

Fiduciary considerations



Fulfill the promise of your ambitions

What's your vision for success? We've learned that success often means achieving a sense of satisfaction and joy about the use of your wealth for yourself, your family and causes you hold dear.

It also means having peace of mind about your financial affairs, trusting that your wealth advisor is managing the complexities of wealth ownership. Additionally, for some, it means that plans are in place to realize your vision for broader community impact and a lasting family legacy.

CIBC Private Wealth can be your partner for all of your investment, wealth planning and private banking needs. Our professionals are dedicated to delivering exceptional performance and service with an unwavering focus on you and your best interests.

We hope the information on the following pages will inspire you to articulate your own vision for your wealth. It would be our privilege to help you bring your ambitions to life.

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CIBC PRIVATE WEALTH

Fiduciary considerations

Trusts: A vital part of wealth planning



Trusts

Like other sound financial management and stewardship tactics, trusts are about planning for the future and planning for the ones you love. While many people think of trusts only as a part of planning for what happens to your wealth when you die, you might want to consider trust planning for reasons that make sense throughout life's progression.

Provide asset management now and if you become disabled: A very popular reason to use a trust is to place your investable assets into a structure that allows for flexible investment management that you can direct while you are able. Those assets can then continue to be managed and used for you if you become disabled or incapacitated, or simply wish to turn the management over to someone else. In these arrangements, called "revocable trusts," you can name yourself as the beneficiary and then name yourself and another person as the trustees. If you become mentally incapacitated or at any time you choose, the other trustee can manage your assets for you and distribute those assets in a way that is in your best interest.

Provide for your family: A common type of trust arrangement is one that comes into existence at an individual's death and is for the benefit of a surviving spouse. These trusts, called "marital trusts", can provide for management of wealth during the spouse's lifetime and distributions for his or her care, and can then direct the ultimate distribution of the assets upon the spouse's death. There are several varieties of marital trusts, but all of them should allow the decedent's wealth to pass to the survivor free of transfer tax, allowing the survivor to have full use of the family wealth without any erosion from estate tax.

Whether your children or other beneficiaries are adults or minors, you may want to use a trust if you plan to leave your assets to them or for their benefit. Because you cannot predict when you might die, you may want to set up a contingent trust in your will in case you die when your beneficiaries are still minors. The assets could then be transferred to the trust, and the trustee could manage the assets and make distributions to them on a timetable you specify. Furthermore, you may wish for the assets to remain in trust for them and even for later generations, to take advantage of the benefits of professional management and protection from creditors.

Reduce or avoid taxes: An important family wealth planning use for trusts is to move appreciation, and income in some cases, to younger generation family members to avoid taxation in the estate of the transferor. Assets that have been transferred to an irrevocable trust during life are typically not included in the transferor's gross estate for estate tax purposes. (This generally applies only if the creator of the trust has not retained an interest in the trust.) While gift taxes may have to be paid at the time of the original transfer to the trust, any appreciation in the assets after the transfer should avoid both estate and gift taxes. One exception to the general rule that assets transferred to an irrevocable trust are not included in your gross estate is a life insurance policy. If you transfer a life insurance policy to an irrevocable trust within three years prior to your death, then the insurance policy may be pulled back into your gross estate. Furthermore, by transferring income-producing assets to certain types of trusts, you may be able to transfer income to heirs who are in a lower income tax bracket than you are. By doing this, you may be able to reduce your own income taxes.

Avoid probate: Assets owned by a trust do not pass through probate at your death. The assets are distributed in accordance with the terms of the trust, which may even continue past your death. The trust, therefore, avoids the cost and delay of probate. A further benefit of using a trust is increased privacy. A will is a public document—anyone can go down to the probate court and review the contents of your will. However, a trust remains private.

Benefit a charity: There are certain types of arrangements in which you may transfer assets to the trust and divide the beneficial interest in the assets between individuals and charity. These "split-interest" trusts may provide you and your family with both income and estate tax benefits, and also allow you to give to your favorite charity.

Life happens—and trusts are one of the ways to prepare for all of those events. In addition, trusts can offer professional management of your assets and can protect your assets from creditors. There are numerous decisions you will face in setting up a trust. The type of assets you might transfer depends on what assets you currently own and what your goals are. Here's a closer look at trust basics and the types of trusts.

What is a trust?

As you consider the various ways in which a trust might be useful in your family's overall wealth plan, it's important to understand what a trust is and how it functions. A trust is a legal entity that is created when you transfer property to a trustee for the benefit of someone (a beneficiary). The trustee manages the property for the beneficiary in accordance with the terms and the instructions in the trust document. In legal terms, the trustee has legal ownership of the property, while the beneficiary has beneficial ownership.

