

# TRUST PROTECTORS

Southern Arizona Estate Planning Council

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## 1. INTRODUCTION

- 1.1 The appointment of trust protectors in revocable and irrevocable trusts has become more routine. Estate planners and professional advisors sometimes recommend that their clients consider the appointment of a trust protector, however few clients appreciate the legal and tax implications that can result once a trust protector exercises authority. The discussion that follows will examine the following:
  - 1.1.1 What is a Trust Protector: Historic and legal underpinnings of third party decision makers in the United States and how this history has shaped the nature and role of trust protectors;
  - 1.1.2 What is the law: Arizona statutes address trust protectors, and differentiate these actors from third-party decision makers who hold the power to direct the trustee. Case law is developing as more states enact laws that apply to trust protectors and define their authority;
  - 1.1.3 Powers granted to Trust Protectors: The terms of a trust can grant the trust protector a range of powers and may also specify whether the trust protector will be presumed to be a fiduciary. Trust Protector powers can either be categorized as “Powers of Direction” or “Powers of Protection”;
  - 1.1.4 Triggers for including a Trust Protector: The trust purpose will help inform settlors and their attorneys what powers are necessary and potentially advantageous to provide to a trust protector. A trust protector’s role, and the nature of the trust protector’s authority, will be shaped by the terms of the trust instrument;
  - 1.1.5 Recommendations for drafting (and reviewing) Trust Protector Provisions: Clear definitions, plans for appointment, removal, resignation and succession guide both trust protectors, and trustees;
  - 1.1.6 Comparing a Trust Protector’s Power to Amend or Restate with a Trustee’s Power to Appoint: Comparison of the different tax consequences.
- 1.2 In addition to the footnotes provided, the attached appendix provides a helpful list of references and includes statutes, case law and sample trust protector language.

## 2. WHAT IS A TRUST PROTECTOR?

### 2.1 *What's in a Name?*

2.1.1 The title “trust protector” can be misleading. Trust protectors are third-party actors who have authority to make decisions relating to the administration of a trust.

2.1.1.1 One should not assume that the use of the terminology “trust protector” for a third-party decision maker is to protect the trust or the trust beneficiaries. Instead this third party will often function as a quasi-settlor, interpreting trust provisions, ensuring the trust complies with the settlor’s intent, or as a judge, to privately resolve disputes between beneficiaries and the trustee.

2.1.1.2 Some practitioners use the term trust protector, others use trustee consultant; the new Uniform Act uses the term trust director.<sup>1</sup> The Uniform Act’s definition of a “trust director” refers to a person other than a serving trustee that is granted a power of direction by the terms of a trust. Such a person is defined as a trust director even if the terms of the trust or the parties call the person a “trust adviser” or “trust protector” or otherwise purport to disclaim trust director status.

2.1.2 No responsibilities or administrative powers are inherent in the term “trust protector,” “trustee consultant,” or “trust director.” In contrast, the term “trustee” carries with it an independent definition, and a general understanding of the legal role (and fiduciary responsibilities) that apply to the trustee throughout the administration of the trust.

2.1.2.1 Some practitioners treat trust protectors similarly to trustees and draft trusts naming the trust protector without providing any description of the role that actor is to serve in, or the powers that that actor may exert. This can be particularly problematic, especially when people assume a trust protector is empowered to protect the trust, trust beneficiaries, or even that a trust protector is inherently empowered to direct the trust’s investments.

2.1.2.2 *A.R.S. §14-10818* and the *In re Stevens Living Trust*<sup>2</sup> case provide that the powers granted to a trust protector can be tremendously broad, and may appear unlimited. However, the same statute and the *McLean*<sup>3</sup> case suggest that a trust protector will only have those powers actually granted in the trust instrument.

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<sup>1</sup> Uniform Directed Trust Act Sec.2(9), approved by the Nat’l Conference of Uniform State Laws on July 19, 2017.

<sup>2</sup> 2015 WL 675429 (La. Ct. App.)

<sup>3</sup> *Robert T. McLean Irrevocable Trust v. Ponder*, 418 S.W.3d 482 (Mo. Ct. App. 2013), *reh’g and/or transfer denied* (Nov. 15, 2013), *transfer denied* (Feb. 25, 2014).

