

Who Should Be Your Trustee?

Different types of trusts include revocable living trusts, lifetime irrevocable trusts and testamentary irrevocable trusts. No matter what kind of trust you have or why you created it -- to reduce your estate tax, provide for your spouse, shelter your assets or increase your cash flow -- you want it to fulfill its purpose. It won't unless your trustee is competent to:

- Manage your assets,
- Make investment decisions,
- Disburse income to beneficiaries,
- Pay expenses, and
- Pay taxes.

How do you select a trustee who can manage all these responsibilities? One with discretion, good judgment, commitment and integrity -- in addition to financial and conflict-resolution skills. Should you choose a corporate trustee, an individual trustee or a combination? Should you choose your spouse? Should you have one trustee or co-trustees? Here's a quick overview of some issues to consider when choosing your trustee.

Choosing a Person Or an Institution

Do you want a person or an institution as your trustee? A person will probably be the better choice for you if you're worried about an institution's staff turnover and you want your trustee to:

- Care about your family,
- Know and understand its needs, and
- Have its best interests at heart.

On the other hand, if you want a trustee who will be around for the long term and won't alter policies or duck responsibility, an institution may better meet your needs. This is especially true if your primary concerns are:

- Objectivity,
- Stability,
- Reliability,
- Investment expertise, and
- Experience in handling estates and trusts.

Choosing Your Spouse

When you consider convenience and security, you may find that your spouse is a good choice for trustee if he or she is financially responsible. If he or she is not financially experienced, your spouse can hire a qualified financial advisor -- such as an accountant, money manager or attorney -- on the trust's behalf.

Instruct your spouse to choose an advisor he or she can communicate with and rely on to protect trust assets and beneficiaries. In the trust agreement or by separate written instructions, you can name persons or firms you trust that you want your spouse to consider consulting. Or you can include guidelines to help your trustee spouse find the needed talent.

Here are some issues to consider when choosing your spouse as trustee:

Flexibility. Appointing your spouse as trustee or as a co-trustee for your lifetime irrevocable trust can increase trust planning flexibility. If your spouse is also a beneficiary, this may permit you, as the grantor, to retain indirect control of and access to trust assets. Designating your spouse as trustee of a testamentary trust clearly places control of trust assets in his or her hands. Within the framework of the trust agreement, having a spouse-trustee may allow greater economic flexibility and tax planning.

Inclusion in your spouse's taxable estate. Suppose you and your spouse have an irrevocable lifetime or testamentary trust, such as the "exemption trust" of your living trust. Are you concerned that trust assets will be included in your spouse's taxable estate?

Even if your spouse is a trust beneficiary, trust assets will be excluded as long as the trust agreement or state law limits his or her ability to self-distribute trust income or principal to an ascertainable standard. Accordingly, the trust agreement should clearly provide for either nondiscretionary mandatory distributions or discretionary distributions to your spouse based on support, maintenance, educational or health needs.

In addition, your spouse should lack the power to satisfy his or her legal obligations with trust assets. If you have minor children, the trust should not permit your spouse -- without an independent or special co-trustee's approval -- to distribute funds that would discharge his or her legal obligation for your children's support. But distributions on behalf of children that do not discharge your spouse's legal obligations may be permissible. (See "Two Potential Traps of Choosing Your Spouse" above.)

Something else to keep in mind is that under the spousal attribution tax rule, the IRS will deem you to hold any power or interest in a lifetime irrevocable trust held by your spouse. Accordingly, if you should not act as trustee for income-tax purposes, then your spouse should not be trustee. But no spousal attribution exists for estate or gift tax.

Choosing Co-Trustees

What are the advantages of naming co-trustees or a board of trustees? Choosing persons with complementary skills may be in your best interest and may also reduce the risk of fraud if more than one trustee is required to consent to carry out decisions. And naming a person and an institution as co-trustees may be beneficial. In addition, you might want to assign different roles to different parties. Just make sure they understand and accept their roles.

Ensuring Accountability And Replaceability

No matter whom you choose to administer your trust, how can you ensure that a trustee is held accountable for his or her actions? For starters, you can:

Give your beneficiaries the right to fire and replace the trustee for “good cause,” or

Empower a third party -- or “trust protector” -- to replace the trustee if necessary, though the beneficiaries or trust protector should not be able to appoint themselves as next trustee.

In addition, you can retain the power to fire and replace the trustee. But this could be dangerous if not done properly in the case of a lifetime irrevocable trust.

And don't overlook setting up a procedure to replace a trustee who becomes unable or unwilling to serve. This situation may arise if he or she has a conflict of interest or acts irresponsibly.

Ensuring Acceptability By Your Heirs

To avoid conflicts between your heirs and the trustee, consult with your children on the trustee choice and the amount of financial authority to give the trustee. Better yet, you can make your children co-trustees.

Also consider allowing your children to determine the amount and timing of distributions to your grandchildren. You can also give your children the power to alter (through their wills), your grandchildren's trust shares.

Ensuring Peace of Mind

These are just a few important considerations involved in selecting a trustee and setting up a trust for your estate. Choosing one or more trustees who will perform these

Two Potential Traps of Choosing Your Spouse

The step plan trap. This potential trap applies only to a lifetime irrevocable trust. A “step plan” could cause trust assets to be included in your spouse's taxable estate. For example, assume you and your spouse hold real estate in joint tenancy and, in connection with a plan, title is transferred to you. In turn, you transfer the property into a trust with your spouse as both trustee and beneficiary. Your momentary sole ownership of the property might not sufficiently sever the joint ownership, and your spouse could be deemed a grantor of half the property. Accordingly, half the property could be included in his or her taxable estate. This is especially a problem in states that recognize marital community property.

The life insurance trap. Special concerns arise if your trust is a lifetime irrevocable trust and the trust is to own life insurance on your spouse's life or on your joint lives. Your spouse-trustee may have incidents of ownership over trust-owned policies, possibly causing the insurance proceeds to be included in his or her taxable estate. If your spouse acts as a co-trustee, the trust agreement should clearly provide that he or she has no power over the insurance policy. But your spouse could be a co-trustee if the other trustee is an adverse or independent party -- such as a trust beneficiary or a bank or trust company. Multiple functions will require careful planning. A professional can help you with this process.