Creator of trust: The person who creates the trust is called the grantor, settlor, donor or trustor. The grantor usually decides what assets will be transferred to the trust, who the beneficiaries will be, what the terms and conditions of the trust will be, and who will be the trustee. The grantor may also be a trustee and/or a beneficiary; this is generally the arrangement for revocable lifetime trusts described below. When irrevocable trusts are created for tax planning purposes, the grantor, trustee and beneficiaries are generally not the same, although a beneficiary can be a trustee.

Trustee: The grantor selects the trustee, which can be a sole trustee or multiple trustees. The trustee can be an individual or a professional trustee, such as a bank trust department. Some trusts may have both a professional trustee and an individual trustee. The trustee assumes responsibility for the management and distribution of the assets in the trust. The trustee's duties include making numerous complex fiduciary decisions. Therefore, the selection of trustee should not be taken lightly. There are many factors that should be considered before selecting a trustee, such as the size of the trust, the purpose of the trust, the duration of the trust, the location of beneficiaries and the tax ramifications. In certain situations, the grantor can name himself or herself as trustee. A family member can be appointed as trustee, as can a friend, the attorney who drafts the trust or your accountant. Finally, a corporate trustee, such as a bank trust department or an independent trust company, can be named. You should discuss these options with an attorney. (Please see our "Choosing a Trustee" white paper in this series.)

Trust situs: Closely associated with choosing a trustee is the decision regarding where the trust will be located. You may have the option of selecting what state law will govern the administration of your trust. Laws regarding state gift, estate and income tax, as well as differences in the rights and obligations of the trustees and beneficiaries, can vary from state to state. The choice of trust situs may be an important decision.

Trust beneficiary: The third party to a trust arrangement is the beneficiary. Trust beneficiaries do not own the assets placed in the trust—they are given a beneficial interest, which means they may enjoy the use of the trust assets subject to the terms that have been specified by the trust's creator. Beneficiaries can have a variety of different types of interests in the trust property, which can range from a right to receive certain amounts to an interest that is totally within the discretion of the trustee. There are many ways to define a beneficiary's interest to meet a wide variety of family needs and circumstances. Since most trusts created for family member beneficiaries are irrevocable in nature, the terms, once set forth, can be difficult, if not impossible, to change. Therefore, it is important to think through carefully how you wish the trust assets to be used.

Trust assets: Another decision you will face in setting up a trust is: Which assets should you transfer to the trust? The types of assets that you may transfer to a trust are almost limitless. You can transfer cash, stocks, bonds, insurance policies, real estate, your personal residence, artwork and almost any other type of asset. The type of asset that you might transfer to a trust depends on what assets you currently own and what your goals are. For example, if you want to provide the beneficiaries with income, you may want to transfer bonds or high-yield stocks. If your goal is to provide the beneficiaries with liquidity to pay estate taxes, you may want to transfer a life insurance policy.

Trust terms: Finally, a trust document specifies the terms under which the trust should be managed and administered. It is a best practice for an attorney to draft the document. Among other things, the trust document names a trustee, directs the trustee about how to manage and invest the assets in the trust, names the beneficiaries of the trust and instructs the trustee regarding when to pay out income and principal to the beneficiaries. The trust document may give explicit and detailed instructions about these duties. Alternatively, the trust document may give only very broad and simple guidance—"for my children's lifelong education," for example. Furthermore, the trust document may give instructions for the distribution of principal that differ from instructions for the distribution of the income generated by the trust. For example, it is very common that a trust document will instruct the trustee to distribute the income to one or more beneficiaries and then pay out the principal to completely different beneficiaries at some point in the future. Because needs and circumstances vary, careful thought and expert guidance are keys to a successful trust arrangement.

Categories of trusts

You can create a trust in your will (a testamentary trust), or you can create a trust during your life (a living trust). You can create a revocable trust (which you can amend or revoke) or an irrevocable trust (which you generally cannot amend or revoke). These basic frameworks can be combined into a multitude of arrangements to meet a variety of family planning needs.

Lifetime trust: Also called an inter vivos trust, this type of trust means that the arrangement is created by you while you are living. It can be either revocable or irrevocable, and can either end or continue at your death. Lifetime trusts can be for you, or they can be a planning tool for others or for charity. Property in the trust is distributed according to the terms of the trust, not your will.

Testamentary trust: A testamentary trust is one that is created and funded under the terms of your will. It does not come into existence until your death. Assets that are transferred to the trust must pass through your will, and thus, through probate. Until your death, you can change the terms of the trust by amending your will. Upon your death, the trust becomes irrevocable.

