SPECIAL ISSUES IN SMALL TRUSTS
First Run Broadcast: February 18, 2016
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There are many more small trusts than large trusts and they pose special challenges for trust planners and administrators. The fees paid to trustees and to investment professionals, together with ongoing reporting and fiduciary income tax compliance costs, can consume a substantial portion of the trust’s liquid assets or income. There are also the challenges in the types of assets most commonly held by small trusts. Many have as their principal assets real estate or an operating (often family) business, which are very difficult to administer. In some instances, trusts may cease to be practically and financially viable, and may need to be restructured or even terminated. This program will provide you with a practical guide to drafting, structuring and administering small trusts – and what to do when they cease to be viable entities.

- Drafting, structuring and administering small trusts
- Economics of small trusts – trustee compensation, reimbursement of expenses, investment fees
- Challenges of trust management of operating businesses and non-liquid assets such as real estate
- When a trust is so small that it’s not economically viable – when and how to restructure or terminate the trust
- Practical alternatives when a small trust is not viable, including custodial accounts
- How choosing a trustee for a small trust differs from trustee selection for larger trusts
- Reporting and tax compliance issues for smaller trusts

Speakers:

John T. Midgett is a founder of Midgett & Preti PC in Virginia Beach, Virginia, where his practice focuses on estate planning, administration and taxation, elder law, and family business planning. He is a Fellow of the American College of Trust and Estate Counsel, a member of the National Academy of Elder Law Attorneys, and the Duke University Estate Planning Council. He has lectured widely on topics relating to estate planning, taxation, probate, elder law, and family businesses. Mr. Midgett received his B.A. from the University of Virginia and his J.D. from the University of Richmond.

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Speaker Contact Information

SPECIAL ISSUES IN SMALL TRUSTS

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Introduction:

A. Reasons for the Uniform Trust Code (UTC)

1. A codification of the law of trusts makes the law “more conveniently accessible than skimming through fragmentary statutory schemes and scattered case law spread among reported decisions going back centuries.

2. The UTC replaces default rules that are not in accord with modern trust administration practice and provides guidance, with a practical approach, to trust administration.

3. The UTC provides mechanisms to facilitate trust administration, many times without the need for judicial involvement, which promotes efficiency and economy for trustees, beneficiaries, and third parties.

B. Opportunities

1. As practitioners, the UTC grants us the freedom to draft our documents as we please to fit the client’s desires and intent. While there are eleven rules that cannot be overridden by the trust instrument, the remainder of the UTC consists of default rules that apply only where the document is silent.

2. The paramount principal of the UTC is to implement the known intent of the grantor of the trust, unless to do so violates public policy or principles of equity.

3. As drafters of trusts, it is incumbent upon us to ferret out the intent of our clients and to express that intent with clarity, with full knowledge and understanding of the rules of the game, and the various costs and expenses associated with administration.
C. Definition.

For the purposes of this presentation a small trust is one with $500,000 or less in trust corpus on an ongoing basis, with no immediate prospect of any significant additions or contributions. **Note:** This is the author’s arbitrary definition developed for the sole purpose of discussion of the cost issues surrounding trust administration.

1. Cost management in small trusts

A. Compensation.

1. UTC Section 708 provides that the Trustee of any trust is entitled to compensation reasonable under the circumstances or, if the terms of the trust specify the trustee’s compensation, the amount so specified.

2. A court having jurisdiction over the trust may allow more or less compensation if:

   a. The duties of the trustee are substantially different from those contemplated when the trust was first created; or

   b. The compensation specified by the terms of the trust would be unreasonably low or high.

3. The power of the court to adjust a trustee’s compensation specified in the instrument which is unreasonably low or high cannot be overridden by the terms of the trust instrument. UTC Section 105 (b) (7).

