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Trust Protector Powers: Tax Implications of the Fiduciary-Duty Issue

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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 with respect to 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 states[2] and may be addressed in case law in other states.[3] The Uniform Trust Code deals with what it calls "directed trusts" in section 808.[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 in the trust instrument negate any such fiduciary duty.[5] The commentary under section 808 of the Uniform Trust Code makes clear that the settlor can negate the protector's fiduciary duty[6]—an approach that is consistent with the overall structure of the Code.[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 so-called 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 such trusts by inserting a provision in the instrument giving the settlor a substitution power, i.e., a power to convey assets to the trust in exchange for trust assets of equal value. Under section 675 of the Internal Revenue Code, the existence of such a power is sufficient to confer grantor-trust status on the trust provided that the settlor's substitution power is held in a non-fiduciary capacity. To the extent that such a 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. Thus, 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.

Consider as a second example 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 and/or administrative provisions.[10] The amendment power makes irrevocable trusts more flexible, permitting alterations from time to time where necessary to accomplish tax or other advantages.[11] Where such an amendment power is used to enhance the interest of one beneficiary and to concomitantly diminish the interest of another beneficiary, the question arises whether a taxable gift is made 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 clearly 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 such a duty—the IRS could well argue that a taxable gift is made by the diminished beneficiary when he or she consents to the amendment or otherwise acquiesces to its implementation.[12] This, of course, 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 such amendment powers should locate their trust in a state that permits the waiver of the protector's fiduciary duty; whether this will result in another iteration of competition among the states to provide a settlor-friendly environment;[13] 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 non-tax perspectives.

Endnotes

1. *See, 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).
2. *See, e.g.*, Alaska Stat. § 13.36.370(a) (2008); Del. Code Ann. tit. 12, § 3313 (2007 & Supp. 2008).
3. *See, e.g., Matter of Rubin*, 143 Misc.2d 303, 540 N.Y.S.2d 944 (Sur. Ct., Nassau Co. 1989), *aff'd*, 540 N.Y.S.2d 944 (2d Dep't 1989).
4. *See also* Restatement of Trusts (Third), section 64.

5. *See* n.2, *supra*.

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

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

8. *See Matter of Rubin, supra*.

9. Much in estate planning depends upon 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, whereas such a 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, providing additional tax advantages for settlors who create grantor trusts.

10. *See* 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.

11. If 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 sections 2036 or 2038 of the Internal Revenue Code.

12. *See* PLR 9811044 and PLR 200339021; cf. 201033025; *but see Estate of Hazelton v. Commissioner*, 29 T.C. 637 (1957).

13. *See* 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 where the tax law overemphasizes state law.

14. *Cf.* 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.