Revocable trust: As the name implies, you can revoke or amend the terms of a revocable trust and change the beneficiaries or trustee. You can add or remove assets from the trust and also change the provisions of the trust. You can even dissolve the trust. Furthermore, at your death, the assets in the revocable trust do not pass by the terms of your will (and thus do not pass through probate). Instead, the assets in a revocable trust are distributed in accordance with the terms of the trust. In fact, many people set up a revocable living trust simply to avoid the delay and cost of probate. The assets in a revocable trust remain under your control and will be included in your gross estate for estate tax purposes. Thus, a revocable trust is not used to avoid estate taxes.

Irrevocable trust: Again as the name implies, an irrevocable trust is one that you generally cannot revoke once the trust has been established. You also generally cannot amend the dispositive terms of the trust. This means that you generally cannot dissolve it, change the beneficiaries or change the terms of the distribution of the trust. In recent years, in recognition of the fact that circumstances change and life is unpredictable, many states have adopted laws that may permit modification of certain provisions of trusts in some cases. However, the ability to change an irrevocable trust is neither certain nor simple, and these arrangements should be thought of as truly permanent. The main advantage to setting up an irrevocable trust is that the assets in the trust, including any future appreciation, are not typically included in your gross estate for estate tax purposes. Of course, the transfer to an irrevocable trust may be a taxable gift, and gift taxes may have to be paid at the time of the transfer. A secondary benefit of an irrevocable trust may be that the assets in the trust are beyond the reach of creditors. Irrevocable trusts are used primarily as wealth transfer tools. With careful planning, you may be able to save substantial amounts in estate taxes.

Many different types of trusts can be used to accomplish a variety of wealth planning objectives. For more information on lifetime gift planning strategies, please refer to our Lifetime Gift Planning white paper series. For more information on charitable giving strategies, please refer to our Effective Philanthropy white paper series.

Trusts are complex legal planning tactics that need the guidance and expertise of a lawyer and estate planning advisor. They're also flexible, powerful and customizable ways to help protect your assets and your family and make passing your assets on more efficient. Consider their benefits—there are good reasons for trusts at almost any age.



CIBC PRIVATE WEALTH

Fiduciary considerations

A matter of trust: Choosing a trustee



A matter of trust

The role of a trustee—holding title to property for the benefit of another—sounds simple enough on its surface, but selecting a trustee is really a complex decision with many nuances. So is considering who succeeds the initial trustee and whether you need a trust “protector.”

Trusts are extremely flexible tools that can serve a variety of estate- and tax-planning goals. How well they succeed depends largely on the trustee responsible for carrying out your intentions. Clients who create trusts usually focus on the trust provisions regarding disposition of the assets put into the trust and their intent on timing and amounts of assets to go to beneficiaries. However, your trustee implements those intentions expressed in the document through administration of the trust. Since your trustee is legally a fiduciary, requiring objectivity and impartiality, it’s critically important to focus on who you will select as trustee in addition to the purpose of the trust. First, keep in mind the primary responsibilities of a trustee:

- Safeguarding, investing and monitoring the assets (either solo or by hiring investment managers)
- Making distributions of income or principal while balancing the needs of income and remainder beneficiaries
- Maintaining records of trust activities and reporting to beneficiaries
- Filing the trust tax return and any other required filings

While you may think that the person you have in mind—your sister-in-law who works for a bank?—will consider it an honor to be named as trustee (and she may indeed), serving as a trustee requires technical skills and sound judgment; the ability to exercise discretion, integrity and objectivity; time to commit to the role; and, perhaps most importantly, the ability to deal with all the family members involved. And those family members may include both current beneficiaries, who are entitled to assets immediately, and remainder beneficiaries, who will not receive distributions until sometime in the future—such as when they reach a certain age or the current beneficiary dies. And since trusts’ purposes can vary—to provide asset management, save taxes, protect assets from creditors, provide for minor children or prevent funds from being eroded by spendthrift family members—it’s important to consider how your trustee will interact with all of the beneficiaries.

Certain kinds of trusts may call for trustees with particular qualities. For example, with a marital trust, designed not only to minimize estate taxes in a couple’s estate, but also to provide for a surviving spouse’s financial needs, it’s crucial that you feel your trustee can relate well to your spouse. If you are establishing a special needs trust to maximize outside resources while providing supplemental benefits to a disabled individual, you may want trustees with particular understanding of the disabilities and needs, as well as the complicated legal requirements of a special needs trust. When looking for a trustee for your revocable, or living, trust, a key consideration is the fact that this trustee will be in charge of your finances if you become mentally incapacitated. Other considerations include whether the trustee has familiarity or experience with specific types of trust assets, such as real estate or a closely held business, assets that are often more difficult to control or monitor than a portfolio of stocks and bonds.

Choosing well—for now and for later

Choosing a trustee is one of the most important, and often challenging, discussions advisors have with clients. The right trustee plays a very important role in preserving a family’s wealth for many years and, often, in preserving family harmony; the wrong one can disrupt both wealth preservation and family relationships. Both the trust grantor and named trustee must carefully consider their respective roles and responsibilities and respect the terms and boundaries of the trust. Naming a trustee or accepting the position of being a trustee is not just a formality.

