A Primer on Trust Administration

By Harry S. Margolis

I. What is a trust?

A trust is a way of holding property, whether real estate or investments, where one or more people - the "trustees" - manage the property for other individuals - the "beneficiaries." The trust document lays out the ground rules that the trustees must follow in carrying out their responsibilities. It governs the circumstances under which they may make distributions to others, their investment options, their accounting responsibilities, and the tax treatment of the trust.

All trusts have at least three "players," the "grantor" who creates the trust, the "trustee" who runs it, and the "beneficiaries" for whom the trust is created and managed. Often the same person fills more than one of these roles.

But the trust document only tells part of the story. Both state statutes and case law also govern trusts and how they are interpreted. For instance, they set out standards for investments and for the duty trustees owe to beneficiaries. The latter is called a "fiduciary" duty, which means that trustees must always act in the best interests of the beneficiaries and are held to the highest standard of probity and fair dealing.

II. Types of Trusts

Since every attorney or law firm creates their own forms and tailors them to meet the needs and goals of each client there are as many types of trusts as there are attorneys and clients. However, trusts can be classified in a number of broad, and sometimes overlapping, categories.

A. Revocable vs. Irrevocable

Trusts are either revocable, meaning that they can be changed by grantor, or irrevocable, meaning that after they are set up they cannot be changed (at least for the most part). Revocable trusts are sometimes referred to as "living" trusts and are often created to avoid probate, to manage assets, and to avoid taxes. In many cases, the grantor also acts as trustee and as the primary beneficiary during her life and as long as she is competent.

Irrevocable trusts are more often used for tax, asset protection, and long-term care planning purposes. In most cases, the grantor does not act as the trustee of an irrevocable trust. While irrevocable trusts cannot be changed in most instances, sometimes flexibility is created by permitting the trustee or someone acting in the role of "trust protector" to make limited changes in the trust document as necessary, for instance, to respond to changes in the law.

Revocable trusts generally become irrevocable upon the death of the grantor, since only the grantor has the right to revoke or amend trusts he creates. This can create some confusion since the trust may still be called “The John B. Grantor Revocable Trust” even though it’s not irrevocable.

B. Self-Settled vs. Third-Party

Another way to classify trusts is whether they were created and funded with the beneficiary's money – self-settled -- or by someone else to benefit the beneficiary – third-party. The distinction can be very important in special needs trusts and for creditor protection purposes, as well as for the tax treatment of the trust in certain circumstances.

C. Special Needs Trusts

Special needs trusts are designed to protect assets for individuals with disabilities both so that the trust funds can be well managed and so that the beneficiary will be able to qualify for public benefits, such as Medicaid, Supplemental Security Income (SSI) and subsidized housing. If the trust is funded with the beneficiary's own funds -- a self-settled trust -- then it generally must meet some very specific legal criteria to qualify under Medicaid and SSI. Generally, these trusts are known as "payback" or "(d)(4)(A)" trusts, the first name referring to the requirement that Medicaid be reimbursed upon the beneficiary's death and the second name referring to the authorizing statute.

Trusts created and funded by others, often parents or grandparents -- third-party special needs trusts -- are not as restrictive as self-settled special needs trusts and do not have a Medicaid payback requirement. This means that if funds remain upon the death of the primary beneficiary, they can pass on to other family members as directed by the grantor.

In most instances, both self-settled and third-party special needs trusts are irrevocable.

D. Family Protection Trusts

It's possible to place money in trust to protect it from creditors or from divorce, and to make certain that it stays in the family. If you create a creditor-protection trust for yourself, you must either limit your access to the principal or use a bank in a state, such as New Hampshire or Rhode Island, that has passed a statute permitting self-settled creditor protection trusts.

The law is much more liberal regarding protections in trusts that one person creates for another. Parents can create trusts for the benefit of their children and grandchildren that permit access to principal but still protect it from creditors or in the event of divorce or lawsuit. These trusts, which we call "family protection" trusts also make sure that the funds pass to grandchildren or back to other family members in the event of the death of a child.

III. The Role of the Trustee

Individuals or institutions such as banks and trust companies may serve as trustee. The trust may have a single trustee or two or more co-trustees. The trustee or trustees manage the trust. This means that they take charge of trust property, whether investments or real estate, and manage it on behalf of the trust beneficiaries. The trustee must take even more care than they would with their own property. If you neglect your own investments, you have only yourself to blame. If you neglect trust investments, you could be legally liable to the beneficiary for any losses that result.

As mentioned above, the trust document is in effect an instruction manual for the trustee. It describes what the trustee may and may not do and what they must do. It lays out the terms for making distributions to beneficiaries as well as accounting to them. It also states who may remove trustees, how the trustee may resign, and who can name new trustees if there's a vacancy. All trustees should start by reading the trust thoroughly and asking the granter or the drafting attorney about any questions they may have.

