Special Session III-A

Trustees, Beneficiaries, Directors! The Uniform Directed Trust Act Can Conjure a Hollywood Ending from Even the Most Difficult Family Script

Planning with Trusts Series

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I. Introduction[1]

The Uniform Directed Trust Act (UDTA) addresses the rise of directed trusts. In a *directed trust*, a person other than a trustee has a power over some aspect of the trust's administration. Such a person may be called a "trust protector," "trust adviser," or in the terminology of the UDTA, a "trust director." The division of power over a trust between a trust director and a trustee subject to a power of direction, sometimes called an "administrative trustee" or, in the terminology of the UDTA, a "directed trustee," raises a host of difficult questions for which the UDTA was drafted to provide clear, practical answers.

In a traditional trust, the responsibility for all aspects of the trust's administration—including custody, investment, and distribution—belongs to the trustee. For centuries, this allocation of authority to a trustee has been a foundation of trust law. In a directed trust, however, this foundation may be modified by a grant of power over some aspect of trust administration to a trust director. A trust director is not a trustee, but has the power either to direct the trustee in the trust's administration or to administer the trust directly. A trust director can have virtually any power over a trust, including the power to direct the trustee in the investment and distribution of trust property and the power to amend or terminate the trust.

The rise of directed trusts raises numerous unsettled questions of law. The most obvious question is how to allocate fiduciary responsibility between a trust director and a directed trustee. If a trust director exercises a power of direction and the directed trustee acts accordingly, a court must decide how much responsibility for the action belongs to the director and how much belongs to the trustee. In addition, a directed trust creates a host of further problems about how to govern a trust director, such as how to discern whether a trust director has duly accepted appointment and how to differentiate between a fiduciary power belonging to a trust director and a nonfiduciary power belonging to the holder of a power of appointment.

The purpose of the UDTA is to address these complications. The UDTA expressly validates terms of a trust that provide for a trust director and prescribes a simple set of rules for directed trusts. The UDTA's basic strategy for allocating fiduciary duty is to impose primary fiduciary responsibility for a trust director's actions on the director, while preserving a minimum core of duty in a directed trustee. A trust director has the same fiduciary duties as a trustee would have in a like position and under similar circumstances, but a trustee that acts subject to a trust director's direction is generally liable only for the trustee's own willful misconduct. The UDTA authorizes a similar allocation of power and duty among cotrustees.

In addition to this modified fiduciary scheme, the UDTA also offers solutions to the many practical problems created by the presence of a trust director. Among other things, the UDTA deals with the sharing of information among a trustee and a trust director and the compensation, succession, and appointment of a trust director.

In this session, we will consider a series of case studies involving recurring difficulties in directed trusts, giving particular attention to how UDTA would resolve those difficulties.

II. Case Studies

A. Investment Concentrations

1. Example 1

Facts: *T* is the directed trustee of a directed trust the terms of which name *B*, one of the beneficiaries, as a trust director with a power to direct *T* in the investment of the trust property. *B* directs *T* to purchase and retain a substantial concentration in a large publicly traded stock. Under *T*'s policies and procedures, it would not normally purchase or retain such a concentration.

Some Questions: Must *T* follow the direction to buy and retain the concentration? Should *T* warn *B* or the other beneficiaries that the concentration is ill-advised?

UDTA: Under UDTA § 9(a), "a directed trustee shall take reasonable action to comply with a trust director's exercise or nonexercise of a power of direction … , and the trustee is not liable for the action," unless per § 9(b) "by complying the trustee would engage in willful misconduct." Moreover, under UDTA § 11(a)(1), "a trustee does not have a duty to … inform or give advice to a settlor, beneficiary, trustee, or trust director concerning an instance in which the trustee

[1] This introduction borrows freely from the Uniform Law Commission's summary, prepared by Professors John Morley and Robert Sitkoff, of the Uniform Directed Trust Act (UDTA). The UDTA and other materials pertaining to it, including the summary on which this introduction borrows freely, are available at http://www.uniformlaws.org/Act.aspx?title=Directed%20Trust%20Act.

might have acted differently than the director." However, as the comment to § 11 elaborates, that section "does not relieve a trustee of its ordinary duties to disclose, report, or account under otherwise applicable law such as under Uniform Trust Code § 813 (2004) or Restatement (Third) of Trusts § 82 (2007)."

B. Tax Returns and Information Sharing

Even if a trustee is directed with respect to a certain matter, the trustee will still have full fiduciary responsibility with respect to other matters for which the trustee is not directed even if the other matters have a connection with the directed matter. Perhaps the clearest example is the obligation of the trustee to file trust income tax returns.

1. Example 2: A Direction Not to Pay Taxes

Facts**:** A Pennsylvania trust is converted (perhaps by a nonjudicial settlement agreement or by decanting) to a Delaware directed trust. Under the terms of the trust, the "administrative" or "directed" trustee, *T*, is subject to direction by *D* with respect to investment of the trust property. *D* instructs *T* not to file a Pennsylvania income tax return after the conversion.

Some Questions**:** What is the scope of *D*'s power of direction? Does a power to direct investment encompass a power to direct the trustee with respect to tax filings? Even if *D*'s power of direction covers tax filings, can *D* give a valid direction not to comply with applicable tax law?

UDTA**:** Under UDTA § 9(a), "a directed trustee shall take reasonable action to comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1), and the trustee is not liable for the action." Accordingly, the initial question is whether the direction not to file a Pennsylvania tax return falls within the scope of *D*'s power of direction as prescribed by the terms of the trust, or if not, whether the direction falls within the provision of § 6(b)(1) that grants every trust director "any further power appropriate to the exercise or nonexercise of a power of direction" under the terms of the trust.

If the direction does not fall within *D*'s express or implied further powers, then *T* is not subject to direction with respect to the tax return, and *T* is not protected from liability by § 9(a) for not filing the return. As the comment to § 9 explains, "A trustee's duty to take reasonable action is limited by the scope of the trust director's power of direction. A directed trustee should not comply with a direction that is outside of the director's power of direction and beyond the director's further powers under Section 6(b)(1). To do so would violate the trustee's duty under subsection (a) and the trustee's background duty to act in accordance with the terms of the trust."