Lawyer or accountant, family, friend or institution—each of these choices for possible trustee has pros and cons. A lawyer or accountant, who may be an expert in financial matters or in planning and crafting trust arrangements, may or may not have the time or capacity for all of the tasks involved in trust administration such as a trust accounting platform or a robust investment program. Similarly, a family member or a friend may be familiar with your beneficiaries, but may not have the time or breadth and depth of knowledge to handle the demands of administering a trust. Sometimes those “demands” are uncomfortable situations that revolve around the choice between no and yes, as described below.

“How will [a family member] trustee react when faced with a choice that favors him at the expense of other beneficiaries—or favors others at his expense? What are the intra-family implications of those choices? For instance, will he alienate one family member by (even properly) denying a distribution, or ingratiate himself to another by being liberal in his policy of making distributions? Can he say ‘no’ to one child and ‘yes’ to another without causing a never-ending family feud? A trustee who is also a family member may be forced by conscience or by duty to make choices injurious to the harmony of family relationships. Will the trustee (such as the grantor’s spouse) be subject to the influence of one or more children (or a second spouse) to make distributions that may not be in the best interest of other beneficiaries? Is the family member trustee easily persuaded or likely to show favoritism? The remarriage of a spouse or child who is named as trustee may result in less than impartial decisions—especially where the trustee has been given discretionary powers over trust income or principal—even if the new spouse is not included in the class of possible recipients. A child/trustee may take on the role of a parent to his or her remaining parent or siblings. This may be positive, but it also may result in an attempt to control the lives of family members through the family finances as if that person were a parent rather than a child.”¹

A bank or trust company with substantial fiduciary experience and a deep bench of professionals offers the expertise, stability, objectivity and permanence that individual trustees cannot provide, which can be especially helpful for long-term, multi-generational planning. In addition, a corporate trustee can manage the accounting and tax-reporting requirements subject to internal and regulatory oversight. Such a trustee also has formal processes for handling distributions and deciding on beneficiary requests.

One trustee—or co-trustees? You can name multiple trustees, and often grantors will name both a family member or very trusted friend and an independent professional trustee. In this scenario, the family member or friend could serve as the touchpoint for the trust’s beneficiaries, providing the perspective of knowing them well. The other trustee, such as an institution, could be relied on for the expertise of providing investment management and administrative experience, and should have an in-depth understanding of tax planning and compliance matters. Many times, parents or grandparents want to include one of the beneficiaries as a co-trustee, an approach that fosters a real involvement with family wealth that beneficiaries might not feel when all of the control rests with a trustee. It’s a nice way to educate the next generation about money, but it’s important to carefully consider the parameters surrounding when beneficiaries may make distributions to themselves, particularly as there could be tax implications associated with having these broad powers. If you decide on co-trustees, make sure the trust document outlines whether the trustees must agree on all decisions.

A variation on this theme now available to grantors establishing trusts in certain states, such as Delaware, New Hampshire, Alaska, Nevada and South Dakota, is the ability to bifurcate trustee duties so that a family member, for example, could be a distribution advisor or trustee, and a corporate trustee could be appointed to handle custody, trust administration or investments. State law sets forth the requirements for creating these roles and protects the named fiduciaries from liability for actions to each other. Individuals with unique assets to be held in trust, such as real estate or business interests, or who want added flexibility in naming trustees, may wish to consider this option.

Sometimes trusts include a trust “advisor” or “advisor committee” made up of family members. One or more family members can be appointed to this role—they don’t have fiduciary responsibility and can offer only non-binding guidance and recommendations to an individual or corporate trustee. A trust advisor can also play a role in replacing trustees. It’s not enough to simply name a trustee and consider that you’re done. There are many reasons why a trustee may have

¹ Stephen R. Leimberg, “The Tools and Techniques of Estate Planning”, 11th ed., 1998.

to resign or be removed. Planning for trustee succession and who will have the power to remove and replace trustees is extremely important, particularly as it is the trustee who has the responsibility to interpret the trust terms and decide on investment and distribution decisions.

Who should succeed?

Some grantors allow individual trustees to choose their successors; others direct that if an individual trustee leaves, that role goes to a corporate trustee. It's common in a marital trust that the surviving spouse be given the right to remove a corporate trustee and that beneficiary children be given the power to remove and replace a trustee after the surviving spouse's death. The trust should specify, as much as possible, the criteria or "triggers" for trustee removal or resignation, such as for incapacity, as well as define whether an individual, professional or corporate trustee should be required to serve. In addition, the trust can specify whether trustee decisions must be unanimous or by majority vote.

