Compliance/Account Administration- Personal and Charitable Accounts

The services discussed below are commonly offered by the majority of trust departments and the duties described are typical. The duties associated with the various fiduciary capacities described vary from state to state. For this reason, they are described in general terms. In order to gain a more complete understanding of the scope of the duties and responsibilities of a given fiduciary capacity examiners should be familiar with applicable state statutes.

This section of the Manual is organized into the following parts:

A. General Overview

B. Types of Product Lines

C. Types of Accounts and Fiduciary Capacities

D. Additional Fiduciary Capacities

E. Asset Protection Trusts

A. GENERAL OVERVIEW

The proper and efficient administration of personal and charitable trust and agency accounts requires the establishment and implementation of policies and procedures, a system to monitor compliance therewith, and prompt correction of nonconformance.

The knowledge and expertise of management and operational staff; active involvement by the board of directors acting through a trust committee, and possibly through subcommittees; and adequate policies and effective procedures, coupled with systems for monitoring and ensuring compliance therewith; form the core of a risk management system designed to monitor, measure, and manage the various risks inherent in the administration of personal and charitable accounts.

Note: Unless specifically indicated otherwise, the term "personal trust" refers to court supervised accounts, personal trust accounts and personal agency accounts.

Policy Guidelines

The breadth and depth found in an institution's policies and procedures depend upon the types, size, and complexity of accounts administered. Most policies, however, include the following elements:

- Account Acceptance Guidelines - Guidelines for the acceptance of accounts establishes limits on the type of fiduciary accounts that will be accepted. In establishing these guidelines, management should consider in establishing these guidelines are the level of expertise and experience available, either in-house or through third-party arrangements. It should also identify circumstances that may render the administration of an account overly complex or risky, such as unique or difficult-to-administer assets or ambiguous or complex terms in the governing document.

As such, an appropriate Account Acceptance Policy, coupled with an adequate pre-acceptance review process, is a fundamental element in an institution's risk management process. One of the most effective methods of limiting the risk inherent in fiduciary operations is to decline appointments for which the institution lacks appropriate qualifications or that present heightened administration or compliance risks. For example, a policy may, within given limits, permit the acceptance of personal trust and investment agency accounts, but state that charitable trusts and insurance trusts should not be accepted. The policy may, however, provide for exception and establish a review process necessary to accept an appointment that would otherwise be contrary to policy. All such exceptions should be approved by the trust committee, or other duly appointed subcommittee thereof.

- *Account Termination (or Closing) Guidelines* - These guidelines ensure that upon terminating an account, the institution has adequately completed all of its administrative duties and responsibilities. The guidelines should identify all documentation required to close the account and include a process whereby account administration will be reviewed so that no outstanding administrative concerns remain unresolved. Often, an institution will develop checklists to ensure that all necessary items have been adequately addressed prior to closing the account. The lack of, or flawed, account closing procedures could result in future litigation.
- *Fiduciary Appointments* - These guidelines describe the types of fiduciary appointments (e.g. trusteeships, guardianships, successor trusteeships, co-fiduciary appointments, etc.) that an institution will accept. The guidelines may be included in account acceptance guidelines, if not addressed in a separate policy.
- *Documentation Guidelines* - These guidelines identify the documentation required to be maintained for each type of account accepted. For less complex accounts, the guidelines may briefly refer to administrative issues and approved checklists. Since a fiduciary must be able to demonstrate the appropriateness and prudence of its account administration, an institution's documentation guidelines must require the maintenance of original governing agreements, or working copies thereof, documentation evidencing fiduciary appointment, synoptic records, legal documents, etc.
- *Account Review Guidelines* - These guidelines communicate the Board's evaluation of the risk characteristics of various types of accounts by designating the depth and level of review. Accounts having a greater degree of complexity or risk may require an individual review performed at the trust committee level, whereas homogeneous accounts posing a relatively lower level of risk may be reviewed in groups at a lower management level. In any event, an institution's account review guidelines should ensure that each account is reviewed at least once during each calendar year. The FDIC's Statement of Principles of Trust Department Management requires an annual review for all accounts, even those that do not involve investment decisions.

Account Administration Considerations

It is the fundamental duty of a fiduciary to administer an account solely in the interest of the beneficiaries without permitting the interests of the trustee, or any third parties, to conflict in any manner. The duty of loyalty is of paramount importance and is the cornerstone of all fiduciary appointments. The successful administration of an account must meet the needs of the beneficiaries in a safe and productive manner and equitably balance the interests of each beneficiary. This is true for any account administered. Therefore, a satisfactory account administration program ensures that accounts comply with applicable laws and the governing agreement. Such a program follows fundamental concepts of management and includes the following:

- Assignment of accounts to a specific officer. In larger departments two officers may be assigned: an administrative officer and an investment officer. This allows for the assignment of accountability for the various aspects of account administration.
- The intent of the testator, settlor, or principal must be clearly understood by the account officer(s). This ensures the identification and fulfillment of the purposes and objections of an account.
- Identification of any restrictive language, such as exculpatory language, provisions governing the invasion of principal, or spendthrift clauses.
- Adherence to the investment provisions, including restrictions, contained in the governing agreement. This affords the income beneficiary and the remainderman or principal beneficiary, respectively, of a level of income or capital appreciation consistent with the intent of the creator of the trust.

Legal Considerations/Applicable Law and Regulations

Both common law and civil law (Federal, state and local statutes and regulations) govern trust activities. There are laws that apply to fiduciary activity in general, to specific fiduciary functions (trustee, conservator, guardian, agencies, etc.), and to the specific type of property under administration (securities, real estate, etc.).

Common Law/Fiduciary Principles

The body of common law is much more voluminous and detailed than civil law. Therefore, management should have at least a general familiarity with some of the more widely known common law authorities such as Scott, Bogert, and the Restatement of the Law of Trusts. Each of these sources provides insight into the general fiduciary principles that should be followed in the administration of personal and charitable trusts. The following are some of the more important duties of a trustee that originated out of common law:

- A trustee owes a duty of loyalty to administer trust affairs solely for the benefit of the beneficiaries. The thrust of this duty is to avoid conflicts of interest that would enrich or provide an advantage to the trust administrator at the expense of the beneficiary.
- A trustee must exercise the skill and prudence, as a person of ordinary prudence would exercise in managing his own property. Trust managers who represent themselves as having expertise will be held to that level of expertise.
- A trustee may not delegate the administration of the trust or the performance of acts that the trustee should personally perform. It should be noted that the trust agreement or state law may permit certain delegations. However, the determination of whether a delegation is appropriate is contingent upon whether the act requires professional skills or abilities not possessed by the trustee. For example, trustees can employ accountants, attorneys, and other professionals, when those qualifications or abilities are lacking in the trust department. Furthermore, a breach of trust for not delegating duties may occur when certain qualifications are necessary but are not possessed or obtained through other sources. Refer to the Prudent Man Rule in Appendix C for additional information.
- A trustee must keep and render accurate accounts. The accountings should reflect receipts and disbursements, gains and losses on investments, and other transactions affecting the account. Such records are also necessary for completion of tax returns. Usually, the state law requirements apply to testamentary trusts or court appointments and call for accountings to the court at specific intervals. If the trustee fails to keep accurate records, the court may take actions, up to and including removal of the trustee. Also, a beneficiary may request an account statement from the trustee, as deemed necessary. Most trust departments provide at least quarterly statements to accountholders, but not beneficiaries.
- The trustee must provide information to the beneficiary that will protect his rights or that would be viewed as important by the beneficiary.

- A trustee has a duty to keep trust property separate from his own property and should not commingle trust property with that of other trust accounts. Trust property should be clearly earmarked. The purpose behind this duty is to provide an audit trail, to prevent the trust's assets from being attached by the trustee's creditors, and to prevent fraudulent use. This duty does not preclude a trust manager from using mutual funds or other pooled investment vehicles.
- A trustee must take title to all titled or certificated assets and secure documents representing intangible assets upon becoming trustee.
- A trustee must make the trust productive and must invest the trust assets for income or increase in market value. Uninvested cash (other than held for distribution or reinvestment) held for periods of time, may be evidence of negligence by the trustee.
- A trustee must comply with all provisions of the trust instrument, including those regarding distributions to or for beneficiaries. The trustee must exercise care to ensure that distributions are made in an accurate and timely manner.
- A trustee must deal impartially with beneficiaries. An equitable balance must be made between the income beneficiaries and principal beneficiaries (remaindermen).
- The trustee must work with persons holding power and control, such as state courts, local taxing authorities, property managers, etc. One task related to this duty is the voting of proxies.
- A trustee has an obligation to work with and exercise skill in communicating with co-trustees. A co-trustee must be especially wary of acting unilaterally, or conversely, being indifferent toward the actions of the other trustee.
- A trustee has a duty to defend against claims involving trust assets or the validity of the trust. It is imperative that fiduciaries have access to legal advice as questions arise and whenever a claim is made.
- The trustee must preserve and protect the property of the trust. In practice, this means obtaining and maintaining insurance, ensuring that deeds, mortgages and titles are properly recorded, and depositing funds within the FDIC deposit insurance limitations. Trustees must maintain buildings, vehicles, and equipment in good condition to prevent deterioration.

