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Administering Stand Alone Trusts:

Differences and Similarities to the Pooled Trust and the Many Considerations in Between

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I. Introduction

The need for the specialized and vital Special Needs Trusts (SNT) services provided by non-profit organizations has always been present. Institutional, or "bank," trust companies that typically focus on generational wealth administration may lack the expertise in public benefits regulations to properly administer SNTs and, as such, may retain the advisory services of companies well-versed in public benefits. This approach is more expensive for the trust, thus potentially shortening the trust's lifespan. The additional oversight, knowledge, liability, and time required to properly administer an SNT generally translates into more trust administration overhead when compared to non-SNT trust administration. As such, many financial institutions are raising minimum account sizes (and fees), scaling back trust offerings, consolidating operations, trimming costs, transitioning trust accounts to successor fiduciaries, and reducing perceived liabilities.

According to an August 27, 2019, Wealth Advisor article by Scott Martin, just a "no-frills [trust] account…[is] probably going to cost at least $3,000 a year." [Martin, Scott. "Who's Charging What for Trust Services?" *Wealth Advisor*, 27 Aug. 2019] In the article, Mike Flinn, a Phoenix-based trust consultant, notes that a $2,500 annual minimum fee may work, "but at that level, it's going to be very difficult to stay in the business." Larger bank trust companies that cater to high-net-worth individuals and families often have minimum annual fees as high as $20,000. However, while a $20,000 annual minimum fee on its face appears to be quite high, it makes sense when an institution's minimum account size is $5 million in investable assets. At that size, the $20,000 minimum fee only equates to 40 basis points (or 0.40%) per year.

Institutional fiduciary fees are also most likely at their nadir already. Fees can only go up because it's expensive to be an institutional fiduciary, especially given the ongoing trend of increased regulation. Audits of federally chartered fiduciaries by the Office of the Comptroller of the Currency ("OCC") are staggering - both in terms of time and cost to the fiduciary. Such regulatory oversight costs have forced many large banks and trust companies to exit the SNT business altogether. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which was prompted by the Great Recession in 2008, led to the biggest changes in financial regulation since the reforms made after the Great Depression. The Dodd-Frank Act is meant to protect the American population from the mortgage and investment fraud that precipitated the Great Recession, but it has also placed an extreme burden on fiduciaries through enhanced oversight and cost.

There are also fewer local bank fiduciary options available for trust administration, mostly due to mergers and acquisitions over the last three decades. For example, the following banks were acquired between 1996 and 2008 to make up the "Big Four" banks in the U.S., leaving fewer options for localized trust administration:

1990 - 1995	2009
TRAVELERS GROUP · CITICORP EUROPEAN AMERICAN BANK · BANAMEX	CITIGROUP
WASHINGTON MUTUAL · GREAT WESTERN FINANCIAL H.F. AHMANSON · DIME BANCORP FIRST CHICAGO · BANC ONE · FIRST COMMERCE JP MORGAN · CHASE MANHATTAN CHEMICAL BANKING · BEAR STEARNS	JPMORGAN CHASE
US TRUST · MBNA · CONTINENAL BANK BANKAMERICA · SECURITY PACIFIC BANCORP NATIONSBANK · FLEET FINANCIAL GROUP BANCBOSTON HOLDINGS · BAYBANKS SUMMIT BANCORP · UJB FINANCIAL COUNTRYWIDE FINANCIAL · MERRILL LYNCH	BANK OF AMERICA
WELLS FARGO · FIRST INTERSTATE BANCORP NORWEST HOLDING COMPANY SOUTHTRUST · WACHOVIA CENTRAL FIDELITY NATIONAL BANK CORESTATES FINANCIAL · FIRST UNION THE MONEY STORE	WELLS FARGO

Before the COVID-19 crisis, there was already a strong case for banks to consolidate for many of the reasons outlined above. Economy of scale has always been a primary driver in banking success. Bank valuations (and shareholder returns) took a beating during the COVID-19 crisis, and some smaller institutions may be feeling severe capital pressure depending on many factors including how they responded to the crisis, their balance sheets, and other marketplace considerations. Credit losses and a longer than normal period of low (or even negative) interest rates put significant pressure on all banks. Banks have also traditionally been slower to adopt new technology, which the market is now demanding - creating another unwelcome expense for banks already struggling to make a profit. All of these factors may lead to further consolidation within the banking industry or even the jettisoning of expensive and low-margin trust departments as a whole.

In contract, Pooled Special Needs Trusts (PSNTs) organizations are in a unique position to serve as trustee on stand alone trusts for the benefit of people with disabilities and older adults. Well established and experienced PSNTs have mastered the administration of their master pooled trust and are familiar with fiduciary duties, trust administration, investments, taxes, etc. as well as the added skills related to people with disabilities such as government benefits eligibility and maintenance, community resources and supports, housing, adaptive and durable medical equipment, specialized service providers, etc. In addition, since PSNTs are non-profit organizations, they are able to operate on a smaller budget and be more competitive with the fees, especially minimum fees, that they charge.

In summary, the factors outlined above present a challenge to attorneys looking for a successor fiduciary. Additionally, institutional fiduciaries will continue to look for successor fiduciaries due to an account falling below their required minimum, the inherent increased oversight and liability of administration, or the economic factors mentioned previously. Family members (whether during *inter vivos* or testamentary planning) or people with disabilities will continue to look for both initiual and successor trustees for fee savings, subject-matter expertise, and public-benefits mastery. A non-profit organization administering both Pooled Special Needs Trusts (PSNTs) and non-pooled ("stand alone") trusts is generally a great option for these concerns.

II. Differences between Stand Alone and Pooled Trusts

Master Trust Document vs. Individual Trust Document

Experienced and stable PSNTs have likely mastered (pun intended) the administration of the Master Trust Document of the PSNT. These skills transfer well to the administration of stand alone trusts. However, there are many differences that need to be considered. Stand Alone trusts are developed by many different attorneys who may or may not be an expert in the area of special needs trusts or trusts specifically for people with disabilities. We will later discuss the importance of attorney review and a standardized letter that is prepared by an attorney can be very helpful in administering many different trusts. A database/Customer Relationship Management software can also be helpful in tracking categories such as First or Third Party, Remainder Beneficiary, Trust Protector, Co-trustee, unusual distribution language, etc.

The PSNT organization may also want to make a distinction internally with which staff are assigned to work with stand alone trusts. Staff who are more experienced and skilled will be more comfortable administering stand alone trusts than staff with little experience. While the skills needed to work with people with disabilities and older adults are nearly the same as those in the pooled trust, the nuances of administering stand alone trusts will require greater skill.

Asset Size

Stand alone trusts are typically, but not always, larger in size. This comes with greater and larger disbursements, including houses and vehicles. In a comparison of annual distributions between a pooled trust and stand alone trusts administered by the Colorado Fund for People with

Disabilities, stand alone trusts averaged thirty (30) percent more distributions than pooled trust sub-accounts. Of course, the disbursements that cost more often come with greater liability and risk to the trustee.

Unique Assets

Especially relevant in all fiduciary administration, but perhaps more so in the management of trusts for beneficiaries with special needs, is the oversight of atypical or "unique" assets held within a trust. PSNT organizations typically see more Unique Assets in SNTs when acting as successor trustee wherein the prior trustee has potentially made an unsustainable purchase of a beneficiary-occupied residence, for example. Additionally, some beneficiaries with disabilities may have diminished capacity or may require the trust to hold unique assets due to their public benefits structure. Or, unfortunately, some beneficiaries with disabilities may be particularly subject to undue influence which can especially manifest in real estate holdings/sole benefit issues.

Accommodating unique assets to promote the independence, welfare, and financial empowerment of beneficiaries is crucial to fiduciary administration. However, the retention of such assets in trusts (in particular) and their prudent management can be an administrative nightmare for administrators - in addition to the potential liability associated with any mismanagement. Of utmost importance in the management of unique assets is the ability to clearly and concisely report on their existence, their market value, and their holding nature (titling) to all stakeholders, including potential remainder persons. While reporting duties to beneficiaries and remainder persons vary from state to state, some form of reporting on unique assets will mitigate potential fiduciary liability and create more documentation for courts or public benefits agencies.

<u>Beneficiary-Occupied Real Estate</u>

The overriding principles guiding unique asset management are perhaps best illustrated in the contemplated purchase of a trust-owned home for an SNT beneficiary in a stand alone (or pooled) trust. When contemplating such a purchase, it is crucial to ensure that all economic factors have been taken into account. While permissible, using a majority of the beneficiary's trust corpus for a home purchase is often unwise for a variety of factors. In doing so, the trustee has potentially violated their duty to diversify the assets of the trust as per the Uniform Prudent Investor Act (UPIA). *Restatement (Third) of Trusts (Restatement of the Law Third, Trusts,* American Law Institute at Washington, D.C. © 2001), ("*Restatement (Third)*"), § 90 recognizes this issue, noting that "efforts to achieve diversification within the affected portion of the trust estate will be complicated" by holding real estate "especially [for] trustees of smaller trusts."

