

DRAFTING OPTIONS UNDER THE MAINE UNIFORM TRUST CODE

Beneficiary Controlled Trusts and Trust Protectors An Analysis of 18-B MRSA §504(3) and §808

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I. Beneficiary Controlled Trusts

A. Statutory Background

The UTC provides creditor protection where, previously, either none existed or where the degree of protection was unclear. Creditors' claims against beneficial trust interests are detailed in Chapter 5 of the Maine UTC.

Section 501 addresses creditors' rights in a trust that does not have a spendthrift provision. Section 501 says, "To the extent a beneficiary's interest is not protected by a spendthrift provision, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary's interest by attachment of present or future distributions to the beneficiary." In other words, if the trust does not contain a spendthrift provision, a creditor may reach the interest of a beneficiary the same as any other of the beneficiary's assets and may obtain an attachment of the trust property after the property leaves the trust but before it reaches the beneficiary. The creditor has no right to reach the assets of the trust, but does have the right to attach distributions actually made to the beneficiary. The creditor may obtain a court order directing the trustee to pay to the creditor any distributions that the trustee is required to make to the beneficiary.

Therefore, if the trust requires distribution of all income to the beneficiary, the creditor may attach the income distributions. Similarly, the creditor may attach discretionary distributions that the trustee actually makes to the beneficiary (although once such an attachment order is issued, it is unlikely that a trustee will make such a discretionary distribution knowing that the distribution will end up in the hands of the creditor). See Uniform Comments to §501.

Under §502, if a trust has a valid spendthrift provision (one that restrains both voluntary and involuntary transfer of a beneficiary's interest), a creditor may not reach the beneficiary's interest or a distribution by the trustee before the beneficiary actually receives the distribution. A valid spendthrift provision exists if the trust says that "the interest of a beneficiary is held subject to a 'spendthrift trust,' or words of similar import." The creditor will therefore not be able to attach trust distributions even if the distributions to the beneficiary are required by the terms of the trust. Instead, the beneficiary's creditor may only attempt to collect directly from the beneficiary after payment is made from the trust to the beneficiary. See Uniform Comment to §502.

Section 504 makes it clear that if the trust does not have a spendthrift provision, a creditor cannot compel a distribution from the trust that is subject to the trustee's discretion, even if the trustee has abused its discretion.

§504. Discretionary trusts; effect of standard

1. Creditor may not compel distribution. Whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if:

- A. The discretion is expressed in the form of a standard of distribution; or
- B. The trustee has abused the discretion.

2. Right of beneficiary not limited. This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for failure to

exercise a discretionary power in accordance with the terms and purposes of the trust or for failure to comply with a standard for distribution.

3. Creditor limited. A creditor may not reach the interest of a beneficiary who is also a trustee, or otherwise compel a distribution, if the trustee's discretion is limited by an ascertainable standard.

Section 504(3) presents drafting creative planning options that were not available pre-UTC. Under §504(3), if a beneficiary is the sole trustee of the beneficiary's trust and the trustee's distribution discretion is limited by an ascertainable standard, the beneficiary's creditors cannot reach the beneficiary's interest in the trust and cannot compel the beneficiary-trustee to make a distribution from the trust, even if the beneficiary-trustee has abused its distribution discretion.

The language of §504(3) was not part of the original UTC as distributed by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The language of §504(3) was part of a revised draft issued by NCCUSL in 2004. After Maine sent its version of the UTC to the Maine legislature for adoption, NCCUSL later modified the language of our §504(3) to say:

If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee.

Although as of the time of this writing there is no formal proposal to change the language of Maine's §504(3) to conform to the current Uniform language, such a change is likely. The Uniform Comment to §504, which Comment accompanies the post-2004 modified UTC language, states:

Trusts are frequently drafted in which a trustee is also a beneficiary. A common example is what is often referred to as a bypass trust, under which the settlor's spouse will frequently be named as both trustee and beneficiary. An amount equal

to the exemption from federal estate tax will be placed in the bypass trust, and the trustee, who will often be the settlor's spouse, will be given discretion to make distributions to the beneficiaries, a class which will usually include the spouse/trustee. To prevent the inclusion of the trust in the spouse-trustee's gross estate, the spouse's discretion to make distributions for the spouse's own benefit will be limited by an ascertainable standard relating to health, education, maintenance, or support.

The UTC, as previously drafted, did not specifically address the issue of whether a creditor of a beneficiary may reach the beneficial interest of a beneficiary who is also a trustee. However, Restatement (Third) of Trusts §60, comment g, which was approved by the American Law Institute in 1999, provides that the beneficial interest of a beneficiary/trustee may be reached by the beneficiary/trustee's creditors. Because the UTC is supplemented by the common law (see UTC Section 106), this Restatement rule might also apply in states enacting the UTC. The drafting committee has concluded that adoption of the Restatement rule would unduly disrupt standard estate planning and should be limited. Consequently, Section 504 is amended to provide that the provisions of this section, which generally prohibit a creditor of a beneficiary from reaching a beneficiary's discretionary interest, apply even if the beneficiary is also a trustee or cotrustee. The beneficiary-trustee is protected from creditor claims to the extent the beneficiary-trustee's discretion is protected by an ascertainable standard as defined in the relevant Internal Revenue Code sections. The result is that the beneficiary's trustee's interest is protected to the extent it is also exempt from federal estate tax. The amendment thereby achieves its main purpose, which is to protect the trustee-beneficiary of a bypass trust from creditor claims.