Examiners should not cite "violations" of common law (equity). Noncompliance with certain principles of equity would normally be treated as another criticism with reference to "generally accepted trust practices", rather than a statutory violation. Noncompliance with common law may involve a substantial exposure to liability and loss.

Trust companies will attempt to limit exposure to liability and loss by inserting exculpatory clauses into the trust instrument. These clauses usually seek to limit liability to severe breaches of trust, such as negligence, bad faith, or willful misconduct, and not for every failure to use ordinary skill and ability. The courts have afforded fiduciaries only limited protection from lawsuits against fiduciaries employing these clauses. Since a trustee purports to have specialized fiduciary skills, courts do not appreciate a defense claiming only ordinary care and skill was utilized. Additionally, the fact that the trustee often demands the insertion of this clause could be construed as conflicting with the fiduciary's duty of loyalty to his client. Clauses which limit losses resulting from a co-trustee's own actions or property under his control, exclusive of the other co-trustee, usually have similar limited effectiveness.

Civil courts have provided several remedies for failure of fiduciaries to properly exercise their obligations. These remedies include setting aside inappropriate transactions, enjoining a disloyal act, monetary damages, forfeiture of fees or interest or nullifying a sale and ordering a re-sale of property. Courts have removed trustees where there were egregious instances of improper administration of trust agreements. Examples of circumstances where a trust could be found liable follow:

- In the event of an improper transaction, such as a sale of assets from a trustee to a trust, or an inter-account transaction, a beneficiary will often be given a choice of either affirming the transaction, setting aside the sale, or taking the profit resulting from the sale. It is the burden of the trustee to prove that any transaction is fair to all parties.
- The failure to adequately defend the trust from attack could result in financial liability. Such attacks may derive from creditors seeking to attach the assets of the trust, a lawsuit challenging the validity of the trust, or attempts to prematurely terminate the trust. Fiduciaries have been found liable for failure to appeal a court case where the trust was held liable. Expenses from a successful court challenge can be paid from the trust; frequently, an unsuccessful challenge can be defended using trust assets if the defense was encouraged by the beneficiary.
- A failure by a trustee to act promptly and competently in receiving and maintaining trust assets could result in whatever loss ensues. For example, failure to ensure trust property could result in the trust being held liable in the event of storm damage or theft. Additionally, unwarranted delays by a successor trustee in obtaining financial assets could result in liability if these assets declined in value during the delays.

- Co-mingling the assets of the trust with the assets of the trustee or another trust could result in significant liability. Should a trustee be unable to trace the source of assets, the trustee may be held liable for damages, or a court may conclude that all the co-mingled assets are those of the trust.
- The failure to make trust assets productive also produces liability exposure. A trustee that does not promptly invest cash, that deposits funds in excess of FDIC insurance coverage, or that does not make necessary changes in investments received, could cause significant liability.

Examiners are not expected to render a legal opinion as to equity matters involved in the administration of personal trusts. However, the examiner should discuss the facts of an apparent violation of a common law principle or of the trust instrument itself and extend contingent liabilities as necessary. In complex and significant matters, the bank's legal counsel may provide a legal opinion concerning the matter.

Federal Statutes

The administration of personal trusts, including charitable trusts, is subject to federal statutes. A fiduciary is subject to Federal laws in the same manner as any individual or business owning or dealing with property. The violation of Federal statute is typically described in the report of examination. Examples of Federal laws and regulations with which a fiduciary must comply include Federal securities laws; consumer protection laws; the Federal Reserve Act and implementing regulations; fair credit laws; U.S. Treasury regulations; the Internal Revenue Code, etc. Violations may result from the activities of a trustee or other fiduciary or apply by reason of the type of property held and/or administered by the fiduciary.

State Statutes

State financial or banking codes include laws governing banks, trust companies, and similar institutions. A growing number of states have adopted various uniform statutes that apply directly or indirectly to the conduct of trust activities. States adopting uniform statutes often modify them. Therefore, management should be familiar with the text of their respective state law. Below are some of the more common uniform codes.

- *Uniform Prudent Investor Act* - The Uniform Prudent Investor Act establishes "modern portfolio theory" as the standard for the management of trust assets, rather than focusing on the prudence of individual investments, as is the case with the Prudent Man Rule. Uniform Prudent Investor Act permits the delegation of investment and management functions, subject to safeguards. The text of the Uniform Prudent Investor Act and comments is found in Appendix C.
- *Uniform Trust Code* - The act comprises a comprehensive codification of trust law. However, many states have modified major portions relating to the rule of perpetuities, and asset protection trusts. See Asset Protection Trusts in this chapter.
- *Uniform Probate Code* - The act simplifies and clarifies the law concerning the affairs of decedents, missing persons, protected persons, minors, and incapacitated persons. The code is designed to promote a speedy and efficient system for liquidating the estate of a decedent and distributing estate assets to the designated heirs, facilitating the use and enforcing certain trusts, and providing a uniform law among various jurisdictions.
- *Uniform Principal and Income Act (UPIA)* - The UPIA provides guidance to fiduciaries regarding the allocation of assets between principal and income. This allocation is very important when the trustee must consider the interests of both an income beneficiary and a remainderman in administrating a trust or estate. The UPIA is a default statute that only operates when the governing instrument is silent. The UPIA provides guidance to the fiduciary when the settlor grants discretion to the trustee or when the trust agreement is silent as to the allocation. Therefore, a settlor may direct the allocation of principal and income in any manner in a revocable trust. The UPIA was originally written in 1931 and was revised in 1962. Another revision, endorsed by the American Bar Association, was drafted in 1997. It is now being recommended for enactment in all states. The recent revision has two main purposes. First, a general revision was necessary to bring the act up to date. Second, the rules for allocating income and principal was updated to address the principles of modern portfolio theory. The 1997 UPIA amends existing rules (it expands the definition of receipts from an entity, provides for uniform treatment of corporate distributions and when an investment in an entity is liquidated, and modifies the treatment of receipts from the exploitation of natural resources, etc.) and establishes rules for asset types (derivatives, asset-based securities, etc.) not mentioned in the prior UPIA. A copy of the 1962 UPIA and 1997 UPIA are found in Appendix C. Please refer to the discussion in Section 3.
- *Uniform Fraudulent Transfer Act (UFTA)* - The UFTA is designed to prevent fraudulent transfers which occur when a debtor intends to hinder, delay, or defraud a creditor, or transfers proceeds under certain conditions to another person without

receiving reasonable equivalent value in return. Included within the law are the "Badges of Fraud", which aid in determining whether the debtor had actual intent to defraud.

- *Uniform Gifts to Minors Act (UGMA)* - The UGMA allows an adult to contribute to a custodial account in a minor's name without having to establish a trust or name a legal guardian for the transfer of property to a minor.
- *Uniform Simultaneous Death Act (USDA)* - The purpose of the USDA is to establish priority of death in the case of simultaneous deaths. The priority affects the distribution of a decedent's assets.

The text of these and other uniform acts is also available at the Internet site of the National Conference of Commissioners of Uniform State Laws https://www.uniformlaws.org.

State laws that apply to classes of property also are relevant. For example, real property held as an asset of a trust or estate would be subject to state real property laws, while some states have intangible taxes on monetary assets.

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B. TYPES OF PRODUCT LINES

The volume and type of personal trust accounts can be segregated into three broad product lines; trusts, estates (including guardianships), and agencies. An important distinction is made between those accounts for which the institution has investment discretion, and those for which it does not. The relationships may be further categorized by the specific capacity in which the institution serves, the purpose of a particular type of account, and/or other unique features of an account. Personal trust accounts can also be segregated into those accounts subject to supervision by a court and those that are not.

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C. TYPES OF ACCOUNTS AND FIDUCIARY CAPACITIES

Court Supervised Accounts

The administration of estates and guardianships is supervised by an appropriate court, referred to in various jurisdictions as probate, chancery, or surrogate court. Judicial supervision is intended to protect the interests of minors, incompetents, unknowns, and the deceased. The court formally appoints the fiduciary (even though perhaps "nominated" by the will) and reviews and approves all acts of the fiduciary. The fiduciary typically must periodically provide the court with "accountings" of the fiduciary's activities in administering the account.

Estates

In an estate, the trust department, as either executor or administrator, is responsible for a decedent's assets from the time of formal appointment by an appropriate court until the estate's final settlement is approved by the court. A fiduciary is not responsible for events prior to its appointment. However, once appointed, the trust department, as executor or administrator, is responsible for protecting the estate's assets, and is held responsible for neglectful or delayed administration. All acts in the administration of an estate are reported to, and subject to approval by, an appropriate court. The department's duties and responsibilities are dictated by the decedent's will and by state and common law.