Additionally, the trustee must ensure that such a purchase (or its continued retention in a successor trustee situation) is sustainable long term and that the trust can still support the beneficiary's spending plan after the purchase is made. The industry standard for allocation of a trust-owned, beneficiary-occupied residence is 15-20% of the trust corpus, assuming that the remaining trust corpus can provide for the beneficiary's needs for their projected lifetime or needs.

It is also the fiduciary duty of the SNT trustee to inform the beneficiary of the other economic factors involved in home ownership, such as real estate taxes, upkeep expenses, insurance costs, and utility charges. All of these factors should be prudently accounted for in a home purchase plan (including rising inflation costs annually) or continued retention plan. Before committing to such a purchase or retention, the trustee or the trustee's investment advisor should perform a Monte Carlo simulation with all relevant factors included to ensure the long-term economic viability of a home purchase.

Should the home be purchased or retained in the name of the trust, the trustee maintains the ongoing duty to monitor the home for beneficiary appropriateness and prudence in the beneficiary portfolio's asset allocation. The trustee must also ensure the maintenance and upkeep of the residence as an asset of the trust. Failure to do so may create an improper or unsafe living situation for the beneficiary and create fiduciary liability for the trustee. A PSNT trustee should also be fully prepared for the difficult situation of having to evict a beneficiary and/or sell the residence if required to fund the beneficiary's long-term needs. Additionally, a professional valuation appraisal should be conducted on the residence from time to time not only to accurately reflect the value of the home on statements but also to ensure continued public benefits eligibility should the home's value escalate above appropriate limits. There is no substitute for the delegation of these functions to a local, knowledgeable, experienced, and properly vetted property manager.

Best Practice Tip: Delegate trust-owned, beneficiary-occupied residence oversight to a local, experienced property manager vetted in accordance with the recommendations made in OCC Bulletin 2013-29 Third-Party Relationships: Risk Management Guidance ("OCC Bulletin 2013-29"). (www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html#).

Oil & Gas/Mineral Rights

Management and oversight of oil and gas, mineral, and water rights interests can be one of the most challenging aspects of trust administration. The task of prudently managing and supervising such holdings requires extraordinarily specialized skill sets not typically found in-house with most SNT trustees. Because such interests are considered “depleting resources,” the simple procedure of receiving and depositing an income check from working interests of these types of assets requires adherence to the Uniform Fiduciary Income and Principal Act (UFIPA) when allocating between principal and income as required by the trust vehicle and/or trust’s tax circumstances. Additionally, division orders or sale propositions can be extremely confusing to a non-professional in this arena. Other factors involved in the management and oversight of these assets include:

- Tax and legal evaluation
- Investment prudence
- Potential pool unitization complications
- Enhanced scrutiny and higher liability
- Complicated contract/leasing negotiations
- Ownership review for sole benefit issues

It is recommended that such assets be listed on the beneficiary’s account statement to avoid complications and questions in terms of funding. For example, if such asset was not listed on a beneficiary’s statement but checks were being deposited from income derived from a working interest, a public benefits agency review may question these deposits as a commingling of first and third-party monies, or more detrimentally, as income to the beneficiary. As such, and as stated before, there is truly no substitute for the delegation of these functions to a knowledgeable, experienced, and properly vetted interest manager.

Best Practice Tip: Delegate oil and gas, mineral, and water rights management to an experienced interest manager vetted in accordance with the recommendations made in OCC Bulletin 2013-29.

In summary, before accepting such unique assets into a PSNT or a stand alone SNT, the trustee must thoroughly review and contemplate all aspects of such assets to ensure they are truly prudent holdings. These types of assets include, but are not limited to, closely held business interests, non-marketable securities, life insurance policies, promissory notes, LLCs/LLPs, commercial real estate, and tangible personal property. Therefore, with any Unique Asset, due diligence on any unique asset before accepting appointment as successor trustee is critical. Things to consider include:

- Beneficiary-Occupied Residence
    - Appropriateness for the beneficiary
    - Economic viability
    - Ongoing costs (insurance, upkeep, taxes, etc.)
    - Location safety
    - Accessibility (present and future)
    - Titling
- Vehicles
    - Lien recording
    - Ongoing costs (insurance, repair, maintenance, etc.)

    - Sole benefit

- Oil and Gas Interests
    - Tax and legal evaluation
    - Investment prudence
    - Principal/Income Accounting
    - Contract and leasing negotiations
    - Titling

- Real Property (e.g., farmland, commercial real estate, etc.)
    - Economic viability
    - Investment prudence
    - Ongoing costs
    - Titling
    - Sole benefit
    - Environmental impact or liability

It is recommended that such evaluations and ongoing management, oversight, and valuation of these types of assets be delegated to an appropriate professional. Performing such evaluations before acceptance of appointment will protect the potential successor trustee not only from liability, but also from starting off on the wrong foot with the beneficiary.

Best Practice Tip: Consult with a subject-matter expert and perform all necessary due diligence as needed.

<u>Successor Trustee</u>

A successor fiduciary's acceptance of appointment should be carefully considered. The successor trustee should engage in due diligence before acceptance to ensure that it is an appropriate fit. In all situations, the successor trustee should attempt to gain as much knowledge about the beneficiary and the current trustee situation as possible. This should include the following:

Where the beneficiary lives - Where the beneficiary resides is especially important in understanding the regulations regarding the public benefits that they may be receiving (or may be eligible for in the future). Before accepting appointment, the successor trustee (and their counsel) should understand the rules specific to the state in which the beneficiary receives public benefits. For example, the State of New Jersey Department of Human Services Division of Medical Assistance and Health Services requires notification of expenditures in an annual period for one item or purpose that exceeds $5,000.00 or "any amount that would substantially deplete the principal of the trust." Although this information is publicly available, if the organization is unaware of this regulation, the beneficiary could potentially lose their benefits simply because the trustee did not properly report. There are other considerations regarding a beneficiary's state of residency to consider as well. For example, there must be a plan in place for services as the beneficiary will not be easy to visit in person in times of crisis.

Potential violations by the current trustee - The current trustee may not be forthcoming about their missteps over the lifetime of the trust. Basic questions should be asked of both the trustee and the beneficiary to attempt to understand if there have been potential violations that the successor trustee may have to address. In many situations, the current trustee may be a layperson (such as a family member) who has been trying to do the right thing but simply didn't understand the laws regulating trusts and public benefits eligibility. Reviewing statements will allow for some insight to start the process but may not provide the full picture of possible violations that can cause future issues with a government look-back period which may impact beneficiary funds. The successor trustee and their counsel should ask:

- Is the beneficiary on Supplemental Security Income (SSI), and have distributions been made for food/housing? The successor trustee should understand if the beneficiary has been receiving a reduction due to these disbursements or if there is a potential of future payback to Social Security.

- Has the trust been supplanting versus supplementing benefits? The successor will need to know if local Medicaid offices may challenge trust distributions, potentially causing a loss in medical coverage.

- Have others benefitted from the trust funds? Understanding if the trust has violated the sole benefit rule and/or if others have become dependent on the trust funds is essential to ensuring entitlements stay in place.

- What fee structure has the current trustee been using? Has the trustee been overcharging for a significant period without court supervision? This may motivate the successor trustee to ask the court to review the previous fees charged and have the prior trustee potentially pay back any overcharges to the trust.

- Has this trust been approved by Social Security (if the beneficiary is on SSI) and/or Medicaid? Further, have accountings been sent to the Medicaid office if this is a requirement in your state?

- Has the current trustee completed Tax Returns and were they completed properly? It is best practice to ask for and review the last three years of tax returns.

- How are the funds currently invested? Are there annuities or other payments (Child support, DFAS benefits) that are assigned to the trust? It is best practice to request a copy of current statements to evaluate current investment of funds, determine any unique assets and identify all income streams to the trust.

***Understanding the beneficiary as a whole person* -** Knowing the beneficiary involves some investigation but will ensure the trust is administered properly and does not expose the successor trustee to undue liability.

- ***Beneficiary social/emotional health* -** It is important to have a basic understanding of who the potential beneficiary is as a person. Often, a current trustee is searching for a successor because the beneficiary has been difficult.

- ***Family dynamics* -** The involvement of the beneficiary's family is also a consideration before accepting appointment. Before accepting appointment, the successor trustee should know if the entire family has been relying on funds from the trust. If the sole benefit of the beneficiary has not been observed for the life of the trust, it will be essential to have a conversation about its importance prior to acceptance. Causing a family to move, change their lifestyle, etc., can permanently strain a relationship and prohibit the successor trustee from providing their best service. It can often cause additional expenses to the trust as the family may hire an attorney or petition probate court to attempt to compel distributions. This can be financially destructive to the trust and potentially expose the successor trustee to unnecessary liability.

- ***Undue influence* -** The potential successor trustee and their counsel should always look for possible undue influence. Influence can come in many different forms that include the people around the beneficiary or the guiding intentions for the funds in the trust.