The protection conferred by this subsection, however, is no greater than if the beneficiary had not been named trustee. If an exception creditor can reach the beneficiary's interest under some other provision, the interest is not insulated from creditor claims by the fact the beneficiary is or becomes a trustee.

In addition, the definition of "power of withdrawal" in Section 103 is amended to clarify that a power of withdrawal does not include a power exercisable by the trustee that is limited by an ascertainable standard. The purpose of this amendment is to preclude a claim that the power of a trustee-beneficiary to make discretionary distributions for the trustee-beneficiary's own benefit results in an enforceable claim of the trustee-beneficiary's creditors to reach the trustee-beneficiary's interest as provided in Section 505(b). Similar to the amendment to Section 504, the amendment to "power of withdrawal" is being made because of concerns that Restatement (Third) of Trusts Section 60, comment g, otherwise might allow a beneficiary-trustee's creditors to reach the trustee's beneficial interest.

The Code does not specifically address the extent to which a creditor of a trustee/beneficiary may reach a beneficial interest of a beneficiary/trustee that is not limited by an ascertainable standard. (emphasis added)

§103(1-A) of the Maine UTC states:

1-A. Ascertainable standard. “Ascertainable standard” means an ascertainable standard relating to an individual’s health, education, support or maintenance within the meaning of Section 2041(b)(1)(A) or Section 2514(c)(1) of the federal Internal Revenue Code of 1986, as in effect on July 1, 2005.

B. Drafting Opportunities

Although the primary purpose of the beneficiary-trustee creditor protection was to provide creditor protection to a credit shelter trust with the surviving spouse as sole trustee, the drafting opportunities of §504(3) extend beyond the credit shelter trust. By creating a trust for a beneficiary, and limiting the trustee’s distribution authority to an ascertainable standard, the beneficiary as sole trustee of the trust will enjoy the benefit of having the trust assets protected from claims by the beneficiary’s creditors.

1. Ascertainable Standard

Internal Revenue Code §2041’s “ascertainable standard” is clarified in Treas. Reg. §20.2041-1(c)(2):

POWERS LIMITED BY AN ASCERTAINABLE STANDARD. A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder’s duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words “support” and “maintenance” are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder’s “support,” “support in reasonable comfort,” “maintenance in health and reasonable comfort,” “support in his accustomed manner of living,” “education, including college and professional education,” “health,” and “medical, dental, hospital and nursing expenses and expenses of invalidism.” In determining whether

a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

An example of a trust that limits the trustee's discretionary distribution authority to ascertainable standards is as follows:

My Trustee may pay to or for the benefit of the child as much of the income and principal of the child's trust as my Trustee determines is necessary or advisable for the child's health, education, support or maintenance.

There appears to be much leeway in the determination of what distributions properly fall within the scope of an ascertainable standard. According to the Restatement Third, Trusts §50, Comment d(2), a support standard:

. . . ordinarily entitles a beneficiary to distributions sufficient for accustomed living expenses, extending to such items 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 of charitable and family giving. Reasonable additional comforts or 'luxuries' that a special vacation of a type the beneficiary had never before taken, may be borderline as entitlements but would normally be within the permissible range of the trustee's judgment, even without benefit of a grant of extended discretion. . . . A support standard normally covers not only the beneficiary's own support but also that of persons for whom provision is customarily made as a part of the beneficiary's accustomed manner of living. This generally includes the support of members of the beneficiary's household and the costs of suitable education for the beneficiary's children. . . . the terms 'support' and 'maintenance' do not . . . authorize distributions to enlarge the beneficiary's personal estate or to enable the making of extraordinary gifts.

2. Power of Appointment

In order to minimize, or avoid entirely, any potential interference by remainder beneficiaries who might be inclined to exercise intrusive oversight of the current beneficiary's distribution discretion, if the goal is to give the beneficiary-trustee virtually the same degree of authority that the beneficiary would have over the trust property if the beneficiary had inherited the property outright as opposed to in trust, the beneficiary should be given either a testamentary

general power of appointment (if estate tax inclusion in the beneficiary's estate is not a concern) or a testamentary "broad limited" power of appointment. Broad testamentary appointment authority, which includes the authority to effectively disinherit a meddlesome remainder beneficiary, will assure the current beneficiary of full control of the trust. The current beneficiary need merely remind a meddlesome remainder beneficiary that a power of appointment is also a power of disappointment.