If you are the trustee for your own living trust, the trust should spell out the specific requirements for when successors should begin serving if it becomes necessary due to your deteriorating physical or mental condition. Your trust can even include a HIPAA privacy release authorizing your doctor to provide information about your ability to manage your own affairs.

Trust protector

Another trend in trusts that is surging in popularity is that of naming a trust "protector." The concept has long been popular in offshore trusts; the first offshore statutory definition of protector was seen in the Cook Islands in 1989 but not in the U.S. until 1997, in South Dakota. A simple definition of this role is a person who has powers over the trust, but who is not a trustee. Nor is the trust protector the same as a trust advisor.

"A protector is typically named to provide watch over a trust that will be in effect for a long time, providing a lot of flexibility to accommodate changes in beneficiary circumstances and to oversee the actions of the trustee," says Alexander Bove Jr., Ph.D., LL.M. in taxation and a partner with Bove & Langa PC, of Boston. "The protector can be given the power to remove or replace trustees, add or delete beneficiaries, veto investment decisions, change the trust's provisions and alter the trust's situs. The protector can also override a trustee decision or direct a trustee to take a specific action. It's a very powerful position in many respects. In the past, when we drafted an irrevocable trust, it was just that—irrevocable. A protector gives a new twist to what's irrevocable and what's not."

A trust protector is expected to address issues or solve problems that couldn't have been anticipated when the trust was drafted. For example, the trust may have specified ages of distribution that no longer make sense for a particular beneficiary who may have creditor issues or special needs. Or it may make sense for the administration of the trust to be moved, or for beneficiary power to be added or removed. Bove says that another good example could be a child whose parent is the trust's grantor but was born "outside the family" and all parties now agree that this child should be added as a beneficiary. "In the past, no corporate trustee would do that without a court's consent, which could be a lengthy and expensive exercise. The protector can do that with the stroke of a pen." A protector can also be valuable for a trust that holds an insurance policy or assets that are expected to appreciate in value. Years down the road, a sizable amount of money could pass to family members—even to one who is estranged from the family. The protector can alter the trust's beneficiaries to reflect that situation. "These are not always pleasant possible circumstances to consider, but they do reflect real life," says Bove, whose book "Trust Protectors: A Practice Manual with Forms" covers the pros and cons of trust protectors in almost every conceivable situation.

Rather than a permanent protector, a "springing" protector can be provided for in the trust. Much like with a "springing" power of attorney, the protector can come in if a certain event is triggered and serve for only a specified period. For example, if the entire family moves far away and it makes no sense to keep an individual or corporate trustee in the original city, the springing protector can make the decision to change the trustee or the trust's situs. "A springing

protector with specific and limited powers is, in many instances, far better than giving the protector as many powers as possible to provide for any and all future changes in circumstances, law or beneficiaries," says Bove.

The biggest question surrounding the role of the trust protector, at least in discussions among lawyers, is whether the protector is a fiduciary or whether the trust document can effectively declare that the protector is not a fiduciary. Bove says while some lawyers don't want to assume fiduciary duty, but are often named as trust protectors, he believes that the role speaks for itself: "If a trust protector is given the power to remove and replace trustees, add or change beneficiaries and amend the trust in minor or significant ways, I believe it's clear that the protector is serving in a fiduciary role," says Bove. "In considering whether the protector is a fiduciary, the question can be answered through another question: What was the grantor's intent and purpose in naming the protector and granting the specific powers? If it was to give the protector the enforceable power to carry out certain objectives consistent with and in furtherance of the grantor's intent and the purposes of the trust, then we can conclude that the grantor expected the protector to use his or her best judgment and exercise the powers in good faith. That's the essence of being a fiduciary."

In creating an arrangement that describes how wealth should be managed and used for the benefit of those you love, it is, of course, crucial to state the terms and provisions of the agreement with thoughtful care. However, it is of equal importance to carefully consider the choice of those whom you are entrusting to carry out your wishes.

What Is a Trust Protector?

Let's assume that you, as the trust grantor, decide to have both one or more trustees and a trust protector. How should you expect these people to interact with each other? Do they have an obligation for regular contact? Is the protector also required to undertake ongoing "monitoring" of the trustees?

Not an easy question to answer, says Alexander Bove Jr., Ph.D., LL.M. in taxation and a partner with Bove & Langa PC, of Boston. It depends on why you wanted a protector in the first place. "If the protector has the power to remove and replace a trustee, when does that happen and under what circumstances? Does he or she simply sit by and wait for the beneficiary to express dissatisfaction with the trustee? Or is there a duty to actively monitor the trustee's actions, rather than just be a passive recipient of account statements and distribution decisions? Unfortunately, the consensus right now seems to be that there is no duty to monitor, but this is based on only one well-known case in the U.S."