Best Practice Tip: Create a checklist of such demographic questions to use before accepting appointment as successor trustee.

Attorney Involvement

Due to the complexities that may come with administering a stand alone trust, there will likely be a need for attorney involvement more frequently and consistently than with beneficiaries of the PSNT. Some examples of reason for hiring counsel include the following: Initial review of the trust document before accepting appointment, revision/restatement of the trust to comply with government benefits, review of purchase or sale of real estate, guardian or conservatorship matters concerning the beneficiary, employment matters, eviction, immigration (especially as it relates to parents serving as caregivers), annuities that are not compliant with government benefits and/or are not being received, resignation matters such as receipt and release, consultation for tax matters such as IRAs, etc., need for attorney representation in complex situations in which the beneficiary and/or guardian has hired counsel.

Stand Alone Trusts may have greater scrutiny by Medicaid and Social Security

While this varies state to state, Medicaid may have greater scrutiny on stand alone trusts, especially first party "disability" trusts. This begins with the review and approval of the trust. As PSNT administrators know well, one of the benefits of a master pooled trust document is that it has already been approved. Each and every stand alone document must be approved, which increases wait times and has the potential of the trust to need to be amended/restated to meet the approval criteria. There may also be greater scrutiny by Medicaid on the disbursements from first party trusts because Medicaid is the remainder beneficiary. For Example, in Colorado, the trustee must notify the Medicaid Department of every expenditure from a first party disability trust that is over $5,000.

Nearly the same goes for the Social Security Administration (SSA). Trusts for the benefit of individuals receiving Supplemental Security Income must be reviewed and "approved" by the Social Security Administration. Oftentimes, the "approval" is not communicated and simply implied by a continuation of benefits. Conversely, a denial of benefits as a result of the trust is communicated by SSA, but little detail is given and one must appeal the decision to learn what areas of the trust need to be amended. Social Security does not typically have as much oversight on trust distributions as Medicaid, but this varies from Region to Region.

Taxation

PSNTs are unique trust vehicles - even when it comes to taxation. While there is little to no guidance from the Internal Revenue Service (IRS) as to how a PSNT is to report the earnings within the pool, the filing of a "Master" trust tax return U.S. Income Tax Return for Estates and Trusts Form 1041 (Form 1041) for the entire pool is becoming industry standard.

A PSNT has legal (with a Master Trust Agreement), administrative (pooling of cash and investments for economy of scale), and tax specificities. A PSNT operates to pool investments in that every beneficiary materially participates proportionally in the gains or losses of the PSNT's investment portfolio. As such, overall performance and daily sub-account valuations should be tracked as to the change in the overall value of the total trust assets itself. This calculation must be combined with beneficiary transactions to derive the sub-account's position in the pool. In other words, every PSNT joinder is assigned a unit value of the pool when they join based on the market value of their contribution amount in relation to the overall fair market valuation of the pool. The beneficiary's unit value is subsequently adjusted not only for every transaction specific to that beneficiary (e.g., annuity payment receipt, discretionary distribution, etc.), but also for market value movement of the trust's investments. This process is often referred to as "unitization." Stand alone SNTs require no such calculations as all activity within the trust is solely for that trust.

PSNTs may file a "Master" Form 1041 for the entire pooled trust and subsequently issue Grantor Tax Letters (1st-Party) or Form K-1 (3rd-Party) for every beneficiary for their proportionate share of taxable events. Assuming that the unitization is being properly accounted for during the tax year, this approach can save the PSNT beneficiaries tremendous amounts of tax preparation fees, thus potentially extending the longevity of their trust funds. Often, such an approach can save the beneficiaries upwards of $400 per year in tax preparation fees - a significant amount for PSNT sub-accounts with lower balances. Conversely, stand alone trusts must file their own Form 1041 tax returns every year.

First Party SNTs

First Party SNTs are almost always considered grantor trusts because the grantor (who is also the beneficiary) retains the right to beneficial enjoyment of the trust property, even if such property is distributed under purely discretionary distribution standards. The analysis is no different because a trust is a sub-account of a pooled trust.

The Internal Revenue Code (I.R.C.) §§ 671-678 lays out the Internal Revenue Service (IRS) guidelines for grantor trusts. Three key provisions of these sections for the determination of grantor tax status are as follows:

- I.R.C. § 673(a): "The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion."

- I.R.C. § 677: "The grantor shall be treated as the owner of any portion of a trust...whose income...in the discretion of the grantor or a nonadverse party...may be (1) distributed to the grantor…."

- I.R.C. § 675: "The grantor shall be treated as the owner of any portion of a trust in respect of which (1) A power exercisable by the grantor...without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or income therefrom…."

As such, First Party PSNTs are almost always grantor trusts. Grantor trust status is most likely beneficial to the beneficiary as all of the trust's taxable events flow through the trust directly to the beneficiary. This is beneficial because the beneficiary's personal tax rates will almost always be lower than a trust's tax rates.

Third Party SNTs

A Third Party SNT is almost always considered a complex trust and potentially may be a Qualified Disability Trust (QDT) because the grantor is someone other than the beneficiary. As such, tax regulations different from a grantor trust apply. This analysis is no different because a trust is a sub-account of a pooled trust. However, there are differences between an irrevocable and a revocable Third Party SNT, which will be discussed later herein.

I.R.C. §§ 661-663 lays out the general guidelines for complex trusts. The three key determinants to classify a trust as a complex trust are as follows:

1) The trust may accumulate income;

2) The trust may distribute corpus; or

3) The trust may make distributions to charity.

Note that only one of those conditions must apply for a trust to be deemed a complex trust. In general, the trust’s deductions for distributions are outlined in I.R.C. § 661, the inclusion of amounts in the income of beneficiaries is outlined in I.R.C. § 662, and other special rules for complex trusts are outlined in I.R.C. § 663.

As a general rule, complex trusts are allowed deductions for the total of any amount of trust accounting income (TAI) that is required to be distributed. However, there are limitations on this distribution deduction that pertain to distributable net income (DNI) and tax-exempt income. In other words, the advantages of all taxable events flowing out to the beneficiary of a grantor trust may not be able to be fully realized in a Third Party PSNT when characterized as a complex trust.

Qualified Disability Trust

Perhaps the largest difference in PSNT Third Party tax filings and stand alone Third Party SNT tax filings is that there are additional tax exemptions available to Third Party SNTs. One common tax exemption is the Qualified Disability Trust (QDT). This exemption amount is $5,050 in 2024 and could be used to lessen the overall burden of the taxes to the trust. However, not every SNT will qualify as a QDT even if the trust is taxed as a complex trust. For a trust to receive the QDT exemption, the trust must meet the statutory requirements of 42 U.S.C. § 1396p(c)(2)(B)(iv). Those requirements are as follows:

- The trust must be irrevocable; and
- The trust must be for the sole benefit of the beneficiary with a disability; and
- The beneficiary must be under the age of 65; and
- The beneficiary must be disabled as defined for purposes of SSI and Social Security Disability Insurance (SSDI).

Additionally, the trust must be taxed as a simple or complex trust under I.R.C. § 652 or 662 to qualify as a QDT. As such, grantor (First Party) SNTs do not qualify. Qualification is further complicated by the fact that there must be an actual determination from the SSA that the beneficiary is disabled. This could pose problems for a beneficiary who would qualify as disabled, but the SSA would deem ineligible because the beneficiary works or may be affected by parental deeming rules.

A narrow reading of I.R.C. § 642(b)(2)(c) would exclude all Third Party SNTs from qualifying as QDTs. Section 1917 of the Social Security Act references 42 U.S.C. § 1396p "Liens, adjustments and recoveries, and transfers of assets." Subsection (c)(2)(B)(iv) states there is no penalty for a transfer of assets if those assets: “(iv) were transferred to a trust **(including a trust described in subsection (d)(4)(a) of this section)** established solely for the benefit of an individual under 65 years of age who is disabled (as defined in section 1382c (a)(3) of this title).” [emphasis added] For a Third Party SNT to receive the QDT exemption, subsection (c)(2)(B)(iv) must be read to include all SNTs not just trusts described under (d)(4)(A). A more reasonable interpretation of I.R.C. § 642(b)(2)(c) would include a Third Party SNT as a QDT provided the special needs beneficiary is receiving SSI or SSDI benefits and the trust was funded prior to the beneficiary turning 65. There are no reported cases or rulings on this point.

Tax Filing

Generally, every trust with any taxable income within the taxable year or with gross income of $600 or over (regardless of the amount of taxable income) is required to file an income tax return per I.R.C. § 6012(a)(4). Under this traditional reporting rule, the trustee must file a Form 1041 if the trust produced at least $1.00 of taxable income or $600 of gross income (26 CFR § 1.6012-3(a)(1)(ii)). However, for any portion of a trust treated as owned by the grantor, the trustee may opt to report income under alternative reporting requirements per 26 CFR § 1.6012-3(a)(9).

