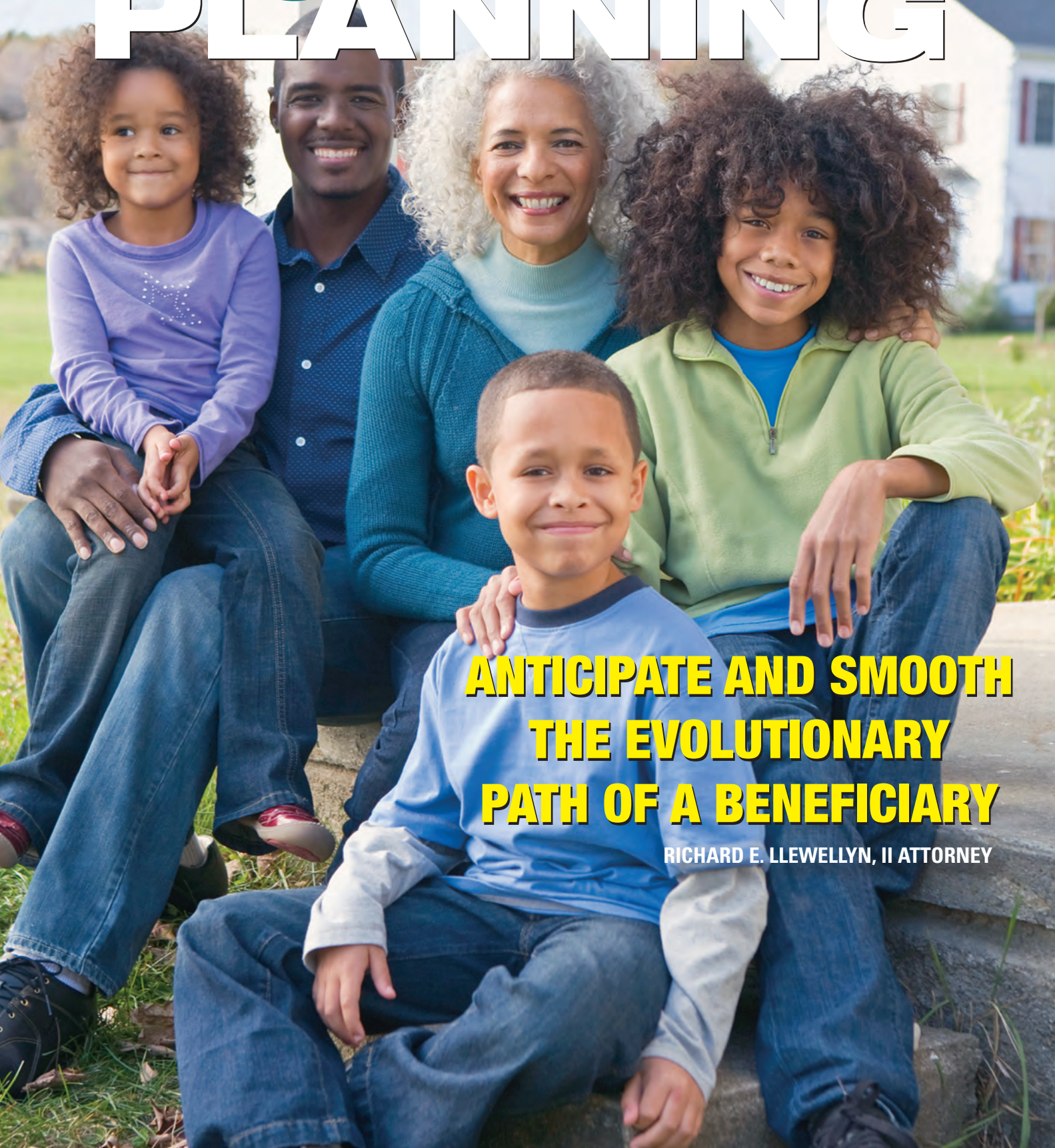


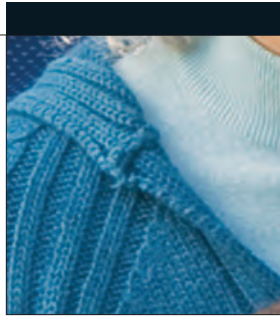
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# ESTATE PLANNING



**ANTICIPATE AND SMOOTH  
THE EVOLUTIONARY  
PATH OF A BENEFICIARY**

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# Anticipate and Smooth the Evolutionary Path of a Beneficiary

Settlors should be alerted to the likely reactions and tensions that beneficiaries will have with respect to their trusts and trustees, and give planning ideas to minimize these concerns.