IV. Distributions

As stated above, the standards for making distributions to beneficiaries are set out in the trust document. Most trusts, however, give little guidance and leave distribution decisions to the discretion of the trustee. This leaves the trustee the responsibility of weighing the current and future needs of the lifetime beneficiaries as well as the interests, if any, of those who would take the trust property upon the death of the current beneficiaries.

This can often mean that the trustee must make difficult decisions, especially when trust funds are limited. Should the trustee simply figure out the life expectancy of the beneficiary and limit distributions to amounts that would guarantee that the trust would last throughout out the beneficiary's lifetime? The answer is no, since it would be simpler, and in many cases cheaper, to purchase an annuity if this was all that was required.

The trustee, instead, must use their judgment in weighing current and future needs. For instance, it may make sense to spend larger amounts while the beneficiary is young to pay for education and tutoring, if that will enable the beneficiary to be self-supporting in life and have less need to rely on the trust funds in the future. This may be seen as an investment.

On the other hand, if the "investment" doesn't work out, overspending could leave the beneficiary destitute later in life. The bottom line is that there is no definite, single distribution rule. However, the trustee is unlikely to be challenged successfully if they diligently consider the beneficiaries' needs and make reasoned decisions. Even if the beneficiary disagrees, courts will defer to the trustee chosen by the granter since the grantor in effect delegated their decision making over the trust to the trustee.

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V. Investments

A. Prudent Investment

Trustees must invest trust property in the same fashion as a "prudent" investor. In short, this means that the investments must be conservative, but not too conservative. As trustee, you cannot invest in your nephew's new restaurant. You must invest in the stock of well-established companies and in investment grade bonds and U.S. Treasury notes. Your investments must be diversified, meaning that the trust portfolio must have both stock and fixed income holdings and that it must not be too concentrated in the stock of a single company or even of a particular industry.

You may ask whether it would be safer to simply invest in highly secure bonds so that the trust portfolio has no risk of loss. Historically, however, stocks have out-performed bonds over time. Your job is not simply to preserve the trust principal but to seek to preserve its buying power. If you simply preserve the capital, the trust's buying power will be eroded by inflation.

While, as they say, the past is no guarantee of future performance, with a well-diversified portfolio you will not have all of your proverbial eggs in one basket. You will limit your risk. As trustee you must minimize risk while seeking moderate growth.

B. Home Ownership

In some cases, as trustee, you may determine that the needs of the trust beneficiaries trump the usual rules governing investments. This comes up most often around the decision as to whether the trust should purchase a home for the beneficiaries. Most trustees are reluctant to own real estate due to the work involved in maintaining the property and the potential liability involved. If a beneficiary needs trust funds to purchase a home, in most cases it makes the most sense to simply distribute to the beneficiary enough funds to purchase the home or make a down payment herself.

The two situations where trusts are most likely to purchase or continue to own real estate involve vacation homes and special needs trusts. Families often use trusts to hold title to vacation homes and to create a set of agree on rules for sharing and maintaining the property.
Special needs trusts often hold title to homes in order to maintain eligibility for public benefits, to avoid a state claim against the home at the death of the beneficiary, and for management purposes. In both of these situations, the trust instrument may provide specifically for home ownership overriding the trustee's usual obligation of prudent investment.

In some instances, rather than owning the home directly, the trust may lend money to a beneficiary or their family for purposes of buying the property. If secured by a mortgage, the trust's interest will be secure and the trustees will not have to deal with the headaches and risk of owning property. In Massachusetts, trusts also sometimes use nominee realty trusts with the beneficiaries holding title on behalf of the trust. Through this mechanism, the trustees of the nominee trust have the responsibility of day-to-day management of the property.

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C. Family Business

Another situation where a trust may be overly concentrated in a single holding occurs when it owns stock in a family-owned business. There may be no ready market for the shares or the family may want to maintain control over the business rather than selling shares to third parties. In these cases, it is preferable that the trust instrument be specific about continued ownership of an interest in the family business. Absent such terms, the trustee should seek to sell at least some of the concentrated holding in order to diversify the trust portfolio.

VI. Accounting

As with other trustee requirements, the trust document will lay out the requirements for accounting. State law also requires annual accountings of trust activities to all current (as opposed to future) beneficiaries. Historically, professional trustees have kept separate accounts for trust income and trust principal. This is because trusts often had separate beneficiaries for income and principal. For instance, the income may be paid to the grantor's children for their lives with the principal passing to the grandchildren upon the death of the last surviving child.

Where there's no such distinction among beneficiaries, this can make formal trust accounts difficult to read since they not only account separately for income and principal but may show transfers from the income account to the principal account.