2.1.3 Defining the role of trust protector: the term “trust protector” really just means any actor, other than the settlor, trustee, or beneficiary, who is authorized by the terms of the trust instrument to manage, oversee and/or exercise authority with respect to the administration of a trust.

2.1.3.1 The extension, or elimination, of the rule against perpetuities has led to a tendency of some drafting attorneys to include trust protectors in every trust, whether revocable or irrevocable. However, rarely do settlors weight the benefits of a trust protector with the potential administrative complexity and expense that a trust protector may create. For this reason, careful attention must be given to what powers are provided to trust protectors and how the exercise of these powers may impact the settlor, the beneficiaries, the trustee, and the trust protector.

2.1.4 The Uniform Trust Code (UTC) makes reference to trust protectors in the comments to Section 808(b), which states that a settlor may authorize a third party to oversee the trustees or make certain decisions about the management or distribution of trust assets. The comment to Section 808(b) states that “[s]ubsections (b)- (d) ratify the use of trust protectors and trust advisors.”

## 2.2 *The Development of the Office of Trust Protector.*

2.2.1 *Early Domestic Use.* Prior to the current proliferation of the use of third-party decision makers in trusts, U.S. case law focused on third-party trust advisors who were appointed to “advise” the trustee with regard to investments, distributions, or other duties inherent in acting as a trustee. In these cases, the advisor was determined to be a bifurcation of the office of trustee, and the “advisor” was invariably deemed to be a fiduciary to the same extent as the trustee.

2.2.2 *Foreign Asset Protection Trusts.* When setting up offshore asset protection trusts in unknown foreign countries, settlors were reluctant to give up all control over their assets to a foreign trustee in a jurisdiction that could make life difficult not only for their creditors but also for them. Consequently, settlors relied on trust protectors to safeguard their interests against wrongdoing or undue control by foreign trustees or governments.

2.2.3 *Domestic Asset Protection Trust.* Although these trusts avoided the complications of setting up an asset protection trust in foreign jurisdictions, many of these statutes specifically included a provision for the appointment of third- party decision makers, referred to as advisers or trust protectors, so as to adopt the same structures already being used by settlors in foreign jurisdiction.

2.2.4 *Forever is a Long Time.* With the extension, or outright elimination, of the Rule Against Perpetuities, trust protectors were seen as a useful tool to:

(i) ensure that a long-term trust continued to satisfy the settlor's objectives as circumstances changed over the years, either with respect to the economy, the family situation, or changing tax or trust law; (ii) ensure local and more personal control over trust administration in cases of the growth, merger, or change in culture of corporate trustees; (iii) encourage privacy and cost efficiency for matters that would otherwise require court involvement.

### 3. ARIZONA STATUTES RELATED TO TRUST PROTECTORS AND DIRECTORS.

3.1 Like many states, Arizona has adopted the UTC, however Arizona only one of nine states who have adopted a form of UTC Section 808: Powers to Direct, *see A.R.S. §14-10808*. Arizona also enacted a separate, more comprehensive statute governing trust protectors, *A.R.S. §14-10818*. When considering the role of a trust protector in Arizona it is imperative to review both *A.R.S. §14-10808*, and *A.R.S. §14-10818*

3.2 *Arizona Trust Protector Statute A.R.S. §14-10818*

3.2.1 Under *A.R.S. §14-10818*, A trust protector is defined as anyone named in a trust instrument with powers similar to a power to (i) remove and appoint a trustee; (ii) modify or amend the trust instrument for any "valid purpose or reason;" (iii) modify or restrict the interests of any beneficiary of the trust; (iv) modify the terms of a power of appointment granted by the trust; or (v) change the applicable law governing the trust.

3.2.2 Except to the extent otherwise provided by the trust instrument, a trust protector under *A.R.S. §14-10818* is **not** "a trustee or a fiduciary and is not liable as a trustee or fiduciary due to his, her, or its actions or omissions when performing or failing to perform the duties of the trust protector under the trust instrument." Arizona's statute specifically restricts a trust protector from: (i) adding a new individual beneficiary or class of beneficiaries who are provided for under the original trust instrument; or (ii) modifying the beneficial interest of a government unit in a special needs trust.