Moreover, even if the direction did fall within *D*'s power of direction or implied further powers, to the extent the direction not to file a Pennsylvania tax return was contrary to law, the power of direction would not be valid. UDTA § 6(a) validates "a power of direction," but as the comment to that section observes, the UDTA does not "override the background law that regulates the formation of a trust, such as the requirements that a trust be lawful, not contrary to public policy, and possible to achieve."

In the event of reasonable doubt, *T* may petition the court for instructions, as confirmed by UDTA § 9(d).

2. Example 3: Tax Ramifications of a Direction

Facts**:** *T* is directed trustee of a trust that holds a family business. The terms of the trust provide that *T* is to retain the business unless directed by *D* to sell it. In mid-December, *D* directs *T* to sell the business. The direction takes the form of instructing *T* to execute the sale documents. *D* provides *T* with no further information about the sale or its proceeds until the week of April 15 in the following year. In consequence, *T* did not increase the trust's state and federal income tax estimates in the prior year. However, if the state taxes resulting from the sale had been paid in the year of the sale, they would have generated an advantageous federal tax deduction a year sooner.

Some Questions**:** Should *D* have considered the tax consequences of the sale and provided *T* with the information necessary to obtain the advantageous deduction? Should *T* have advised *D* about the benefits of paying the state income taxes on the sale in the year of sale? Should *T* have sought the relevant information from *D* before the end of December?

UDTA**:** Under UDTA § 8(a)(A), *D* "has the same fiduciary duty and liability in the exercise or nonexercise of" *D*'s power to direct the sale of the family business "as a sole trustee in a like position and under similar circumstances." Under prevailing trust fiduciary law such as Uniform Prudent Investor Act § 2(c)(3) (1994), a trustee must consider tax consequences in evaluating the prudence of a transaction. So *D* should have considered the tax consequences of the sale.

Under UDTA § 10(b), *D* was under an affirmative duty to provide information to *T* about the sale price, because that information was reasonably related to both *D*'s and *T*'s powers and duties. Moreover, under the same provision *T* was entitled to demand that information—and arguably it should have, because that information was necessary for *T* to carry out its duties in connection with paying trust income taxes. However, under UDTA § 11(a), *T* was expressly relieved of any duty to inform or give advice to *D* regarding *D*'s exercise of its power of direction.

C. Litigation with Multiple Trust Fiduciaries

1. Example 4: A Direction to Bring a Lawsuit

***Facts*:** *T* is the directed trustee of a trust the terms of which provide that *D* has a power to direct *T* in the investment of the trust property. *D* directs *T* to enter into a contract with *S* to purchase an asset from *S* for the trust. After *S* reneges on the deal, *D* directs *T* to sue *S* for breach of contract.

***Some Questions*:** Must *T* follow the direction to bring suit against *S*? Can *D* bring the suit instead?

***UDTA*:** Under UDTA § 7(b)(1), "a trust director may exercise any further power appropriate to the exercise or nonexercise of a power of direction granted to the director" by the terms of the trust. Even if the terms of the trust do not expressly grant *D* a power to direct litigation, therefore, arguably in this case directing *T* to bring a lawsuit against *S* is an "appropriate" further power. Moreover, irrespective of whether *D* directs *T* to bring litigation against *S*, under prevailing trust fiduciary law, such as Uniform Trust Code § 811 (2000), a trustee is under a duty to "take reasonable steps to enforce claims of the trust and to defend claims against the trust."

An interesting twist, however, is that under UDTA § 7(b)(1), arguably *D* could bring a lawsuit against *S* on behalf of the trust on the theory that bringing the lawsuit is an implied further power "appropriate" to the express power to direct *T* to contract with *S*. Indeed, the comment to § 7 points to a power to "prosecute, defend, or join an action, claim, or judicial proceeding relating to a trust" as an example of a further power that might be "appropriate." Moreover, under UDTA § 8(a)(A), *D* "has the same fiduciary duty and liability in the exercise or nonexercise of" *D*'s powers "as a sole trustee in a like position and under similar circumstances." As such, the familiar duty to "take reasonable steps to enforce claims of the trust and to defend claims against the trust," as under Uniform Trust Code § 811, would apply to *D* as well as to *T*.

2. Example 5: A Director's Secret Lawsuit

***Facts*:** *T* is the directed trustee of a trust the terms of which provide that *D* has power to direct *T* in the investment of the trust property. The terms of the trust are silent about *D*'s power to bring or participate in litigation involving the trust. *D* brings litigation against a third party over a trust asset without informing *T*.

***Some Questions*:** Did *D* act beyond its power in bringing the lawsuit? Even if *D* had the power to bring the suit, did *D* act improperly in failing to inform *T* about the suit? What are *T*'s duties upon discovering the suit?

***UDTA*:** As we have seen in the analysis of example 3, above, under UDTA § 7(b)(1), *D* might have the power to bring the lawsuit if bringing the suit was "appropriate" to *D*'s express power to direct investments. However, under UDTA § 10(b), *D* was probably under an affirmative duty to inform *T* about the litigation, as it is hard to see how the suit is not related to *T*'s powers and duties. Upon discovering the suit, under UDTA § 11(a) *T* is expressly relieved of a duty to advise *D* with respect to the suit. However, under prevailing trust fiduciary law, such as Uniform Trust Code § 811 (2000), *T* is under a duty to "take reasonable steps to enforce claims of the trust and to defend claims against the trust," and for that reason might need to participate in the suit. Moreover, under UDTA § 9(a), *T* is under a duty to take "reasonable action" to facilitate *D*'s suit, provided that it is within *D*'s further power under § 7(b)(1).

D. Beware Conflicts of Interest

1. Example 6: Feuding Siblings

***Facts*:** Brother and Sister each create irrevocable directed trusts. The trusts name *T* as the directed trustee and Brother and Sister respectively as trust director with a power to direct investments. Brother and Sister direct *T* to make a variety of investments for each trust across common LLCs and LLPs. After Brother and Sister's relationship sours, each gives *T* conflicting investment directions regarding the common LLCs and LLPs that would injure the other sibling's trust investments in those entities.

