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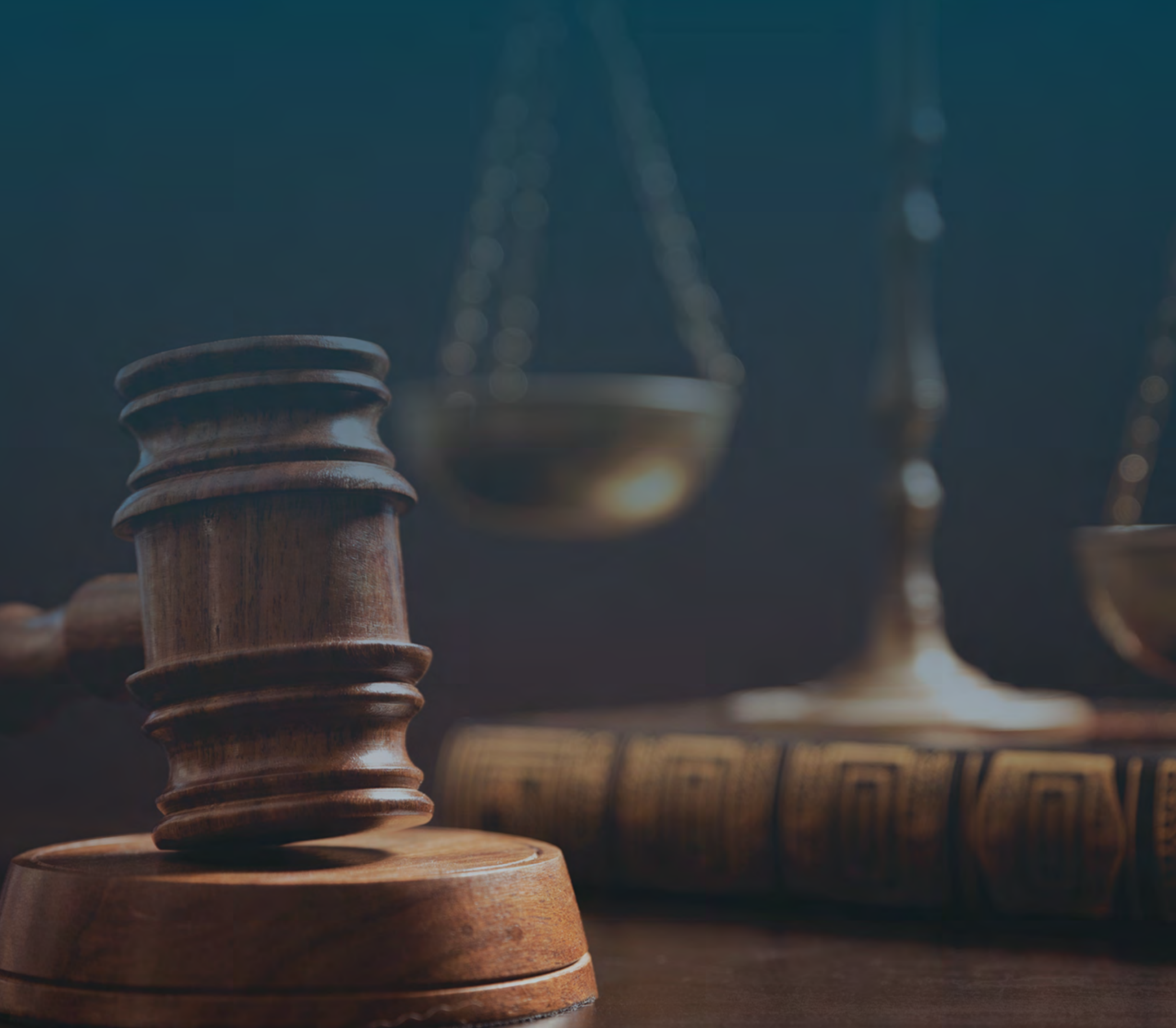
THE GROWING POPULARITY OF

Directed Trusts



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Directed Trusts

Directed and delegated trusts are common types of irrevocable trusts. Historically, the delegated trust model has been favored; however, over time we have observed the directed trust model is gaining popularity. The directed trust model provides families with greater flexibility, control, and protection in the drafting and administration of modern trusts. While both trust models can provide the right structure for transferring assets to future generations, they each have different consequences. These consequences relate to the level of control and choices available to the individual creating the trust (i.e., grantor, or sometimes called settlor) as well as the risk and time it takes for trustee(s) to carry out their duties and obligations in accordance with the trust instrument. Deciding on the appropriate trust model centers on how much power the grantor wants to retain for the family or delegate to the trustee in making decisions around investment management, trust distributions, and outsourcing of trustee duties.

The Trustee Role:

A trustee is an individual or corporation legally responsible for managing the trust assets in alignment with the terms of the trust instrument. A trustee is held to a high standard of care and has the duty to act impartially, meaning the trustee must balance the interests of all beneficiaries of a trust when making any decisions. Selecting a trustee, or delegating authority to others, with the appropriate skills and expertise to carry out certain duties of the trust is critical because effectively, the grantor is giving up control and responsibility to the trustee to properly manage the trust's assets today and into the future.

Delegated Trust Model:

Under a delegated trust model, the investment management, administrative, and distribution duties are bundled under one individual or corporate trustee, or both as co-trustees. Oftentimes these trustee powers are held by large institutional corporate trust companies. The trustee has more authority which also means the trustee has greater exposure and risk. Greater exposure and risk are inherent because a delegated trust is not drafted with indemnification language nor does the trust allow for bifurcation of trustee duties. The trustee must fulfill its fiduciary responsibilities when making any decisions and when taking any action. For example, if a trustee appoints a third-party investment advisor to manage trust assets, the trustee must perform due diligence on the selected manager as well as oversee and monitor investment selections and performance.