3.2.3 *A.R.S. §14-10818(D)* creates an exception to the rule that unless provided in the terms of the trust, a trust protector is not a fiduciary. For Trusts, which became irrevocable *before* January 1, 2009, where the grantor reserved the power to remove and replace the trust protector, the statute provides that the trust protector **MAY** be a fiduciary.

3.2.4 Finally, under *A.R.S. §14-10818(E)* a trust protector's exercise of powers is the exercise of a special power of appointment. This provision was included because a special power of appointment is a "personal" power that is generally not subject to review by a court.

3.2.5 While a trust protector under *A.R.S. §14-10818* is absolved of fiduciary duty unless the terms of the trust state otherwise, a trust protector could still be

liable for breach of duty if the trust terms specify a standard of care that the Trust Protector fails to meet when exercising powers granted through the trust.

- 3.3 *Arizona Revised Statutes §14-10808: Powers to Direct.*
- 3.3.1 While a trust is revocable, the trustee may follow a direction of the settlor that is contrary to the terms of the trust.
- 3.3.2 If the trust provides that the assets in the trust are subject to the direction of the settlor or a co-trustee, beneficiary or third party, the trustee has no duty to review the directions provided (e.g. directed) by the settlor or co-trustee, nor does the trustee have to notify the beneficiaries regarding any investment action taken pursuant to the direction. The trustee is not responsible for the purchase, monitoring, retention or sale of assets that are subject to the direction of the settlor or a co-trustee, beneficiary or third party. The trustee is not subject to liability if the trustee acts pursuant to the direction, even if the actions constitute a breach of fiduciary duty, unless the trustee acts in bad faith or with reckless indifference.
- 3.3.3 The terms of a trust may confer on a trustee or other person a power to direct the modification or termination of the trust.
- 3.3.4 **Unless the trust instrument provides otherwise**, a person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty.
- 3.4 Other than with regard to a third party authorized to “direct” the trustee, neither *A.R.S. §14-10808* nor *§14-10818* makes a distinction between a trust protector having powers inherently similar to those exercised by a trustee in carrying out the trustee’s typical duties of administering the trust, and those powers of a trust protector that are not usually within the gamut of the trustee’s typical duties.
- 3.5 Under *A.R.S. §14-10105(B)(2)* and *(3)*; *§14-10703*; and *§14-10801* the trust instrument eliminates all Trustee liability except the duty of good faith, that the trustee must not act with reckless indifference. However, if a trust instrument relieves a trustee of liability for breach of trust, then that clause is unenforceable to the extent the provision either: (1) was inserted as a result of “an abuse by the trustee of a fiduciary or confidential relationship to the settlor,” or (2) “relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries.” For trusts created or amended after 2008, the burden is on the trustee to prove that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor (*A.R.S. §14-11008*).
- 3.6 Under *A.R.S. §14-10818*, a trust protector has no fiduciary liability except to the extent provided otherwise in the trust instrument. However, under *A.R.S. §14-*

10808, a third party who can direct investments of a trust is deemed to be liable as a trustee (i.e. fiduciary duty standard applies) unless the terms of the trust instrument provide otherwise.

3.6.1 The terms of the trust, rather than statutory provisions contained in the Arizona Revised Statutes, define the various third-party actors (e.g. Trustee, Trust Protector, Investment Director), and whether or not an actor's role is well-defined in the trust instrument will make a difference.

3.6.1 Thoughtful drafting, will clearly define a trust protector's power and duties. The terms of the trust will dictate the fiduciary standard (and exposure to liability) that a trust protector will face under *A.R.S. §14-10818* and *A.R.S. §14-10808*. When the terms of the trust instrument are silent as to the standard of care that applies to the powers exercised by the trust protector, Arizona law suggests that a trust protector will only be held to a fiduciary standard when he or she directs the investments of a trust.

#### 4. **POWERS GRANTED TO TRUST PROTECTORS**

4.1 The powers that govern trustees and trust protectors will differ. While a settlor and his or her attorney may prefer to include broad, expansive provisions that govern the authority of a trustee, there is no requirement that the powers of a trust protector be as broad. In fact, providing broad powers to a trust protector may create more harm than good.