Family member trustees are less likely to be so formal and traditional in their accountings. If they manage all of the trust assets through a single investment account, they can simply share the year-end statement with the beneficiaries on an annual basis. If they keep a clear checkbook register showing and explaining all disbursements, they will be able to answer any questions that may arise.

VII. Taxes

Most revocable trusts use the grantor's Social Security number on accounts and do not need to file a separate tax return. Most irrevocable trusts need to obtain their own tax identification numbers and file their own tax returns on IRS Form 1041. If the trust maintains a single investment account, this can be a relatively simple process

If the grantor of a revocable trust is not also acting as a trustee, the trust must also obtain its own tax identification number and file an informational return. However, all the income will continue to be taxed to the grantor.

In the case of irrevocable trusts, the tax liability follows the income. To the extent that the trust distributes income to one or more beneficiaries, these distributions are deductions on the trust's tax return. The trust must provide the beneficiaries who receive income with a K-1 form reporting the income. This has a similar effect to a Form 1099 and must be reported on the beneficiary's tax return.

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To the extent an irrevocable trust retains income, it is liable for the taxes. Trusts have a much more accelerated graduated tax than individuals, so trust income can be subject to a higher tax rate. However, if the trust is not earning very much income, it may still be subject to a lower rate, depending on the income of the beneficiaries. In some instances, trustees will take the tax differential into account in making distributions.

Unlike individuals, most irrevocable trusts do not qualify for a personal exemption. The one exception to this rule applies to certain special needs trusts.

VIII. Miscellaneous Provisions

A. Powers of Appointment

Many trusts permit beneficiaries to direct where the trust property will go when they pass away through a so-called "power of appointment." Typically, the beneficiary must exercise the power of appointment in his will, directing who will receive the trust property at his death. These are known as "testamentary" powers of appointment. The trust grantor often restricts this power, permitting the beneficiary to direct the trust property only to their descendants and spouses, or to charitable organizations.

Typically, trusts do not depend on the power of appointment for final distribution of the trust property. The trust sets out who will receive the trust property. But the power of appointment permits a beneficiary to alter the ultimate recipients if appropriate.

This adds flexibility to the trust without giving the beneficiary carte blanche over the ultimate distribution of the trust assets. Flexibility is important because the trust may not end until many decades after it was created by the grantor and it's impossible to predict the family's circumstances so far in advance.

B. Trust Protector

Increasingly, trusts include a role known as trust "protector" to watch over the shoulders of the trustees. Coming from the world of off-shore trusts used by rich people for asset protection, trust protectors have become common in special needs trusts where the beneficiary often needs as much protection as possible. Often the role consolidates functions already typical of trusts, such as the right to hire and fire trustees and to review accounts. While beneficiaries often have these powers, a beneficiary with special needs may not be able to fulfill these functions themself, making it appropriate and necessary to bring someone else into this role.

It's not unusual in the case of a special needs trust to use a professional trustee, such as a bank, trust company or law firm, so as not to burden or depend too much on family members.
But one or more people in the family, while not having the time or expertise to act as trustee, may look out for the beneficiary by acting as trust protector.

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If you would like more information about trusts and their administration, read Harry S. Margolis's book, *The Baby Boomers Guide to Trusts: Your All-Purpose Estate Planning Tool,* available on Amazon here: *https://www.amazon.com/Baby-Boomers-Guide-Trusts-All-Purpose/dp/1733931066*

So, You've Been Appointed Trustee: What Now?

Whether it's an honor or a burden (or both), you have been appointed trustee of a trust. What responsibilities have been thrust upon you? How can you successfully carry them out?

Here are some dos and don'ts to get you started:

1. **Do** read the trust document. It sets out the rules under which you will operate. So you need to understand it completely.

2. **Do** create a checking account for the trust. All income and expenses should go through this account. While you can and should invest the money, a checking account will enable you to make distributions and payments and keep track of them.

3. **Do** keep the best interests of the beneficiaries in mind at all times. You have what's called a "fiduciary" duty to them, which is the highest standard imposed by law.

4. **Don't** have any personal financial dealings with the trust. For instance, you cannot borrow money from the trust or lend the trust money to anyone.

5. **Do** provide the beneficiaries and anyone else indicated in the trust with an annual account of trust activity. This can be a copy of the checking and investment account statements or a more formal trust account prepared by an accountant or attorney.

6. **Do** invest the trust funds prudently and productively. You cannot simply leave the trust funds in a savings account. And you can't put them all into a promising new company. You need to diversify the trust portfolio among stocks and fixed income securities. It is wise to get professional investment advice.

7. **Do** keep in regular contact with the beneficiaries to understand their needs.

8. **Do** be aware of any public benefits the beneficiaries may be receiving and make sure you do not jeopardize the beneficiaries' eligibility.

9. **Do** file annual income tax returns for the trust.

10. **Don't** fly solo. Get professional advice to make sure you are correctly fulfilling your role.

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