Following is an example of a testamentary general power of appointment:

The child shall have the testamentary unlimited and unrestricted general power to appoint, by a valid last will and testament or by a valid living trust agreement, the entire principal and any accrued and undistributed net income of the child's trust as it exists at the child's death. In exercising this general power of appointment, the child shall specifically refer to this power.

The child shall have the sole and exclusive right to exercise the general power of appointment.

This general power of appointment specifically grants to the child the right to appoint property to the child's own estate. It also specifically grants to the child the right to appoint the property among persons, corporations, or other entities in equal or unequal proportions, and on such terms and conditions, whether outright or in trust, as the child may elect. This power of appointment is intended to be a general power of appointment as defined in Section 2041 of the Internal Revenue Code.

To the extent that any part of the child's trust shall not be effectively appointed, my Trustee shall distribute the remaining unappointed balance to the child's then living descendants, *per stirpes*.

If the child has no then living descendants, my Trustee shall distribute the balance of the trust property to my then living descendants, *per stirpes*.

If there is a desire to avoid having the trust assets included in the beneficiary's estate, and assuming the trust is exempt from generation skipping transfer tax, the beneficiary should be given to a limited power of appointment - - the power to appoint the property to anyone other

than the beneficiary, the beneficiary's estate, the beneficiary's creditor's, or the creditors of the beneficiary's estate. See Internal Revenue Code §2041(b)(1). For example:

The child shall have the testamentary limited power to appoint, by a valid last will and testament or by a valid living trust agreement, the entire principal and any accrued and undistributed net income of the child's trust as it exists at the child's death. In exercising this limited power of appointment, the child shall specifically refer to this power.

The child shall have the sole and exclusive right to exercise the limited power of appointment.

The child shall not exercise this power in favor of the child, the child's creditors, the child's estate, or the creditors of the child's estate.

To the extent that any part of the child's trust shall not be effectively appointed, my Trustee shall distribute the remaining unappointed balance to the child's then living descendants, *per stirpes*.

If the child has no then living descendants, my Trustee shall distribute the balance of the trust property to my then living descendants, *per stirpes*.

A limited power of appointment can be crafted to be as limited as desired; for example, it could permit the beneficiary to appoint the trust assets only to the child's descendants. The critical limiting design element, to avoid the power from being a general power of appointment and to avoid the trust assets from being included in the beneficiary's estate, is that the beneficiary must not have the power to appoint the trust property to the beneficiary, the beneficiary's estate, the beneficiary's creditor's, or the creditors of the beneficiary's estate. A "limited limited" power of appointment, in contrast to a "broad limited" power of appointment, however, is somewhat inconsistent with the underlying premise of a beneficiary controlled trust, which is to give the beneficiary the broadest possible control over the trust property while still providing the benefit of creditor protection and, if desired, estate tax exclusion. Therefore, a beneficiary controlled trust is likely to provide the beneficiary with either an unlimited general power of appointment or a "broad limited" power of appointment.

3. The Ideal Beneficiary-Trustee

The ideal beneficiary to be the sole trustee of his or her own trust is the beneficiary who, but for the option of a UTC beneficiary controlled trust, would likely have received his or her inheritance outright; *i.e.*, a beneficiary who is mature enough and responsible enough that there is minimal concern about the beneficiary's ability to responsibly manage his or her own financial affairs. For that beneficiary, if given the choice of receiving his or her inheritance outright and receiving the inheritance in a trust where he or she has virtual full control of the trust and where the trust assets are protected from claims of creditors and are excluded from his or her taxable estate at death, the answer for most beneficiaries would seem obvious - - opt for the beneficiary controlled trust. For many beneficiaries, it is hard to imagine a circumstance where outright distribution would be preferred over a beneficiary controlled trust. Because the creditor protection provided by §504(3) only applies when the trustee's discretion is limited by an ascertainable standard, the beneficiary-trustee who wants to preserve the creditor protection (and estate tax exclusion, if estate tax exclusion is a design element of the trust – as in a credit shelter trust or a trust exempt from generation skipping transfer tax) should be cautioned to honor the ascertainable standard distribution discretion. Otherwise, a creditor that is intent on piercing the protection provided by §504(3) will argue that because the beneficiary-trustee ignored the ascertainable standard limits of the trust, the beneficiary should not benefit from the creditor protection afforded by §504(3). Note that the Uniform Comment to §504 says, “The Code does not specifically address the extent to which a creditor of a trustee/beneficiary may reach a beneficial interest of a beneficiary/trustee that is not limited by an ascertainable standard.”

If creditor protection is an immediate and known concern (for example, the beneficiary is the defendant in a pending lawsuit, or a judgment has already been entered) the beneficiary

controlled trust is not the optimum design choice. Stronger creditor protection will be available with an independent trustee, either as a co-trustee with the beneficiary, or as sole trustee. The effectiveness of creditor protection is a design continuum and the degree of creditor protection desired will affect the design of the trust. As a general pragmatic rule of design, the more “bullet proof” the degree of creditor protection desired, the less control the beneficiary should be given over the trust.