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**W**hen settlors are working with their attorneys to establish a trust, they usually focus on the trust terms, trustee powers, and distribution provisions. All of this is done with the goal of implementing the settlor's wishes for the beneficiary. Often overlooked, however, is the fact that the existence of the trust itself is likely to have an impact on the beneficiary that will last for many years. Once a beneficiary becomes entitled to distributions, an evolutionary process is set in motion. This process often follows a well-established pattern that is predictable and consistent with human nature. Awareness of this process can help a settlor design a trust and accompanying documents so as to minimize the potentially adverse effects of the evolutionary process.

## Three-stage development

The evolution has three distinct stages. The first occurs on the death of the settlor, or whenever the trust

reaches the appointed time for the beneficiary to receive distributions.

### *Being innocent and cooperative.*

The first stage is marked by the beneficiary's innocence. He or she is often totally unfamiliar with trust and fiduciary concepts. The beneficiary may have some investment knowledge, but rarely will it extend to awareness of such matters as the Prudent Investor Act and Uniform Principal and Income Act. The entire trust experience is new, and the beneficiary may be extremely grateful that the settlor did not designate the beneficiary as the trustee.

In this stage, the beneficiary is cooperative with the trustee and seeks to know how the trust will

work. To the beneficiary, the trustee appears to be totally knowledgeable and to have all the answers. The beneficiary appreciates the trustee and has little remorse that the settlor placed his or her property in trust instead of leaving it outright to the beneficiary. Even if the beneficiary would have preferred an outright bequest, the trustee can provide the reasons why the trust made sense to the settlor and how the beneficiary may ultimately be better suited by the trust than had the property been left outright. This first stage is the "honeymoon" period for the trustee; it lasts for a few years, depending on the experience and sophistication of the beneficiary.

### *Seeking increased participation.*

After these early years, the beneficiary becomes familiar with the trust. This stage is identified by the increase in the beneficiary's attempts to participate in the trust administration and attentive review

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## EXHIBIT 1 Sample Ancillary Letter

Dear Children,

Please excuse our typed letter. We would have written it in long hand, but we have a great deal to explain.

As you may know, we have left your inheritances in trusts. You need to know that we have not created these trusts because we didn't think each of you could handle your inheritances wisely or that you were not capable of properly managing money. Quite the contrary, we love you more than anything, and we have complete faith and confidence in each of you and your decision-making abilities. We set up these trusts because we believe that they will provide you with more advantages than if we had given you the money outright. Your powers as co-trustees will give you significant control, and your rights as beneficiaries will provide substantial benefits and powers for you and your families. In addition, the trust should result in less income, gift, and estate taxation than if we had left you the money and assets outright; and if you choose, the trusts provide a method for you to pass money to your children someday and possibly at no additional tax cost.

Here are some of the benefits your trusts can offer that you could not match with an outright inheritance: The trusts can buy you a home and let you live in it rent-free. Although the right to live in a house without rent is valuable, the current laws do not consider this right to be income to you, so it is income-tax-free too. That's a good deal. For your lifetime, you can have a nice home that might never have a mortgage, and the home can be passed on to your children without being taxed in your estate. Should you have some bad luck in life, the trusts can protect your home from being taken from you because, technically, you don't own it. This is known as "asset protection."

Let us go on a bit about some of the other potential benefits of these trusts:

- First, if the trust is properly invested, and if the distributions do not exceed the annual net return after inflation, you will never want for money, and your children will also inherit the trust. Putting assets in trust increases the likelihood money will be available to you should you need it.
- Second, you will be able to use the distributions from the trusts to supplement your own earnings and investment income.
- Third, as we have mentioned, the trusts can own assets that you use and enjoy, such as a home, vacation property, or works of art. If the trust assets appreciate, the trust principal has increased. The property, however, is not taxed in your estate when you die, but it goes to your children.
- Fourth, the trust can make investments in businesses or partnerships, including helping you start a business. The trust may supply the capital you would otherwise have to borrow from a bank. Of course, you will need to satisfy the co-trustee that your business plan is sound or your deal is worthy of investment.
- Fifth, the trust can be used to make donations on your behalf to your children, grandchildren, or charities of your choice.
- Sixth, as you get older, there is an increased chance that you could become ill or incapacitated. The trust continues to provide for the management of your affairs during such periods.
- Seventh, a spouse, relative, or friend may want to borrow money from you or want you to invest in some activity. Rather than having to make what can be an uncomfortable decision, you can refer the person to the other co-trustee. The trust can serve as a financial consultant, so there will be no loan if there isn't adequate security, and there will be no investment if the deal lacks merit in the trustees' opinion. This may preserve a friendship for you since it is not you who refuses the loan to the friend, but rather the other co-trustee.
- Eighth, the trust assets are forever your separate property. In most states, separate property is not subject to division between spouses on divorce. With 55% of marriages today ending in divorce, a trust provides some financial protection. Even though you may feel that you would never get divorced, we recommend that you keep the trusts intact and not pull assets out to commingle with your spouse's assets. This may sound harsh, but you never know what the future holds in store for you.
- Ninth, income can be accumulated in the trust if you don't need it. In many cases, it can be distributed later with little or no taxes.
- Tenth, and finally, the trust offers significant creditor protection. Should you have the misfortune of being in a situation where someone claims you owe him or her money, generally speaking, the person will not be able to get any money from your trust.