Therefore, some type of reporting to the IRS must be completed for any beneficiary of an SNT who received at least $1 of taxable income (note that the $600 caveat could not apply to a grantor trust as the trust cannot have gross income itself since all income flows out to the beneficiary). The IRS requires notification of when income is attributable to the grantor. The IRS has issued regulations regarding reporting requirements for grantor trusts under 26 CFR §1.671-4. However, all of the options available under §1.671-4 are designed for individual trusts or trusts with a limited number of grantors or beneficiaries. Even reporting options for trusts with more than one grantor require attributing income among various owners, per 26 CFR §1.671-4(b)(3).

The SNT trustee must still meet its obligations under 26 CFR §1.671-4(b)(2)(iii)(B)(1) to inform the IRS that the grantor is liable for any income tax and to provide basic information to the grantor/beneficiary regarding investment and dividend income. This information must also contain a list of trust expenses for the year. Simplified information may be sufficient under 26 CFR §1.671-4(b)(2)(iii)(B)(1)(ii) to provide the grantor with "the information necessary to take the items into account in computing the grantor's...income." As such, a prudent trustee will file a Form 1041 for each SNT.

III. Trust Document Review

Attorney Review

Attorney review of the trust prior to the trustee accepting appointment is highly recommended. The attorney can determine if the trustee is able to serve under the current document (Ex: the PSNT Organization may be prohibited if the requirement is for a Bank to serve as trustee). Further, this review can serve as a guide to the trust administrator that identifies any unique provisions such as those relating to trust disbursements, investment of trust assets, prohibitions, remainder persons, etc. A sample attorney review template is below.

The trust review will include the following:

a. Verify the Trust document is complete and signed;

b. Verify that the Trust document allows for a single Trustee to serve;

c. Verify the process for current trustee to resign*;

d. Verify that PSNT qualifies to serve as sole trustee under the Trust document;

e. Verify any process in the Trust document for PSNT to accept the role of sole trustee;

f. Verify who must receive notice of Resignation and Acceptance of Office*;

g. Verify the appropriate party to sign a Release document*;

h. Note the applicable standard of trustee liability;

i. Verify the identity of beneficiaries entitled to accountings;

j. Note any unusual trust distribution limitations or provisions;

k. Review of holdings of trust, including unique assets*;

l. Note any other drafting problems with the trust;

m. Identify Trustee compensation in the document;

n. Recommendations

* Successor trustee only

There are a few other considerations with this attorney review, such as who will pay for the review, who will do the review and how to address conflicts of interest. The author suggests that the trust is responsible for this payment and paid up front as a part of the set up fee. If the trust has not yet been funded, then the organization may pay the attorney fee and then be reimbursed after funding. It is beneficial to find two or three attorneys who will do these reviews so that they are consistent in the information provided, etc. and there is a way to address conflict in the event that the attorney who typically does the reviews is the drafting attorney and/or representing the beneficiary, grantor and/or trustee. Further, finding a handful attorneys who will charge a set flat fee is beneficial to this review process and ultimately to the beneficiary.

<u>Situs</u>

When accepting appointment as trustee of a stand alone SNT, the trustee should review all facets of trust situs. Trust situs can mean several things - all of which play an important role in the trust's administration.

The trust's legal situs refers to the state or jurisdiction that has primary control over a trust's legal matters. This is often referenced in the trust vehicle by stating something similar to "this trust is intended to create a valid trust under the laws of [state]", or "this trust is governed, construed, and administered by the laws of [state]." This type of situs is crucial as different states have different rules that apply to trusts - and some states' rules are more favorable than others, which is why some trustees prefer to have situs amended (generally by court order) in order to take advantage of such rules. States such as Nevada, South Dakota, Delaware, Alaska and Wyoming generally have very favorable trust laws.

In its "Powers of the Trustee" section, a trust vehicle will also usually state that "the Trustee may exercise those powers set forth in the [state] Fiduciaries' Powers Act." If the trustee administering this trust is unfamiliar with the specified state's Fiduciaries' Powers Act, they should ensure that they become familiar. States' Fiduciaries' Powers Act can differ in myriad ways, including: how income is treated (Uniform Fiduciary Income and Principal Act), delegation and/or directed trust language, the requirements for notice to beneficiaries (e.g., statement frequency), remainderperson considerations, investment restrictions, etc.

Best Practice Tip: Review all applicable state Fiduciaries' Powers Act and keep a copy of the Act on file.

A trust's administrative situs refers to its principal place of administration. Generally, this means the state or county in which the trustee is located. A trust's administrative situs may necessitate state- or county-specific requirements. These requirements may include trust registration with the local probate court, Medicaid or Social Security or HUD-specific reporting, or transaction reporting to the court of jurisdiction.

A trust's tax situs also plays a critical role in its administration. The trust's tax situs may be determined by its legal situs, its administrative situs, where the beneficiary resides, or even where the trustee resides or has an office. All of these factors may determine which state's income tax applies - which may necessarily affect the trust's investment structure (e.g., municipal bond inclusion), Distributable Net Income (DNI) rules, and tax filing requirements. For example, a trust may have a beneficiary that resides in New York, a trust legal situs of Pennsylvania, and a trustee that resides in California. In this case, three separate state income tax filings may be required.

Best Practice Tip: Consult with a CPA or tax advisor when determining a trust's tax situs.

Discretionary Distribution Language

Trust document language for a stand alone trust is often very different from PSNT trust document language. When vague stand alone discretionary distribution language is coupled with ever-changing trust laws and public benefits regulations (in addition to being dissimilar from PSNT trust language), a trustee can quickly become perplexed. Even the ever-present "HEMS" (Health, Education, Maintenance and Support) discretionary distribution standards can be tricky. Trustees must rely on the trust document, state and federal statutes, case law, and industry standards, which are often at odds with each other, when determining the appropriateness of discretionary distributions from a trust. Uninformed decisions by the trustee can quickly subject them to enhanced scrutiny and potential litigation. The stand alone trust trustee will need review common law, *Restatement (Second) of Trusts* (*Restatement of the Law Second, Trusts,* American Law Institute © 1959) [*Restatement (Second]), Restatement (Third) of Trusts (Restatement of the Law Third, Trusts,* American Law Institute © 2003) [*Restatement (Third*]), and the Uniform Trust Code (National Conference of Commissioners on Uniform Laws © 2003) (UTC) for direction.

Support and Maintenance

Even when contemplating a non-Special Needs Trust, drafters must carefully craft discretionary distribution language as these provisions may be interpreted differently by all parties: the attorney, the beneficiary, the grantor, and the trustee. For example, the most commonly used terms in discretionary distribution provisions are "support" and "maintenance." In an SNT, most parties understand that "support" and "maintenance" discretionary distribution provisions supplement (rather than supplant) the beneficiary's public benefits. However, the overall interpretation of these provisions may vary widely.

Generally, a court or trustee will consider the terms “support” and “maintenance” as virtually synonymous and will interpret these terms as “distributions necessary to maintain the beneficiary in the beneficiary’s accustomed manner of living.” *Restatement (Third)* expands on this principle to include support or suitable education of the beneficiary’s children and payment of household expenses. Obviously, this may become an issue for beneficiaries receiving public benefits as it may violate the sole benefit rule. “Support” and “maintenance” may also allow for other appropriate expenditures such as “regular mortgage payments, property taxes, suitable health insurance or care, existing programs of life and property insurance, and continuation of accustomed patterns of vacation and charitable and family gifting” (*Restatement (Third)* §50).

Numerous court cases support these broad definitions of support and maintenance:

- “Customary lifestyle or station in life” *Hartford-Connecticut Trust Co. v. Eaton*, 36 F.2d 710 (2d Cir. 1929).
- “Property taxes and premiums for fire and liability insurance for house” *Orange First Nat. Bank v. Preiss,* 2 N.J. Super. 486, 64 A.2d 475 (Ch. 1949).
- “‘Needs and necessities’ reasonably necessary to meet personal needs of the beneficiary in accustomed standard of living at time of death of the settlor” *Amoskeag Trust Co. v. Wentworth*, 99 N.H. 346, 111 A.2d 198 (1955).

Accustomed Manner of Living

Often, a settlor and drafter want to ensure that a trust beneficiary maintains their current lifestyle after the settlor's passing. To achieve this, many drafters add "in their accustomed manner of living" to the trust's discretionary distribution provisions. But how does a trustee establish a baseline for a beneficiary's "accustomed manner of living"? A defining court case provides a methodology. In *Goss v. McCart,* 847 P.2d 184 (Colo. App. 1992), the court found that the trustee had access to extensive financial information derived from the beneficiary and settlor's financial life together, allowing them to determine how to maintain standard-of-living distributions. A simple review and annualized average of the beneficiary and settlor's expenditures and income over four years provided ample documentation and confirmation of the beneficiary's "standard of living." This case also contemplates using the same formula to encompass the discretionary distribution standard of "comfort." This application is also confirmed in *Marsman v. Nasca,* 30 Mass. App. Ct. 789, 573 N.E.2d 1025, and *Barnett Banks Trust Co. v. Herr*, 546 So.2d 755 (Fla. App. 1989).