In that case, filed in Missouri in 2009, the trust protector, who was designated a fiduciary and had the power to remove and replace the trustee, nevertheless allegedly stood by while the trustee totally dissipated the trust funds over a period of less than 24 months—funds that were intended to provide for the beneficiary during his anticipated life expectancy of more than 25 years. "The trustee did not steal money or charge excessive fees; he simply continuously acquiesced to the beneficiary's requests for funds, which were spent frivolously," says Bove.

A successor trustee sued the protector for breach of duty for failing to remove the trustee and for the resulting damages. The protector argued that he had no duty to monitor the trustee, and thus no liability for damages. The court noted that no evidence was offered to show specific damages resulting proximately from the protector's failure to remove the trustee. As a result, the district court directed a verdict for the protector. The Missouri appeals court sent the case back to the district court to reconsider. The district court then found that the protector did have liability if it could be shown that he became aware of the trustee's breach and still failed to act. However, the plaintiff failed to prove any damages, so the protector was not held liable. Nevertheless, it is important to note that the law regarding the fiduciary liability surrounding the trust protector role is evolving.

"The good news about this case was that the court acknowledged that the protector was clearly a fiduciary," says Bove. "The bad news is that the court said, 'We don't really know what a protector is.' Amazing, really. It's clear that protectors have duties. But in this case, the court ruled that 'duty' did not extend to regular monitoring. This is why it's important to spell out the protector's responsibilities in the trust document—it could be as simple as 'shall monitor the activities of the trustee at least quarterly.' Of course, there are always the gray areas. A trust protector can veto distributions to a beneficiary, but you certainly don't want a protector second-guessing every decision. Moral of the story: Adding a trust protector requires very careful consideration, discussion with your lawyer and advisor, and extremely thoughtful drafting of the documents."



CIBC PRIVATE WEALTH

Fiduciary considerations

What to expect from your trust: A beneficiary's guide



What to expect from your trust

Trusts are often created for the long term, with certain beneficiaries enjoying a current interest in the trust and others having an interest that takes effect in the future. Because of this, there can be an inherent tension between trust beneficiaries. The role of the trustee is to balance the potentially adverse interests of the beneficiaries impartially while carrying out the terms of the trust and always following trust law.

Lifetime, or current, beneficiaries generally seek the largest possible payout, while future (remainder) beneficiaries prefer trust assets to grow in value. Trustees are charged with balancing these competing interests. They must be impartial to both sets of beneficiaries when investing and distributing trust property. A trustee's responsibility is to look to the trust agreement for direction regarding the purpose for which the trust was created and guidance regarding how to treat all beneficiaries equitably.

Understanding the nature of your interest in a trust, as well as the role of the trustee in carrying out the terms specified by the trust's creator, can help set your expectations regarding management and distributions.

What is a trust?

As you consider the various ways in which a trust might be useful in your family's overall wealth plan, it's important to understand what a trust is and how it functions. A trust is a legal entity that is created when an individual transfers property to a trustee for the benefit of someone (a beneficiary). The trustee manages the property for the beneficiary in accordance with the terms and the instructions in the trust document. In legal terms, the trustee has legal ownership of the property, while the beneficiary has beneficial ownership.

Creator of trust: The person who creates the trust is called the grantor, settlor, donor or trustor. The grantor usually decides what assets will be transferred to the trust, who the beneficiaries will be, what the terms and conditions of the trust will be, and who will be the trustee. The grantor may also be a trustee and/or a beneficiary; this is generally the arrangement for revocable lifetime trusts. When irrevocable trusts are created for tax planning purposes, the grantor, trustee and beneficiaries are generally not the same, although a beneficiary can be a trustee.

Trustee: The grantor selects the trustee, which can be a sole trustee or multiple trustees. The trustee can be an individual or a professional trustee. Some trusts may have both a professional trustee and an individual trustee. The trustee assumes responsibility for the management and distribution of the assets in the trust. The trustee's duties include making numerous complex fiduciary decisions. Therefore, the selection of trustee should not be taken lightly. There are many factors that should be considered before selecting a trustee, such as the size of the trust, the purpose of the trust, the duration of the trust, the location of beneficiaries and the tax ramifications. In certain situations, the grantor can name himself or herself as trustee. A family member can be appointed as trustee, as can a friend, the attorney who drafts the trust or the grantor's accountant. Finally, a corporate trustee, such as a bank trust department or an independent trust company, can be named. The creator of the trust should discuss these options with the drafting attorney. Please see our "Choosing a Trustee" white paper in this series.

Trust situs: Closely associated with choosing a trustee is the decision regarding where the trust will be located. The creator of the trust may have the option of selecting what state law will govern the administration of the trust. Laws regarding state gift, estate and income taxes, as well as differences in the rights and obligations of the trustees and beneficiaries, can vary from state to state. The choice of trust situs may be an important decision.