Some Questions: Can *T* follow the conflicting directions? Can *T* take a directed action with respect to one trust if the action will injure the beneficial interest in the other trust? What options does *T* have to extricate itself from the situation?

***UDTA*:** Under UDTA § 9(a), "a directed trustee shall take reasonable action to comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1), and the trustee is not liable for the action." However, this provision is qualified by § 9(b), which provides that "A directed trustee must not comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1) to the extent that by complying the trustee would engage in willful misconduct." Moreover, the exoneration from liability in § 9 other than for willful misconduct pertains only within the one directed trust. To the extent that compliance with a direction within one trust will injure the beneficiaries of another trust for which the directed trustee is also trustee, the trustee has a structural conflict of interest. A trustee cannot act in a manner inimical to the interests of a beneficiary of one trust on the grounds that doing so was necessary to comply with the trustee's duties in another trust.

In these circumstances, the trustee should petition the court for instructions or the appointment of a trustee ad litem, or perhaps should resign. UDTA § 9(d) expressly contemplates that a directed trustee "that has reasonable doubt about its duty" to comply with a direction in a directed trust "may petition the [court] for instructions."

2. Example 7: Taking Control of a Family Business

***Facts*:** *T* is the directed trustee of two mirror-image trusts, one for the benefit of Brother, the other for the benefit of Sister. The terms of the trusts provide that they will terminate, and pay out the entire corpus, upon the primary beneficiary reaching age 50. Each trust holds a diversified portfolio of liquid financial assets plus half of the shares in a closely held family business that was created by the settlor, who is now dead. Brother is today the dominant manager in the business. Brother is named by the terms of both trusts as a trust director with a power to direct *T* in the investment of the trust property. After a falling out with Sister, Brother directs *T* to use funds from his trust to buy one share in the family business from Sister's trust at the fair market value for one share (without regard to control premium effects). If this transaction is carried out, then in the coming years when the trusts terminate Brother will have a slight majority interest in the business, and Sister will have a minority interest, instead of each of them owning half.

***Some Questions*:** Should *T* follow the direction? Can *T* take a directed action with respect to one trust if the action will injure the beneficial interest in the other trust? What options does *T* have to extricate itself from the situation?

***UDTA*:** Much of the same analysis as in Example 5 pertains, except in this case *T* is directed as to both trusts. As such, *T* is protected by § 9 with respect to its directed actions in each trust, provided that those actions do not amount to willful misconduct.

The difficulty is that going forward with this transaction will obviously diminish Sister's beneficial interest, as in return for the fair market value of one share she'll ultimately receive a minority rather than equal share in the business. Whether going forward with the directed transaction in such circumstances amounts to willful misconduct is uncertain owing to the paucity of case law. To avoid this risk, *T* could petition for instructions.

E. Opaque Investment Holdings

1. Example 8: Trust Holds Membership Interest in LLC with All Activity at the LLC Level

Facts: *T* is the directed trustee of a directed trust the terms of which name *B*, one of the beneficiaries, as a trust director with a power to direct *T* in the investment of the trust property. At *B*'s direction, *T* conveys the entire trust fund to a new LLC in return for a 100 percent membership interest in the LLC. *B* is the manager of the LLC. Under the terms of the LLC's governing instrument, *B* has plenary management power over the LLC.

Some Questions: What steps must *T* take, if any, if *T* does not have adequate information about the goings on within the LLC? Thus:

- Suppose that *B* fails to give *T* valuations of the LLC or its underlying assets. How is *T* to make reports or accountings to the beneficiaries or required tax filings?

- Suppose that *B* causes the LLC to guarantee a large loan to *B*. Must *T* as trustee bring an action against *B* as manager to protect the trust's membership interest in the LLC? What if *B* as trust director directs *T* not to take such action?

- Suppose *B* causes the LLC to make distributions directly from the LLC to himself or the other beneficiaries. Must *T* as trustee take action against *B* as manager to protect the trust's membership interest in the LLC and *T*'s fiduciary power over impartial distributions? What if *B* as trust director directs *T* not to take such action?

UDTA: These questions bring together a variety of provisions that have been discussed in the prior examples. Thus:

- Under UDTA § 10(b), *B* is under a duty to give valuation information to *T*, as that information is reasonably related to both the powers and duties of *B* and of *T*.

- Under prevailing trust fiduciary law, such as Uniform Trust Code § 811 (2000), a trustee is under a duty to "take reasonable steps to enforce claims of the trust and to defend claims against the trust." If *B* directs *T* not to take such an action, the question will be whether *B*'s power of direction as prescribed by the terms of the trust includes a power to direct *T* not to bring such a suit, and if not, whether the direction falls within the provision of UDTA § 6(b)(1) that grants every trust director "any further power appropriate to the exercise or nonexercise of a power of direction" under the terms of the trust. Even if *D* has the power to direct *T* not to bring the action, under UDTA § 9(a)-(b) *T* will not be protected from liability if not bringing the action would amount to willful misconduct.

- Much of the same analysis pertains here, with the further wrinkle that *B* has used his power of direction over investment to take control of distributions, raising the question of whether *T* not taking action would constitute willful misconduct.

F. A Directed Co-Trustee

1. Example 9: Direction by a Family Co-Trustee

***Facts*:** *S* creates a trust for his son, *C2*, naming a local bank, *TrustCo*, and his other son, *C1*, as cotrustees. The terms of the trust provide that *C1* alone has exclusive power over the investment of the trust property, and that *TrustCo* must follow *C1*'s investment directions and "shall not be liable" for doing so. *C1* directs *TrustCo* to invest the bulk of the trust property in a series of fledgling technology startup companies in which *C1* is variously an investor or a member of the board of directors or for which *C1* provides consulting services. *TrustCo* is aware of *C1*'s conflicts of interest, that *C1* has not undertaken due diligence to support the investments, and that collectively the investments are not prudent in light of *C2*'s limited risk tolerance.

***Some Questions*:** Must *TrustCo* follow the directions? Will *TrustCo* be protected from liability by the terms of the trust?