When such information is readily available or can be obtained, the trustee should follow this procedure as they contemplate a discretionary distribution or discuss adding such language to the settlor's estate plan. *Restatement (Third)* § 50, comment d(2) elaborates: "Distributions may increase for inflation and subsequent increases in needs resulting from situations such as deteriorating health or added burdens from the needs of another."

<u>Education</u>

The definition of "education" varies widely in common law. A trustee may be faced with a discretionary distribution request for education from an adult professional, college tuition for a "professional student"/underachiever, or high school or grade school expenses for a minor beneficiary. *Restatement (Second)* §128, comment e, gives the trustee leeway to determine their own particular definition of education by stating that "when the trustee has discretion to pay so much of the income or principal for the education or support of the beneficiary, the beneficiary cannot compel the trustee to pay to him or to apply for his benefit more than the trustee in the exercise of a sound discretion deems necessary for his education or support." *Restatement (Third)* §50, comment d(3) adds more guidance for the trustee and includes higher education by stating that "education generally includes the payment of living expenses as well as fees and other costs of attending an institution of higher education, or the beneficiary's pursuit of a program of trade or technical training, as may be reasonably suitable to the individual and to the trust funds available for that purpose." However, as noted above, case law swings back and forth on this subject:

"Pro"- Education

- Distributions for high school as preparation for college were allowable pursuant to discretionary distribution language allowing expenses to "defray the reasonable expense of a college education." *Security Trust Co. v. Smith*, 284 Ky. 611, 145 S.W.2d 512 (1940).

- Distributions for the "proper education of my [beneficiary]" were considered to be lifelong. *In re Wolfe's Estate*, 164 Misc. 504, 299 N.Y.S. 99 (Sur. Ct. 1937).

- "Support" included education of a minor. *In re Wells' Will*, 165 Misc. 385, 300 N.Y.S. 1075 (Sur. Ct. 1937).

- "Support" included college education of the children of the beneficiary. *First Nat. Bank of Beaumont v. Howard*, 149 Tex. 130, 229 S.W.2d 781 (1950).

“Anti”- Education

- “Education” does not include further education of adult beneficiaries. *New Britain Trust Co. v. Stoddard*, 120 Conn. 123, 179 A. 642 (1935).

- Trustee can deny payments for “education” for adult beneficiaries who are already well-educated. *Lanston v. Children's Hospital*, 148 F.2d 689 (D.C.Cir.1945).

- “Education” covers undergraduate work but not medical school. *Epstein v. Kuvin*, 25 N.J.Super. 210, 95 A.2d 753 (1953).

Supplanting the parental duty of support for a minor beneficiary’s education will always be a concern of the trustee. It is widely held that the payment of a minor child’s standard public education tuition is the responsibility of their parent(s). An exception to this tenet will generally be made if the trustee can properly verify and document that the parent(s) does not currently have the financial wherewithal to make such expenditures. The trustee will likely consider extracurricular activities, tutoring, and the like to be allowable education expenses for minor beneficiaries outside of the parental duty of support.

Higher education (college, postgraduate, technical school, etc.) expenses can be more difficult for a trustee to consider. The trustee must balance longevity of the trust, purpose of the trust, other trust beneficiaries, remainder beneficiaries, and settlor intent before approving such educational discretionary distribution requests when the definition of education within the trust instrument is left ambiguous. In the case of multiple beneficiaries within the same trust, it has been noted that the trustee must consider how distributions for one beneficiary would affect another beneficiary in *Snyder v. Dept. of Public Welfare*, 528 Pa. 491, 598 A.2d 1283 (1991)).

Comfort/Happiness

"Comfort" is generally interpreted by trustees and drafting attorneys alike to have a broader meaning than "support" or "maintenance." "Comfort" was said to be "broader than necessity" in *Estate of Curtis*, 253 Wis. 119, 33 N.W.2d 193 (1948). Some courts go further. Consider the ruling in *Equitable Trust Co. v. Montgomery*, 28 Del.Ch. 389, 44 A.2d 420 (1945) wherein "comfort" was defined as "a state of tranquil or moderate enjoyment, resulting from the satisfaction of bodily wants and freedom from care or anxiety; a feeling or state of well-being, satisfaction, or content." However, *Restatement (Third)*, §50, comment d(3) states that "comfort adds nothing to the usual standard of support for a beneficiary whose lifestyle is reasonably comfortable" but notes that "it may elevate the standard of living for a beneficiary whose standard is modest."

The terms "benefit," "comfort," and "happiness" grant the broadest discretion for trustees and drafting attorneys. See *Restatement (Third)* §50, comment d(3):

The terms "benefit" and "welfare" imply something beyond a support standard. Although "benefit," "welfare," and "happiness" may imply something beyond support, they are less objective standards of support and may inhibit the ability of a beneficiary to compel a distribution. "Happiness" implies that the trustee's discretion should be exercised generously.

This section of *Restatement (Third)* also states that "happiness may protect the trustee from challenge by remainder beneficiaries for almost any reasonably affordable distributions" but notes that the trustee "can still resist a request from a beneficiary because the distribution is in the trustee's discretion."

Other common trust provisions may warrant careful consideration and review before accepting appointment as successor trustee. Some such provisions include:

- Mandatory beneficiary visitation provisions such as “the trustee shall visit my beneficiary in person no less than quarterly….”
    - This requirement may be problematic for a successor trustee to fulfill. If the successor trustee cannot fulfill this requirement or if the fulfillment of such duty would be too expensive for the trust to outsource, an alternative successor should be considered.

- Provisions mandating distribution of net income to or for the benefit of the beneficiary such as “all net income shall be distributed to my beneficiary no less than quarterly….” (Note that such provisions were common for tax planning purposes.)
    - Such provisions may disqualify the beneficiary from public benefits in some states.

- No invasion of principal provisions such as “no distributions from the principal (or corpus) of the trust shall be considered….”
    - Limiting the trustee’s discretionary distribution authority only to the income of the trust may severely limit the trustee’s ability to properly care for a beneficiary with a disability.

- “Incentive trust” or “dead hand control” language
    - “My trustee shall only distribute the income or principal of the trust for the beneficiary's expenses for a college education….”

        - Limiting the trustee's discretionary distribution authority only to the beneficiary's college education may severely limit the trustee's ability to properly care for a beneficiary with a disability.
        - It is unclear what may be a permissible distribution for "college education." For example, does this standard include room and board or just college tuition? Is technical schooling included in the definition of "college education"?

- "Once my beneficiary has successfully submitted X clean drug tests over the course of Y months, the trustee may distribute…."
    - This requirement adds additional oversight and cost to the trustee for review and compliance.
    - Health Insurance Portability and Accountability Act (HIPAA) and beneficiary privacy concerns exist.
    - The definition of "drug" may be unclear. For example, recreational marijuana laws vary from state to state.

In these cases, the successor trustee always has the option to petition the court for judicial reformation or construction. Such proceedings come with heightened cost to the trust and should be carefully considered. Trust decanting may also be a prudent option. Many modern trusts and state statutes provide for decanting as a way to reform trusts that have outdated or problematic provisions. Additionally, many trusts may employ a trust protector who can change such provisions. It is important to note that decanting or the use of the trust protector to achieve trust revision may or may not require judicial oversight.

Best Practice Tip: Consider trust amendment, decanting or court petition as needed.

Trust Advisory Committee/Trust Protectors

Dissimilar to most PSNT arrangements, stand alone SNTs may employ the use of Trust Advisors or Trust Protectors. Knowing the intent and scope of each arrangement is important as it can alter the SNT's administration policy and procedure.

Trust Advisory Committee:

Trust advisory committees have been incorporated in trust documents since the inception of the SNT. It has become common practice for an SNT to incorporate an advisory committee or a trust protector to ensure that settlor intent and the needs of the beneficiary are fulfilled. This can also allow for a system to make changes in the document as laws and policies change, and replacement of the trustee if needed.

Development of a distribution plan may be the primary focus of the trust advisory committee. This allows the committee, the SNT trustee and the beneficiary to provide input, work collaboratively, and potentially pre-approve distributions, giving everyone a clear path to follow while promoting beneficiary independence. It is imperative to be clear about how the trust committee is structured, who is in charge, and when and how the committee members need to act. It is also becoming more common to require the trustee to work with a care manager to create an annual distribution plan to be reviewed by the committee and beneficiary (as appropriate).

Sample trust advisory committee language graciously provided by WealthCounsel:

The Trust Advisory Committee shall consist of a minimum of 3 members, but no more than 5 members to be determined by the chairperson(s) then serving. If any member of the Trust Advisory Committee is unwilling or unable, for any reason, to act or continue to act as a committee member, the chairperson(s) then serving may decide whether or not to fill the vacancy. However, there shall be at least three (3) members serving at all times. If there are fewer than 3 members serving and the chairperson(s) then serving are unable or unwilling to appoint a successor committee member, the Trustee may appoint the successors.