A beneficiary-trustee of a beneficiary controlled trust who finds himself or herself facing a creditor’s attempt to reach the trust assets will not need to forego the benefits of the trust. Under that circumstance, the beneficiary-trustee has two options available: purchase assets in the name of the trust to make available for the beneficiary’s benefit (for example, the trustee could purchase a home or camp in the name of the trust); or, make distributions of trust property “for the benefit of” the beneficiary, rather than to the beneficiary. Under Maine UTC §501, if the trust does not contain a spendthrift provision, a creditor may attach distributions to the beneficiary (but not “for the benefit of” the beneficiary). Maine deleted the “for the benefit of” language from the Uniform version of the UTC as originally distributed by NCCUSL. Under Maine UTC §502, if the trust does contain a spendthrift provision, a creditor “may not reach the interest or a distribution by the trustee before its receipt by the beneficiary”. Therefore, with or without a spendthrift provision, the trustee will be able to effectively use trust assets for the beneficiary’s benefit and effectively frustrate a creditor’s efforts to attach the beneficiary’s interest in the trust.

4. Trustees and Successor Trustees

When children are not yet of an age or maturity level that the parents are comfortable with the notion of the child having immediate full control of the child's inheritance, the beneficiary controlled trust can be designed to phase in at a designated age. For example, the trust might be written to have a corporate trustee serve until the child is 25 years old; at age 25, the child may step in as co-trustee with the corporate trustee; and at age 35, the child may be given the right to be the master of his/her own destiny and serve as sole trustee. An example of trustee language to accomplish a "phase in" of beneficiary control:

Upon the creation of a separate trust for one of my children, if the child has not yet attained the age of 25 years, Bank & Trust, N.A. shall serve as Trustee of the child's separate trust.

Upon the creation of a separate trust for one of my children, if the child has attained the age of 25 years the child shall have the right to serve as Cotrustee of the child's separate trust with Bank & Trust, N.A. or with any other corporate fiduciary appointed by the child. The child, upon attaining 25 years of age, shall have the power to remove Bank & Trust, N.A. or any other corporate fiduciary as Trustee by giving notice of removal as provided in Section _____, but shall appoint a corporate fiduciary to serve as successor Trustee before the removed corporate fiduciary shall relinquish its trusteeship. If the child has attained 25 years of age but has not yet attained 35 years of age, and the child is unable or unwilling to serve as Trustee, then Bank & Trust, N.A. or any other then serving corporate fiduciary shall serve as Trustee of the child's separate trust.

A child, upon attaining 35 years of age, shall have the right to serve as the sole Trustee of the child's separate trust. Upon attaining 35 years of age, the child shall have the right, in writing, to appoint one or more persons to serve as Trustee, with such appointment to take effect at such time and under such conditions, including upon the death, resignation or incapacity of another Trustee, including the child, as the child may select. The child shall have the right to retract the appointment at any time, before or after the appointed person takes office as Trustee.

If the child has attained 35 years of age, is unable or unwilling to serve as Trustee, and has not appointed one or more persons who the child has expressly designated, in writing, shall serve or continue to serve if the child is unable or unwilling to serve, then upon the child's inability or unwillingness to serve as Trustee, then Bank & Trust, N.A. shall serve as Trustee.

In a case where there will be an independent trustee (a trustee not related or subordinate to the beneficiary within the terms of Internal Revenue Code §672(c)) serving until the beneficiary reaches a designated age, it may be desirable to provide the independent trustee with distribution authority that extends beyond ascertainable standards.

My Trustee, other than an Interested Trustee, may pay to or for the benefit of the child as much of the income and principal of the child's trust as my Trustee, in its sole and absolute discretion, may determine advisable for any purpose. If my Trustee is an Interested Trustee, my Trustee may pay to or for the benefit of the child as much of the income and principal of the child's trust as my Trustee determines is necessary or advisable for the health, education, maintenance or support of the child.

My Trustee, other than an Interested Trustee, in exercising its discretion, may make distributions to or for the benefit of the child to enable the child to:

Purchase, expand or remodel a residence;

Participate in, purchase or establish a business or professional practice; or

Pursue and take advantage of any other extraordinary opportunity deemed by my Trustee to be in the best interests of the child.

Such language will require adding including definitions in the trust document to define an "Interested" trustee, as distinguished from an "Independent" trustee.

The successor trustee language for a beneficiary controlled trust where the child will control the trust from the date it is created might say:

Upon the creation of a separate trust for one of my children as provided in this trust agreement, the child shall serve as the sole Trustee of the child's separate trust.

The child shall have the right, in writing, to appoint one or more persons to serve as Trustee, with such appointment to take effect at such time and under such conditions, including upon the death, resignation or incapacity of another Trustee, including the child, as the child may select. The child shall have the right to retract the appointment at any time, before or after the appointed person takes office as Trustee.