***Traditional Law*:** The modern authorities are uniform in recognizing a duty in each cotrustee "to use reasonable care to prevent a cotrustee from committing a breach of trust and, if a breach of trust occurs, to obtain redress."[2] The prevailing view, moreover, is that this duty applies even if the settlor limits the role or function of one of the cotrustees. The Restatement (Third) of Trusts explains: "Even in matters for which a trustee is relieved of responsibility, … if the trustee knows that a co-trustee is committing or attempting to commit a breach of trust, the trustee has a duty to take reasonable steps to prevent the fiduciary misconduct."[3]

***UDTA*:** Under the UDTA, the terms of a trust can opt out of the default law of cotrusteeship, and instead subject cotrustees to the more permissive rules of a directed trusteeship as prescribed by Sections 9, 10, and 11. The drafting

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[2] Restatement (Third) of Trusts § 81(2) (2007); *see also* Uniform Trust Code § 703(g) (2000).

[3] Restatement (Third) of Trusts § 81(2) cmt. b (2007).

committee reasoned that, because a "settlor could choose the more permissive rules of a directed trusteeship by labeling one of the cotrustees as a trust director and another as a directed trustee," there was little reason not to allow the settlor to apply "the fiduciary rules of [a directed trust] to a cotrusteeship."[4] To this end, UDTA § 12 provides:

> The terms of a trust may relieve a cotrustee from duty and liability with respect to another cotrustee's exercise or nonexercise of a power of the other cotrustee to the same extent that in a directed trust a directed trustee is relieved from duty and liability with respect to a trust director's power of direction under Sections 9 through 11.

Under the UDTA, therefore, the question in this case is whether by complying with *C1*'s directions, *TrustCo* would engage in willful misconduct. On the facts given, there is a very strong argument that the answer is yes.

[4] Id. cmt. The drafting committee also took note of similar provisions in three states. After Section 12 was in draft form, a small handful of other states adopted similar provisions.

UNIFORM DIRECTED TRUST ACT

drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS ONE-HUNDRED-AND-TWENTY-SIXTH YEAR
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WITHOUT PREFATORY NOTE AND COMMENTS

November 3, 2017

UNIFORM DIRECTED TRUST ACT

SECTION 1. SHORT TITLE. This [act] may be cited as the Uniform Directed Trust Act.

SECTION 2. DEFINITIONS. In this [act]:

(1) "Breach of trust" includes a violation by a trust director or trustee of a duty imposed on that director or trustee by the terms of the trust, this [act], or law of this state other than this [act] pertaining to trusts.

(2) "Directed trust" means a trust for which the terms of the trust grant a power of direction.

(3) "Directed trustee" means a trustee that is subject to a trust director's power of direction.

(4) "Person" means an individual, estate, business or nonprofit entity, public corporation, government or governmental subdivision, agency, or instrumentality, or other legal entity.

(5) "Power of direction" means a power over a trust granted to a person by the terms of the trust to the extent the power is exercisable while the person is not serving as a trustee. The term includes a power over the investment, management, or distribution of trust property or other matters of trust administration. The term excludes the powers described in Section 5(b).

(6) "Settlor" means a person, including a testator, that creates, or contributes property to, a trust. If more than one person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion.

(7) "State" means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any other territory or possession subject to the jurisdiction of the United States.

(8) "Terms of a trust" means:

(A) except as otherwise provided in subparagraph (B), the manifestation of the settlor's intent regarding a trust's provisions as:

(i) expressed in the trust instrument; or

(ii) established by other evidence that would be admissible in a judicial proceeding; or

(B) the trust's provisions as established, determined, or amended by:

(i) a trustee or trust director in accordance with applicable law; [or]

(ii) court order[; or

(iii) a nonjudicial settlement agreement under [Uniform Trust Code Section 111]].

(9) "Trust director" means a person that is granted a power of direction by the terms of a trust to the extent the power is exercisable while the person is not serving as a trustee. The person is a trust director whether or not the terms of the

trust refer to the person as a trust director and whether or not the person is a beneficiary or settlor of the trust.

(10) "Trustee" includes an original, additional, and successor trustee, and a cotrustee.

Legislative Note: *A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 103(18), defining "terms of a trust," or Uniform Trust Decanting Act (2015) Section 2(28), defining "terms of the trust," should update those definitions to conform to paragraph (8). A state that has enacted Uniform Trust Code Section 103(15) and (20) could replace paragraphs (6) and (10) of this section with cross-references to those provisions. A state that has not enacted Uniform Trust Code Section 111 should replace the bracketed language of paragraph (8)(B)(iii) with a cross reference to the state's statute governing nonjudicial settlement or should omit paragraph (8)(B)(iii) if the state does not have such a statute.*

SECTION 3. APPLICATION; PRINCIPAL PLACE OF ADMINISTRATION.

(a) This [act] applies to a trust, whenever created, that has its principal place of administration in this state, subject to the following rules:

(1) If the trust was created before [the effective date of this [act]], this [act] applies only to a decision or action occurring on or after [the effective date of this [act]].

(2) If the principal place of administration of the trust is changed to this state on or after [the effective date of this [act]], this [act] applies only to a decision or action occurring on or after the date of the change.

(b) Without precluding other means to establish a sufficient connection with the designated jurisdiction in a directed trust, terms of the trust which designate the principal place of administration of the trust are valid and controlling if:

(1) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction;

(2) a trust director's principal place of business is located in or a trust director is a resident of the designated jurisdiction; or

(3) all or part of the administration occurs in the designated jurisdiction.

Legislative Note: *A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 108(a) could omit subsection (b) and instead add subsection (b)(2) to Section 108 if the state also adds to the state's Uniform Trust Code the definitions of power of direction and trust director from Section 2(5) and (9).*

SECTION 4. COMMON LAW AND PRINCIPLES OF EQUITY. The common law and principles of equity supplement this [act], except to the extent modified by this [act] or law of this state other than this [act].

SECTION 5. EXCLUSIONS.

(a) In this section, "power of appointment" means a power that enables a person acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over trust property.