The primary duties of an executor, or administrator cum testamento annexo (c.t.a.), include the following:

- assembling of decedent's assets;
- preparation of an inventory of all assets of the deceased;
- taking control or custody of such assets;
- orderly conversion of certain assets "in kind";
- payment of administration costs, taxes (including Federal estate and/or state inheritance taxes), and all other legal claims against the estate;
- distribution of the net estate in accordance with the terms of the will; and
- filing of a final accounting with the court of competent jurisdiction, if required.

Probate procedures may also require interim accounting, but this varies between states. The duties of an administrator are essentially the same as for an executor or administrator c.t.a. but are dependent upon the intestacy laws of individual states.

Generally, the trust department will act in one of the following capacities:

Executor

An executor, whether an individual or an institution, is nominated in a will by the maker (testator) to settle an estate and to perform in any other manner described in the will. Before a bank acts as executor, it must have the will accepted by a court of competent jurisdiction as the valid and final will of the deceased. The court will then issue written authority to serve as executor, often termed Letters Testamentary.

Administrator

An administrator is appointed by the court to settle the estate of a person who died leaving no valid will. Without a will, the administrator must carry out its functions solely in accordance with state intestacy laws. Written authority, often termed Letters of Administration, must be received from the court to serve as administrator of an estate.

Administrator Cum Testamento Annexo (c.t.a.)

The court appoints an administrator c.t.a. (i.e., with the will annexed) when there is no executor named in the will, or when the executor named is unable or unwilling to serve. As with an executor, the will must be accepted by a court of competent jurisdiction, and the administrator c.t.a. must receive written authorization to settle the estate. Settlement of the estate is made in accordance with the terms of the will. When an executor or an administrator c.t.a. dies or is removed before completing the settlement of the estate, the substitute fiduciary is known as an administrator c.t.a., d.b.n. (de bonis non) (i.e., administrator with the will annexed for assets not yet distributed).

Ancillary Administrator

Ancillary administration may be necessary if an estate contains property in a state or jurisdiction (foreign country) other than the decedent's domicile at the time of death. The ancillary administrator represents the estate on all matters within the alternate jurisdiction. Typically, performance in this capacity involves the handling of real property when an estate contains property in another state.

Guardianships

A guardian is an individual or institution appointed by a court to care for the property and/or the person (referred to as the "Ward") of a minor, an incompetent, a spendthrift, or other incapacitated person. The powers and responsibilities of the guardian are governed by the provisions of state statutes and court decisions. Investment limitations are often delineated by statute and any exceptions require court approval. The guardian's duties may be limited to the property (guardian of the estate), the person (guardian of the person), or both (guardian). Banks generally will serve only in the capacity of guardian of the estate and many states prohibit a bank from serving as the guardian of a person.

Under a guardianship, the ward is the beneficial owner of property. A guardian is an agent of the court and has no legal or equitable title to the ward's property. The guardian of a minor receives, holds and manages the property, renders accountings to the court and makes a final settlement with the minor when he becomes of age. A guardian for an incompetent or absentee performs the above duties as long as the incompetency or absenteeism lasts. Such words as committee, conservator, curator and tutor are used in various states to describe particular types of guardianships.

Obligations of a guardian include:

- Protect and preserve the assets;
- Submit an inventory and appraisal to the court;
- Retain or reinvest assets as advised by the court, or as permitted under state law;

- Use income and principal to meet the needs of the ward; and
- Submit accountings (usually annually) to the court.

Personal Trusts

A trust is a fiduciary relationship by which legal title to property is held by one person or corporation for the benefit of another. In trust relationships, the trustee has the responsibility of ownership and holds legal title to the trust property, while the beneficiary enjoys the benefit of ownership and holds equitable title.

Personal trusts can be broadly classified as either testamentary (also known as trust under will) or living (also known as inter vivos or trust under agreement). Trusts can further be classified as revocable or irrevocable. In a revocable trust, the settlor retains the right to change or terminate the trust at any time and does not relinquish control over the assets held in a revocable trust. Therefore, under Federal estate tax law, those assets are considered owned by the grantor. Furthermore, the revocable trust is not a public record, and assets transferred to beneficiaries via a revocable trust remain a private transaction. For irrevocable trusts, the trust cannot be modified or revoked by the settlor; however, the instrument may provide that a designated person can modify or terminate the trust. The settlor of an irrevocable trust relinquishes control over the assets and is, therefore, those assets are not subject to estate taxes. An irrevocable trust may be amended or revoked under specific circumstances. For example, one state supreme court held that a person who is both a settlor and sole beneficiary of an inter vivos trust may revoke the trust when the agreement specifically provides that the trust is irrevocable. As with the revocable trust, assets transferred to beneficiaries remain a private transaction. Under common law, if the instrument is silent regarding revocation, the trust is assumed to be irrevocable.

Fiduciary powers and duties should be clearly defined in the trust agreement. A lack of definition may cause uncertainty, impair investment performance, and prevent the trustee from taking actions in the best interests of the beneficiaries. In the absence of clearly defined provisions, state statutes also contain a list of the trustee's powers and duties. The general responsibilities of the trustee include:

- Preservation of the assets composing the trust;
- Management of assets to provide income;
- Distribution of income to designated beneficiaries;
- Accounting for all actions; and
- Dealing with interested parties.

The administration of personal trust accounts is primarily controlled by the terms of the governing instrument. State statutes and common law technically govern only when the instrument is silent, or the provisions violate public policy. Refer to the discussion of Account Administration Considerations.

The fiduciary capacity under which personal trusts are administered is generally that of trustee under will, trustee under agreement, trustee by declaration, or in some circumstances, trustee by order of the court.

Trustee Under Will

A trust under will (testamentary trust) is created when the decedent's will bequeaths property to be held in trust for the benefit of a person, corporation, or charitable organization. The trustee receives the property from the executor or administrator and administers the assets for the beneficiaries. A probate court usually has jurisdiction over a testamentary trust. When the will is probated, the trust included in the will becomes a public record. Frequently, the bank may first serve as executor (or administrator c.t.a.), and then follow as trustee if the will establishes a trust, and the court permits by necessary appointment.

Common types of testamentary trusts used by modern estate planners include: the marital deduction trust and non-marital (a.k.a. bypass trust, credit shelter, or exemption-equivalent) trust. These two are frequently used in conjunction with one another and are sometimes referred to as "a-b" trusts. Another is the QTIP (Qualified Terminable Interest Property) trust. Testamentary "support", "education", and "health and welfare" trusts for spouses, children, and grandchildren, are also common. Other types of trusts may also be encountered. In each instance, the successful administration, and supervisory review of such administration, requires an understanding of the objectives of the trust, as well as the specific language of the trust instrument.

Trustee Under Agreement or by Declaration

A trust under agreement (living or inter vivos trust) comes into existence when the creator of the trust enters into an agreement or contract with the trustee setting out the terms of the trust. A trust by declaration is created upon declaration by one person to be trustee of property for the benefit of someone else. The trustee's duties are set out in the agreement or declaration and may include a wide range of responsibilities. The creator may have reserved the right to amend or terminate the agreement, in which instance the trust is considered either partially or fully revocable. Irrevocable forms of agreement are also used and may have certain tax advantages.

The desire of individuals to obtain favorable tax treatment under Federal income tax laws has led to the creation of various types of special purpose irrevocable trusts. Examples of such trusts include "Clifford Trusts," "Crummey Trusts", and various gift-related estate tax reduction trusts (RPM Trusts, Grantor Retained Income Trusts, Grantor Retained Annuity Trusts, and Grantor Retained Unitrusts)." To properly administer such trusts, trustees must have a comprehensive knowledge of the applicable Federal income tax laws, since a failure to satisfy all the requirements of the Federal tax code could cause a trust to lose the favorable income tax treatment for which the trust was created.

Other types of living trusts are Medicaid trusts, family incentive trusts, and insurance trusts. Such trusts have a unique or limited purpose. The successful administration of such trusts requires an understanding of each trust's unique objectives, including the specific provisions contained in the trust instrument, and the laws and regulations governing such trusts.

Trustee by Order of The Court

A court of competent jurisdiction may appoint a bank as trustee to receive property in trust and administer it for the benefit of the person(s) designated. In some states, the capacity is known as a guardianship or conservatorship rather than trusteeship. Often, the court appoints the trustee for a special purpose arising from litigation. In divorce proceedings or real property disputes, the court may appoint a trustee to care for disputed property and account to beneficiaries pending settlement. The trustee in this instance may have full or only directed authority over the management of the disputed property.

Charitable Trusts

A charitable trust may be established by will or agreement for religious, educational, cultural or community-welfare purposes. It is normally exempt from Federal income tax if it meets the requirements of the Internal Revenue Code. In many states, the rights of the charitable beneficiary are enforced by that state's attorney general. Some charitable trusts may last forever, while duration of other trusts is limited by the rule against perpetuities, which differs in important respects from state to state. The purposes of charitable trusts depend upon the intent of the trustors, but tax planning will usually be important.

The following sections provide an overview of the Internal Revenue Code as it applies to charitable trusts and of the potential adverse consequences of failing to comply with the requirements of the Code. The discussion is general in nature and primarily focuses on "nonexempt" activity.