Trust beneficiary: The third party to a trust arrangement is the beneficiary. Trust beneficiaries do not own the assets placed in the trust—they are given a beneficial interest, which means they may enjoy the use of the trust assets subject to the terms that have been specified by the trust's creator. Beneficiaries can have a variety of different types of interests in the trust property, which can range from a right to receive certain amounts to an interest that is totally within the discretion of the trustee. There are many ways to define a beneficiary's interest to meet a wide variety of family needs

and circumstances. Since most trusts created for family member beneficiaries are irrevocable in nature, the terms, once set forth, can be difficult, if not impossible, to change. Considering how and for whom trust assets are to be used is a critical element of trust creation.

Trust assets: The types of assets that may be used to fund a trust are almost limitless and can include cash, stocks, bonds, insurance policies, artwork and almost anything else. The type of asset selected depends on the goals of the trust. For example, if the desire is to provide the beneficiaries with income, bonds or high-yield stocks may be appropriate. If the goal is to provide the beneficiaries with liquidity to pay estate taxes, life insurance policies are often used.

Trust terms: Finally, a trust document specifies the terms under which the trust should be managed and administered. Normally, an attorney will draft the document. Among other things, the trust document names a trustee, directs the trustee about how to manage and invest the assets in the trust, names the beneficiaries of the trust and instructs the trustee regarding when to pay out income and principal to the beneficiaries. The trust document may give explicit and detailed instructions about these duties. Alternatively, the trust document may give only very broad and simple guidance—"for my children's lifelong education," for example. Furthermore, the trust document may give instructions for the distribution of principal that differ from instructions for the distribution of the income generated by the trust. For example, it is very common in older trusts that a trust document will instruct the trustee to distribute the income to one or more beneficiaries and then pay out the principal to completely different beneficiaries at some point in the future. Because needs and circumstances vary, careful thought and expert guidance are keys to a successful trust arrangement.

What are the trustee's duties regarding trust investments?

Trustees have an obligation to take a balanced approach to portfolio management. The Uniform Prudent Investor Act (the "Act"), adopted by most states, provides that a trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust. The circumstances that a trustee should consider include, but are not limited to, the total return from income and appreciation, the correlation and purpose of each individual investment within the portfolio, needs for liquidity or a regular income stream or asset preservation, expected tax consequences of investment decisions, an asset's special relationship or value to the trust or a beneficiary, and general economic conditions. The actual asset allocation will depend upon all of these factors as well as the expected duration of the trust and the nature of the property that funded the trust at the outset.

In addition, the duty to diversify trust assets is specifically included in the Act to lessen the extent to which a decline in any single asset will cause a decrease in the overall portfolio value. When a trustee assumes responsibility for an existing trust, the trustee may inherit a portfolio with concentrated positions. Many families built their wealth by investing in the stock of a single company. Whether it was a business they started or one that employed a family patriarch or matriarch, they may have emotional attachments to that stock. In these situations, the duty to diversify intersects with the needs and purposes of the trusts and its beneficiaries. As a matter of policy, many professional trustees seek to diversify concentrated holdings. However, diversification can often trigger a large capital gains tax, depleting the trust's value. When it is necessary to reduce a concentrated position, a professional trustee may put in place a gradual plan for diversification that takes into account several factors, including the economic impact and profit from selling the asset, as well as the tax liability. The desire that grantors sometimes have to maintain an investment concentration or a unique asset in a trust, despite the trustee's duty to diversify, has been addressed by a number of states, including Delaware, by trust legislation that permits directed trust investments. For more information on directed trusts, please see our Delaware Trust Planning white paper series.

The responsibility to apply the principles of the Uniform Prudent Investor Act is a key duty of a trustee regarding trust investments. And even beyond these investment principles, trustees are also charged with the duty of loyalty and the duty of impartiality. These overarching responsibilities require trustees to manage the assets solely in the interests of all

beneficiaries and to act impartially in investing and managing the trust assets, taking into account any differing interests they may have.

Does a trustee need to consult beneficiaries about investments?

Because the trustee has a responsibility to manage and invest trust assets solely in the best interests of the beneficiaries, it is, of course, crucial that the trustee understand the needs of the beneficiaries. For their part, beneficiaries should understand, and be involved in, setting the investment objectives of the trust and how the trustee plans to execute them, even if they do not have that responsibility or control. It is important for beneficiaries to understand diversification strategies and the trustee's philosophy surrounding asset allocation to be sure they are comfortable with the approach the trustee is taking. Moreover, discussions about trust investments are often a useful platform for financial education with younger beneficiaries, providing them valuable insights into stewardship of the family wealth. Ultimately, however, the responsibility and decision-making regarding investments rests with the trustee.