If the child is unable or unwilling to serve as Trustee and the child has not appointed one or more persons who the child has expressly designated, in writing, shall serve

or continue to serve if the child is unable or unwilling to serve, then upon the child's inability or unwillingness to serve as Trustee, Bank & Trust, N.A. shall serve as Trustee.

Because a trustee's powers will be attributed to a beneficiary who has the power to remove and replace the trustee with a trustee who is related or subordinate to the beneficiary as defined by Internal Revenue Code §672(c), trusts that give the trustee broad distribution discretion (not limited to an ascertainable standard) are often carefully drafted to fastidiously avoid the risk of having the trustee's powers attributed to the beneficiary. Attribution to the beneficiary of the trustee's broad discretionary distribution authority will result in the beneficiary being deemed to hold a general power of appointment over the trust property and will, therefore, result in the trust property being included in the beneficiary's estate at death. See *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993); *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992); Rev. Rul. 95-58. Although a trustee's powers will be attributed to a beneficiary who has the power to remove and replace the trustee with a trustee who is related or subordinate to the beneficiary as defined by Internal Revenue Code §672(c), if the trustee's discretionary distribution authority is limited to ascertainable standards, attribution of the trustee's authority to the beneficiary does not risk estate tax inclusion.

C. GST Planning and Exclusion from the Beneficiary's Estate

Because the beneficiary controlled trust under §504(3), by definition, limits discretionary distributions to ascertainable standards, it may be used for generation skipping transfer tax planning as long as there is an allocation of GST exemption to give the trust an inclusion ratio of zero. See Rev. Rul. 78-398 (ruling that the discretion of a beneficiary-sole trustee, who had the power to distribute principal to himself for his maintenance and medical care, was governed by

an ascertainable standard and that the trust property was therefore not includable in his gross estate). Even if there is concern that the scope of the beneficiary-trustee's discretion is broader than an ascertainable standard, §814(2)(A) of the Maine UTC has a savings clause that will prevent the trustee from exercising any discretionary power in excess of an ascertainable standard. (“A person other than a settlor who is a beneficiary and trustee of a trust that confers on the trustee a power to make discretionary distributions to or for the trustee's personal benefit may exercise the power only in accordance with an ascertainable standard”.) See also, PLR 200530020, where a beneficiary served as trustee and had the power to distribute income to herself in such amounts “as the trustees in their sole and absolute discretion deem advisable”. The IRS ruled that a state savings clause similar to §814(2)(A) of the Maine UTC converted what would otherwise be a general power of appointment to an ascertainable standard and that, therefore, no portion of the trust income would be included in the beneficiary-trustee's estate.

Section 414(1) of the Maine UTC says, “After notice to the qualified beneficiaries, the trustee of a trust consisting of trust property having a total value less than \$100,000 may terminate the trust if the trustee concludes that the value of the trust property is insufficient to justify the cost of administration.” Under § 414(1), upon termination of the trust, “the trustee shall distribute the trust property in a manner consistent with the purposes of the trust.” It is unclear whether the savings clause of §814(2)(A) would prevent a beneficiary-trustee from being considered as having a general power of appointment over a trust containing property valued at less than \$100,000. If avoiding estate tax inclusion, even for a trust that is less than \$100,000 in value, is an important planning goal, an easy way to avoid that result is to add to the trust document a provision that only permits an Independent Trustee (defined as one that is not a beneficiary of the trust and not related or subordinate to a beneficiary of the trust within the

meaning of Internal Revenue Code §672(c)) to terminate the trust based on a determination that the trust is no longer economical to administer. The trust should also contain a provision that says substantially the following:

If for any reason the Trustee of any trust created under this agreement is unwilling or unable to act as to any trust property of that trust, or with respect to any provisions of this agreement, the Trustee shall appoint, in writing, a corporate fiduciary or an individual who is neither a beneficiary of the trust nor related or subordinate to any beneficiary of the trust within the meaning of Section 672(c) of the Internal Revenue Code to act as a special Independent Trustee as to such property or with respect to such provisions, and may revoke any such appointment at will.

Each special Independent Trustee so acting shall exercise all fiduciary powers granted by this agreement unless expressly limited elsewhere in this agreement or by the delegating Trustee in the instrument appointing such special Independent Trustee. Any special Independent Trustee may resign at any time by delivering written notice to the Trustee to that effect.

II. Trust Protectors

A. Statutory Background

Section 808 of the Maine UTC introduces, in a statutory framework, a concept that has existed for many years in the arena of offshore trust planning. Traditionally, a trust has been a tripartite structure comprised of grantors, trustees and beneficiaries. Section 808 introduces a fourth party - - someone with a “power to direct” the trustee. This new player in the traditional trust triad is popularly known as a “trust advisor” or “trust protector”.

§808. Powers to direct

1. Revocable trust; direction of settlor. While a trust is revocable, the trustee may follow a direction of the settlor that is contrary to the terms of the trust.

2. Directions of person conferred power to direct trustee. If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an

exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust.

3. Modification or termination. The terms of a trust may confer upon a trustee or other person a power to direct the modification or termination of the trust.