Internal Revenue Code

The administration of charitable trusts is governed to a significant extent by the provisions of the Internal Revenue Code (IRC). These rules and regulations are quite extensive and complex, and it is essential that the trustee have a good working knowledge of the applicable provisions of the Code and the requirements for maintaining a charitable trust's favorable tax treatment. The failure to maintain the favorable tax status may result in unfavorable tax consequences to individual donors and the charitable organization itself. In such cases, the trustee may be subject to losses as a result of legal actions and court surcharges. The miscalculation of payments and distributions may also result in surcharges and other liabilities.

The first step in the management process for charitable trusts is determining whether a charitable organization and the trust created for its benefit are classified as "exempt" or "nonexempt".

- *Organizations are granted tax-exempt status under Section 501(a) of the IRC*. Though there are many types of exempt organizations, the most common are found in Section 501(c)(3). These are nonprofit organizations operated exclusively for

charitable or educational purposes. Exempt organizations are then further categorized by the Tax Reform Act of 1969, which introduced the concept of a "private foundation". The act differentiates between two groups: public charities and private foundations. The restrictions and requirements imposed upon private foundations to qualify favorable tax treatment are numerous and complex.

Additional information is available from the Department of Treasury, Internal Revenue Service, Publication 557, "Tax-Exempt Status of Your Organization." Publication 557 can be found on the IRS web site www.irs.gov.

- *Nonexempt organizations are those that do not qualify for tax-exempt status*. However, they involve certain charitable purposes for which a contributor is allowed a deduction. Nonexempt activity is governed by section 4947(a)(2) of the Internal Revenue Code. There are two categories of nonexempt trust. The first are trusts that devote all of their "unexpired interests" to charitable purposes. The second are trusts where the unexpired interests are devoted to both charitable and non-charitable purposes. These are also known as "split-interest" trusts. There are three types of split-interest trusts: Charitable Lead, Charitable Remainder, and Pooled Fund trusts. The split-interest trusts are more fully discussed in the following sections.

Charitable Lead Trust

A charitable lead trust is a trust for a fixed term of years wherein a charity is the beneficiary of an annual annuity or unitrust payment, with the remainder interest belonging to a noncharitable beneficiary. It is designed to provide income payments to at least one qualified charitable organization. The fixed term may be measured by a fixed number of years, the lives of one or more individuals, or a combination of the two. If the life of an individual option is chosen, the individual must be alive at the origination of the trust. After the expiration of the fixed term, trust assets are paid to the grantor or one or more of the noncharitable beneficiaries named in the trust agreement. As previously noted, the trust may be designed as either an "annuity trust" or a "unitrust".

In an annuity trust, a trust is formed where a fixed amount is paid not less often than annually. The fixed amount (the annuity) may be stated as a fixed percentage of the initial net fair market value of the trust assets, as a fixed sum, or an amount determined by a formula stated in the trust agreement. The annuity may be changed during the term of the trust; however, there are specific criteria that must be met. In the event that trust income is insufficient to meet the annual annuity payment, the corpus of the trust may be invaded.

In a unitrust, a trust is formed where a fixed percentage of the net fair market value of its assets, valued at least annually, is distributed, not less often than annually. The net fair market value of the trust assets may be determined under a number of methods, provided the methodology and timing used are consistent. The determination may be made on any one date during the taxable year or may be made by taking an average of the valuations made on more than one date during the taxable year. If the trust agreement is silent, the trustee may select the method and date.

Other key features of unitrusts include the following:

- Charitable organizations are described in IRC Section 170(c)
- No minimum or maximum payout annuity or payout rate
- No five-percent probability test
- No maximum term for the trust unless required by state law
- Additional contributions allowed (Note: Adding additional monies to an annuity trust will not increase the income paid out.)

Charitable Remainder Trusts

A charitable remainder trust is an irrevocable trust that provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of whom is not a charity. The term of the trust is not to exceed the lesser of 20 years or the life or lives of the individual beneficiary(ies). If the beneficiary is an individual, he must be living at the time the trust is created. The irrevocable remainder interest is held for the benefit of, or paid over to, one or more qualified charities. The specified distribution must be either a sum certain (annuity) or a fixed percentage (unitrust).

A Charitable Remainder Annuity Trust (CRAT) provides a sum certain that is paid out, not be less than 5 percent nor more than 50 percent of the initial net fair market value of the property placed in the trust. The annuity amount may be a percentage of the

initial fair market value, or an amount fixed in the trust agreement. Neither the percentage nor the fixed payment may can be changed, regardless of fluctuations of portfolio value. Therefore, additional contributions are prohibited. [Authority under IRC 664(d)(1)]

A Charitable Remainder Unitrust (CRUT) provides for the payment to a noncharitable beneficiary, of a fixed percentage, not less than 5 percent nor more than 50 percent of the net fair value of its assets, valued annually. The fair market value of the trust assets may be determined on any one date during the taxable year of the trust, or by taking an average of the valuations made on more than one date during the taxable year. The valuation method must be applied consistently, although the annual payment from a unitrust will vary, depending upon the value of trust assets. There are a number of payout options: standard, income, net income, make-up, and flip. Each option presents unique payout considerations that the trustee must be familiar with to ensure that proper distributions are made. Additional contributions are permitted. [Authority under IRC 664(d)(2)]

Charitable remainder trusts may be constructed with many variations and require a good understanding of the Internal Revenue Code. Other important considerations for this type of trust include:

- Charitable contributions are defined in IRC Section 170(c).
- To qualify as a charitable remainder trust, the trust must meet all of the requirements set forth in IRC Section 664. Note, the IRS no longer issues determination letters stating that a charitable remainder trust qualifies for a charitable income, gift, or estate tax deduction. The IRS does provide sample documents to provide guidance.
- There is a requirement called the "10 Percent Minimum Present Value", or prequalification floor. In 1998, the law was revised to require that the present value of the charitable remainder interest be at least 10 percent of the net fair market value of the property transferred into the trust on the date of transfer. If a trust fails this test, there are additional rules to provide relief.
- The transfer of trust principal and excess income to the charitable remainderman prior to the termination of the trust is permitted within certain limitations.

Pooled Income Fund

A pooled income fund is a trust established by a charity to receive donated property and to provide the donors with income for life. The pooled fund maintains an investment portfolio and provides the donor a rate of return on the donated property. The donor receives income, gift, or estate tax deductions. Trust departments may be appointed to act as an administrator or investment manager for pooled income funds. Refer to Section 7, Subsection N.4, Bank Managed "Pooled Income Funds" Organized by Outside Entities for additional information.

Charitable Contribution "Clifford Trusts" for Banks

This special purpose account combines charitable features with the customary Clifford Trust, a form of personal trust created for a period exceeding 10 years. The grantor of such a trust transfers assets irrevocably in trust (i.e., for the duration of the trust) and, the income is not taxable to the grantor during the term of the trust. It is important to note that the income may, or may not, be used for charitable purposes. The Tax Reform Act of 1986 eliminated the 10-year or Clifford trusts exception from grantor-trust taxation rules, thereby eliminating the establishment of such trusts. Some older trusts may still exist.

A bank itself may have established a Clifford Trust, primarily for income tax purposes. Under the Internal Revenue Code, a corporation is restricted to a maximum percentage of its taxable income that may be deducted as a charitable contribution. By employing the trust vehicle, a bank may increase its charitable contributions beyond the percentage limitation without subjecting the excess amount contributed to taxation. The trust is funded with bank assets, usually cash or prime quality securities, and all of the income is distributed to charities, with the principal reverting to the bank upon termination of the trust. One or more of the bank's directors and/or officers may be appointed as individual trustee(s). In such cases, the bank does not need trust powers. However, if the bank has a trust department it would be preferable for that department to be named as trustee.

The trust instrument should: provide a statement of the purpose and objectives of the trust; specifically prohibit "insider" transactions, self-dealing and conflicts of interest; provide for disclosure of the trust's operations to the FDIC and State banking authority; and require periodic (at least annual) accountings to the board of directors. The trust instrument should not include any authority to borrow funds or permit trust assets to be mortgaged, pledged or otherwise encumbered.

A bank's current and projected liquidity, its future earnings and the adequacy of its capital are impacted by a Clifford Trust arrangement. In light of these considerations, it seems reasonable to expect a bank to be able to project that a Clifford Trust will not seriously impact its capital, liquidity, and earnings during the term of the trust.

Agencies

An agency relationship is created by an agreement under which the trust department is appointed to act as agent for the property belonging to the principal. Many banks use standardized language in agency agreements. The use of such agreements eases account administration by standardizing the institution's fiduciary duties, which also limits the potential risks that can result from complex, non-standard agency contracts. There are two basic distinctions between an agency relationship and a trust relationship:

- Ordinarily, agents do not hold legal title to property, while trustees hold legal title for the benefit of account beneficiaries. (Agency assets are now registered in the name of the bank, or its nominee, more frequently as this expedites trading and the transfer of ownership when assets are sold.)
- An agency is usually revocable at the option of the principal, and is automatically terminated at the death of the principal (account assets must then be turned over to the executor of the estate or to a court appointed administrator). Trusts, on the other hand, may be irrevocable, and continue long after the death of the settlor and/or the original beneficiary(ies).

