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## **Investment Directions, Rights And Powers - - Potential Pitfalls And Unanswered Questions (The American Perspective)**

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### **I. Is The Reserved Right Or Granted Power To Direct Investment (“Ptdi”) Held In A “Fiduciary Capacity?”**

#### **A. PTDI Reserved by the Settlor.**

The question whether a settlor’s reserved PTDI is held in a fiduciary capacity or for personal use and enjoyment can be resolved easily enough by clear provision in the trust agreement, but where there is no such provision, there is a predisposition to the assumption that the settlor has reserved the PTDI in a fiduciary capacity. *See FRATCHER, SCOTT ON TRUSTS*, § 185 n.5 (4th Ed.); *Cushman v. Commissioner*, 153 F.2d 510 (2d Cir. 1946) (“It is a question of interpretation whether or not the powers reserved as grantor are held in a fiduciary capacity or for the grantor’s own purposes. Ordinarily, they are held in a fiduciary capacity, and have been reserved only because of some special talent or particular source of knowledge of the grantor.”); and *Steiner v. Hawaiian Trust Company*, 393 P.2d 96, 107 (Hawaii 1964) (“It is clear from the nature of the trust assets that the exercise of this power was for the benefit of the beneficiaries of the trust generally and not for the benefit for the settlor alone . . . Especially is this true since on and after January 1, 1944, the trust became irrevocable.”).

Notwithstanding the aforesaid predisposition in favor of finding that a PTDI reserved to the grantor is a fiduciary power, examples are numerous of PTDIs reserved by the grantor in a non-fiduciary capacity with the intention of exercising the PTDI solely for his own benefit. *See e.g., Chandler v. Commissioner*, 119 F.2d 623 (3d Cir. 1941). In the American context, the experience of the author suggests that most settlors of revocable trusts who also reserve a PTDI assume that they may exercise the PTDI for their own personal interests to the exclusion of consideration of other beneficiaries. For the avoidance of doubt and to preclude the necessity of a corporate fiduciary’s having to consider whether the exercise of the PTDI is appropriate in particular circumstances (see discussion under II, *infra*), a draftsman should stipulate a settlor’s intention with respect to a reserved PTDI in the trust instrument.

#### **B. A PTDI Granted to a Third Party.**

In most cases in which a PTDI is granted to a third party (as opposed to being reserved by the settlor) a presumption will attach that the PTDI is to be exercised in a fiduciary

capacity even where the power holder is also a beneficiary of the trust albeit this may raise fine points of conflict of interest. See *RESTATEMENT THIRD TRUSTS*, § 64 (Tentative Draft No. 3, 2001). The “Reporter’s Notes” for *RESTATEMENT THIRD TRUSTS* § 64 acknowledge that, although third party power holders (frequently referred to a “protectors”) represent “. . . an important development in trust and estate practice in recent years . . . especially in connection with offshore trusts, but somewhat increasingly also in the design of domestic trusts . . .”, “trust law in this country [viz. the United States] shows virtually no appellate experience with these questions [such as the circumstances under which a trust protector is a fiduciary] and negligible legal development of the protector concept and principles for similar roles.” *But cf.*, Note, *Trust Advisors*, 78 *HARVARD L. REV.* 1230 (1965); *Crocker-Citizens Nat’l Bank*, 481 P.2d 222, 228 (California 1971).

The case most typically cited for the proposition that a third party has been granted a PTDI for personal rather than investment reasons is that of the surviving widow to whom a life interest has been given in various assets including the “family residence” with the power to block sale for the duration of her lifetime. See *FRATCHER*, *supra*, § 185 n.2. For guidance on how to classify a particular third party’s duties and obligations (if any) with respect to a PTDI, Reporter’s Notes for *RESTATEMENT THIRD TRUSTS* § 64 (Tentative Draft No. 3, 2001) suggest that because of the greater breadth of English experience with PTDIs conferred upon third parties, English case law as it has developed during the last decade both in the U.K. and some of the offshore trust jurisdictions will influence American law.

## **II. TRUSTEE OBLIGATIONS AND POTENTIAL LIABILITIES IF A PTDI IS IMPROPERLY EXERCISED**

If the PTDI is reserved to the settlor with the intention (and subject to the clear stipulation) that the PTDI is exercisable by the settlor for his own personal benefit and not in a fiduciary capacity, the trustee’s situation is greatly simplified. It may comply with whatever instructions it receives from the settlor in the exercise of his PTDI and is under no obligation to consider the consequences of such exercise for other beneficiaries. *Ditmars v. Camden Trust Co.*, 76 A.2D 280, 328 (N.J. Sup. Ct., Chancery Div., 1950).