4. Power to direct; fiduciary duty. A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty.

The Uniform Comment to §808 explains the role of the trust protector:

Subsections (b)-(d) ratify the use of trust protectors and advisers. Subsections (b) and (d) are based in part on Restatement (Second) of Trusts Section 185 (1959). Subsection (c) is similar to Restatement (Third) of Trusts Section 64(2) (Tentative Draft No. 3, approved 2001). “Advisers” have long been used for certain trustee functions, such as the power to direct investments or manage a closely-held business. “Trust protector,” a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust. Subsection (c) ratifies the recent trend to grant third persons such broader powers.

A power to direct must be distinguished from a veto power. A power to direct involves action initiated and within the control of a third party. The trustee usually has no responsibility other than to carry out the direction when made. But if a third party holds a veto power, the trustee is responsible for initiating the decision, subject to the third party’s approval. A trustee who administers a trust subject to a veto power occupies a position akin to that of a cotrustee and is responsible for taking appropriate action if the third party’s refusal to consent would result in a serious breach of trust. See Restatement (Second) of Trusts Section 185 cmt. g (1959); Section 703(g)(duties of cotrustees).

Frequently, the person holding the power is directing the investment of the holder’s own beneficial interest. Such self-directed accounts are particularly prevalent among trusts holding interests in employee benefit plans or individual retirement accounts. See ERISA Section 404(c) (29 U.S.C. Section 1104(c)). But for the type of donative trust which is the primary focus of this Code, the holder of the power to direct is frequently acting on behalf of others. In that event and as provided in subsection (d), the holder is presumptively acting in a fiduciary capacity with respect to the powers granted and can be held liable if the holder’s conduct constitutes a breach of trust, whether through action or inaction. Like a trustee,

liability cannot be imposed if the holder has not accepted the grant of the power either expressly or informally through exercise of the power. See Section 701.

Powers to direct are most effective when the trustee is not deterred from exercising the power by fear of possible liability. On the other hand, the trustee does have overall responsibility for seeing that the terms of the trust are honored. For this reason, subsection (b) imposes only minimal oversight responsibility on the trustee. A trustee must generally act in accordance with the direction. A trustee may refuse the direction only if the attempted exercise would be manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty owed by the holder of the power to the beneficiaries of the trust.

The provisions of this section may be altered in the terms of the trust. See Section 105. A settlor can provide that the trustee must accept the decision of the power holder without question. Or a settlor could provide that the holder of the power is not to be held to the standards of a fiduciary. A common technique for assuring that a settlor continues to be taxed on all of the income of an irrevocable trust is for the settlor to retain a nonfiduciary power of administration. See I.R.C. Section 675(4).

B. Drafting Opportunities

The potential scope of a Trust Protector's powers can be as broad or as narrow as desired, and can be tailored to accomplish the goals of each trust. In perhaps its broadest possible role, a Trust Protector can be given the authority to entirely re-write an irrevocable trust, making an irrevocable trust entirely revocable - - by the Trust Protector. More than one grantor has struggled with the wisdom of creating a trust safety net for a child who has, for one reason or another, not lived up to the grantor's expectations. A Trust Protector can be given the power to add a child who was omitted from a trust that was created when the child was not in the family's good graces, or can be given the power to remove a child as beneficiary if the child falls out of the family's good graces. Such powers are extreme and most Trust Protectors would not want to take on the responsibility for exercising such extreme powers.

Some grantors will prefer to limit a Trust Protector's authority to removal and replacement of the trustee, if for some reason they do not want such power vested in the beneficiaries. Or, a Trust Protector's authority could be broadly framed to give the Trust Protector the authority to amend the trust as needed to change the trust in any way desired to better accomplish the trust's goals, without requiring court approval. If the concept of an "irrevocable" trust makes clients nervous, it should make the drafting lawyer equally nervous. It is probably a fair statement to say that every lawyer who has written irrevocable trusts has had occasion to review a trust after it was signed with a touch of regret (or panic) at not having written the trust slightly differently, and wishing there were an easy way to correct a word processing error, a latent ambiguity, a tax sensitive provision or a substantive omission.

Many of the powers given to a Trust Protector can be, and traditionally have been, given to the trustee. The role of the Trust Protector provides a new option for trust design and as a result, adds greater flexibility to trust planning. When a corporate fiduciary is serving as trustee, it may be desirable to have an individual Trust Protector who is more readily willing than a corporate fiduciary to make amendments to the trust without seeking court approval.

Following is suggested language as a starting point for the role that a Trust Protector. The following language was used in a joint irrevocable trust designed to hold a "second to die" life insurance policy on the grantor's lives:

Section 1.01 Provisions for Trust Protector

a. Function of Trust Protector

The function of the "Trust Protector" is to assist if needed in protecting the interests of our beneficiaries and in achieving the objectives and purposes of this trust agreement. To carry out this function we intend that the Trust Protector be empowered to correct any errors or ambiguities found in this agreement and to

respond to changes in the law that affect any trusts created under this agreement, and exercise the powers expressly granted to the Trust Protector in this Section.

b. Designation of Trust Protector

The Trust Protector of each trust under this agreement shall be _____.