An example of some of the duties performed under an agency agreement include accepting possession of the principal's assets, collecting and distributing income, and buying and selling investments, either at the department's discretion or as directed by the principal. A trust department acting as an agent should always operate under a written agreement, with the agent's authority and duties clearly defined by the terms of the agreement. Some of the most common agency capacities in which a trust department may serve include:

Custodian

In a Custodianship, the trust department has only the duties of safekeeping property and performing ministerial acts, as directed by the principal. As a rule, investment management or advisory duties are not exercised. For example, in the exercise of custodial duties involving securities, the bank may be required to collect income and principal; notify the principal of defaults, called securities, stock rights for purchase; and execute instructions to buy and sell securities.

Escrow Agent

In this capacity, a bank has the responsibility of holding the assets and other documents delivered into its custody until the conditions for their release to a third party have been fulfilled according to the terms of the escrow agreement. Added responsibilities include ensuring that the conditions specified in the escrow agreement have been fully satisfied before assets and other documents are delivered to the third party. The bank is liable for its actions not only to the principal, but also to the third party. The bank as escrow agent should: assume no liability under the terms of the agreement; perform in accordance with the duties and obligations set forth in the escrow agreement; and not arbitrate in the case of disputes or disagreements between the principal and the third parties to the escrow agreement.

Trustee for Land Trusts or Real Estate Trusts

A land trust may be used for privacy purposes, for estate planning purposes, or to facilitate borrowing arrangements. The bank as trustee acts solely as the holder of the legal title to the property. Typically, the beneficiary(ies) retains the power of direction and control over the trust property. In some cases, however, the trust document may indicate that another party (not the bank) has the power to direct the trust. This is a unique type of fiduciary relationship that is not allowed in every state. Illinois is the state in which land trusts are most prevalent.

The administration of this type of trust, if allowed, is addressed in state statute. Typical documentation includes:

- *Land Trust Agreement* - This is a document that identifies the property(ies) held in trust, the individuals or entity that holds a beneficial interest in the trust, the manner in which the benefit is held (tenets in common, joint tenet, etc.), the successor

beneficiary, and the individual(s) or entity with power of direction. There should be no responsibilities assigned to the trustee other than that of holding title to the property and recordkeeping.

- *Deed of Trust* - This is a document that conveys property into and out of the trust and is sometimes referred to as a "deed in trust". This document evidences legal title to the parcel of land and the change in ownership. State law dictates whether the deed must be recorded.
- *IRS filing (Notice of Fiduciary Relationship)* - This is required at the time a property is deeded into or out of the trust.
- *Legal Notices* - As the trustee is the holder of legal title, it will receive all legal notices pertaining to the property. The notices should be forwarded for further action to the party or parties identified in the agreement. If the notice requires disclosure of the names of the beneficial owner(s), the trustee will be guided by state statute for direction.
- *Written Letters of Direction* - These are instructions to convey a property into or out of a trust. They also inform the trustee if the property is to be encumbered with a mortgage or with the assignment of a beneficial interest, and so on. The direction is to be signed by the individual or entity identified in the trust agreement.

To appropriately administer this type of account, management must understand applicable state law and IRS statutes. Good recordkeeping procedures require the documentation of all actions taken with regard to the property in the trust. Since the trustee assumes minimal liability from holding title to the property and has no duty to maintain the property or to defend claims against it, management may view the administration of land trusts as a low risk activity. This is not, however, the only risk factor to be considered. The level of risk also depends upon the type of property held and the beneficiary. The lowest risk is typically associated with an owner occupied single family residential property. Administering this type of property in a land trust requires only limited recordkeeping, basic documentation, and limited monitoring. A higher level of risk accompanies the holding of commercial property (income producing properties, land development, raw land) and/or beneficiaries who are not individuals (e.g., partnerships and corporations, etc.). The higher risk results from the volume of transactions associated with commercial property, along with the specialized documentation required. For example, administering a land trust holding a parcel of land under development by a corporation represents a higher level of risk to the trustee. The additional risk results from multiple conveyances of the property, changes in legal descriptions (as the parcel is subdivided), and changes in encumbrance. The type of beneficiary requires specialized documentation to allow the trustee to clearly identify which individuals are the beneficial owners.

"Qualified Intermediary" for 1031 Exchange or "Like Kind Property Exchange"

In this capacity, the bank serves as a specialized custodian identified by the IRS as a "qualified intermediary." This is an agency relationship governed by IRC Section 1031 (26CFR1.1031(k)-1). The agreement governing this relationship is commonly referred to as "Starker", "Exchange" or "1031 Exchange" trust. The client typically uses this type of account as a method of deferring income tax on the exchange of business-use property, but it may also be used to structure a tax-free exchange. Essentially, it permits property used in a trade or business or held for investment ("relinquished property") to be exchanged solely for like-kind property ("replacement property") which will be used in a trade or business or held for investment. Like-kind exchange does not mean 100 acres of farmland for 100 acres of farmland. A transaction may, for example, be structured to exchange farmland for apartment buildings. Items transferred in this manner may include real estate (as mentioned in the explanation of like-kind), heavy equipment, or collectibles. The exchange is usually a three-way transaction that is facilitated by an intermediary, referred to as a "qualified intermediary". There are five types of exchanges: delayed/deferred, simultaneous, reverse, improvement, and clearing house.

The typical sequence of events for a simple deferred exchange is described as follows:

- *Sale* - The seller sells the "relinquished" property.
- *Establishment of Agency Relationship* - At the close of a sale, the proceeds go to a "qualified intermediary". The funds are held in a "qualified escrow account" or "qualified trust" - essentially an account for the benefit of the seller. The relationship must be set forth in a written agreement that includes language expressly limiting the seller's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalents held in the account prior to the consummation of the entire transaction. The "qualified intermediary" may not have a fiduciary relationship with the seller. This means that the "qualified intermediary" cannot give legal or tax advice. The "qualified intermediary" must return the funds held on deposit, with any accrued interest, to the seller if any of the timing restrictions cannot be met.

- The "qualified intermediary", whose duties are set forth in the Exchange Agreement, must acquire the "relinquished property" from the seller, transfer the "relinquished property" (to the buyer), acquire the "replacement property", and transfer the "replacement property to the seller (who is now the buyer).
- *Identification Period* - The seller identifies replacement property(ies) within 45 days of the closing of the sale of the "relinquished" property. The property does not have to be purchased or under a contract to purchase in 45 days, it simply must be identified. The written notification must designate the property as "replacement" property and be signed by the seller. Identification must be unambiguous, e.g., for real estate the legal description or legal address. The written notification must be delivered to the "qualified intermediary" by midnight of the 45th day following the close of the sale of the "relinquished" property.
- *Exchange Period* - The seller (now the buyer) closes on the replacement property within 180 days of the sale of the "relinquished" property. The funds are wired from the account to the closing agent.

A "reverse exchange" occurs when the replacement property is closed before the relinquished property is sold. The IRS allows a bank to be a "qualified intermediary" to take title to the property and hold it until the relinquished property is sold. As long as the length of the holding period is 180 days or less, then the exchange should be allowed by the IRS.

These are complex transactions that must meet specific IRC requirements. As demonstrated by the example, the agency agreement is specially tailored, and the bank's primary duty is to document the chain of events required to qualify for the favorable tax treatment afforded by the IRC. This documentation is essential if the IRS audits the seller. To effectively supervise this type of arrangement, management must have a fundamental knowledge of IRS requirements, maintain sufficient documentation to prove the chain of events, and have a method of monitoring all the triggering events (ticklers for notification purposes and the triggering of a tax event). This topic is also discussed in the Asset Management section of the manual.

Investment Advisory Agent

As Investment Advisory Agent, the bank may exercise a number of duties, with the primary duty being to offer investment recommendations to the principal. Other responsibilities may include: execution of security transactions; collection and disbursement of funds; and other custodial duties. Generally, written approval of the principal is needed for investment transactions or the disbursement of funds and/or assets.

Managing Agent

In a Managing Agency, the bank normally has the same duties as an investment advisory agent, with the additional authority to make investment selections and execute transactions without the written consent of the principal. Managing agency agreements are general in nature, and sometimes grant agents significant discretionary authority. While a managing agency may appear similar to a trust relationship, basic differences in the transfer of title and revocability, as previously discussed, remain. However, an exception may exist in certain conventional managing agency accounts, whereby the agreement may provide for assets to be registered in nominee form, to facilitate trading activities. The agency relationship terminates upon the revocation by either party or at the death of the principal.

