



Legal Alert

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Should Your Estate Plan Incorporate the Concept of the Trust Protector?

... and ...

What Really is the Job of the Trust Protector?

Effective January 1, 2009, Arizona finally joined¹ with the now 25 other states in adopting some form of the Uniform Trust Code. One of the UTC's more intriguing provisions is the introduction of the concept of a Trust Protector. The Trust Protector is not the settlor or creator of the trust, its trustee or a beneficiary. The Trust Protector can be granted broad powers to remove the trustee, materially change the distribution scheme, modify the trust instrument unilaterally to achieve favorable tax treatment or respond to changes in the tax law, and change the situs of the trust. Despite such powers, the Trust Protector is not generally considered to be a "fiduciary" and, thus, has no fiduciary responsibilities to anyone.

Settlors generally like the idea that they can control trusts "from the grave" by placing a trusted confidant to act like The Godfather over the trust, trustee and the beneficiaries. However, the law is quite unsettled on exactly what is the liability and role of a Trust Protector, or what it should be, and for whom he is really "protector."

The concept of the Trust Protector – which was a mainstay of off-shore asset protection trusts – emanates from the belief that having an independent third party adds an additional layer of both protection and flexibility for the trust. Some state statutes have so broadly defined the Trust Protector's powers that they are whatever the governing instrument says they are. A.R.S §14-10818 grants the settlor unbridled authority in defining the powers of the Trust Protector. The statute expressly states that the list of permitted powers "may include the following," suggesting that, except to the extent a power is expressly statutorily denied to a Trust Protector, the "sky is the limit."

¹ In 2003, Arizona became one of the first states to pass a version of the UTC. However, its provisions were roundly criticized for, among other things, requiring notification to children of the provisions of their parent's revocable trusts. As a result, Arizona repealed the UTC before it became effective. After extensive revisions, it was finally enacted into law in 2008.

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The Arizona statute does impose some limits on the powers that can be exercised by a Trust Protector, unless expressly authorized by the governing instrument. For instance, a Trust Protector (absent express authorization in the governing instrument to do so) could not grant a beneficial interest to an individual or a class of individuals unless the individual or class is specifically provided for under the trust instrument. In addition, a Trust Protector cannot modify the beneficial interest of a governmental unit in a special needs trust. A.R.S §14-10818(C).

A.R.S §14-10818 also enshrines the notion that the Trust Protector is not deemed to be a fiduciary, unless the settlor wants him to be so treated:

D. Any provision of this title to the contrary, but except to the extent otherwise provided by the trust instrument, a trust protector is not a trustee or fiduciary and is not liable or accountable as a trustee or fiduciary because of an act or omission of the trust protector when performing or failing to perform the duties of a trust protector under the trust instrument. This subsection does not apply to trusts that become irrevocable before January 1, 2009 if the trust instrument allows the settlor to remove and replace the trust protector.

Having created this watchdog of sorts, who is to watch the watchdog? There is nothing in the statute that makes the Trust Protector answerable to the settlor, if he or she is still alive. And, it is clear that the Trust Protector is not answerable to the trustee, since he or she may have the unbridled ability to replace the trustee – with or without cause. Neither would the Trust Protector be answerable to the beneficiaries since, as noted, he or she can change beneficiaries and their distributive share if given the power in the governing instrument to do so.

The Arizona statute, as is the case with other state statutes, implies that a settlor would reserve the right to remove the Trust Protector. However, the IRS has, in the past, taken the position that the unrestricted right of a settlor to remove and replace a trustee was tantamount to reserving the right to control the use, disposition and enjoyment of the assets of the trust and, thus, cause inclusion of the trust assets in the estate of the settlor for federal estate tax purposes. This is expressly proscribed where the trustee has broad discretion over who can and cannot receive trust assets. See Treas. Regs. §20.2038-1(a)(3). If the Trust Protector is given such broad powers and the settlor has the unrestricted right to remove and replace the Trust Protector (with himself), there is the specter of inclusion of the trust in the settlor's estate under Section 2038.

Because there is no case law in Arizona (and little in other jurisdictions) concerning what actually is the job of the Trust Protector, clients might wish to proceed with caution when incorporating trust protector provisions into a trust agreement. Clients need to know not only what the relevant law allows, but give serious thought to whether the powers to be granted to, or withheld from, the Trust Protector should be set forth in great detail, including the standard of care to be imposed on the Trust Protector. While such an exercise might seem tedious, it will not only provide invaluable guidance to the Trust Protector, it will likely limit the possibility of future litigation.

If you would like to discuss the concept of the Trust Protector as a component of your estate plan, or to discuss any of your estate planning needs, please feel free to contact me.