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Trust Protector Powers: Fiduciary Duty and Tax Issues

By Mitchell M. Gans



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Legislature on the adoption of the Uniform Trust Code.

Whether a trust protector's power is subject to the terms of the instrument and to a fiduciary duty — a matter of state law — can lead to critically important tax consequences.

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Much has been written recently about the use of trust protectors.¹ Broadly defined, a trust protector is a person appointed by the settlor to direct the actions of the trustee regarding specified functions. For example, the settlor might provide in the trust instrument that the trustee must follow the directions of a trust protector regarding investments. The treatment of trust protectors and trustees who follow directions provided by the trust protector is the subject of statutes in some states² and may be

¹See, e.g., Richard C. Ausness, "The Role of Trust Protectors in American Trust Law," 45 *Real Prop. Tr. & Est. L.J.* 319 (2010); Gregory S. Alexander, "Trust Protectors: Who Will Watch the Watchmen?" 27 *Cardozo L. Rev.* 2807 (2006) (discussing the role of a trust protector); Stewart E. Sterk, "Trust Protectors, Agency Costs, and Fiduciary Duty," 27 *Cardozo L. Rev.* 2761 (2006) (same). John P.C. Duncan and Anita M. Sarafa, "Achieve the Promise — and Limit the Risk — of Multi-Participant Trusts," 36 *ACTEC J.* 769 (2011).

²See, e.g., Alaska Stat. section 13.36.370(a) (2008); Del. Code Ann. tit. 12, section 3313 (2007 and Supp. 2008).

addressed in case law in other states.³ Section 808 of the Uniform Trust Code (UTC) deals with what it calls "directed trusts."⁴

A critical question about the treatment of trust protectors is whether the protector is subject to a fiduciary duty. Under some statutes, it is clear that the settlor can negate any fiduciary duty through the trust instrument.⁵ The commentary under UTC section 808 makes clear that the settlor can negate the protector's fiduciary duty⁶ — an approach that is consistent with the overall structure of the UTC.⁷ On the other hand, in some states, a protector is in effect treated as a co-trustee whose fiduciary duty cannot be waived by the settlor.⁸ This fiduciary duty question, obviously a matter of state law, can have important tax implications.

Consider two examples. First, assume the settlor wants to create a trust that will be treated as a grantor trust for tax purposes, appreciating that transactions between the settlor and the trust will be ignored for tax purposes.⁹ Many settlors have created this type of trust by inserting a provision in the instrument giving the settlor a substitution power — that is, power to convey assets to the trust in exchange for trust assets of equal value. Under

³See, e.g., *Matter of Rubin*, 143 Misc.2d 303, 540 N.Y.S.2d 944 (Sur. Ct. Nassau County 1989), *aff'd*, 540 N.Y.S.2d 944 (2d Dep't. 1989).

⁴See also Restatement of Trusts (Third), section 64.

⁵See *supra* note 2.

⁶The commentary says that "settlors could provide that the holder of the power is not to be held to the standards of a fiduciary."

⁷Section 105 of the UTC provides that subject to some exceptions specified in the section, all the code's provisions are default rules that can be modified or displaced by the settlor. Because there is no cross-reference in UTC section 105 to UTC section 808, the indication in the text of UTC section 808 that a protector is presumptively a fiduciary must be understood as a mere default rule.

⁸See *Matter of Rubin*.

⁹Much in estate planning depends on the status of a trust as a grantor trust. If, for example, a settlor sells an appreciated asset to a grantor trust, no gain is recognized for tax purposes, but a similar sale to a non-grantor trust would result in gain recognition. See Rev. Rul. 85-13, 1985-1 C.B. 184 (indicating that no gain is recognized on a sale by a settlor to a grantor trust). See also Rev. Rul. 2004-64, 2004-2 C.B. 7, *Doc 2004-13722*, 2004 TNT 129-8 (providing additional tax advantages for settlors who create grantor trusts).

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section 675, the existence of this sort of power is sufficient to confer grantor trust status on the trust, provided that the settlor's substitution power is held in a nonfiduciary capacity. To the extent that this substitution power is treated as a trust protector power that is fiduciary in nature, the trust is not a grantor trust, and the tax advantages sought by the settlor are unavailable. In a state where a protector is subject to a fiduciary duty that cannot be waived in the instrument, this kind of planning is not feasible. It may be appropriate therefore for states that impose a non-waivable fiduciary duty on protectors to consider creating a specific exception for this kind of planning.

In our second example, consider an amendment power. It has become somewhat common for settlors to grant the right in the instrument to a third party to amend the trust's substantive or administrative provisions.¹⁰ The amendment power makes irrevocable trusts more flexible, permitting alterations from time to time when necessary to accomplish tax or other advantages.¹¹ When an amendment power is used to enhance the interest of one beneficiary and to concomitantly diminish the interest of another beneficiary, the shift in interest could be considered a taxable gift by the beneficiary whose interest is diminished. If the beneficiary's interest were diminished by a third party's exercise of a power of appointment, it would not be treated as a taxable gift. But if the third party is a trust protector subject to a fiduciary duty under state law — as distinguished from the donee of a power of appointment, who is not subject to a fiduciary duty — the IRS could argue that a taxable gift is made by the diminished beneficiary when he consents to the amendment or otherwise acquiesces to its implementation.¹² This raises several issues:

- whether states that are inclined to make a trust protector's power subject to a fiduciary duty should create an exception for amendment powers;
- whether settlors who want to create amendment powers should locate their trusts in states that permit the waiver of the protector's fiduciary duty;

- whether decisions to locate trusts in states that allow waivers of protectors' fiduciary duty will result in another iteration of competition among the states to provide a settlor-friendly environment¹³; and
- whether settlors can accomplish their objective by drafting the amendment power as a power of appointment instead of a trust protector power.¹⁴

In sum, trust protector provisions are becoming increasingly common. The fiduciary duty issue is likely to become an important one as a matter of state law. The resolution of this issue will, in turn, implicate important tax considerations. States considering trust protector legislation will need to consider the fiduciary duty issue from both the tax and nontax perspectives.

¹³See Max M. Schanzenbach and Robert H. Sitkoff, "Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust," 27 *Cardozo L. Rev.* 2465 (2006) (discussing the location of trust in states that permit a perpetual duration in order to accomplish tax advantages); Mitchell M. Gans, "Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?" 48 *Emory L.J.* 871 (1999) (indicating that problematic outcomes under the tax law occur when the tax law overemphasizes state law).

¹⁴Cf. John H. Langbein, "Mandatory Rules in the Law of Trusts," 98 *Nw. U.L. Rev.* 1105 (2004) (suggesting that the distinction between a power of appointment and a provision exonerating a fiduciary duty can be justified on a truth-in-labeling ground, *i.e.*, that a settlor who creates a power of appointment must fully appreciate the wide scope of discretion conferred on the donee of the power).

¹⁰See Edward C. Halbach Jr., "Uniform Acts, Restatements, and Trends in American Law at Century's End," 88 *Cal. L. Rev.* 1877 (2000) (discussing and anticipating the widespread use of amendment powers).

¹¹If the settlor retained the amendment power, it would likely result in inclusion of the trust's assets in the grantor's estate for tax purposes under section 2036 or 2038.

¹²See LTR 9811044, *Doc 98-9164*, 98 *TNT* 50-69, and LTR 200339021, *Doc 2003-21151*, 2003 *TNT* 188-57; cf. LTR 201033025, *Doc 2010-18546*, 2010 *TNT* 162-43. But see *Estate of Hazelton v. Commissioner*, 29 T.C. 637 (1957).