4. Compensation language frequently employed by trust documents may provide for a percentage of the trust value, an hourly rate, or reference to a fee schedule.

   a. Many corporate fiduciaries employ fees schedules whereby a percentage is charged against the principal of the trust, the income earned during the trust’s tax year, with a minimum annual fee to be charged.

   b. The minimum fees can vary significantly from institution to institution, running as high, in the author’s experience, as $12,000 per year.
c. At a percentage of trust corpus, usually 1%, a minimum fee of $12,000 would require a minimum trust corpus of $1,200,000 to be cost efficient.

d. Since the creation of trusts under one minimum fee schedule, many corporate Trustees have significantly altered the minimum fee schedules to make the continued administration of the Trust by corporate fiduciaries uneconomical.

5. Reimbursement of expenses.
   According to UTC Section 709 reimbursement of expenses is proper.

   A. A trustee is entitled to be reimbursed out of the trust property, with interest as appropriate, for:

   1. Expenses that were properly incurred in the administration of the trust; and

   2. To the extent necessary to prevent unjust enrichment of the trust, expenses that were not properly incurred in the administration of the trust.

   B. An advance by the trustee of money for the protection of the trust gives rise to a lien against trust property to secure reimbursement with reasonable interest.

2. When (and how) to terminate an unprofitable trust

According to UTC Section 410, a trust terminates to the extent the trust is revoked or expires pursuant to its terms, no purpose of the trust remains to be achieved, or the purposes of the trust have become unlawful, contrary to public policy, or impossible to achieve or by the methods of termination prescribed by §§ 411 through 414.

When drafting, it is always wise to provide a “sunset” clause or provision within the document. Common trust provisions may provide that the trust shall terminate upon the happening of an event (such as, when my child
attains the age of 25), or upon the expiration of time (such as, twenty (20) years from the date this trust was created).

Trustees and Qualified beneficiaries of a trust also may revoke or modify a trust without judicial proceedings in certain instances. See UTC §414(a).

The power of a court to modify or terminate a trust under the UTC 410 through 416 cannot be modified or restricted by the terms of the trust instrument. UTC §105 (a)(4).

Judicial intervention or approval is required to terminate trusts over $50,000.00. UTC §414(b). This amount was placed in brackets in the UTC so that the enacting states could increase or decrease the amount at which a non-judicial reformation could take place.

The grantor can modify or expand the rights to modify to terminate the trust, but cannot restrain the court’s power.

3. Alternatives to small trusts, including custodial accounts
   A. UTMA Accounts
   B. Custodial Trusts under State Law
   C. Deferred Annuities
   D. Pooled Income Trusts

4. Challenges of trust management of operating businesses and real estate
   A. Prudent Investor Rules
   B. Diversification of Assets
   C. Lack of Experience/Exposure as Trustee in general
   D. Lack of Experience/Exposure in running business or managing real estate
   E. Environmental Concerns
   F. Time Constraints

5. Trustee selection issues
   A. The settlor, a cotrustee, or a beneficiary, or in the case of a charitable trust, the Attorney General, may petition the court to remove a trustee, or a trustee may be removed by the court on its own initiative.

   B. The court may remove a trustee if:
1. The trustee has committed a serious breach of trust;

2. Lack of cooperation among co-trustees substantially impairs the administration of the trust;

3. Because of unfitness, unwillingness, or persistent failure of the trustee to administer the trust effectively, the court determines that removal of the trustee best serves the interests of the beneficiaries; or

4. There has been a substantial change of circumstances or removal is requested by all of the qualified beneficiaries, the court finds that removal of the trustee best serves the interests of all of the beneficiaries and is not inconsistent with a material purpose of the trust, and a suitable co-trustee or successor trustee is available. UTC Section 706.

It may be prudent to grant to the qualified beneficiaries of a trust the power to replace the trustee (or a co-trustee) for reasons that do not reach the level that would allow a court to do so, or to streamline the process of removal so that judicial involvement is not required.

See Estate of Helen S. Wall, 101 TC 300 (1993) wherein a retained power to remove a trustee was held not equivalent to a de facto reservation of a trustee's power as the decedent/settlor had no power to appoint herself as trustee and under the terms of the trusts, only a qualified corporate trustee independent from decedent could be appointed as replacement. Since the decedent had no ownership interest in the trustee-bank, and didn't retain any other power or interest in the trusts, the trusts were not includable in her estate under Internal Revenue Code Section 2036. Further, mere threat of replacement would not make a trustee subservient to decedent's wishes because in irrevocable trusts, the trustee is accountable to beneficiaries, not to settlor.

