CHAPTER ELEVEN

Problems with Trusts

Trusts are not a panacea. That is, there can be problems associated with using a trust as an estate settlement method. Trust is the primary problem. Your trustee has to be trustworthy. Since there is no oversight by a court or anyone else, the trustee is the one responsible for making good decisions—investment decisions, financial management decisions, and so forth.

For example, in a down stock market it may be wise to hold stocks for a period of time rather than selling to protect the value of the trust principal. Timing of the sale of assets is a financial management decision. Selecting which assets in which to invest trust funds is a critical decision. Trustees are supposed to be conservative and, absent instructions to the contrary, are supposed to diversify the trust investments. Certainly we would not want to choose a trustee who might invest all the funds in a risky stock.

But because there is no oversight, the only ones the trustee has to report to are the trust beneficiaries, and then only after the fact. The trustee is required to keep good records and keep the trust beneficiaries informed as to trust income and expenses. Unfortunately, by the time the beneficiaries find out about a mistake, the money may already be gone with no way to recover it.

How do we remedy this potential problem? There are four ways:

1. Find a very reliable trustee who will not make these mistakes and who will act honestly. This is a judgment call at best. Most of the time trustees *do* act honestly and competently and there are no problems. Do

not take the warnings here as any indication that trustee abuse is widespread, because it is actually quite rare.

2. Use cotrustees. When more than one trustee is responsible for trust management, there is less likelihood of sloppy bookkeeping, poor asset management, or a trustee embezzling the trust funds.
3. Use an institutional trustee. Banks and trust companies are in the business of acting as trustees and managing trust funds. Their fees typically are about 1 percent of the trust assets per year, but they often can make that up in higher earnings than an individual trustee investor can achieve.
4. Register the trust with the court. Most courts have procedures that allow a trust to be supervised by the local probate court. While this may be more trouble for the trustee and may incur annual attorney fees, it is a way of insuring as best we can that the trust instructions will be carried out and that the trust assets will be preserved. Generally, we do not want court oversight because of the additional paperwork and bureaucracy attendant, but if you are unsure of your trustee's likelihood of acting in the best interests of your estate, you may want to go for it.
5. Give all trust beneficiaries a copy of the trust and a let them know about the responsibilities of the named trustee. The beneficiaries need to be educated as to what a trust is and their rights and responsibilities. One big problem is that lack of communication may cause each beneficiary to hire a separate attorney, which really stirs up the mud and complicates things. (You could also give them each a copy of this book.)

THE TRUST PROTECTOR

The Uniform Trust Act, which is currently in force or pending in a couple dozen states, provides potential protection for trust beneficiaries from a wayward trustee or from changes in circumstance. The act allows the grantors of the trust to appoint a third party or a committee of outside people to supervise the trustee.

The protector's role is set out in the language of the trust document. The protector may be given limited rights to be sure that the intent of the grantor(s) is carried out. These powers may include the right to change the trustee, to change the terms of the trust, or even to add beneficiaries under certain conditions. The rights of the protector are limited to what is given to him in the trust. The purpose is first to be sure the trustee is doing what is supposed to be done. The second purpose is to be sure that if unexpected changes occur, the trust is still going to do what was intended. For example, the trust may provide for a share of the trust assets to be given to the five grandchildren of the grantors. Perhaps at the time the trust was made there was no likelihood that there would be any more grandchildren. Then—surprise—another one is born. The protector may be given the ability to add the new grandchild as a beneficiary even if the grantors are long dead.

Or maybe the trustee is just not doing the job properly. Rather than having to go through the probate court to have the trustee replaced, the protector could be given the right to have the trustee replaced. This saves time and money for the beneficiaries.

Or there may be a change in the tax laws that would benefit the trust estate if the trust language could be changed. The protector could do that.

Family members and beneficiaries should not be the protector, though they may be considered as a committee the protector consults before making a change in the trust. Typically, the protector would be the family accountant, a trusted financial advisor, or another disinterested, nonbeneficiary third party.

This is not a role that should be put in every trust. In most cases, the trust provisions provide for a complete distribution of trust assets soon after death. In continuing trusts, though, a protector may be advantageous to cover the ongoing events and life changes that may present themselves. Also, keep in mind that you are adding another layer of complexity to the trust process by having a protector, and that this is a paying position. A protector could be a pricey position to create if it is not strictly needed.

Actually, it is not necessary for the Uniform Trust Act to be enacted in your state for you to have a protector. Trusts are so flexible that you can add the specific language to create this position even without the act. Just be careful putting it in if it is not needed, since this means there is someone looking over the shoulder of the trustee at all times and may add significant cost and delay to the trust settlement process.

TRUSTS AND CREDITORS

A revocable trust does not provide asset protection. There are seminars and courses offered that promote the use of trusts as a way of protecting your assets from your creditors. Most of these involve the use of either irrevocable trusts or offshore trusts with foreign trustees and are sold for big prices by those running the seminars. In some cases these techniques work, but sometimes they can be disastrous, and the trust owner finds himself prosecuted for fraudulent transfers or income tax evasion. Be very careful and get independent legal advice before using any of these types of trusts. Similarly, having your assets in a revocable trust does not guarantee that you will qualify for Medicaid benefits for nursing-home care. The asset and income limitations still apply, and trust assets are considered as your assets for qualification purposes.

The purpose of the revocable living trust is not creditor protection. The trust described in this book has as its purposes—probate avoidance, asset management, and estate tax minimization—but not protection from creditors or lawsuits.

GUARDIAN AND TRUSTEE ARE TWO DIFFERENT ROLES

One problem we occasionally see is when the guardian of minor children is also named as the trustee of their trust-fund money. This is an inherent conflict of interest, because the guardian would be the one asking the trustee for funds for the care of the children. It sounds okay but can lead to abuses.

Here’s an example: Mom and Dad died, leaving three young children as survivors. A friend of the family was named as their trustee and guardian. The trustee had children of her own and made a decision to use the trust funds to add onto her house to provide a playroom for all the children. While this decision temporarily benefited the children, in the long run it benefited the trustee, because the money added to the value of her home. (She had to give the money back.)

Had the trustee and guardian roles been separated, it is unlikely the trustee would have agreed to the building of the playroom.

WHY YOU MAY NOT WANT A JOINT TRUST

A joint trust between two or more people normally will have their joint and individual assets funded into it. Then there is one set of instructions that tells the trustee what to do with those assets at one or both deaths. The first thing that is done after identifying the assets is paying the debts. That can be a problem.

If one partner has a lot of debt that is not jointly owed by the other partner, the amount of the individual debt will have to be paid from the joint trust assets at the death of the debtor. This can be disastrous to the surviving grantor.

I had a client whose husband, who was seriously ill, owed over $100,000 resulting from a lawsuit over a failed business venture. At his death, the joint trust would have been responsible for the entire debt, even though most of the assets belonged to the wife before the marriage. Fortunately, before he died, we were able to revoke the joint trust, remove her assets, and set up an individual trust for her. When he died, only his separate assets were liable for the debt, so the wife’s assets were preserved. Analyze the respective debts of the two grantors to see if this could be an issue.