(b) This [act] does not apply to a:

(1) power of appointment;

(2) power to appoint or remove a trustee or trust director;

(3) power of a settlor over a trust to the extent the settlor has a power to revoke the trust;

(4) power of a beneficiary over a trust to the extent the exercise or nonexercise of the power affects the beneficial interest of:

(A) the beneficiary; or

(B) another beneficiary represented by the beneficiary[under Uniform Trust Code Sections 301 through 305] with respect to the exercise or nonexercise of the power; or

(5) power over a trust if:

(A) the terms of the trust provide that the power is held in a nonfiduciary capacity; and

(B) the power must be held in a nonfiduciary capacity to achieve the settlor's tax objectives under the United States Internal Revenue Code of 1986[, as amended][, and regulations issued thereunder][, as amended].

(c) Unless the terms of a trust provide otherwise, a power granted to a person to designate a recipient of an ownership interest in or power of appointment over trust property which is exercisable while the person is not serving as a trustee is a power of appointment and not a power of direction.

Legislative Note: *A state that has not enacted Uniform Trust Code (Last Revised or Amended in 2010) Sections 301 through 305 should replace the bracketed language in subsection (b)(4)(B) with a cross reference to the state's statute governing virtual representation or should omit the bracketed language if the state does not have such a statute.*

A state that does not permit the phrase "as amended" when incorporating federal statutes or permit reference to "regulations issued thereunder" should delete the bracketed language in subsection (b)(5)(B).

SECTION 6. POWERS OF TRUST DIRECTOR.

(a) Subject to Section 7, the terms of a trust may grant a power of direction to a trust director.

(b) Unless the terms of a trust provide otherwise:

(1) a trust director may exercise any further power appropriate to the exercise or nonexercise of a power of direction granted to the director under subsection (a); and

(2) trust directors with joint powers must act by majority decision.

SECTION 7. LIMITATIONS ON TRUST DIRECTOR. A trust director is subject to the same rules as a trustee in a like position and under similar circumstances in the exercise or nonexercise of a power of direction or further power under Section 6(b)(1) regarding:

(1) a payback provision in the terms of a trust necessary to comply with the reimbursement requirements of Medicaid law in Section 1917 of the Social Security Act, 42 U.S.C. Section 1396p(d)(4)(A)[, as amended][, and regulations issued thereunder][, as amended]; and

(2) a charitable interest in the trust, including notice regarding the interest to [the Attorney General].

Legislative Note: *A state that does not permit the phrase "as amended" when incorporating federal statutes or that does not permit reference to "regulations issued thereunder" should delete the bracketed language in paragraph (1) accordingly.*

In paragraph (2), "Attorney General" is in brackets to accommodate a state that grants enforcement authority over a charitable interest in a trust to another public official.

SECTION 8. DUTY AND LIABILITY OF TRUST DIRECTOR.

(a) Subject to subsection (b), with respect to a power of direction or further power under Section 6(b)(1):

(1) a trust director has the same fiduciary duty and liability in the exercise or nonexercise of the power:

(A) if the power is held individually, as a sole trustee in a like position and under similar circumstances; or

(B) if the power is held jointly with a trustee or another trust director, as a cotrustee in a like position and under similar circumstances; and

(2) the terms of the trust may vary the director's duty or liability to the same extent the terms of the trust could vary the duty or liability of a trustee in a like position and under similar circumstances.

(b) Unless the terms of a trust provide otherwise, if a trust director is licensed, certified, or otherwise authorized or permitted by law other than this [act] to provide health care in the ordinary course of the director's business or practice of a profession, to the extent the director acts in that capacity, the director has no duty or liability under this [act].

(c) The terms of a trust may impose a duty or liability on a trust director in addition to the duties and liabilities under this section.

SECTION 9. DUTY AND LIABILITY OF DIRECTED TRUSTEE.

(a) Subject to subsection (b), a directed trustee shall take reasonable action to comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1), and the trustee is not liable for the action.

(b) A directed trustee must not comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1) to the extent that by complying the trustee would engage in willful misconduct.

(c) An exercise of a power of direction under which a trust director may release a trustee or another trust director from liability for breach of trust is not effective if:

(1) the breach involved the trustee's or other director's willful misconduct;

(2) the release was induced by improper conduct of the trustee or other director in procuring the release; or

(3) at the time of the release, the director did not know the material facts relating to the breach.

(d) A directed trustee that has reasonable doubt about its duty under this section may petition the [court] for instructions.

(e) The terms of a trust may impose a duty or liability on a directed trustee in addition to the duties and liabilities under this section.

Legislative Note: *A state that has enacted the Uniform Trust Code (Last Revised or Amended in 2010) should move Section 808(a) into Section 603, delete Section 808(b) through (d), and add "subject to [insert cite to Uniform Directed Trust Act Sections 9, 11, and 12]," to the beginning of subsection (b)(2) of Section 105. Section 105(b)(2) prescribes the mandatory minimum fiduciary duty of a trustee, which is superseded with respect to a directed trustee by the willful misconduct mandatory minimum of this section.*

The term "court" in subsection (d) of this section should be revised as needed to refer to the appropriate court having jurisdiction over trust matters.

SECTION 10. DUTY TO PROVIDE INFORMATION TO TRUST DIRECTOR OR TRUSTEE.

(a) Subject to Section 11, a trustee shall provide information to a trust director to the extent the information is reasonably related both to:

(1) the powers or duties of the trustee; and

(2) the powers or duties of the director.

(b) Subject to Section 11, a trust director shall provide information to a trustee or another trust director to the extent the information is reasonably related both to:

(1) the powers or duties of the director; and

(2) the powers or duties of the trustee or other director.

(c) A trustee that acts in reliance on information provided by a trust director is not liable for a breach of trust to the extent the breach resulted from the reliance, unless by so acting the trustee engages in willful misconduct.

(d) A trust director that acts in reliance on information provided by a trustee or another trust director is not liable for a breach of trust to the extent the breach resulted from the reliance, unless by so acting the trust director engages in willful misconduct.

SECTION 11. NO DUTY TO MONITOR, INFORM, OR ADVISE.

(a) Unless the terms of a trust provide otherwise:

(1) a trustee does not have a duty to:

(A) monitor a trust director; or

(B) inform or give advice to a settlor, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director; and

(2) by taking an action described in paragraph (1), a trustee does not assume the duty excluded by paragraph (1).