C. Filling Vacancies

1. A vacancy in a trusteeship occurs if
   a. A person designated as trustee rejects the trusteeship;
   b. A person designated as trustee cannot be identified or does not exist;
   c. A trustee resigns;
   d. A trustee is disqualified or removed;
e. A trustee dies; or
f. An individual serving as trustee is adjudicated an incapacitated person. UTC Section 704.

2. If one or more Co-Trustees remain, a vacancy in a trusteeship need not be filled. A vacancy in a trusteeship shall be filled if the trust has no remaining trustee. UTC Section 704 (b).

If the operation of the trust depends upon one or more independent co-trustees serving, or if it is the desire and intent of the grantor to have more than one trustee serving at any time, it is incumbent upon the drafting attorney to so provide in the trust document.

6. Reporting and tax compliance issues

A. UTC Section 813 imposes upon a Trustee a duty to inform and report. Accordingly:

A trustee shall keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests. Unless unreasonable under the circumstances, a trustee shall promptly respond to a beneficiary's request for information related to the administration of the trust. This provision may be illustrative of common law, as it is in Virginia. See Fletcher v. Fletcher, 253 Va. 30 (1997).

B. A trustee:

1. Upon request of a beneficiary, shall promptly furnish to the beneficiary a copy of the trust instrument;

2. Within 60 days after accepting a trusteeship, shall notify the qualified beneficiaries of the acceptance and of the trustee's name, address, and telephone number;

3. Within 60 days after the date the trustee acquires knowledge of the creation of an irrevocable trust, or the date the trustee acquires knowledge that a formerly revocable trust has become irrevocable, whether by the death of the settlor or otherwise, shall notify the qualified beneficiaries of the trust's existence, of the identity of the settlor or
settlors, of the right to request a copy of the trust instrument, and of the right to a trustee's report as provided in subsection C; and

4. Shall notify the qualified beneficiaries in advance of any change in the method or rate of the trustee's compensation.

C. A trustee shall send to the distributees or permissible distributees of trust income or principal, and to other qualified or nonqualified beneficiaries who request it, at least annually and at the termination of the trust, a report of the trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee's compensation, a listing of the trust assets and, if feasible, their respective market values. Upon a vacancy in a trusteeship, unless a co-trustee remains in office, a report shall be sent to the qualified beneficiaries by the former trustee. A personal representative, conservator, or guardian may send the qualified beneficiaries a report on behalf of a deceased or incapacitated trustee.

D. A beneficiary may waive the right to a trustee's report or other information otherwise required to be furnished under this section. A beneficiary, with respect to future reports and other information, may withdraw a waiver previously given.

E. The notice provisions apply only to an irrevocable trust created on or after the effective date of this chapter, and to a revocable trust which becomes irrevocable on or after the effective date of this chapter.

A grantor may not wish for certain beneficiaries, or any beneficiary, to receive some or all of the notices mandated by this section. Any person wishing to restrict these requirements must do so explicitly in the trust instrument.

F. The above provisions may not be preferred where there is a possibility of a challenge to the validity of a revocable trust. The UTC allows a challenge to the validity of a revocable trust if brought within the earlier of

Three (3) years after the settlor’s death; or
One hundred twenty (120) after the trustee sends the potential contestant a copy of the trust and a notice informing the person of the trust's existence, of the trustee's name and address and the time allowed for commencing a proceeding. **Note:** The three year and 120 day requirements were in brackets in the UTC, allowing states to substitute longer or shorter periods of time.

G. Income Tax Returns. The Trustee has a duty to prepare the Federal Fiduciary Income tax returns (Form 1041) and any applicable state returns and to forward an appropriate K-1 schedule to the qualified beneficiaries of the trust.

H. Potential Conflicts of Interests.