In some cases, a beneficiary may be appointed to serve as co-trustee, with the authority and responsibility to participate in investment decisions. Depending upon the beneficiary's wishes, or the terms of the trust itself, that participation can be high level or very involved. If the former, the beneficiary may contribute in setting the investment objectives and the investment plan to implement the objectives. In such a case, the individual co-trustee delegates the day-to-day execution of the investment program to the professional. In other situations, a beneficiary-trustee may be involved with the daily decision-making of trust investments—approving each purchase and sale of trust assets. In either case, a beneficiary serving as a co-trustee has the same fiduciary duty of impartiality over investments and must balance his or her own current needs with the interests of the future beneficiaries.

How does a trustee decide how much to distribute to a beneficiary?

From a legal standpoint, the interests of current and future beneficiaries are adverse: Distributing assets to a current beneficiary depletes the trust for the benefit of the future, or remainder, beneficiaries. Conversely, preserving assets for remainder beneficiaries may deprive current beneficiaries of enjoyment of the trust. The terms of the trust are the guiding factor, but no trust can anticipate all the circumstances that trustees and beneficiaries will face.

As stated earlier, sometimes, generally in older documents, a trust will provide that all of the income is to be paid to the current beneficiary, and principal is to be preserved for the remainder beneficiaries. In such trusts, the distribution direction is clear. However, this arrangement often produces an investment dilemma, since investing to produce a significant income stream for the current beneficiary may not produce the best overall return for the trust as a whole, while investing for the highest total yield may result in relatively low current income.

This quandary has been alleviated by adoption in most states of the Uniform Principal and Income Act (UPIA), which includes among its provisions a grant of authority to trustees to adjust between principal and income, or to distribute an amount greater than the investment income by encroaching on principal, even if that power is not in the trust document, when necessary to treat all beneficiaries fairly.

In newer trust agreements, the direction regarding distributions generally is drafted with more flexibility, giving the trustee discretion over when to make distributions from income or principal, in accordance with stated guidelines. This guidance over when to distribute can range from such purposes as "health and education" to broad discretion such as "comfort and well-being." This discretion, while allowing a trust to meet the needs of beneficiaries that might not have been anticipated when the trust was created, places a responsibility on the trustee to evaluate every distribution in the context of the stated purpose of the trust and the competing interests of current and future beneficiaries.

How does a beneficiary obtain a distribution from a discretionary trust?

When a trustee is given discretion to make distributions to a trust beneficiary, the process of exercising that discretion should be initiated by a request from the beneficiary. At CIBC Private Wealth, we evaluate whether it is appropriate to distribute the requested amount by considering several factors, including:

- First, what did the trust grantor state in the document regarding the purposes for which the trust assets are to be used? Specific purposes such as “health and education” are more clear-cut than broader guidelines like “comfort and welfare,” which require a thoughtful exercise of judgment.
- Did the grantor direct that other resources available to the beneficiary should be considered before distributions are made from the trust? If so, the trustee may need to document what he or she knows about outside sources of income to which the beneficiary is entitled.
- What sort of documentation has the beneficiary provided regarding the intended use of the distributed funds? Generally, the more precise the beneficiary can be in supplying receipts or other documentation of expenses, the smoother the evaluation process will be.
- And finally, how large is the requested distribution in relation to the size of the trust? Even if the requested distribution is for a purpose provided for in the trust, the trustee still must weigh the interests of the future beneficiaries and generally should not make distributions that deplete trust principal.

Trustees have a fiduciary responsibility to manage and distribute trust property in accordance with the purpose of the trust as set forth by the trust’s creator. This responsibility requires balancing the interests of people who may have competing needs. Understanding the nature of trust administration and the terms and purposes for which a particular trust was created, can help to make the relationship between beneficiaries and their trustees a harmonious and productive one.

Making the relationship with your trustee work for you

Understanding the nature of trust administration and the terms and purposes for which a trust was created can help to make the relationship between beneficiaries and their trustees a harmonious and productive one.

Even though a trust does not include a list of duties for a beneficiary to follow as it does for a trustee, beneficiaries can optimize their interest in a trust by:

- Understanding the nature of your interest in the trust
- Understanding the purpose of the trust and know the answer to the question “why was it created?”
- Understanding the dispositive terms of the trust
- Understanding the investment objective of the trust

Regarding discretionary distributions from the trust, expectations can best be met when a beneficiary understands the factors that govern trust distributions. These factors may include:

- What the trust grantor stated in the document regarding the purposes for which the trust assets are to be used
- Any specific instructions from the grantor regarding distributions
- Direction from the grantor that other resources available to the beneficiary should, or need not, be considered before distributions are made from the trust
- Documentation required of the beneficiary regarding the intended use of the distributed funds
- The amount of the requested distribution in relation to the size of the trust
- The income tax consequences to the beneficiary of distributed funds

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