Directed Trust Model:

Under a directed trust model, the investment management, administrative and distribution duties are unbundled. The grantor can bifurcate trustee duties and decision-making responsibilities by delegating authority, in the trust document, to someone other than the trustee. For example, naming a third-party investment advisor to manage the trust's assets. In this model, the exposure and risk relating to these duties are shifted away from the trustee to the delegated third party, and the grantor has control to choose who has authority over what duties in the administration of the trust.

Investment Management Differences:

In a directed trust, the grantor, under the terms of the trust, has the power to appoint a trust advisor and/or investment committee. The investment committee, which typically includes family members and the independent trustee, selects the investment manager/advisor responsible for the investment policy, asset allocation, and portfolio construction for the trust assets. This allows families greater flexibility with asset classes, allocation, and diversification they might not be able to achieve under most traditional or "delegated trust" statutes. Further, most large corporate trust companies have policies that may restrict certain investments or require diversification for an asset that makes up a concentrated portion of the portfolio.

The use of an investment committee allows more complex asset types such as Limited Liability Companies (LLCs) and

Family Limited Partnerships (FLPs), real estate, closely held assets, or illiquid nontraditional assets to be held within the trust other than stock and bonds. Incorporating an LLC to hold the underlying assets of the trust can result in more efficient administration, reduced fees, and greater asset protection for the trust and the beneficiaries.

Trust Distribution Differences:

Whether a delegated or directed trust, the process of making trust distribution decisions is complex because any decision impacts the current and future trust beneficiaries. The trust instrument is meant to provide guidance in making trust distribution decisions, but the level of guidance can vary. Much of the time the trustee, or someone the grantor delegates authority to, is forced to interpret the grantor's intent because the trust language may be ambiguous around purpose and priority of trust distributions, sometimes intentionally. The question becomes - Who should have the authority to interpret the grantor's "intent"? Grantors will sometimes name a trust protector in the legal instrument who can provide additional guidance around the grantor's intent for trust distributions as well as act as an intermediary between the decision-makers and beneficiaries. The trust protector role is typically a non-fiduciary role, and its use is not dependent on a directed or delegated trust structure. Rather, how the trust protector role is defined and considered is dependent on the situs of the trust instrument as each state may be different.

Under a delegated trust model, a trustee has the power to decide on trust distributions. The trustee's decision is based on the terms of the trust instrument, the grantor's intent, as well as what is in the best interest of the current and future trust beneficiaries. If a corporate trustee (e.g., bank or trust company) is serving, a trust committee is responsible for reviewing, approving, or denying all trust distribution requests. If the trust instrument is vague; for example, the trust committee may require the requesting beneficiary to provide documentation, such as personal financial information, to demonstrate a need for support. Other factors such as the size of the trust, other sources of income, the age of the beneficiary, and the impact to future beneficiaries are also considered. The trust committee process can be lengthy and cumbersome, and decisions are not immediate.

In comparison, the trustee is not responsible for deciding the appropriateness of making a trust distribution, or not, when these duties are delegated to someone else under a directed trust structure. While forming a distribution committee is not required, in some cases, a distribution committee is put in place to help make trust distribution decisions in accordance with the trust instrument. In addition to the individual delegated authority over trust distributions, the distribution committee may include for example, an independent trustee, family members, and/or other advisors. Having the input and guidance of family members and/or people closely associated with the requesting beneficiary, and the grantor, can prove to be beneficial because they bring a level of understanding and care to the decision-making. Additionally, family members and/or people close to the grantor are best at interpreting the grantor's "intent." An institutional trust committee may not have the same perspective.

Trust Administration Differences:

Administration of a trust is serious business and includes day-to-day tasks such as:

- Safeguarding Assets
- Establishing and Maintaining Trust Bank Accounts
- Preparing and Signing Trust Tax Returns
- Providing Trust Statements and Accounting
- Making Trust Distributions
- Receiving Trust Contributions

Under a delegated trust model, if a corporate trustee is named, the administrative tasks are handled by the corporate trustee. However, if an individual trustee is named, a bank or trust company is oftentimes hired to serve as administrative trustee, or agent to the individual trustee. In an agency role, the duties are purely record-keeping with no fiduciary responsibilities. Under the directed trust model, the role of an administrative trustee is similar. Oftentimes, the administrative trustee will serve on the distribution committee.

Other Considerations:

Old or poorly drafted trust instruments can be reformed, modified, or decanted. Additionally, a trust situs can be changed to move a trust to a top trust law state jurisdiction with favorable tax laws and statutes. When reforming or modifying a trust, the original trust remains in place whereas decanting results in the transfer of assets from an existing trust to a newly formed trust. Modernizing the terms of an old trust, lack of flexibility, adjusting for powers of appointment, or to avoid adverse tax consequences are some reasons for deciding to make a change to an existing trust. However, there are laws and guidelines that must be followed. Most old trusts are delegated trusts because laws for directed trusts were not in existence until the mid-1980's; thus, the ability to reform, modify, or decant a trust has the greatest impact on delegated trust structures.

How to Choose:

While both types of trusts are an option, over time we have observed the directed trust model is growing in popularity. The directed trust model often is viewed as the "modern-day" trust due to its enhanced flexibility as well as the grantor's ability to control and bifurcate decision-making authority over investment management, trust distributions, and other administration duties. The time to make the decision on whether to structure a trust as a directed or delegated trust is during the drafting phase. In most instances, a trust can be reformed, modified, decanted, or a trust jurisdiction changed after the trust is originally created; although, the process can be costly and time-consuming depending on the desired changes.

For more information, contact your relationship manager at Callan Family Office.

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