In summary, our lifetime experiences have proved to us the benefit of trusts. We believe the benefits of the trust far outweigh the benefit that would have come from outright distribution to you.

## EXHIBIT 1

### Sample Ancillary Letter, *cont'd*

We have made you a co-trustee. You are not entitled to a fee, but the other co-trustee is. If the co-trustee performs his role, his fee will be deserved. Our nominees for successor co-trustees are all experienced, and we hope they will advise you in trust matters. Institutional or corporate co-trustees can assist you by keeping records and preparing trust tax returns, the basic structure for the administration of the trust.

An institution could also be the investment co-trustee, or you may hire an investment manager. Either way, the one you select to do the investing should provide research for the investment process and collaborate with you in the investment objective, asset allocation, and investment selection processes. The trust powers we have provided should result in your being very involved with the money and investments, give you few (if any) administrative tasks to perform, and give you considerable power, including the most important power, that is, the power to replace the other co-trustees if they fail to properly perform their functions.

We have a great deal of faith in the co-trustees we have nominated. That is why we have permitted them to determine the discretionary distributions made to you. We want you to go to them with your ideas and requests, much the same as you might have come to us. They should help you and counsel you. This might include times when the co-trustees ask you to justify your request, and even after justification, they might deny your request if they determine it is too risky or not to be in your best interest.

This is not to say that the co-trustees can do what they want. They have a litany of duties to you that are prescribed by law. We fully expect the people that we have chosen will serve you well. However, people can change. If you should ever suspect that a co-trustee is not being truthful with you, you need to take action to ensure that your inheritance is being properly managed. Do not hesitate to hire an experienced attorney to make inquiries and to protect your interests. Your attorney's fees can be paid from the trust. But remember, each co-trustee is entitled to legal counsel and they may all be paid from the trust. Therefore, we suggest you consider using your power to replace the trustees instead of litigation. Litigation gets expensive quickly and often produces less than satisfactory results.

When we say people can change, we include you too. If your co-trustee experience is typical, there will be three stages to it. First, you will be a rookie co-trustee. The professionals will educate you about all the various trust matters, such as investments, taxes, and estate planning. You are likely to be very grateful and appreciative during this stage.

As time goes by, you will evolve into stage two, where you are an active co-trustee. You will offer valuable comments based on your acquired knowledge of how the trust works. You are likely to remain appreciative of the efforts of the other trustees, but now understand that they have legal duties to you.

As your experience increases, you evolve into stage three. It can be the most stressful stage for all. Typically, you will have acquired enough knowledge and experience that you may feel that you no longer need the other co-trustees. This resentment usually conflicts with the feelings of the other co-trustees who may feel that they deserve some gratitude for their efforts over the years, especially for educating you about the world of trusts. We hope instead that in stage three you will understand the value of your co-trustees, rely on their specific expertise, and continue to show your gratitude for their loyalty and administrative support.

So this trust is not our attempt to "rule from the grave." Instead, we hope that we have left you a special legacy—one that provides you with some financial security, opportunities to learn and participate in the investment and business world, and the means for you to take what we have left and integrate it as you see fit into your own lives and estate plans for your respective families. Now it is up to you. Have fun and enjoy it; it is there for you.

All our love, until we meet again,  
Dad and Mom

of statements. The beneficiary has learned how the trust operates, including such things as how to request discretionary distributions, why there is an investment policy statement, what an asset allocation is, and how to read the trust's financial statements. The beneficiary's admiration and respect for the trustee has leveled off. The trustee

is now regarded simply as a person doing his or her duty in exchange for adequate compensation.