(b) Unless the terms of a trust provide otherwise:

(1) a trust director does not have a duty to:

(A) monitor a trustee or another trust director; or

(B) inform or give advice to a settlor, beneficiary, trustee, or another trust director concerning an instance in which the director might have acted differently than a trustee or another trust director; and

(2) by taking an action described in paragraph (1), a trust director does not assume the duty excluded by paragraph (1).

SECTION 12. APPLICATION TO COTRUSTEE. The terms of a trust may relieve a cotrustee from duty and liability with respect to another cotrustee's exercise or nonexercise of a power of the other cotrustee to the same extent that in a directed trust a directed trustee is relieved from duty and liability with respect to a trust director's power of direction under Sections 9 through 11.

Legislative Note: *A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 703(c) or (g) should revise those sections to make them subject to this section. In the alternative, the state could insert this section as a new subsection in Section 703, and make subsections (c) and (g) subject to that new subsection if the state also adds to its Uniform Trust Code the definitions of "directed trustee," "power of direction," and "trust director" from Section 2(3), (5), and (9).*

SECTION 13. LIMITATION OF ACTION AGAINST TRUST DIRECTOR.

(a) An action against a trust director for breach of trust must be commenced within the same limitation period as[under Uniform Trust Code Section 1005] for an action for breach of trust against a trustee in a like position and under similar circumstances.

(b) A report or accounting has the same effect on the limitation period for an action against a trust director for breach of trust that the report or accounting would have[under Uniform Trust Code Section 1005] in an action for breach of trust against a trustee in a like position and under similar circumstances.

Legislative Note: *A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 1005 should update the bracketed language to refer to that enactment. A state that has enacted a statute other than Uniform Trust Code Section 1005 to govern limitation of an action against a trustee should replace the bracketed language with a cross reference to that statute. A state that has not enacted a statutory limitation should delete the bracketed language.*

SECTION 14. DEFENSES IN ACTION AGAINST TRUST DIRECTOR. In an action against a trust director for breach of trust, the director may assert the same defenses a trustee in a like position and under similar circumstances could assert in an action for breach of trust against the trustee.

SECTION 15. JURISDICTION OVER TRUST DIRECTOR.

(a) By accepting appointment as a trust director of a trust subject to this [act], the director submits to personal jurisdiction of the courts of this state regarding any matter related to a power or duty of the director.

(b) This section does not preclude other methods of obtaining jurisdiction over a trust director.

SECTION 16. OFFICE OF TRUST DIRECTOR. Unless the terms of a trust provide otherwise, the rules applicable to a trustee apply to a trust director regarding the following matters:

(1) acceptance[under Uniform Trust Code Section 701];

(2) giving of bond to secure performance[under Uniform Trust Code Section 702];

(3) reasonable compensation[under Uniform Trust Code Section 708];

(4) resignation[under Uniform Trust Code Section 705];

(5) removal[under Uniform Trust Code Section 706]; and

(6) vacancy and appointment of successor[under Uniform Trust Code Section 704].

Legislative Note: *A state that has enacted the Uniform Trust Code (Last Revised or Amended in 2010) provisions cited in this section should update the bracketed language to refer to the appropriate provisions of that enactment. A state that has enacted relevant statutory provisions other than the provisions of the Uniform Trust Code cited in this section should replace the bracketed language with cross references to those provisions, except that a state that allows statutory commissions rather than reasonable compensation for a trustee is advised for the reasons given in the comments below to apply a rule of reasonable compensation to a trust director. A state that has not enacted relevant statutory provisions should delete the bracketed language.*

SECTION 17. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this uniform act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

SECTION 18. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT. This [act] modifies, limits, or supersedes the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001 et seq., but does not modify, limit, or supersede Section 101(c) of that act, 15 U.S.C. Section 7001(c), or authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. Section 7003(b).

SECTION 19. REPEALS; CONFORMING AMENDMENTS.

(a) . . . .

(b) . . . .

(c) . . . .

SECTION 20. EFFECTIVE DATE. This [act] takes effect . . . .

APPENDIX 2:

TRUST DIRECTOR STATUS AS FIDUCIARY HAS TAX IMPLICATIONS

1. Estate tax inclusion and grantor trust status.

In the 1970s two cases dealing with the Goodwyn family established the principle that if a trust agreement prohibited the grantor from acting as de facto trustee the mere fact that the grantor did in fact act as de facto trustee would not established a retained interest under section 2036, Estate of Goodwyn, T. C. Memo. 1973-153, nor a power for the grantor trust provisions of sections 671ff, Estate of Goodwyn v. Commissioner, T.C. Memo. 1976-238. In the 1973 opinion the court stated:

> Under the terms of the deeds creating these trusts, the trustees were granted broad discretionary powers with respect to both the distribution of income to the beneficiaries and the investment and management of the corpus of the trusts. Notwithstanding the designation of Richards and Russell as trustees, it further appears that at all times from the establishment of the trusts until his last illness, the decedent exercised complete control with respect to the purchase and sale of trust assets, investment of any proceeds, and the determination of the amounts, if any, to be distributed to the respective beneficiaries.
>
> The assets of the various trusts, together with other trusts, as well as property owned by the decedent, were accounted for by a single set of records maintained in the offices of the decedent. Except for the Federal income tax returns prepared and filed by the decedent on behalf of the various trusts, no separate records were maintained showing the assets and income of any of these trusts.
>
> The respondent argues that the decedent should be treated as trustee, in fact, possessing such rights and powers as to cause the inclusion of the assets thereof in his gross estate, relying on sections 2033, 2036 (a)(2), and 2038. Section 2033 requires a finding that the decedent had an interest in the assets of the trusts at the time of his death. There is no basis for such a finding. Section 2038(a)(1) relates to "a power" exercisable by the decedent "to alter, amend, revoke, or terminate," the trusts.[4] No such power was reserved by the decedent. Accordingly, in the final analysis the respondent's position is predicated on the determination that by reason of the de facto control exercised by the decedent the trusts are includable in his estate pursuant to section 2036(a)(2).[5] It is clear that the powers granted to the trustees would, if reserved by the decedent, be such as to require the inclusion of the assets of the trusts in the estate of the decedent. *United States v. O'Malley* [66-1 USTC ¶ 12,388], 383 U.S. 627 (1966). Does the fact that the decedent was able to exercise such powers through the cooperation of unrelated trustees require a different result? The question thus presented for decision is whether the value of such trusts is includable in the estate of the decedent by reason of the de facto control over the trusts exercised by the decedent, notwithstanding that no power to exercise such control was reserved to or by the decedent once he resigned his duties as trustee of certain of these trusts.
>
> In the course of the trial of this case, and in his briefs, respondent made no secret of the fact that support for respondent's position was to come from the decision of the U.S. Supreme Court in the case of *United States v. Byrum* then pending on writ of certiorari from the U.S. Circuit Court of Appeals for the Sixth Circuit ([71-1 USTC ¶ 12,763] 440 F.2d 949). The Supreme Court has since rendered its decision in that case. [72-2 USTC ¶ 12,859] 408 U.S. 125 (1972). By that decision, the Supreme Court has rejected the