4.2 *Broad Powers are Possible, but They will be Strictly Interpreted.*

4.2.1 In the *In re Stevens Living Trust*<sup>4</sup> case, the court determined that the terms of a trust appointing a trust protector with the powers expressed in the trust instrument will be given affect unless they are contrary to public policy. Very few state statutes limit the possible power that may be granted to trust protectors. For example, Rhode Island limits the powers that can be given to a trust director to the power to remove and replace the trustee or trust advisors and the power to direct, consent to or veto trust distributions. *A.R.S. §14-10818* provides an illustrative list of potential powers but contains no limitations on other possible powers.

4.2.2 While broad powers are possible, the case of *Schwartz v. Wellin*<sup>5</sup> clarifies that the courts are not likely to impute powers to the trust protector beyond those actually granted under the trust instrument.

4.2.2.1 Keith Wellin created the Wellin Family 2009 Revocable Trust, a grantor dynasty trust for the benefit of his three children and their respective lineal descendants. His children and the South Dakota Trust Company were appointed the Trustees. The Trust provided for

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<sup>4</sup> 2015 WL 675429 (La. Ct. App.)

<sup>5</sup> 2014 WL 1572767 (D.S.C., Apr. 17, 2014).

the appointment of a trust protector and gave the trust protector the power to amend the Trust “with regard to how the beneficiaries will benefit from the trust, and to amend the trust administrative provisions.” It further provided that the trust protector may “release, renounce, suspend, or modify to a lesser extent any or all powers and discretions conferred under this instrument.” After creating this Trust, the settlor sold his interest in the Friendship Partners LP to the Trust, taking back a promissory note for \$50 Million. In 2013 a dispute arose between the settlor and his children, when his daughter, as manager of the LLC that was the general partner of the FLP, proposed to sell all of the assets of the FLP, liquidate the FLP, set aside \$50 Million to pay the promissory note and distribute the remaining \$95 Million to the three children. The trustees believed the sale of the FLP was justified to avoid a \$40 Million income tax liability that would be incurred when the settlor turned off the Trust’s grantor trust status. In order to prevent the sale and liquidation, the trust protector amended the Trust to give the trust protector “the power to represent the Trust with respect to any litigation brought by or against the Trust if any Trustee is a party to such litigation”, and “to prosecute or defend such litigation for the protection of trust assets.” The trust protector then filed suit against the three children individually and as trustees of the Trust. The Court found that although the amendment of the administrative provisions of the Trust were within the scope of the trust protector’s powers granted in the trust instrument, the trust protector’s amendment added an entirely new provision to the Trust that purported to expand his powers over the Trust. The Court determined that the new authority granted to the trust protector in his trust amendment exceeded the express authority given to the trust protector in the Trust, and therefore was invalid. The trustees of the trust then removed the trust protector (as they were authorized to do), but did not appoint a new trust protector. Four days after being removed, the purportedly removed trust protector executed a document removing the trustees (as the acting trust protector was authorized to do) and appointed a successor trustee. The case found its way back to court, and the Court ruled that because the trust instrument provided that a trust protector must be appointed at all times, the initial trust protector remained the acting trust protector of the Trust until the appointment of his successor and thus the removal of the trustees and appointment of a successor trustee was valid.

4.2.2.2 In its rulings, the Court enforced a literal and exact reading of the trust instrument in determining the authority of the trust protector and refused to recognize the existence of even an implied power in trust protectors to sue to enforce the express powers given to the trust protector in a trust instrument.

4.2.3 Likewise, in the case of *Minassian v. Rachins*<sup>6</sup> that Court carefully examined the trust protector provisions in the trust instrument, which included the power to modify or amend the trust provisions to “correct a drafting error that defeats my intent, as determined by the Trust Protector in its sole and absolute discretion, following the guidelines provided in this Agreement.” The court concluded that the trust protector’s amendments were consistent with the provisions of the trust instrument and were made to effectuate the settlor’s intent and were within his authority granted in the trust instrument.

4.2.4 The provisions of the trust instrument control the authority of the trust protector and all elements in dealing with the trust protector, including the manner in which the trust protector is removed. The *Wellin* and *Minassian* decisions illustrate that, whenever a trust protector is appointed to carry out the settlor’s intentions, the trust instrument should specifically include the scope of the power desired.