The initial Chairpersons for the Trust Advisory Committee shall be:

XXXX

XXXX

<In the event that either XXXX or MaryXXX cannot or will not serve, then the remaining chairperson shall <serve alone/select a successor chairperson/elect whether to select a co chair.>

or

<In the event that neither XXXX nor XXXX is willing to serve, then the remaining advisory committee members shall select a chairperson by majority vote.>

Duties of the Chairperson(s)

The Chairperson(s) primary duty is to ensure that the duties and the timelines of the Trust Advisory Committee are followed, and to make sure that there are at all relevant times the proper number of members on the committee.

Selection of the Remaining Trust Advisory Committee Members

The grantors shall maintain a schedule of successor Trust Advisory Committee members to be updated from time to time to provide guidance for the Trust Advisory Committee for selection of successor Trust Advisory Committee members to maintain the requisite number of committee members.

<u>Trust Protector:</u>

Similar to a trust advisory committee, a trust protector role can be extremely useful. In addition to the duties and rights of trust advisory committees, trust protectors are generally granted the power to amend the trust, either to satisfy settlor intent or to adapt to changes in public benefits regulations. Being able to make such changes without court intervention saves the trust unwarranted and potentially onerous legal fees. Additionally, a trust protector with the power to advise and weigh in on discretionary distribution decisions can be a wonderful tool for managing beneficiary expectations. When the trust protector or trust advisory committee has this right (not duty), it can potentially help to keep family members, etc. involved in a beneficiary with a disability's life while providing priceless insight and guidance for the trustee.

Below, please find select pertinent provisions relating to Trust Protector or Trust Advisor appointment, graciously provided by Bradley J. Frigon, JD, LL.M, CELA, CAP:

- "Any Trust Protector (including successors) shall have the right to appoint a Successor Trust Protector in writing, such appointment to take effect upon the death, resignation or incapacity of the appointing Trust Protector. If a Successor Trust Protector is named, the appointment of a Successor Trust Protector under this subsection shall take effect only if, and when, all Trust Protectors named in this Agreement fail to qualify or cease to act."

- "The Trust Protector shall have the authority to remove any Trustee with or without cause. Whenever the office of Trustee of a Trust is vacant and no Successor Trustee is effectively named, the Trust Protector shall appoint an individual or a corporate fiduciary to serve as Trustee."

- "The Trust Protector may amend any provision of this Agreement, as it applies to any Trust for which the Trust Protector is serving, pursuant to [subsequent restrictions]. Notwithstanding the foregoing, the Trust Protector may not amend this Agreement in any manner that would make Trust corpus or income available to the Beneficiary for Medicaid eligibility. Further, the Trust Protector may not limit or alter the rights of the Beneficiary in any Trust assets held by the Trust before the amendment, nor may the Trust Protector remove or add any individual or entity as a beneficiary of any Trust asset."

- "Any amendment made by any Trust Protector in good faith is conclusive on all persons interested in the Trust. The Trust Protector is not liable for the consequences of making or not making any amendment. Any amendment to this instrument made by any Trust

Protector must be made in a written instrument signed by the Trust Protector and delivered to the Beneficiary or the Beneficiary's Legal Representative and the Trustee of the Trust."

- "Notwithstanding any other provision in this Agreement to the contrary, the Trust Protector shall not participate in the exercise of a power or discretion conferred under this Agreement that would cause the Trust Protector to possess a general power of appointment within the meaning of Sections 2041 and 2514 of the Internal Revenue Code. Specifically, the Trust Protector may not use such powers for his or her personal benefit, nor for the discharge of his or her financial obligations."
- "The Trust Protector shall have no duty to monitor any Trust created under this Agreement in order to determine whether any of the powers and discretions conferred by this Agreement on the Trust Protector should be exercised. Further, the Trust Protector shall have no duty to keep informed as to the acts or omissions of others or to take any action to prevent or minimize loss. Any exercise or non-exercise of the powers and discretions granted to the Trust Protector shall be in the sole and absolute discretion of the Trust Protector, and shall be binding and conclusive on all persons. The Trust Protector is not required to exercise any power or discretion granted under this Agreement."

Delegated/Directed Administrative Powers

Most SNT trustees do not have experienced investment professionals on staff. Additionally, many stand alone SNTs may come as referrals from investment advisors, or come with an inherited investment advisor on the account from the prior trustee. UPIA § 9 states that "a trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances" and continues on to outline the specific parameters and oversight requirements by which a trustee should adhere. This section of the Act is largely modeled on *Restatement Third*, Prudent Investor Rule § 171. Additionally, the power to delegate is typically found within a broad set of trustee's powers drafted into the SNT trust vehicle, in the governing state's Fiduciary Powers Act, or in the Uniform Trustees' Powers Act.

Delegated Investment Advisory

Section 9 of the UPIA makes it abundantly clear that even while delegating (or retaining the previous advisor) the investment function, the trustee still has a fiduciary duty (and therefore continued liability) to the trust and its beneficiaries. With respect to investment management delegation, UPIA § 9(a) states: "[T]he trustee shall exercise reasonable care, skill and caution in (1) selecting an agent." Trust law generally relies upon the duties of loyalty and impartiality to ensure prudent delegation of trust duties. Judicial and audit oversight functions may also protect the beneficiaries' best interests in these cases. In order to prudently select or retain an investment advisor, the following factors should be reviewed:

- Past or pending legal actions against the investment firm
- Sample Investment Policy Statement
- Fee schedule
- Investment management agreement
- Staff experience

- SEC or state-specific registration
- Conflict of interest review
- Historical performance comparable to applicable benchmarks
- Soft-dollar arrangements with broker dealers
- Proprietary investment products
- Assets under management
- Insurance coverage
- Data security protocols
- Depth of knowledge in SNT-specific areas

In cases of delegation or retention, extensive vetting of the investment manager must occur to ensure the trustee has fulfilled their duty of loyalty and impartiality to the trust and its beneficiaries. Effectively delegating investment management to an advisor with specialized skills, experience, knowledge, and dedication to the SNT arena will greatly benefit all beneficiaries of the trust. However, delegation to an improper advisor without SNT-specific knowledge will not only be extremely detrimental to the beneficiaries but will also leave the non-profit trustee itself open to risk and potential litigation.

Best Practice Tip: The PSNT Board of Directors or Investment Committee should perform a thorough review of multiple candidates before delegating investment management.

UPIA § 9(a)(2) states that the trustee also needs to exercise reasonable care, skill, and caution in "establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust." This clause reminds the trustee or fiduciary that the investment advisory agreement from the advisor must be carefully reviewed to ensure compliance with the trust's terms and with the duty of loyalty to the trust and its beneficiaries. As an example, a trustee should not agree to an investment management agreement that fully releases the investment advisor from any and all harm or recompense, thus leaving the trust without recourse in the event of mismanagement. Additionally, the investment management agreement should be reviewed carefully for fee clauses that could potentially allow the advisor to charge an overall fee on assets under management while also collecting an internal fee on their proprietary mutual funds within the portfolio. This practice is commonly referred to as "double dipping."

Best Practice Tip: Have outside counsel thoroughly review any investment management agreement before executing.

Finally, UPIA § 9(a)(3) states that the trustee has an ongoing duty to "periodically [review] the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation." Fortunately, with internet access to information, ongoing reviews of the delegated investment advisor are less onerous than in the past. This ongoing monitoring is critical not only to ensure the trust's beneficiaries are properly and prudently served but also to mitigate the risk and liability inherent in any delegation of trust duties. UPIA § 9(c) states that the delegating trustee "is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated." However, such release of liability is only valid to "a trustee who complies with the requirements …" to prudently select, establish the scope of, and periodically review the advisor. Case law is littered with examples of trustees and fiduciaries who have been held personally liable for delegating investment management and never prudently reviewing the delegated advisor thereafter.

Best Practice Tip: Review the delegated investment advisor no less than annually for the above factors as well as comparable rates of return to applicable benchmarks. Keep all such review documentation on file.

Directed Investment Advisory

Many SNT trustees also look to directed trust arrangements as a vehicle to further insulate themselves from potential investment liability. Generally, a directed trust arrangement essentially "directs" the trustee to utilize the services of a named investment advisor, with purportedly no continued oversight or duties in respect to said advisor. The Uniform Directed Trust Act (UDTA) was drafted by the National Conference of Commissioners on Uniform State Laws in 2017. As is the case with the UPIA, most states have adopted the UDTA or something similar. The UDTA indicates that in a directed trust, the terms of the trust vehicle grant power to a person (sometimes known as a "trust protector," "trust advisor," or "trust director") other than the trustee over some aspect of trust administration (e.g., investment duties). As such, because the directed trustee's authority to act with respect to the investments of the trust is reduced or non-existent, the trustee's fiduciary duty (and liability, potentially) is reduced as well. In common law, directed trust arrangements were noted in both Restatement (Second) § 185 and Restatement (Third) § 75.