During this stage, the beneficiary's questions reflect much more understanding of the trust and fiduciary concepts. The trustee's focus on investment performance is now keenly shared by the beneficiary. The beneficiary may question the

purchase of certain investments or the retention of certain assets. The beneficiary may begin to wonder why the settlor felt it was necessary to appoint a trustee to do what the beneficiary now perceives he or she could have done all along.

The cooperative attitude erodes somewhat and transforms into a more inquisitive attitude. The ben-

eficiary is no longer asking objective questions; now they are more challenging, such as, why the trustee chose to take this particular action when other options were available. The trustee's meetings with the beneficiary change. No longer is the trustee reporting to the beneficiary; now the trustee and beneficiary discuss the administration of the trust. Questions may arise anticipating the termination or final distribution of the trust even though the term may have several years remaining.

**Questioning trustee's actions.** The third stage is marked by yet another change in the beneficiary's attitude; now the beneficiary has matured. After the first two stages, the beneficiary has evolved to the point that he or she truly understands the trust's administration. The beneficiary may even feel comfortable challenging the settlor's reasons for establishing the trust in the first place, and the beneficiary may begin to feel that it is the trustee that stands between the beneficiary and his or her inheritance. The beneficiary may feel confident that he or she could do the trustee's job and as a result there is no need for the trust to continue. The beneficiary may now openly question the trustee's actions and offer alternatives that the beneficiary believes would be better. Any appreciation for the trustee's years of patient understanding and guidance has evaporated.

This is the stage that may cause a trustee to consider resignation. This stage may last for the remaining term of the trust. Unfortunately, the beneficiary's evolution is now complete and the trustee's resignation will simply result in the beneficiary challenging a new person. The beneficiary may even attempt to assert himself or herself in the succession process with the hope that a more pliant and under-

standing successor trustee can be found. And so it goes.

### **Countermeasures for settlor to take**

If the settlor is aware of the evolutionary process at the time the trust is drafted, he or she can anticipate the process and implement countermeasures in advance. Some of the countermeasures are provisions that can be included in the trust provisions; others are more philosophical in nature and are best addressed in written documents that accompany the trust agreement. These ancillary documents are sometimes referred to as "living wills" or "ethical wills." They can include any topic, but generally are limited to sage advice offered from the senior generation to the next generation.

One countermeasure that can be implemented in the trust is making the beneficiary a co-trustee. Appointing a beneficiary as a co-trustee can motivate the individual to be part of the solution rather than part of the problem.

Another countermeasure is giving the beneficiary the power (subject to a standard) to replace the trustee. The beneficiary can be one of two or three co-trustees, so that no improper or imprudent action can result due to the requirement that trustees act together (in the case of two co-trustees) or by majority (in the case of three or more co-trustees). Providing the beneficiary with the power to replace his or her co-trustee enables the beneficiary to mitigate victimization. The power should be subject to standards for its use.

In addition to the typical standard from the Code (i.e., the successor co-trustee must not be a "non-adverse party" as that term is defined in the Code), other standards should be included. For example, the beneficiary co-trustee should

have the power to replace the investment manager or co-trustee responsible for investment management if the manager or co-trustee has failed to meet or exceed the appropriate performance benchmark in any two years of a three-year period. When a beneficiary exercises the power to replace a co-trustee, the next nominated successor co-trustee is automatically offered the office.

Should the beneficiary co-trustee have a personality conflict with his or her existing co-trustee, then a standard could provide that the beneficiary co-trustee may replace the existing co-trustee, provided that the next nominated successor co-trustee acknowledges that replacement would be advisable and the successor is willing to fill the office. This should resolve conflicts that result from differences of opinion over family values.

The beneficiary also has the statutory power to seek relief from a court. Reminding the beneficiary of this fact by including it in the trust provisions can also add to the beneficiary's feeling of empowerment.

The most important and effective countermeasures are those that are left in a letter or writing to accompany the trust. These ancillary writings can be much more personal than the trust documents because there is no need for any legalese. It is here that the settlors can explain why they have chosen to create the trust and how they see it helping the beneficiaries. If nothing else, it can exemplify the good faith of the settlors in trying to do what they felt was best for the beneficiaries. This can easily lead into a short caution to the beneficiaries about the evolutionary process. Making both the beneficiaries and trustees aware of the evolutionary process can help each group understand the position of the other

and thereby improve communication between them.

**Planning strategy**

The evolutionary process can easily be observed once an advisor

knows what to look for. It is worth considering along with the other items that settlors focus on when creating a trust. The trust countermeasures and ancillary writings are not appropriate for all fami-

lies, but they certainly could be used much more often than they are today. The sample ancillary letter in Exhibit 1 includes most of the countermeasures described above. ■



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