## 5. CATEGORIES OF TRUST PROTECTOR POWERS.

5.1 Trust protector powers fall into three different categories: Inherent Trustee Powers (Type 1), Powers that Could be Reserved to a Settler or Beneficiary Without Adverse Tax Consequences (Type 2), or Powers that Cannot be Given to a Beneficiary, or a Trustee, or Reserved by a Settler for Tax or Other Reasons (Type 3).

5.2 *Inherent Trustee Powers (Type 1 Powers).*

5.2.1 Powers granted in order to bifurcate the administration of the trust between the trustee and a third party, like a trust protector or a trust director must be well defined. The trust director or trust protector may be responsible for overseeing a certain aspect of the administration of the trust by the trustee. The administration of a trust by a trustee involves management and investment of the trust assets and decision making related to distributions of trust property. Practically speaking, it is important to remember that although the terms of the trust instrument bifurcate the powers of trustees and third parties, the powers that are exercised by one party can (and usually do) effect the entire trust administration and all the actors involved.

5.2.2 Examples:

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<sup>6</sup> 2014 WL 6775269 (Fla. Dist. Ct. App. Dec. 3, 2014).

- 5.2.2.1 *Advise or oversee the exercise of a discretionary distribution powers* – Provides: (i) flexibility to allow settlor to act as trustee of irrevocable trusts with multiple current beneficiaries, an alternative to distribution committees when the stability and certainty of a corporate trustee is desired; and (ii) a sounding board or check on “friendly” trustees;
  - 5.2.2.2 *Make or veto the allocation of sale proceeds to income* – Provides a neutral party to make a decision that necessarily implicates the trustee’s duty of loyalty;
  - 5.2.2.3 *Make, veto, or direct investment decisions* – Allows a long-term investment advisor to continue to invest trust assets;
  - 5.2.2.4 *Consent to or supervise the actions of the trustee* – Can provide guidance to an inexperienced trustee or humanity to a large corporate trustee;
  - 5.2.2.5 *Act as a tie-breaker when co-trustees are deadlocked* – An alternative dispute resolution device by someone with special insight, knowledge or experience;
  - 5.2.2.6 *Manage a business interest owned by the trust* – Allows specialized assets to be managed by someone with special insight, knowledge or experience; and
  - 5.2.2.7 *Vote the shares of stock owned by the trust* – Can allow the settlor to act as trustee of an irrevocable trust and allows specialized assets to be managed by someone with special insight, knowledge or experience.
- 5.2.3 In the absence of the appointment of a trust director or trust protector, each of these powers would otherwise be subsumed in the powers and duties of the trustee as part of serving as trustee. In such case, the trustee would be acting in a fiduciary capacity. However, under *A.R.S. §14-10818* and *§14-10808*, with a little drafting, the trust protector can exercise these same powers without owing any duty to the beneficiaries.
- 5.2.4 The terms of the trust document can structure the relationship between the trustee and the trust protector. The trustee may or may not be relieved of liability for following the directions of the trust protector on matters with the scope of the trust protector’s powers. *A.R.S. §14-10808* relieves the trustee from liability for following the directions of a third-party decision maker with regard to investment decisions, but the courts are not always so kind. Careful drafting may be able to protect the trustee from any duty to challenge the directions of a trust protector and any duty to warn the beneficiaries of the trust protector’s actions.
- 5.2.5 A settlor who wants to create a check and balance system between the trustee and trust protector can do this with careful drafting, however in practice,

lots of back and forth between these actors, may create an additional level of administrative work (and cost). For example: A trustee may be responsible for managing investments, and a trust protector may be responsible for oversight of the trustee. Does this arrangement mean that the trust protector is required to review accountings, confer with the trustee about the trustee's investment strategy, or review investment fees? In this arrangement, unless the terms of the trust dictate otherwise, it appears that both actors have some responsibility to stay informed about the same thing (investments), but only once actor (the trustee) has exposure to fiduciary liability.

5.2.6 Depending on how the powers of the trust protector are defined, consistent attention may be required by both the trustee and the trust protector. In these arrangements, some may argue that a trust protector should be compensated on the order of a trustee. What is reasonable compensation for a trust protector? Is it reasonable pay the same compensation to an actor who is shielded from liability?