A directed trust arrangement does not involve the delegation of a trustee's duty and is therefore not necessarily subject to the delegation oversight requirements previously mentioned. Nor is a directed trust arrangement a co-trusteeship wherein the agent shares in all matters of trust administration and fiduciary duties. Because the agent appointed via direction is vested with specific investment functions, the directed trustee has no perceived ability to act on these duties and, therefore, the trustee's potential liability is lessened. Typically, though, the trustee must continue to ensure there are no acts or failures to act on the part of the appointed investment advisor that would be considered grossly negligent or constitute willful misconduct. As such, some oversight by the directed trustee is implied within the UDTA. For example, if the appointed investment advisor directed all of the trust's holdings to be moved to an offshore bank of which they were an owner, the trustee would be obligated to review the prudence of such and potentially petition a court for instruction.

While directed trust arrangements appear to be a panacea for trustees looking to outsource or retain legacy investment management with reduced oversight requirements, it is important to note that not all oversight duties are completely removed from the trustee. In fact, the directed trustee provisions in the Uniform Trust Code (UTC) § 808 do not bifurcate the investment function and fully remove it from the trustee's fiduciary duties because the trustee will always be liable for the advisor's actions if these actions constitute a breach of trust. Additionally, while some states' directed trustee statutes relieve the trustee of notifying the beneficiaries of the actions of the appointed agent, common law may disagree. This is best illustrated in Rollins vs. Branch Banking & Trust Co. of Va., 20011 WL 34037931 (Va. Cir. Ct. April 30, 2001). In this case, the trustee was directed to hold an individual security, which represented a large portion of the trust's overall portfolio (aka "overconcentration"). The security's value significantly declined, and the trust beneficiaries brought suit against the trustee for failure to diversify the investments, among other claims. The court found that the trustee was not liable for failure to diversify, as the trustee was directed to hold the asset in the trust vehicle. However, the court did find the trustee liable for breach of trust for failing to warn the beneficiaries of the impending decline of the investment.

Best Practice Tip: SNT trustees should perform some form of review of directed investment advisors no less than annually.

IV. Acts of Prior Trustee

Accepting appointment as successor trustee can be fraught with potential liability. Therefore, counsel for the potential successor trustee must be aware of all pitfalls before their client accepts appointment. As a primary principle of trust and fiduciary law, successor trustees can generally not be held liable for the acts, failures to act, or omissions of the prior trustee. Most well-drafted trust instruments will typically state that a "successor trustee is not liable for the acts, omissions, or failures to act of the prior trustee" and outline trustee succession or the procedure to remove and replace (or fill the vacancy of) the office of the trustee. However, careful review and consideration of the acts of the prior trustee must occur before the successor trustee accepts appointment.

For example, the successor trustee may be liable if the successor trustee "(a) knows or should know of a situation constituting a breach of trust committed by [their] predecessor and improperly permits it to continue; or (b) neglects to take proper steps to compel the predecessor to deliver the trust property to [them]; or (c) neglects to take proper steps to redress a breach of trustee committed by the predecessor." (*Restatement (Second) of Trusts (Restatement of the Law Second, Trusts,* American Law Institute at Washington, D.C. © 1959)), ("*Restatement (Second)*"), § 223. This may be interpreted as an affirmative duty placed on the successor trustee to not only proactively remedy any administration errors by the prior trustee, but also to bring suit for any breach of trust committed by the prior trustee. In *Fernandez v. K-M Industries Holding Co., Inc.*, 585 F. Supp. 2d 1177 (N.D. Cal. 2008), the Court found that the successor trustee could be liable for its own subsequent breach of trustee duty by allegedly failing to take any steps to remedy the original breach by the predecessor. In the case of *In Matter of Donald E. Bradford Trust*, 524 So.2d 1213 (La. Ct. of App. 1989), a successor trustee was held liable to the trust beneficiaries for not pursuing the prior trustee for breach.

Best Practice Tip: If breach by the prior trustee is suspected, review all options before accepting appointment as successor trustee.

As outlined in the UTC § 705 (2000), a prior trustee continues to be liable for acts or omissions committed during their tenure. Additionally, a resigning trustee continues to have residual obligations to the trust beneficiary *Restatement (Third)* § 36. Typically, the powers to bring action against a prior trustee are restricted by the state-specific statute of limitations applicable to contract or tort law. However, in the much-publicized *O'Connor v. Redstone* (896 N.E.2d 595 (Mass. 2008)) case, the Supreme Court of Massachusetts held that the successor trustee's knowledge of a prior trustee's breach of fiduciary duty (and not the knowledge of the beneficiary) was sufficient to begin the statute of limitations on any claims. As noted above in *Restatement (Second)* § 223, trust beneficiaries or remainderpersons may have cause of action against the successor trustee for not pursuing the prior trustee for breach.

Best Practice Tip: As soon as potential breach by a prior trustee is suspected, take action within the appropriate statute of limitations.

Courts generally treat layperson fiduciaries more leniently than they treat professional fiduciaries. As such, professional fiduciaries serving as successor fiduciaries could be deemed as "should have known" about the breaches of prior fiduciaries if they've vetted the accountings and records of the prior fiduciaries thoroughly. While some states are more lenient in terms of successor trustee duties, it is very important to fully review and understand the prior trustee's accountings before accepting appointment as successor trustee. Careful review of the trust's statements, income tax returns, and relevant estate and gift tax returns should be at the top of the list before accepting appointment, regardless of applicable state statute. This review will not only protect the successor trustee from potential liability, but also help the successor trustee fulfill their fiduciary duty of loyalty to the trust beneficiaries. Failure to do so may result in a claim (and subsequent remedy) against the successor trustee as in the case of *In re Will of Crabtree*, 449 Mass. 128, 865 N.E.2d 1119 (2007), wherein it was determined that the successor trustee breached their duty, after accepting appointment, to ensure that the prior trustee had properly accounted for the entirety of the trust estate.

Distributions

A potential successor trustee must review past distributions to know if they will have to make regulation-related changes. The previous trustee may not have been in compliance for a variety of reasons, including being unaware of the rules. This can make for a challenging conversation because even though the past distributions may have been improper, any changes may still be a shock to the beneficiary. The problematic disbursements can include family members being paid directly for care, others receiving benefit from the funds, regular payments of in-kind support and maintenance, or simply overspending.

Best Practice Tip: Ensure that there is a conversation with the beneficiary or their designated agent before acceptance so there are clear lines drawn as to how future distributions will be made. These discussions should include information in writing as to how the successor trustee makes disbursements and explanations as to why some disbursements cannot be made.

Taxes

The failure of the prior trustee to submit proper tax returns for a trust can be especially problematic. Often, the prior trustee may not have known that such filings were even required (e.g., a layperson or family member trustee) and may not have filed trust tax returns for years. The outstanding tax liability in such situations may be egregiously burdensome in terms of cost (e.g., tax preparation fees, penalties, tax due, etc.). Such situations will have a severe impact on the trust's longevity and the funds subsequently available to the beneficiary for discretionary distributions. In these cases, the potential successor trustee and their counsel should carefully consider the effect such costs will have on the trust before accepting appointment.

Best Practice Tip: consult with a CPA or tax professional before accepting appointment as successor trustee.

V. Investments

Asset Allocation

A factor to consider when potentially accepting appointment of successor trustee of a stand alone trust is the inherited makeup of the investments within the trust. One key element to review is the fiduciary account's current asset allocation. Asset allocation refers to how a portfolio's composition is structured over different asset classes to balance risk and reward and account for prudent diversification, a key principle outlined by the Uniform Prudent Investor Act (UPIA). The asset allocation for a fiduciary account's portfolio should reflect the trust's goals, financial plan or budget, and risk tolerance, as the trust is often the beneficiary's only significant financial resource. A successor fiduciary may find that the asset allocation for the account may have been appropriate at the account's inception but is not prudent now as circumstances have changed. Noting this discrepancy and any potential remedies (such as the rebalancing of the account and the impact of capital gains to do so) to the account and its beneficiaries before accepting appointment as successor fiduciary results in prudent expectation management (necessary for a harmonious relationship with beneficiaries) while also protecting the successor fiduciary from potential liability.

Diversification

Another factor to review in terms of investments is diversification within the portfolio. Diversification of investments is a key focus of the UPIA. Put simply, diversification is a risk-management strategy that combines a variety of different investments and asset classes within a portfolio. In other words, don't put all your eggs in one basket (whether that "basket" is one stock, one sector, or even one geography). Barring a clear and documented rationale of the reasonableness of an alternative or less diversified strategy, failure to prudently diversify may have dire consequences for the fiduciary. In 2013, a Native American tribe sued the United States, seeking an accounting and asserting a claim for monetary losses and damages relating to an alleged breach of fiduciary duty by the Bureau of Indian Affairs (BIA). The Federal Court held *inter alia* that by keeping unreasonably large balances in relatively low-yield, short-term investments and failing to properly diversify the tribe's portfolio, the BIA breached its fiduciary duty to maximize the trust income. As such, the BIA was ordered to pay the tribe the investment income lost by its imprudent management. *Jicarilla Apache Nation v United States*, 112 Fed. Cl. 274 (2013).