Farm Management Agent

Farm management agency account relationships are utilized for a number of reasons. Agricultural assets are unique and require a particular expertise to maximize income potential and enhance value. Whether the assets are held in a trust, or in an agency capacity, the fiduciary must exercise the requisite level of care. Some farms may be managed as an account investment alternative, assuming farmland returns compare favorably to other investments. An account beneficiary may be interested in retaining ownership and operating a family farm. An absentee owner or a retired farmer may contract for farm management because they no longer may be able to manage the farm themselves.

Banks offering farm management services must address the following areas: the establishment of a written agreement clearly delineating the responsibilities of the bank (as an agent or other capacity) and the principals; the appointment of a farm operator or manager responsible for actual day to day operation of the farm; the execution of a lease governing the operation of the farm; and the monitoring of the farm operator's performance in order to identify and correct problems with farm operations. Each of these is discussed below.

Establishment of Farm Management Agreements

- The governing agreement should delineate the bank's responsibility for operating, leasing, retaining, deeding, or selling the farm; making crop planting and marketing decisions; entering into borrowing arrangements; making major capital improvements; and selecting and dismissing tenants.
- The agreement should include any provisions whereby the bank must obtain the approval of other parties to the agreement for matters cited in the preceding paragraph.

Appointment of a Farm Operator or Manager

- Leases with tenant farmers should be current and of an appropriate duration in order to facilitate the removal of poor tenants or the alteration of lease terms.
- If an outside agent is used to manage farmland, they should be carefully selected, adequately bonded, and should submit reports of their activities to the institution.
- Obtaining financial statements from the farm operator may also be appropriate to ensure their capacity to perform under the lease terms.

Lease Arrangements

The types and terms of leases vary in each account, but one type of lease arrangement may be more prevalent in a given geographic area. Account officers should periodically determine which arrangement maximizes the return for beneficiaries relative to the level of the risk appropriate for the account. Leases are usually written for one year, but typically a farm operator's tenure is considerably longer, providing the tenant continues to perform satisfactorily. The more prevalent types of lease arrangements are summarized below.

- *Cash rent lease*. Under this arrangement, the farm operator pays a predetermined sum of cash rent for the use of the farm in a given year. A portion of the rent is usually paid in the Spring, with the balance of the rent paid in the Fall. The farm operator retains all of the crop production, receives the government crop production subsidies, provides all labor and equipment, and pays all of the cost for seed, fertilizer, chemicals, etc. The landowner contributes the land and buildings and typically pays the real estate taxes, insurance and maintenance expenses. Cash rental arrangements are becoming increasingly popular because the arrangement provides a predetermined annual return to the trust that is not subject to the significant risks of crop production and market price variations. Cash rental rates are also readily comparable and can allow competitive bidding by potential farm operators.
- *Bushel rent lease*. The bushel rent lease is very similar to cash rent; however, the rent is paid in the form of a specified number of bushels of grain, in lieu of cash, delivered to a local market. The farm operator and landowner pay the same respective expenses as mentioned in the cash lease arrangement. This rental arrangement results in a moderate increase in income volatility compared to the cash rent lease. The return is not subject to production risk; however, the return is subject to changes in grain market prices.
- *Net share lease*. Under the net share lease arrangement, the landowner’s rent is a predetermined percentage of the crop produced. Depending on the geographic location and the crop produced, the arrangement may require 25 to 35 percent of the crop. The farm operator and landowner pay the same respective expenses as mentioned in the cash lease arrangement. This rental arrangement results in a moderate increase in income volatility compared to the bushel rent lease. The return is subject to both production risk and to changes in grain market prices.
- *Crop share lease*. The 50/50 crop share lease has historically been the most prevalent farming arrangement for good quality farms in the Corn Belt. The farm operator provides all labor and equipment, pays 50 percent of all of the cost for seed, fertilizer, chemicals, etc., retains 50 percent of all of the crop production, and receives 50 percent of the government crop production subsidies. The landowner contributes the land and buildings, pays the real estate taxes, insurance and maintenance expenses, pays 50 percent of all of the cost for seed, fertilizer, chemicals, etc., retains 50 percent of all of the crop production, and receives 50 percent of the government crop production subsidies. This rental arrangement results in a moderate increase in income volatility compared to the net share lease. The return is subject to an increased share of both production risk and to changes in grain market prices.
- *Custom farming operation*. Under this arrangement, the landowner pays 100 percent of the crop production costs, real estate taxes, insurance and maintenance expenses, retains 100 percent of all of the crop production, and receives 100 percent of the government crop production subsidies. The landowner pays the farm operator specified "custom fees" to provide labor and

equipment to perform the planting, harvesting, etc. This rental arrangement has the potential for a greater overall return but results in a higher level of income volatility. The return is subject to all of the crop production risk, along with the change in grain market prices.

- *Direct farming operation*. Under this arrangement, the landowner owns all of the farm equipment and pays all of the necessary operating expenses, including labor. A resident manager is paid by the farm operation, and the landowner receives 100 percent of all crop proceeds. The return is subject to the risks described in the custom farming operation; however, the arrangement has the added risk of equipment ownership verses the elimination of "custom fees."

Monitor the account and the farm operator's performance.

- A record of farm income and expense should be available for the property under management.
- Evidence that taxes have been paid should be maintained.
- Evidence that proper insurance is in force should be maintained. Three types of insurance should usually be required: fire and extended coverage on buildings and improvements, public liability, and multi-peril crop insurance. Some farm operators may only carry crop hail insurance. Hail insurance is a private (and often expensive) insurance program that insures only crop losses related to hail. Multi-peril crop insurance is a very widely utilized government farm income insurance program. Government subsidies make multi-peril insurance an affordable income management tool. Multi-peril insures crop yields and, depending on the policy provisions selected, crop revenues. Multi-peril protects the landowner and/or the tenant's crop revenue from all types of perils that could adversely impact yields, including wind, hail, disease, frost, drought, insects, weeds, and flooding. Multi-peril crop insurance is strongly warranted in crop share and custom farming arrangements, i.e. arrangements where crop yield is the deciding factor on the return realized from the farmland investment. Crop yield coverage levels vary from 50 percent to 85 percent of a normal crop yield. The higher coverage levels are available at higher premiums. The farm management agent must determine what level of crop and income risk protection is appropriate for a given account.
- On-site farm visits are essential. The type of lease arrangement dictates the frequency and nature of on-site visits. In a custom farming or crop share lease arrangement, two or more visits may be warranted during the planting/growing/harvesting season to monitor the quality of the tenant and crop conditions due to the weather, disease, insects, weeds, etc. A cash rental lease arrangement may require only an annual visit to monitor maintenance of the soil and any facilities. Detailed records of visitations should include the date, purpose, persons contacted, observations made, and any facts or opinions that were developed.
- Cash flow projections are considered a good management tool and are often essential to obtain credit. Annual crop plans should be on hand. USDA yield averages for the area may provide a benchmark performance measurement.
- Farm management agents marketing grain should maintain records of prices obtained and document decisions regarding grain sales.
- A record should be maintained showing the quantity and storage location of harvested crops (on the farm or stored in elevators or warehouses). When not on the farm, detailed storage receipts should be on hand.
- Soil maps should be retained to assist in determining soil quality, soil erodibility, and whether drainage might be a problem. Soil tests should be performed every few years because soil fertility may be subject to depletion over time. Lease arrangements, supported by periodic farm inspections and soil testing, should be designed to ensure the farm operator's practices maintain soil fertility.

Other Problems

- *Inadequate Performance*. A bank may encounter problems where the farm is not achieving adequate returns or there are conditions that limit the value of the farm. Lease arrangements may be outdated and no longer provide the risk/return appropriate for the managed account.
- *Environmental Concerns*. The farm management agent should have policies and procedures to identify potentially adverse environmental conditions such as fuel storage tanks, improper disposal of pesticide containers, dump sites, or other hazardous conditions. Such conditions may require that an environmental specialist or engineer review the situation and, if necessary, supervise proper cleanup. Environmental monitoring safeguards the value of the asset and reduces the farm management agent's potential exposure to liability.
- *Conservation Concerns*. Problems can arise involving compliance with governmental conservation programs. "Swamp buster" is intended to prevent the drainage of wetlands. "Sodbuster" is intended to protect the farming of highly redouble lands (HEL). "Conservation Compliance" provisions require an acceptable conservation plan on highly erodible soils to prevent soil erosion. Compliance with conservation programs by farming operations is important because compliance usually

is a prerequisite to receiving related government income support. Financial incentives such as the Wetland Reserve Program (WRP) and the Environmental Conservation Acreage Reserve Program (CRP) may be attractive alternatives for enhancing the value of environmentally sensitive cropland.

- *Livestock*. The complexities of properly monitoring, growing, and marketing livestock or operating livestock enterprise investments within a trust arrangement could result in relatively high risk to the account. Livestock arrangements are highly unusual and should require a high level of expertise and monitoring.
- *Conflicts of Interest*. Banks sometimes obtain a discount for seed purchases by buying seed in large quantity or by being a "district dealer" for seed companies. District dealer status should be approved by a committee. These discounts present potential conflicts of interest in the form of side commissions, paid either to a farm manager personally or to a bank for being a district dealer; or from a bank retaining a portion of the bulk discount obtained. A bank, however, might be entitled to a small portion of such a discount in return for the bank's efforts in negotiating the discount, if most of the discount were passed on to the farm. In addition, a conflict of interest may arise if the bank as farm management agent enters into a lease arrangement with a farm operator that is also a borrower from the commercial side of the bank. Policies should adequately address the conflict of interest to ensure the farm lease arrangement is not adversely impacted.