> position of the respondent in the instant case that the de facto exercise of control over the management and investment of the trust res is within the ambit of section 2036.
>
> In distinguishing *United States v. O'Malley, supra*, the Supreme Court in the *Byrum* case said:
>
> In our view, and for the purposes of this case, *O'Malley* adds nothing to the statute itself. The facts in that case were clearly within the ambit of what is now § 2036(a)(2). That section requires that the settlor must have "retained for his life * * * the *right* * * * to designate the persons who shall possess or enjoy the property or the income therefrom." *O'Malley* was covered precisely by the statute for two reasons: (1) there the settlor had reserved a legal right, set forth in the trust instrument; and (2) this right expressly authorized the settlor, "in conjunction" with others, to accumulate income and thereby "to designate" the persons to enjoy it.
>
> It must be conceded that *Byrum* reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in *O'Malley*. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.
>
> The right or power upon which the tax is predicated must thus be a legal right reserved in the trust instrument, or at least by some form of agreement between the trustees and the settlor. Admittedly, such a right did not exist in the case of the Richards and Russell Trusts. To hold otherwise would not only be contrary to the reasoning of the Supreme Court in the *Byrum* case but would present the insuperable problem of determining to what degree compliance on the part of unrelated trustees with the wishes of the grantor would be sufficient to constitute requisite control over the trust res within the meaning of section 2036.
>
> It would indeed be an unusual situation for a grantor to appoint trustees, whether corporate or otherwise, in the expectation that such trustees would, where given a choice, act contrary to the wishes and intent of the grantor. Notwithstanding that Richards and Russell permitted the decedent full discretion in the management of these trusts, as a matter of law the trustees were responsible and answerable for the decedent's acts on their behalf. See 2 Scott, Trusts 1388 (3d ed., 1967); 3 Scott, Trusts 1794 (3d ed., 1967). Had they so elected, Richards and Russell could have taken control of the trust res at any time. (footnotes omitted)

The 1977 opinion renders an identical holding, bolstered by certain legislative history:

> There is nothing in the record to show that the trustees could not have undertaken exclusive control of the trust res if they had elected to do so. Whatever power Goodwyn exercised over the trust assets, administration or distribution, he did so on the trustee's behalf and not in his own right.
>
> Because of Goodwyn's failure to have a legally enforceable right, we have already held, following *Byrum*, that the assets of these trusts were not includable in the decedent's estate under 2036(a)(2). Since a similar legal right or power is a prerequisite under section 674(a), consistency appears to require the same decision with respect to the applicability of this section. We see no other possible decision.
>
> Section 671 precludes attributing the income to Goodwyn on any other theory of dominion and control under the definition of gross income, including the *Clifford* doctrine. We interpret this limitation to mean that if Goodwyn cannot be

> considered as a trustee, in fact, under the statutory provisions of subpart E, he cannot be considered as such by virtue of the judicial doctrines arising from the *Clifford* case which Congress intended to limit through the enactment of subpart E. But the protection of section 671, as explained in the House Ways and Means Committee Report, cited *supra,* does not extend to situations involving the assignments of future income. (footnotes omitted)

With respect to the legislative history of the 1954 Code, the 1977 opinion states:

> While the record indicates that the legal formalities have been complied with, it also indicates that the designated "independent" trustees, whether by agreement or otherwise, entrusted the management of the trusts' assets and the distribution of income therefrom to the sole discretion of the decedent. The decedent kept all the records, made all of the investments and decided the amount to be distributed to beneficiaries. The trustees merely acquiesced in these actions.
>
> On the basis of these facts, the judicial decisions following the Supreme Court's decision in *Helvering v. Clifford* [40-1 USTC ¶ 9265], 309 U.S. 331 (1940), and the later so-called *Clifford* regulations might well warrant the attribution of the income from these trusts to the decedent. However, to the extent these previous principles are not embodied in the present statutory provisions of the Code, they must be considered no longer applicable. Section 671 provides that subpart E represents the sole criterion of dominion and control under section 61 (relating to the definition of gross income) and thereby also under the *Clifford* doctrine.
>
> The Report of the Committee on Ways and Means on the Internal Revenue Code of 1954 explains clearly that this exclusivity was the intent of Congress:
>
> It is also provided in this section [671] that no items of a trust shall be included in computing the income or credits of the grantor (or another person) solely on the grounds of his dominion and control over the trust under the provisions of section 61 (corresponding to sec. 22(a) of existing law). The effect of this provision is to insure that taxability of *Clifford* type trusts shall be governed solely by this subpart. However, this provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the trust. Thus, this subpart has no application in situations involving assignments of future income to the assignor, as in *Lucas v. Earl* [2 USTC ¶ 496] (281 U.S. 111), *Harrison v. Schaffner* [41-1 USTC ¶ 9355] (312 U.S. 579),and *Helvering v. Horst* [40-2 USTC ¶ 9787] (311 U.S. 112), whether or not the assignment is to a trust; nor are the rules as to family partnerships affected by this subpart.4
>
> Consequently, in order for a grantor to be held taxable pursuant to subpart E on the income of a trust which he has established, he must have one of the powers or retained interests proscribed by subpart E. (footnotes omitted)