5.2.7 Some settlors and beneficiaries may like the idea of a check and balance system in theory, but later find that the additional oversight (without the fiduciary obligation) is not worth the administrative cost.

### 5.3 *Powers that Could be Reserved to a Settler or Beneficiary Without Adverse Tax Consequences (Type 2 Powers).*

5.3.1 There are some powers that provide flexibility in long-term trusts and these administrative powers are not inherently part of the trustee's administrative duties. These powers do not relieve a trustee from the duty to perform its administrative functions, and therefore do not relieve the trustee of its liability for a failure to act. They are powers that one would generally not expect for a trust protector to incur any liability for exercising and are powers that generally could be granted to beneficiaries but may not be appropriate in all circumstances.

5.3.2 Examples:

5.3.2.1 *Approve trustee compensation* – Allows an independent party to judge reasonableness of trustee fees;

5.3.2.2 *Remove and replace the trustee* - Provides a mechanism for ensuring an appropriate or responsive Trustee;

5.3.2.3 *Change the governing law of the trust* – Allows trusts to access the more favorable laws of other jurisdictions related to creditor protection, trust modification, and other trust administration issues;

5.3.2.4 *Change the situs of the trust* – Provides a means for reducing the cost of administration of a trust by utilizing the law generally applicable to the trustee and obtaining state income tax efficiencies;

- 5.3.2.5 *Approve trustee accountings and release the trustee from liability with respect to those accountings* - Allows an independent party to judge reasonableness of trustee's actions;
- 5.3.2.6 *Exchange trust assets for assets of equal value* – Can allow for income tax efficiencies for tax basis adjustments and results in results in grantor trust status; and
- 5.3.2.7 *Advise the trustee as to matters concerning the beneficiary* – Can allow additional insight into a beneficiary's needs or character.
- 5.3.3 While these powers are ones that could be given to the beneficiary or in some cases reserved by the settlor, or given to the trustee without adverse tax issues, there may be circumstances in which it may not be prudent to give these powers to such persons. For example, a beneficiary may be considered too young to exercise a certain power, or a beneficiary of a discretionary trust having the power to remove and replace the trustee may exert too much control over that trustee, even if the new trustee must be non-related or subordinate party.
- 5.3.4 Administrative powers like these can have a profound impact on the administration of a trust and for this reason, appointing a trust protector who is a neutral third party, unrelated to the settlor, beneficiaries or trustee, is often desirable.
- 5.3.5 These types of powers are unlikely to require constant attention by the trust protector and are therefore typically compensated for on a case by case basis depending on the time and effort required to exercise the particular power(s).
- 5.4 *Powers that Cannot be Given to a Beneficiary, or a Trustee, or Reserved by a Settlor for Tax or Other Reasons (Type 3 Powers).*
  - 5.4.1 These types of powers add flexibility to long term trusts, promote privacy by offering solutions without the requirement of Court intervention, and ultimately reduce administrative costs to the trust.
  - 5.4.2 Examples:
    - 5.4.2.1 *Arbitrate disputes among beneficiaries or between beneficiaries and trustees* – Allows disputes to be settled in a private cost-efficient manner by someone (presumably a neutral party) with specialized knowledge.
    - 5.4.2.2 *Modify the trust instrument to change administrative provisions or modify the beneficial interests* – Provides flexibility to “fix” inappropriate trust provisions;
    - 5.4.2.3 *Interpret the terms of the trust instrument or provide instruction to the trustee as to the trustee's duties under certain circumstances* - Allows disputes to be settled in a private cost-efficient manner by

someone with specialized knowledge and provides flexibility to “fix” drafting ambiguities;

5.4.2.4 *Terminate a trust, including providing direction as to the distribution of trust assets on termination* – Provides a means for terminating unnecessary or uneconomic trusts;

5.4.2.5 *Remove and replace the trustee of a self-settled special needs trust created as an OBRA '93 Trust under 42 U.S.C. § 1396(d)(4)(A))* – Ensures that a beneficiary with special needs does not exercise power over the trustee causing the trust assets to be counted as an available asset;

5.4.2.6 *Add or remove beneficiaries of the trust and restrict or expand the beneficial interests of those beneficiaries* – Provides flexibility to long term trusts to account for changes in circumstances and relationships based upon current observations, ensures appropriate spendthrift, predator (divorce), and creditor provisions, and results in grantor trust status;