If _____ cannot or will not serve as Trust Protector, the successor Trust Protector shall be the successor Trust Protector effectively named under Section 1.01.d.

The Trust Protector of any trust created in this agreement shall be a person who is neither a beneficiary of the trust nor related or subordinate, within the meaning of Section 672(c) of the Internal Revenue Code, with respect to either of us or to any beneficiary of the trust to which the Trust Protector is serving.

Under no circumstances shall a person be permitted to hold the office of both Trustee and Trust Protector. In the event a person is named to serve simultaneously as both Trustee and Trust Protector, the person shall be deemed to have immediately resigned from the position as Trustee in favor of serving as Trust Protector.

c. Removal of Trust Protector

By a notice of removal signed by an Independent Trustee of any trust created under this agreement, the Independent Trustee may remove a Trust Protector. Our Independent Trustee need not give a Trust Protector being removed any reason, cause, or ground for such removal.

Notice of removal shall be effective in accordance with the provisions of the notice and shall be made in writing by either:

Personally delivering notice to the Trust Protector and securing a written receipt, or

Mailing notice in the United States mail to the last known address of the Trust Protector by certified mail, return receipt requested, or

Mailing or delivering notice by courier delivery service and securing evidence of delivery.

d. Lack of a Named Trust Protector

If at any time the office of Trust Protector for any trust is vacant, a Trust Protector may be appointed by an Independent Trustee of the trust.

In addition, any beneficiary of a trust may petition a court of competent jurisdiction to appoint a successor Trust Protector to fill any vacancy remaining unfilled after a period of thirty (30) days.

The court that designates the successor Trust Protector shall not acquire jurisdiction over any trust created under this agreement, except to the extent necessary to name a successor Trust Protector.

e. Resignation of Trust Protector

The Trust Protector of any trust created under this agreement may resign by giving written notice to the Trustee of the trust for which the Trust Protector is serving, or if there is no Trustee, the notice shall be delivered to all of the beneficiaries then eligible to receive mandatory or discretionary distributions of net income from the trust for which the Trust Protector is serving.

Such resignation shall take effect on the date set forth in the notice, which date shall not be earlier than thirty (30) days after the date of delivery of the written resignation, unless an earlier effective date shall be agreed to by the Trustee, or if there is no Trustee, by a majority of the beneficiaries then eligible to receive mandatory or discretionary distributions of net income from the trust. Upon the effective date of such resignation, the Trust Protector shall be relieved of any further duties and responsibilities and shall not be liable or responsible for the act of any successor Trust Protector.

f. Good Faith Standard Imposed

The authority of our Trust Protector is conferred in a fiduciary capacity and shall be so exercised. The Trust Protector shall not be liable for any action taken in good faith for the benefit of the trust beneficiaries. The trust shall pay on behalf of the Trust Protector or shall reimburse the Trust Protector for the costs of defending, settling or satisfying any claim made against the Trust Protector unless the Trust Protector's actions were not taken in good faith for the benefit of the trust beneficiaries.

g. Power to Amend Trust Agreement

The Trust Protector may, in its sole and absolute discretion, with respect to any trust as to which the Trust Protector is acting, amend:

The trust's administrative provisions;

The Trustee's investment powers;

The trust administrative provisions relating to the identity, qualifications, succession, removal, and appointment of the Trustees. Provided, however, the Trust Protector shall not change the trust provisions in any way that would result in the appointment as Trustee of (i) the Trust Protector, or (ii) any person who is related or subordinate, within the meaning of Section 672(c) of the Internal Revenue Code, with respect to the Trust Protector;

The trust's provisions in any way as deemed necessary by the Trust Protector to permit the trust to qualify as an eligible S-corporation shareholder under Section 1361 or any successor provision of the Internal Revenue Code, including amending the trust's provisions to convert the trust from an electing small business trust to a qualified subchapter S trust or from a qualified subchapter S trust to an electing small business trust, in such frequency as deemed appropriate by the Trust Protector;

The trust's provisions related to the amount and timing of the distribution of trust net income to the trust beneficiary or beneficiaries, including but not limited to (i) the amendment of the trust's provisions by requiring the distribution to the beneficiary of all trust net income (within the meaning of Section 643(b) of the Internal Revenue Code) at least annually, (ii) granting our Trustee discretion to distribute income, with or without a standard of distribution, and (iii) the amendment of the trust's provisions to require that at the beneficiary's death, our trustee shall distribute to the beneficiary's estate any accrued and undistributed net income remaining in the beneficiary's trust;

The trust provisions to respond to changes in the law that adversely affect trust administration;

The trust provisions in any way appropriate, as determined by our Trust Protector, to improve or ease the burden of trust administration or to address circumstances that adversely affect trust administration;

The withdrawal rights, if any, granted under this agreement (except a withdrawal right that has already matured at the time the Trust Protector seeks to exercise the power conferred under this subparagraph);

The trust provisions to correct ambiguities that might otherwise require court construction; and

The trust provisions to grant a beneficiary of any separate trust created in this trust agreement a testamentary general power to appoint by a valid last will and testament or by a valid living trust agreement any property remaining in the trust the distribution of which would otherwise constitute a taxable generation-skipping transfer in excess of any available generation-skipping transfer tax exemption.