If the trustee is directed by the terms of the trust instrument to act on the instructions of a person holding a PTDI, the trust instrument provides that the trustee shall be held harmless for acting upon such instructions, such person calls for a concentrated investment of trust assets in speculative equities and the trust suffers material financial losses as a result, one might presume that the trustee is without fault. Nonetheless, a trial court in New York considering this set of facts did hold the Bank of New York liable because it had invested half of the trust estate in shares of closely held corporations on the instructions of the settlor and substantial losses had ensued. See *In Matter of Bank of New York (Cowles)*, N.Y.L.J., January 9, 1964, p. 13, col. 1. The New York Appellate Division reversed holding that the trustee had merely complied with the requirements of the trust instrument directing that it act only on the instructions of the settlor, that the trustee had acted in good faith in following such instructions and accordingly all conditions for trustee exculpation under the terms of the trust agreement itself had been met. See *Matter of Cowles*, 255 N.Y.S. 2d 160 (App. Div., 1st. Dept., 1965).

The Hawaii Supreme Court dealt less kindly with a corporate fiduciary where, under the terms of the trust agreement, diversification of assets was called for but by the terms of such agreement the trustee's ability to diversify had been rendered subject to settlor consent and consent for diversification had been withheld by the settlor. *See Steiner v. Hawaiian Trust Company*, 393 P.2d 96 (Hawaii 1964). Of some potential significance, the Hawaii Court in *Steiner* found that the settlor power to consent to trust investment had been reserved for the benefit of the beneficiaries of the trust generally and not for the benefit of the settlor alone as evidenced by the irrevocable status of the trust, and that in consequence the settlor's veto power over investment was a fiduciary power, a factor which rendered the corporate trustee liable for its failure to submit a reinvestment plan to the settlor and if necessary seek instructions from the court. Although the *Steiner* case has been discussed and cited with approval by other Hawaii courts, it is noteworthy that it has not been cited as persuasive by courts in other U.S. jurisdictions and that an intermediate appellate court in the State of Washington distinguished *Steiner* as "inapposite" in a circumstance in which Bank of California acting in conformity with the trust instrument instructions had failed to diversify assets. *See Baldus v. Bank of California*, 530 P.2d 1350 (Wash. Ct. App., Div. 1, 1975). The distinguishing feature between *Baldus* and *Steiner* appears to have been the absence in *Steiner* of explicit language in the trust agreement, such as was found by the court in *Baldus*, authorizing the retention of stock in a particular company.

### **III. WHAT CONSEQUENCE IF A HOLDER OF A PTDI FAILS TO ACT?**

If the holder of a PTDI dies and there is no provision for a successor to assume the duties of the deceased holder under the terms of the trust instrument, the trustee should clearly assume authority and responsibility for investment of trust assets. This is equally so if kidnapping, incarceration, war or some other such event precludes a person from exercising a PTDI. *See e.g., Chase National Bank of New York City v. Reinicke*, 76 N.Y.S. 2d 63 (N.Y. Sup. Ct., Special Term, Part III, 1947) (where the settlor and his wife are precluded as "enemy aliens" from giving investment direction, the trustee is authorized to exercise its discretion in respect of investment). Likewise, where a power holder unequivocally refuses to exercise a PTDI, it is the obligation of the trustee to act in respect of trust investment. *See Palisades Trust & Guaranty Co. v. Probst*, 16 A.2d 271 (N.J. Ct. Chancery 1940) ("The remaining question is as to the right of the trustee to make investments without the approval of the executors . . . when . . . the executors refuse to assume any responsibility for investments . . . surely, the creator did not contemplate that large sums of money should accumulate and remain completely idle over a long period of years.")

A more difficult question confronts the trustee if there has been an unexplained hiatus in the flow of investment instructions from a power holder in possession of a PTDI. Traditionally, corporate fiduciaries have themselves solicited "boilerplate" clauses authorizing them to act in an "emergency" where instructions are not forthcoming from a person in possession of a PTDI. Recently, however, the author has encountered corporate fiduciary demands for much greater precision regarding the circumstances under which the responsibility for the direction of investment shall be deemed to have passed from the holder of the PTDI to the trustee.