Attorney-in-Fact Pursuant to an Executed Power of Attorney

A bank becomes Attorney-in-Fact when it receives a formally executed written power of attorney. There are various types of powers of attorney: general, special power, heath care, "durable", and "springing." Each of these is defined in Appendix H, under power of attorney. The durable and springing aspects may be added to any type of power of attorney.

To limit fiduciary risk, a trust department that accepts an appointment as attorney-in-fact should only do so under a special power of attorney. A specialized power of attorney can be tailored to limit the attorney-in-fact's responsibilities to those found in a revocable personal trust agreement. A general power of attorney provides too broad a range of powers and the health care power of attorney addresses issues not traditionally administered by bank fiduciaries. A general power of attorney grants authority to the bank to do anything as attorney-in-fact which the principal could legally do, including: the voting of stock; signing or endorsing checks; signing proxies; collecting debts; conveying real estate; transferring personal property; or performing similar services. Principal is the term used to identify the person who executes the power of attorney.

The principal may wish to use a power of attorney to manage his personal financial affairs, as it is traditionally an inexpensive means to have another party take care of principal's affairs when the principal is incapacitated or otherwise unable to care for his financial affairs. It is generally less costly than a revocable trust and provides more management options than an investment management account. Note, in order for the power of attorney to be effective in the event of the principal's incapacitation, it must be a "durable" or "springing" power of attorney. Appointing an Attorney-in-Fact is typically less costly and easier to acquire, than a court appointed conservatorship.

Regardless of the type of power of attorney accepted, the trust department must act in the principal's best interest, keep accurate records, keep the principal's property separate and distinct from that of all other accounts, and avoid conflicts of interest. Management must be aware of any state statutes governing this type of fiduciary appointment. For example, in some states, to effect real estate transactions the power of attorney must be recorded within a particular jurisdiction, such as a county. In some states the power-of-attorney must be notarized before becoming effective, and in some states the Attorney-in-Fact must appear before a public official and state under oath that he intends to give the power (knowing full well of its consequences).

Safekeeping Agent

A bank performs safekeeping duties when it limits itself to the safekeeping and delivery of property (to the principal or others as the principal may direct), with no ministerial duties required. The safekeeping division of the trust department should maintain adequate records and controls, together with suitable physical security. Articles left for safekeeping should not be commingled with bank assets, but should be properly identified and adequately insured.

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D. ADDITIONAL FIDUCIARY CAPACITIES

Co-Fiduciaries

In each of the aforementioned trust capacities, the bank, in accordance with the governing instrument or appointment, may be required to share the administration of an account with another fiduciary, referred to as a co-fiduciary. Examples of co-fiduciary arrangements include the following:

- A court may appoint a co-guardian to provide for special expertise over investments, or more commonly, may appoint a separate Guardian of the Person (Ward), while the bank serves as the Guardian of the Property.
- A co-fiduciary relationship may be requested by the testator of a will, or the settlor of a trust, to provide for special expertise over investments, or to be assured that certain family interests are considered when the account is being administered.

It is not uncommon for a family member to be appointed co-trustee with a financial institution. A co-fiduciary may also be one or more individuals, or another bank or trust company. If the co-fiduciary is an individual, the bank is commonly referred to as the corporate fiduciary. Regardless of the term used, each fiduciary has a responsibility to participate in the administration of the account.

It is generally held under common law that co-fiduciaries act in unison. It is the duty of each co-fiduciary to use reasonable care to prevent other co-fiduciaries from committing a breach of trust, and if a breach occurs, to compel the responsible party to correct it. Co-fiduciaries can be held responsible for a breach of trust committed by co-fiduciaries if, by neglect or willful misconduct of its own, it fails to protect the account from the other co-fiduciary's breach of trust. Further, while a fiduciary is ordinarily liable only for its own actions, a corporate fiduciary is often held to a higher standard of care than an individual co-fiduciary. As a result, a corporate fiduciary may be held liable if it does not compel a co-fiduciary(ies) to initiate corrective action to cure a breach of trust.

As a matter of sound policy, and to protect against possible liability, management should ensure the following:

- *Documentation of Co-Fiduciary Actions* - Management should maintain documented approvals from co-fiduciaries for all investment transactions and all other discretionary actions made during an account's administration. Approvals should be in written form and retained as permanent file documentation.
- *Physical Control of Account Assets* - It is generally undesirable for an individual (i.e. non-corporate) co-fiduciary to maintain physical possession or control over account assets. When this occurs, management should evaluate the controls over the assets in the custody of co-fiduciaries, as well as any bonding requirements applicable to the individual fiduciary.
- *Joint Responsibility for Administration* - Management should not delegate excessive authority over investments or other matters to the individual co-fiduciary. Examples of excessive delegation include purchasing assets requested by the non-corporate co-fiduciary without proper research or making a discretionary distribution requested by the non-corporate co-fiduciary without first substantiating that the distribution meets the needs of the beneficiary and/or the purpose of the account.
- *Appropriate Response to a Disinterested or Uncooperative Co-Fiduciary* - Situations may be encountered where a co-fiduciary has become disinterested or uncooperative and is not performing properly. Ideally, the bank, as corporate fiduciary, should try to avoid such situations through pre-acceptance review of the account. Failing that, special efforts may be needed to obtain the co-fiduciary's cooperation or, ultimately the bank may have to seek relief through a court.

Successor Trusteeships

The bank may be requested or appointed to serve as successor trustee in the event the originally appointed trustee is removed, unable, or unwilling to continue in office. Often, potential successor trustees are specifically designated in the trust document. Accepting an appointment as a successor trustee can entail additional risk to the bank. Although a successor trustee is generally not liable for acts of prior trustees, it can be held liable for actions of predecessor trustees if: (1) the successor trustee knows, or should know, of a breach of trust, or any other situation injurious to the account, and (2) it fails to take action to compel its predecessor(s) to remedy the situation.

Before acceptance, the bank should perform a due diligence review of an account's prior administration and require the prior trustee to furnish a complete accounting of its administration leading up to the time the successor is formally appointed. If the review discloses acts of improper administration, the successor trustee should either: (1) refuse to accept the appointment, or (2) take immediate steps to protect the account by asserting liability against its predecessor(s). The bank may also request appropriate releases from the court and/or all beneficiaries to further protect itself from the assumption of liability arising from the administration of prior trustees. The bank should maintain written documentation of both the performance of a due diligence review and any measures that were taken to protect both the account and the bank from potential liability arising from the actions of prior fiduciaries.

Even if the due diligence review does not disclose improper administration by the previous fiduciary, the bank should consider other factors prior to accepting the trust, such as:

- Does the beneficiary of the trust have unrealistic expectations regarding the rate of return on investments or level of service that can be provided?
- Is the language of the trust document overly complex or contradictory?
- Are the assets managed by the successor trustee unusual or beyond the expertise of the trust officers?
- Are fees sufficient in relation to the degree of difficulty in management of the trust?
- Is the trust subject to the laws of other states and, if so, is the trust department capable of complying with all required regulations?

A will or trust instrument may include an exculpatory clause, which relieves, or attempts to relieve, a fiduciary from liability for breach of trust. However, a fiduciary is not always fully protected by an exculpatory provision, and such provisions do not protect fiduciaries from breach of trust or actions which are illegal. Some states have passed statutes affording protection to the successor fiduciary from acts of its predecessor(s).

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E. ASSET PROTECTION TRUSTS

In most instances, trusts are created to preserve and protect assets for beneficiaries. The most prominent attacks against assets come from the following sources:

- Contract creditors including personal debt contracted for a variety of reasons.
- Tort creditors resulting from court or other legal judgments.
- Regulatory liability imposed by government to achieve social goals. One of the most common sources of regulatory liability is the cost of cleaning up environmentally damaged property.
- Divorce claims.
- Disabled beneficiaries. Often many clients will create trusts for an immediate family member, with the purpose of avoiding having the trust assets included in determining eligibility for Medicaid or public assistance.

Assets afforded Creditor Protection

Certain assets are exempt or partially exempt from creditors under either federal or state law. Many states allow an individual or married couple to retain a certain amount of equity in their residence. ERISA and many state laws protect qualified retirement plans from creditors. Some states also protect cash value of life insurance and annuities from creditors.

