of the beneficiary, the court will intervene. Indeed, were that not true, **the power would not be held in trust at all**; the language would be no more than a precatory admonition."

Stix v. Commissioner (2d Cir. 1945)

Two Components of the Ability to Challenge

Access to Information

Access to a Forum

Beneficiaries' Access to Information [pp. 30-35]

- Section 813(a) of the Uniform Trust Code (2000):

  "A trustee shall **keep the qualified beneficiaries of the trust reasonably informed** about the administration of the trust and of the material facts necessary for them to protect their interests. Unless unreasonable under the circumstances, a trustee shall **promptly respond to a beneficiary's request for information** related to the administration of the trust."

- But the provision is not "mandatory"!
- North Carolina enacted the UTC without that provision.
- *Wilson v. Wilson* (N.C. App. 2010):

  Two 1992 trusts purported to relieve the trustee of any duty to give accounts or reports to any beneficiary.

North Carolina Court of Appeals [pp. 32-33]

"[T]he beneficiary is always entitled to such information as is reasonably necessary to enable him to enforce his rights under the trust or to prevent or redress a breach of trust …

"If a fiduciary can be rendered free from the duty of informing the beneficiary concerning matters of which he is entitled to know, and if he can also be made immune from liability resulting from his breach of the trust, equity has been rendered impotent. The present instance would be a **humiliating example of the helplessness into which courts could be cast** if a provision, placed in a trust instrument through a settlor's mistaken confidence in a trustee, could relieve the latter of a duty to account. Such a provision would be virtually a license to the trustee to convert the fund to his own use and thereby terminate the trust."

- **The court got it right.**

Beneficiaries' Access to a Forum [pp. 35-46]: No-Contest (*In Terrorem*) Clauses [pp. 35-40]

- *Callaway v. Willard* (Ga. Ct. App. 2013) [p. 35]:
  - "**Not favored** in the law."
- *Hamel v. Hamel* (Kan. 2013) [p. 36]:
  - **Invalid if probable cause** ("the existence, at the time of the initiation of the proceeding, of evidence which would lead a reasonable person, properly informed and advised, to conclude that there is a substantial likelihood that the contest or attack will be successful").
  - The court found probable cause ("The beneficiary relied upon the advice of disinterested counsel sought in good faith after a full disclosure of the facts.")
  - At least a portion of the challenge was successful.
  - **This court also got it right.**

A More Cautious Approach: A “Test” Lawsuit

- *Hunter v. Hunter* (Va. 2020) [pp. 36-37]:
  - Count I: Whether Count II is a “contest.”
  - Count II: Determination of rights of beneficiaries (“if, and only if” the answer to Count I is no).
  - Held: “Test” does not trigger no-contest provision.
- *Knopik v. Shelby Investments* (Mo. 2020) [p. 37]:
  - Missouri statute allowed a “test” lawsuit.
  - Beneficiary simply alleged a breach of trust.
  - Held: Statute didn’t help.

Some Surprising Results

- *Gowdy v. Cook* (Wyo. 2020) [pp. 15 & 37]:
  - Court viewed a beneficiary's attempt to change the trustee's qualifications by decanting as an attack on the trust sufficient to trigger a no-contest clause.
- *Strom Irrev. Trust III* (N.Y.Surr.Ct. 2022) [pp. 38-39]:
  - Court viewed questioning whether decedent had effectively transferred her dwelling to a trust as an attack on the trust triggering a no-contest clause.
- *Giller v. Slosberg* (Ga. Ct. App. 2021) [p. 39]:
  - Appellate court held that a no-contest clause applied to bar a contest even though a jury had held for the beneficiary on the merits!
  - But the Georgia Supreme Court reversed (2022).

Beneficiaries' Access to a Forum (cont.): Mandatory Binding Arbitration [pp. 40-46]

- Allowed by statute, for example, in Arizona, Florida, Kansas, Missouri, Nevada, Ohio, and South Dakota.
- Questionably allowed in *Rachal* (Tex. 2013) [pp. 40-41]: Grantor's son sued successor trustee (the **lawyer** who drafted the trust), for **misappropriation of trust assets**.
  - Lawyer/drafter/trustee moved to compel arbitration.
  - Trial court said no; appellate court affirmed.
  - The Texas Supreme Court reversed, stating that:
    - Texas Arbitration Act requires "agreement," such as **accepting rights under the terms of the trust**.
    - "Federal and state policies favor arbitration," citing two cases involving **commercial transactions** and one in which the parties had **agreed** to arbitration.

Boyle v. Anderson (Va. 2022) [pp. 41-43]

- "Access **to the courts** to seek legal redress is a constitutional right" under the Virginia constitution.
- "[A] party cannot be compelled to submit to arbitration unless he has first **agreed** to arbitrate."
- The Virginia Uniform Arbitration Act (VUAA) "establishes a public policy in favor of arbitration," **but**
  - "**A trust does not qualify as a contract or agreement**. Trusts are generally conceived as donative instruments."
  - Unlike a trustee, "[n]o rule prevents parties to a contract from acting freely for their own interests."
  - Trustee has legal title; beneficiary equitable title.

Estate of Hekemian (N.J. Sup’r Ct. 2022) [pp. 43-44]

- “The affirmative policy of the state of New Jersey **favors arbitration**.”
- “A hallmark principle … is that **a testator’s intentions** are to be honored and effectuated.”
  - And the testator’s will mandated arbitration.
- “Plaintiff cannot be compelled to arbitrate because

  (1) the will is **not a contract** between two parties in the traditional sense and

  (2) the benefits of the will have not extended to the Plaintiff based on the ‘traditional principles of contract and agency law.’”

Arbitration and the IRS [pp. 44-45]

- In PLR 201117005, the IRS was wary, but reserved judgment until an actual arbitration, to see if it would be "based on an enforceable right under state law properly interpreted."
- In CCA 201208026, the IRS ignored *Crummey* powers enforceable only in an Orthodox Jewish beth din (which the CCA referred to as an "Other Forum").
  - In *Mikel v. Commissioner* (2015), the Tax Court disagreed and respected the *Crummey* powers.
- Isn't a beth din a forum? Isn't arbitration a forum?
  - But a parallel path to court may still be prudent, to preserve the trust as a trust.

The Model of a Trust Relationship [p. 47]

- **Trusting**: Administered by the trustee **for** the beneficiaries.
- **Transitory**: Humble and flexible.
- **Truthful**: Moderate and honest. Disclosure helps. Beware of aggressive approach that overlooks "trusting" aspects.
- **Teaching**: An occasion for discussion and mentoring.
- **Tax-Smart**: No shame in preserving tax benefits.

Questions and Comments?

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