#### **IV. DOES A SETTLOR'S RESERVATION OF A PTDI IN A NON-FIDUCIARY CAPACITY CONVERT A TRUST TO A "MERE AGENCY"?**

##### **A. The U.S. Position: the Extent of Reserved Powers Is Not a Determining Factor.**

For more a half-century American jurisprudence and state statute law have eschewed the doctrine of the "illusory trust" premised upon excessive reservation of powers by the settlor. *RESTATEMENT SECOND TRUSTS*, § 57 (1957 main volume) states: "Where an interest in the trust property is created in a beneficiary other than the settlor, the disposition is not testamentary and invalid for failure to comply with the requirements of the Statute of Wills merely because the settlor reserves [among other things] ... a power to control the trustee as to the administration of the trust." The American Law Institute was merely acknowledging in 1957 what had been established over a decade earlier by decisions such as *National Shawmut Bank of Boston v. Joy*, 53 N.E.2d 113 (Massachusetts 1944) and *Leahy v. Old Colony Trust Co.*, 93 N.E.2d 238 (Massachusetts 1950) ("A reservation by a settlor of the power to control investments does not impair the validity of a trust."). *RESTATEMENT THIRD TRUSTS* § 25 (Tentative Draft No. 1, 1996) confirms, in even stronger language than the *SECOND RESTATEMENT*, the irrelevance of the extent of reserved powers to the determination of whether a trust is a trust when it states "[a] trust that is created by a settlor's declaration of trust, by his or her inter vivos transfer to another, or by beneficiary designation ... is not rendered testamentary merely because the settlor retains extensive rights such as [among other things] ... the right to serve as or control the trustee ..."

##### **B. Distinguishing Between "Excessive Retained Power" and Genuine Lack of Clarity, Excess Informality or Sheer Carelessness.**

As the Reporter's Notes for § 25 make clear, one should not divine from modern American antipathy toward the "illusory trust" doctrine that anything will pass muster as a "trust" as a matter of American law. "[I]t does not matter what interests are then given or retained ... claims of trust fail in modern cases not because terms confer too many rights on the settlor but because of genuinely unclear, excessively informal or casual manifestations of intention, or sheer carelessness, or other types of conduct that leave a trier of facts in doubt about the alleged trust intent." *RESTATEMENT THIRD TRUST* § 25 (Tentative Draft No. 1, 1996), Reporter's Notes in respect of Comment b. For an excellent example of a recent American case holding that a trust had failed on account of carelessness implementing a competently drafted revocable trust instrument, see *Pizel v. Pizel*, 643 P.2d 1094 (Kansas App., 1982), a case which subsequently led to protracted malpractice litigation. See *Pizel v. Zuspahn*, 795 P.2d 42 (Kansas 1990), modified, 803 P.2d 205 (Kansas 1990), appeal after remand, 845 P.2d 37 (Kansas 1993).

##### **C. A Social Explanation for Loss of American Interest in the Illusory Trust Doctrine.**

A careful parsing of now dated American judicial decisions which invalidated trusts on the premise that they were illusory by reason of excessive retained powers shows that many derive from the following fact pattern: the monied spouse in an unhappy marriage endeavors to circumvent then emerging protective legislation designed to confer a statutory or "forced" share upon a surviving spouse in respect of the probate estate by employing an *inter vivos* trust in respect of which substantial powers (often including the power of revocation) are reserved by the monied spouse up to the moment of death.

Typical of this genre is *Newman v. Dore*, 9 N.E.2d 966 (New York 1937) (octogenarian husband attempts to circumvent the forced share to which his 30 year-old wife of four years is otherwise entitled by creating a revocable trust in favor of children of a prior marriage).

Dissatisfied with the efficacy of the illusory trust doctrine and two other doctrines known as the “intent test” and the “reality test” as a solution to evasive action in respect of a surviving spouse’s “forced share,” legislatures in those states adhering to “common law” and eschewing community property developed the concept of the “augmented estate,” which extended the forced share of the surviving spouse to “will substitutes,” including life insurance, pension accounts, joint accounts and revocable trusts. In consequence, the revocable trust (typically characterized by the retention of other substantial powers as well by the settlor) ceased to be an effective mechanism for the avoidance of the surviving spouse’s forced share with a result that the “illusory trust” test was rendered a social irrelevance.