The Trust Protector may not amend the trust in any manner that would cause any portion of the trust to be included in the gross estate of either of us.

Except as related to withdrawal rights (if any) during my lifetime, the Trust Protector may not amend the trust in any manner that would limit a beneficiary's beneficial interests in a trust created under this agreement.

Other than as appropriate in the Trust Protector's discretion to grant a beneficiary a testamentary general power of appointment over any property remaining in the trust the distribution of which would otherwise constitute a taxable generation-skipping transfer in excess of any available generation-skipping transfer tax exemption, the Trust Protector may not amend the trust in any manner that would cause any portion of the trust to be included in the estate of any beneficiary, to a greater extent than existed before the amendment. An amendment made in good faith shall be binding and conclusive on all persons interested in the trust and the Trust Protector shall not be liable for the consequences of any amendment or for not having amended the trust.

Any such amendment shall be made in writing signed by the Trust Protector and delivered to the Trustee.

h. Not a General Power of Appointment

Despite any conflicting provision in this agreement, the Trust Protector shall not participate in the exercise of a power or a discretion conferred under this instrument for the Trust Protector's personal benefit, for the discharge of the Trust Protector's financial obligations or in any manner that would cause the Trust Protector to possess a general power of appointment within the meaning of Sections 2041 or 2514 of the Internal Revenue Code.

i. Release of Powers

The Trust Protector, acting on its own behalf and on behalf of all successor Trust Protectors, may at any time, by a writing signed by the Trust Protector and delivered to the Trustee, irrevocably release, renounce, suspend, cut down or modify to a lesser extent any or all powers and discretions conferred upon the Trust Protector under this agreement.

j. No Duty to Monitor

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 under this agreement should be exercised. 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 of, or failure to exercise, 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 interested in the trust. The Trust Protector is not required to exercise any power or discretion granted under this agreement.

k. Compensation

Any Trust Protector shall be entitled to receive reasonable compensation for services rendered on behalf of a trust created under this agreement. The Trust Protector shall be entitled to reimbursement for all expenses incurred in the performance of duties as Trust Protector, including travel expenses.

Serving in the capacity of Trust Protector shall not prevent the Trust Protector from also providing legal services on behalf of the trust or the trust beneficiaries. If the Trust Protector is providing legal services, the Trust Protector is entitled to charge its normal and customary legal fees.

l. Right to Examine

The books and records of each trust created under this agreement, including all documentation, inventories and accountings shall be open and available at all reasonable times to our Trust Protector.

m. Rights of Successor Trust Protectors

Any successor Trust Protector shall have all of the rights, powers, and privileges as given to the original Trust Protector. Any successor Trust Protector shall be subject to any restrictions imposed on the original Trust Protector.

No successor Trust Protector shall be responsible for any act or omission of any previous Trust Protector.

When drafting Trust Protector provisions, consideration should be made to ensuring that the Trust Protector's powers are not so broad as to constitute a general power of appointment under Internal Revenue Code §2041 and result in the trust assets being included in the Trust Protector's estate. For example, if the Trust Protector is given the power to amend the trust or to add beneficiaries, the Trust Protector's powers should be expressly limited to provide that the Trust Protector may not amend the trust in any way that would benefit the Trust Protector. For example, see sub-section h. above.

Also consider who should be given the power to remove and/or replace the Trust Protector. The most obvious options to consider are:

1. Permit the beneficiaries to remove and replace;
2. Permit the Trust Protector to appoint its own successor or in the absence of a named successor, permit the court to appoint a successor; or
3. Permit the trustee to remove and replace.

Although there is no known case law or IRS pronouncement on point, it is likely that the rule of attribution of a trustee's powers to a beneficiary who has the power to remove and replace the trustee with a trustee who is related or subordinate to the beneficiary as defined by Internal Revenue Code §672(c), (See *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993); *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992); Rev. Rul. 95-58), would similarly apply to a beneficiary's power to remove and replace a Trust Protector. Therefore, in order to avoid having the Trust Protector's powers attributed to a beneficiary who has the power to remove and replace the Trust Protector, resulting in potential estate tax inclusion in the beneficiary's estate, the beneficiary's power should be limited to appointing a Trust Protector who is not related or subordinate to the beneficiary as defined by Internal Revenue Code §672(c).

A more conservative approach, to avoid a risk of inclusion of the trust's assets in the estate of a beneficiary, would be to permit a successor Trust Protector be appointed by an independent trustee. The most conservative approach would be to permit a successor Trust Protector be appointed by the court, upon request by any beneficiary or by the trustee.