In *In Re Rousey* 347 F.3d 689 (8th Cir. 2003), the debtors voluntarily filed for relief under Chapter 7 of the Bankruptcy Code. Included in their assets were two IRA's, which were funded as roll-overs from their previous employer's pension plans. No additional funds were added to the accounts. The U. S. Court of Appeals for the Eighth Circuit ruled that IRA's were not exempt under 11 U.S.C. §522(d)(10)(E), affirming the decision of the Bankruptcy Appellate Panel. The court found that IRA's should not be exempted from a person's bankruptcy estate and pointed out that Congress could easily change the law if it wanted to protect IRA's. Furthermore, the Eighth Circuit held that because the Rousey's could withdraw money, the IRA's were similar to savings accounts. The debtors appealed. The U.S. Supreme Court is scheduled to hear the case in the Fall 2004 term. See *In Re Rousey* 347 F.3d 689 (8th Cir. 2003), cert granted, 72 U.S.L.W. 3740 (U.S. June 7, 2004) (No. 03-1407).

Other methods established to protect assets against creditors include:

- *Limited Partnerships*. Under this type of partnership agreement, a limited partner's exposure for the debts of the partnership is limited to the investment in the partnership, and the creditor cannot attack the personal assets of the limited partner.
- *Limited Liability Companies (LLC)*. The LLC limits the liability similar to other corporations, but allows flow-through treatment of taxable income or loss.

In general, a beneficiary's creditors cannot reach trust assets if a trust is created in good faith by an individual other than the beneficiary. Under the English "Statute of Elizabeth", which is embodied in the Second Trust Restatement, if a person created a trust for his own benefit, his creditors could reach the trust assets. Both Offshore Protection Trusts and Domestic Protection Trusts have been designed to overcome this traditional precept.

Offshore Protection Trusts

Offshore protection trusts established in several jurisdictions purport to offer considerable protection against creditor claims. A key feature that generally differs from trusts established in the United States is that a settlor is permitted to create a spendthrift trust for the settlor's own benefit. With a few exceptions, laws in the states require someone other than a beneficiary to create the trust.

Offshore trusts are difficult for creditors to attack for several reasons, including:

- Simply because it's a foreign trust may deter creditors.
- Legal costs may be high. Several jurisdictions do not allow contingency fees or require deposits to commence a proceeding.
- Some jurisdictions do not recognize foreign judgments, forcing the creditor to obtain judgments in both the United States and the foreign jurisdiction.
- A foreign jurisdiction may offer anonymity with respect to wealth.

The effectiveness of the ability of the offshore trust to protect assets from creditors is often dependent upon the amount of control retained by the settlor. Generally, the more control that is retained by the settlor, the less protection is provided by the trust against creditors.

Additional provisions frequently found in offshore protection trust designed to increase protection against potential creditors include:

- Ability of Foreign Trustees or Other Fiduciary to Change Situs of Trust Assets. The trust can be given power to change the situs of the trust assets to another jurisdiction if an action against the trust is threatened in the original jurisdiction. This can increase the costs of and time consumed by the creditor.
- Letter of Wishes. The settlor can provide nonbinding written guidelines to the trustee, covering the settlor's intent regarding investment of assets and distributions.
- Duress Clause. This clause directs a trustee to ignore direction of a U. S. trustee, if such direction is given under duress, including court compulsion.
- No Benefits Term. The trust might include a provision that provides for a term in which the beneficiaries are persons other than the settlor. The term could correspond with the limitations period applicable to claims of creditors in the foreign jurisdiction governing the trust.
- Restrictions on Beneficial Interests. The trust can provide that the settlor is only one of several permissible beneficiaries with the trustee having the power to choose among them or remove one or more. This trust can also provide upon the occurrence of certain events, the settlor's beneficial interest in the trust may either be terminated or held in abeyance for a specific period of time.

Offshore trusts have not proved impenetrable from state or Federal court actions; in fact, court decisions have order repatriation of assets to U. S. jurisdictions. Courts are generally unkind if evidence indicates a fraudulent transfer or attempts to avoid payment of alimony or child support. Creditors can often force bankruptcy or make it very difficult for a beneficiary to obtain the use of the assets of an offshore protection trust.

Domestic Protection Trusts

Domestic Protection Trusts (also known as Dynasty Trusts) are attempts by several states to provide spendthrift protection for trusts in which the settlor is the beneficiary (self-settled trusts), similar to offshore protection trusts. States that have adopted Domestic Protections Trusts include Nevada, Rhode Island, Delaware, and Alaska, and other states are considering adopting similar measures. Two effects of a discretionary self-settled trust are:

- Any gift made by the settlor to the trust in which the settlor retains an interest causes the trust to be incomplete for federal gift tax purposes.
- The settlor's interest in the trust will continue to be part of the settlor's gross estate for federal estate tax purposes.

Several states permit exceptions of Domestic Protection Trusts which allow creditors to reach the trust assets of self-settled trusts include:

- Creditors can reach the assets if the transfer of assets into the trust was intended to hinder, delay or defraud creditors, that is, it was a fraudulent conveyance.
- The claim resulted from an agreement or a court order for child support, or at the time of the transfer of assets, the settlor was delinquent in child support payments. Some states also include court orders arising out of divorce decrees.
- The administration of the trust must take place in the state where the trust was created.

During 2003, the State of Alaska modified its trust statutes allowing substantial protection for beneficiaries from creditors desiring to attach assets of self-settled trusts. Major provisions of the statute include the following:

- The statute provides protection for the trust assets against claims for spousal support, alimony, child support, providers of necessities, and claims for tort liability. Note, however, that a settlor cannot be delinquent in a child support obligation when the trust is settled.
- The statute prohibits an order or attachment against the beneficiary's assets held in trust.
- A non-resident beneficiary is now allowed to act as co-trustee with distribution authority without compromising creditor protection.
- Claimants of pre-existent creditors must demonstrate evidence that a specific claim was made prior to assets being transferred to the trust or file an action within four years of an asset transfer asserting a specific cause of action based on an act of omission prior to the transfer, such as negligence. Most other states have unlimited statutes of limitations for actions that occurred prior to the asset transfer.
- The definition of a "fraudulent conveyance" has been modified, hampering the ability of a creditor to assert that an asset transfer was fraudulent. The phrase "hinder or delay" has been removed from the statute, so now a claim of fraud must prove that the transfer was intended to defraud a creditor. The higher standard in the new statute will make it significantly more difficult for a creditor to attach the assets of the trust.

Should other states follow the example of Alaska and loosen the restrictions on self-settled trusts, the effects could be far-reaching and substantially inhibit creditors and other claimants from reaching the assets of these trusts.

While self-settled trusts reduce the ability of creditors to attach trust assets, several limitations restrict their ability to protect trust assets. Some of these limitations include:

- Since states cannot exempt themselves from Federal law, the state cannot hinder the IRS, a federal court, or some other Federal body from reaching the trust assets.
- The effectiveness is usually limited to the state where the trust is administered. Since a state cannot impose its regulations upon assets located in other states, the trusts can provide only limited ability to protect assets located in other states, even if these assets are administered by the trusts.
- States are required to recognize the judgments of other states, so judgments ordered in one state can be enforced in the state where the trust is administered, despite the terms of the trust.
- While an offshore protection trust can maintain some degree of confidentiality and secrecy, a domestic protection trust is subject to subpoena or discovery either through Federal courts or the regulations of another state.

- Most states will allow claims that originated prior to the transfer of assets. Claimants usually are unable to transfer assets into dynasty trusts after claims have been presented.

Signs of Fraudulent Transfer of Assets

Trust Department managers must be wary of trusts being used for fraudulent transfers. Most states have adopted legislation similar to the Uniform Fraudulent Transfer Act which defines several factors, called *Badges of Fraud*, which are indicators that the transfer of assets to a trust may be fraudulent. These factors are:

- the transfer or obligation was to an insider;
- the debtor retained possession or control of the property transferred;
- the transfer or obligation was concealed;
- before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
- the transfer was of substantially all the debtor's assets;
- the debtor absconded;
- the debtor removed or concealed assets;
- the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
- the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
- the transfer occurred shortly before or shortly after a substantial debt was incurred; and
- the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Rule Against Perpetuities

In order to compete with states with liberal trust laws, many states have recently passed regulations abolishing or severely modifying the "rule against perpetuities." The "rule against perpetuities" is the rule originating in common law that prohibits the grant of an estate unless the future interest granting that estate vests within 21 years after the death of someone alive when the interest was created. In other words, the estate must distribute assets no later than 21 years after the death of someone now living.

The original purpose of the rule was to strike a compromise between allowing an owner of assets to exercise his will over his assets at death and, on the other hand, tying up assets in such a way and for an indeterminate time so as to prevent the workings of a free market.

Estate planners have created innovative methods of using trusts in states that have abolished the above rule. In one instance a trust was created in order to perpetuate and grow a business. This was accomplished through the use of a defective trust, so income taxes were paid outside the trust, allowing the trust and the business to continue to grow for future generations.

Examination review of trusts designed to protect assets should insure that the transfer of assets was not fraudulent and did not violate any state regulation, including the "rule against perpetuities". Furthermore, most states have passed a version of the Uniform Fraudulent Transfers Act, designed to ensure transfers are not made into trusts to avoid an immediate claim by creditors, or avoid child support or alimony.