It is not uncommon for a successor fiduciary to inherit the investment strategy and investment holdings from a trust's original settlor. This is especially true when the settlor has been adjudicated as lacking capacity or is the subject of undue influence. In such cases, the successor fiduciary may be taking over a portfolio invested solely in highly appreciated oil and gas stocks (for example). While the family of the settlor or the settlor themselves may be adamant that the successor fiduciary retain these investments for sentimental reasons or otherwise, the successor fiduciary generally has the duty to properly diversify the assets, barring a clear, documented rationale for continued retention. For instance, a 2012 New York State Appellate Court ruling found that a co-fiduciary of a testamentary trust violated both the prudent-person rule of investment and the Prudent Investor Act by maintaining a concentration of certain stock in trust for more than 20 years, warranting a surcharge of $4,322,412.40 with statutory interest. The ruling continues on to state that the co-fiduciary "never formulated an investment plan for the trust that included diversification of [the] concentration of stock … and failed to take steps to determine whether retaining non-diversified holdings was in the beneficiaries' best interests." *In re Hunter*, 955 N.Y.S.2d 163, 165 (N.Y. App. Div. 2d Dept. 2012).

Best Practice Tip: Consider consulting with an investment advisor before serving as a successor fiduciary.

<u>Capital Gains Taxation</u>

Embedded (or "legacy") capital gains inherited from a prior trustee and their investment manager can be a significant challenge for the successor trustee. Additionally, a successor trustee is usually asked to serve at the request of a referring attorney. These referring attorneys can be adamant about the successor trustee accepting all assets from the prior trustee in-kind so the beneficiary does not incur what appears to be onerous capital gains realization just to change trustees. This discussion is usually complicated by the fact that the potential successor trustee has an investment manager that has their own set of investment strategies that may not incorporate the same asset allocation or securities.

In these cases, a thorough review of the trust's current portfolio is necessary. This review should vet the current investments, asset allocation, and diversification of the portfolio, as well as analyze the beneficiary's personal tax situation. Many referring attorneys may not understand that a full liquidation of the portfolio before transfer to the successor trustee is more prudent under certain circumstances and may have no impact on the beneficiary's tax situation whatsoever. Consider the following hypotheticals:

**Please note that all situations below apply 2024 tax rates.*

*** Please also note that all tax situations are simplified for illustrative purposes.*

<u>Hypothetical #1 - Not Required to File</u>

- First Party SNT (i.e., Grantor Trust for tax purposes)
    - Note: In a Grantor Trust, all taxability flows out from the trust to the beneficiary and is taxed at the beneficiary's applicable tax rates.

- Trust corpus of $100,000 with $10,000 in long-term (i.e., held more than one year) appreciation (or unrealized capital gains)
  - Trust's anticipated annual taxable interest = $500
  - Trust's anticipated annual ordinary dividends = $500
- Beneficiary receives Supplemental Security Income (SSI) and Medicaid and has no other income sources.
  - No itemized personal deductions, 2024 standard deduction = $14,600
  - Beneficiary files as "single" taxpayer.
  - Beneficiary is 66 years of age.

Conclusion: As all taxable events flow out to the beneficiary in a Grantor Trust, realization of capital gains in full may be appropriate as the beneficiary's "gross income" is below $14,600. Note that SSI is generally not taxable income.

<u>Hypothetical #2 - No Capital Gains Tax Due</u>

Note: Changes in fact pattern bolded below.

- First Party SNT (i.e., Grantor Trust for tax purposes)
  - Note: In a Grantor Trust, all taxability flows out from the trust to the beneficiary and is taxed at the beneficiary's applicable tax rates.
- Trust corpus of ***$200,000*** with ***$25,000*** in long-term (i.e., held more than one year) appreciation (or unrealized capital gains)
  - Trust's anticipated annual taxable interest = ***$1,500***
  - Trust's anticipated annual ordinary dividends = ***$1,500***

- Beneficiary receives SSI and Medicaid and has no other income sources.
    - No itemized personal deductions, 2024 standard deduction = $14,600
    - Beneficiary files as "single" taxpayer.
    - Beneficiary is 66 years of age.

Conclusion: As all taxable events flow out to the beneficiary in a Grantor Trust, realization of capital gains in full may be appropriate as the beneficiary's long-term realized gains would total $25,000 and thus are taxed at 0%. However, consideration should be given to the fact that the same $25,000 in realized long-term capital gains is includable in the beneficiary's Adjusted Gross Income (AGI) (Line 11, Form 1040 (2023)). As such, there may still be income tax due on the beneficiary's personal 1040, calculated as:

Beneficiary AGI:	$28,000 *(Line 11, Form 1040 (2023))* (long-term capital gains + taxable interest + ordinary dividends) **Note that SSI is generally not taxable income.*
Beneficiary Taxable Income:	$13,400 *(Line 15, Form 1040 (2023))* ($28,000 AGI minus 2024 standard deduction of $14,600)
Beneficiary Tax Due:	$1,608 *(Line 16, Form 1040 (2023))* See IRS 2023 1040 Instruction Form, Tax Table.

In this scenario, selling the assets with long-term gains appears to be prudent as the tax due of $1,608 only represents 0.80% of the total trust corpus, which is a de minimis expense for rectifying any diversification, asset allocation, or ease-of-administration concerns.

Capital gains tax rates follow for Grantor Trusts (wherein all taxability flows out to the beneficiary). Note that short-term capital gains (e.g., sales of securities held for one year or less) are taxed as ordinary income (or at the beneficiary's tax rate, as applicable).

2024 Capital Gains Tax Rates *(Single Filers)*

Long-term capital gains tax rate	**Beneficiary's Income**
0%	$0 - $47,025
15%	$47,026 - $518,900
20%	$518,901+

<u>Hypothetical #3 - Third Party Trust, No Capital Gains Tax Due</u>

Note: Changes in fact pattern bolded below.

- Third Party SNT (i.e., Complex Trust for tax purposes)
    - Note: In a Complex Trust, taxability may flow out from the trust to the beneficiary via Distributable Net Income (DNI) for distributions to or for the benefit of the beneficiary.
    - **Note that the Qualified Disability Trust (QDT) exemption is not contemplated here for brevity's sake.**

- Trust corpus of **$200,000** with **$25,000** in long-term (i.e., held more than one year) appreciation (or unrealized capital gains)
    - Trust's anticipated annual taxable interest = **$1,500**
    - Trust's anticipated annual ordinary dividends = **$1,500**
    - **Trust's anticipated annual distributions = $30,000**
    - **Trust provisions and state statute (via the state's Uniform Principal and Income Act) allocate capital gains to income rather than principal, and the fiduciary's powers include the Power to Adjust.**
- Beneficiary receives SSI and Medicaid and has no other income sources.
    - No itemized personal deductions, 2023 standard deduction = $13,850
    - Beneficiary files as "single" taxpayer.
    - Beneficiary is 66 years of age.

Conclusion: Generally, capital gains are ***excluded*** *from DNI and are allocated to principal (see IRS Regs. § 1.643(a)-3(b)) unless authorized by the trust instrument or "local law," or pursuant to the fiduciary's discretion to adjust between principal and income. In this fact pattern, all taxable events would flow out to the beneficiary (as in a Grantor Trust). As such, realization of capital gains in full may be appropriate as the beneficiary's long-term realized gains would total $25,000 and thus are taxed at 0%. However, consideration should be given to the fact that the same $25,000 in realized long-term capital gains is includable in the beneficiary's Adjusted Gross Income (AGI) (Line 11, Form 1040 (2023)). As such, there may still be income tax due on the beneficiary's personal 1040, calculated as:*

Beneficiary AGI: $28,000 *(Line 11, Form 1040 (2023))*

(long-term capital gains + taxable interest + ordinary dividends)

**Note that SSI is generally not taxable income.*

Beneficiary Taxable Income: $13,400 *(Line 15, Form 1040 (2023))*

($28,000 AGI minus 2024 standard deduction of $14,600)

Beneficiary Tax Due: $1,608 *(Line 16, Form 1040 (2023))*

See IRS 2023 1040 Instruction Form, Tax Table.

Here again, selling the assets with long-term gains appears to be prudent as the tax due of $1,608 only represents 0.80% of the total trust corpus, which is a de minimis expense for rectifying any diversification, asset allocation, or ease-of-administration concerns.

VI. Conclusion

Non-profit trustees provide vital services and advocacy to beneficiaries and can make a tangible difference in the lives of beneficiaries. However, while there are significant opportunities to serve as trustee for stand alone trusts, accepting appointment should be approached with the organization's eyes wide open. A fiduciary maintains the duties of loyalty and impartiality to all of its beneficiaries, and, as such, must carefully weigh the benefit of serving as stand alone trustee against the potential inherent liability of such. A negative outcome or being held liable for acts of a prior trustee could harm the reputation of the fiduciary (and potentially their PSNT), thus potentially threatening its ability to serve its current beneficiaries. However, acting as stand alone trustee is a sorely needed service that significantly increases the overall impact we can have in the community.

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