So, that's where the law has stood for many years. Along comes a bad facts makes bad law case, that of <u>Securities and Exchange Commission v. Wyly</u>, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014). The issue there was whether certain trusts should be considered grantor trusts for income tax purposes, thus causing the grantors to owe income tax, or whether the trusts were properly considered to be offshore, managed by an Isle of Man trustee. The opinion states:

> Section 674(a) provides that: "[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party." Quoting a prominent tax treatise, defendants concede that the "power of disposition" includes "powers to 'effect such major changes in the enjoyment of a trust's income and corpus as the addition and

elimination of beneficiaries' as well as 'minor and customary power[s]' over income and corpus distribution." Because a non-beneficiary trustee is considered a non-adverse party under the statute, "[s]ection 674(a) captures virtually every trust, including the [IOM] trusts." Thus, defendants concede that "[u]ltimate liability under [s]ection 674[] … turns on whether any of the statutory exceptions apply." In his treatise, defendants' expert confirms that the Wylys' had a power of disposition under this statute. See Robert T. Danforth, Norman H. Lane, and Howard M. Zaritsky, Federal Income Taxation of Estates and Trusts §9.04[1] ("A right to use trust funds without adequate compensation also affects beneficial enjoyment, because the holder can reduce the assets from which the named beneficiaries can benefit. Thus, a grantor's right to live rent-free in a house owned by the trust is a power of disposition under Section 674(a).").

According to defendants, the Bulldog Trusts are not grantor trusts because they fall under the section 674(c) exemption. Under that exemption, section 674(a) does not apply to "certain powers that are exercisable by independent trustees." According to the corresponding IRS regulation, which summarizes the statute, [t]he powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. To determine whether the Bulldog Trusts are covered by this exception, it is necessary to answer three questions: 1) Did the IOM trustees have the power to "distribute, apportion, or accumulate income" or "pay out corpus" to or for a beneficiary or beneficiaries?; 2) Were the IOM trustees a) the grantor, or b) a "related or subordinate" party as defined by the statute?; and 3) Were the trustees able to "exercis[e] [those powers] solely (without the approval or consent of any other person)"?

The first two questions are straightforward. First, the IOM trustees certainly had the power, as set out in the trust deeds, to "distribute, apportion, or accumulate income" or "pay out corpus" to or for a beneficiary. Second, the IOM trustees were neither the grantor, nor one of the individuals on the exclusive list of "related or subordinate" parties defined by the statute. The only remaining question is whether the IOM trustees were able to exercise those powers "solely" or "without the approval or consent of any other person."

Defendants argue, citing a 1976 Tax Court case, that a grantor may only be taxed on "a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes." As such, defendants contend that the Wylys did not share in the power to distribute, apportion, or allocate income, or to pay out corpus, because the trust deeds allocated those powers solely to the IOM trustees. Thus, the Bulldog Trusts fall within the shelter of 674(c)'s "independent trustees exception."

I disagree. "Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that 'tax law deals in economic realities, not legal abstractions.'" As Professor Robert Danforth, the defendants' own expert, writes in his treatise, "[i]t would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person." The Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their every order, and that is exactly what the trustees did.

The evidence amply shows that the IOM trustees followed every Wyly recommendation, whether it pertained to transactions in the Issuer securities, making unsecured loans to

> Wyly enterprises, or purchases of real estate, artwork, collectibles, and other personal items for the Wylys and their children. The trustees made no meaningful decisions about the trust income or corpus other than at the behest of the Wylys. On certain occasions, such as the establishment of the Bessie Trusts, the IOM trustees actively participated in fraudulent activity along with the Wylys. The Wylys freely directed the distribution of trust assets for personal purchases and personal use. Because the Wylys and their family members were beneficiaries, the IOM trustees were thus "distributing" income for a beneficiary at the direction of the grantors—the Wylys. (footnotes omitted)

The issue that arises after Wyly is what to do. The Goodwyn rule was clear, but if you believe Wyly then in many trusts we would likely discover that the grantor or beneficiaries were "pulling the strings" although they had no legal right to do so.

An additional consideration is what effect does a non-fiduciary holding a power to direct a trustee have for tax purposes. The Goodwyn holdings are based on a fiduciary having authority; if an advisor who is not a fiduciary can direct a trustee, and the trustee must follow the direction, then Goodwyn seems unlikely to protect the grantor, or potentially the beneficiary, whose advisor follows the grantor's advice regularly. Consider also a power of appointment held during the lifetime of the settlor; by definition, a power of appointment is a non-fiduciary power.

2. What Does Active Participation Mean in the Trust Context?

The application of the net investment income tax under section 1411 to trusts that own closely-held business interests is controversial, and there is considerable uncertainty how a fiduciary that owns interests in a closely-held business can materially participate and thereby avoid the imposition of the tax. In Mattie K. Carter Trust v. U.S., 256 F. Supp.2d 536 (N.D. Tex. 2003), the court held that in determining material participation for trusts the activities of the trust's fiduciaries, employees, and agents should be considered. The government argued that only the participation of the fiduciary ought to be considered but the court rejected that argument. In Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014), the Tax Court held that the trust qualified for the real estate professional exception under section 469(c)(7) (deemed material participation) because three of the six co-trustees were full time employees of the trust-wholly owned LLC that managed the rental properties. In addition, the Tax Court also considered the activities of co-trustees that had co-ownership interests in the entities held by the trust, reasoning that the interests of the co-trustees were not majority interests, were never greater than the trust's interests in the entities, and were compatible with the trust's goals.

Notwithstanding the foregoing, the IRS ruling position is that only the fiduciary's activities are relevant. The IRS ruling position is illustrated by TAM 201317010 which states:

> The focus on a trustee's activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] . . . are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An

> interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).

At issue in the TAM were the activities of "special trustees" who did the day-to-day operations and management of the companies in question but lacked any authority over the trust itself:

> The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

The need for a trustee to be active may affect the organization of business entities held in trust. For instance, a member-managed LLC may be more efficient than a manager-managed LLC unless a fiduciary is the manager.