Curiously, the hot topic today in this area is not whether a trust in respect of which substantial controls have been reserved may be used effectively to disinherit a surviving spouse (clearly it cannot); but rather whether life insurance is an effective tool for one predisposed to such action. See, e.g. Bridge, *Uniform Probate Code, Section 2-202: A Proposal to Include Life Insurance Assets Within the Augmented Estate*, 74 CORNELL L. REV. 511 (1989) and Gary, *Share and Share Alike? The UPC’s Elective Share*, 12 ABA Probate & Property 18 (1998).

## **V. What Tax Impact a Reserved or Granted PTDI?**

### **A. U.S. Federal Taxes.**

In the realm of federal gift and estate taxation, the determination whether a power granted by a settlor to a third party to manage the investment of a trust is a potentially lethal “general power of appointment” or a benign “limited power of appointment” turns upon the question whether the PTDI is exercisable in a fiduciary capacity. See Treas. Reg. § 25.2514-1(b)(1) and Treas. Reg. § 20.2041-1(b)(1) (“the mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity ... is not a power of appointment.”). For purposes of intergenerational tax planning, a limited power of appointment is in most cases considered far more desirable than a general power of appointment because possession of a general power of appointment is for federal transfer tax purposes deemed the functional equivalent of ownership and a basis for assessing either gift or estate tax upon the transferor, either when he exercises the power during his lifetime or dies in possession of same.

On the income tax side, the difference between a PTDI held by a grantor in a fiduciary capacity and a PTDI held by a grantor in a non-fiduciary capacity is potentially the difference between the individual who has funded a living trust being classified as a “non-grantor” and his being classified as a “grantor.” See IRC § 675(4). For federal income tax purposes, the “grantor” of a trust is treated as the owner of the trust, and he includes in the computation of his taxable income and credits all those items of income deduction and credit against tax which are attributable to or included in any portion of the trust of which he is treated as the owner. Purposeful retention in a non-fiduciary capacity

of investment control powers is sometimes used in modern American estate planning to create a “defective” irrevocable trust, which (if the “ideal” is achieved) places the trust property outside of the grantor’s estate for federal estate tax purposes but at the same time causes the grantor to be treated as the owner of such property for federal income tax purposes during his lifetime.

### **B. The State Tax Conundrum.**

Taxation of trusts at the state level within the United States is not currently uniform and shows no signs of becoming uniform. Some states compete avidly through their local legislation to attract trust business, while others in frustration seize upon constitutionally suspect contact points as nexus for income tax assessment. Unlike expatriation at the national level, which is the subject matter of considerable political debate but which in reality affects only a miniscule number of individuals, movement of individuals from one state to another within the 50 American states is commonplace. How, therefore, does a state deal with a transient resident for whom income is accumulated in a out-of-state trust during his period of residence only to be paid out in the exercise of trustee discretion after such resident has removed to another state having friendlier state and local tax regimes?

Some states, such as California, endeavor to draw distinctions between contingent and non-contingent beneficiaries and, in the case of non-grantor trusts having one or more administering fiduciaries resident in the state of California, seek to levy income tax on trust accumulations by reason of the residence of the trustee See Calif. Rev. & Tax Code § 17742(a). This begs a question which, so far as the author is aware, has not been addressed yet by any state: is a protector or other third party in possession of a PTDI the functional equivalent of a trustee holding and administering trust assets for the purpose of creating nexus for state income tax assessment? One commentator at least has raised the question. See Fogel, *What Have You Done for Me Lately, Constitutional Limitations on State Taxation of Trusts*, 32 UNIV. RICHMOND L. REV. 165, 222-223 (1998).

Professor Fogel argues that a trust protector who controls trust investments seems to have a closer relationship to a trust than a trustee who is merely the custodian of the trust assets, but at the same time he acknowledges “... that expanding the class of individuals whose residence may be constitutionally significant increases the complexity of a constitutional limitation on state income taxation of Resident Trusts.” Fogel, *supra*, 32 UNIV. RICHMOND L. REV. 165, 223. Very likely, Professor Fogel would also acknowledge that where the protector is obliged to act as a fiduciary, the trustee is much more than a mere custodian. It acts at its peril if it does not diligently insist that the protector instructions and consents be given in accord with the trust instrument and if it does not make a good faith effort to ensure that the protector is observing his fiduciary duties.

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