5.4.2.7 *Eliminate the retained grantor powers of the settlor or make a discretionary payment to the grantor to reimburse the grantor for payment of income tax liability associated with income earned on trust assets* – Provides a means for creating tax efficiencies and flexibility for changes in financial circumstances of beneficiaries and grantors;

5.4.2.8 *Consent to the exercise of a power of appointment by a beneficiary* – Creates flexibility in long terms trusts and provides guidance in exercising powers of appointment by inexperienced or spendthrift holders; and

5.4.2.9 *Enforce the trust by legal proceedings.*

5.4.3 Historically these powers were reserved by the Court since retention of these powers could cause estate tax inclusion if retained by the settlor, are simply unworkable or could cause loss of creditor protection if held by the beneficiary, or would be impossible to exercise by a trustee without violating the trustee’s duty of loyalty. The power to arbitrate disputes cannot be held by one of the parties to the dispute or by a party with a duty of loyalty to both disputing parties. Likewise, a trustee could never be expected to remove or replace themselves, add or remove a beneficiary (to whom it owes a duty of loyalty) or change the grantor trust status on a trust to cause the trust or the beneficiaries to pay the income tax liability associated with the trust’s income. However, a trust protector, without fiduciary duties, is able to act as an independent third-party decision maker, to ensure the orderly administration of the trust in accordance with the settlor’s intent

given changes in circumstances, changes in norms, drafting errors, and inevitable conflict.

5.4.4 These types of powers are also unlikely to require constant attention by the trust protector and are therefore most often compensated for on a case by case basis depending on the time and effort required for a particular exercise.

5.5 While Type 1 “Powers of Direction” powers may include a continuing duty on behalf of the trust protector to participate in the trust administration, Type 2 and Type 3 “Powers of Protection” should be interpreted as discretionary powers that do not require monitoring of the ongoing administration of the trust.

5.5.1 In the case of *Robert T. McLean Irrevocable Trust v. Ponder*<sup>7</sup> the Court was called upon to determine if a trust protector acting under a trust instrument that granted him the power to: (1) remove the trustee; (2) appoint a successor trustee; and (3) resign as trust protector, could be held liable for failing to remove a trustee. The Trust instrument described the role and duties of the Trust Protector as follows: “The ‘Trust Protector’ of such trust shall be [Ponder]. The Trust Protector’s authority hereunder is conferred in a fiduciary capacity and shall be so exercised, but the Trust Protector shall not be liable for any action taken in good faith.” In this case, the initial trustees of a Special Needs Trust resigned within the first couple of months after the Trust was created, and the trust protector appointed a successor trustee, who served for two years, before resigning. The trust protector then appointed another successor trustee and then resigned as trust protector. Suit was filed by the beneficiary’s mother who became a trustee after the third trustee resigned a year later. The petition alleged that the trust protector “breached his fiduciary duties to the beneficiary and acted in ‘bad faith’” by failing to monitor and prevent the trustee from making certain expenditures for the benefit of the beneficiary. The Court, on appeal, reiterated the holdings in the trial court’s directed verdict, recognizing that the trial court had “deferred to the language of the trust for direction in determining the duties of the trust protector,” and stated that the trust protector’s authority “is limited to the power to remove” and “under the terms of the trust agreement, the trust protector had no obligation to monitor the activities of the trustee.”

## 6. TRIGGERS FOR INCLUDING A TRUST PROTECTOR.

6.1 *When a Settlor Wants to Act as Trustee of an Irrevocable Trust:* Certain “grantor trust” powers are desirable to include in the terms of a trust, however these powers cannot be retained by the settlor without resulting in estate tax inclusion under IRC

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<sup>7</sup> 2013 WL 5761058 (October 24, 2013)

§2036(a). It is problematic to assign these powers to a trustee because the exercise of these powers could be a breach of fiduciary duty (duty or loyalty). For this reason, these are ideal powers to grant to a trust protector – a non-fiduciary, third-party actor, who will not be deemed to have a general powers of appointment over the trust.

6.1.1 Power to add beneficiaries.

6.1.2 Power to Exchange trust assets.

6.1.3 Power to make discretionary distributions between multiple current beneficiaries.

6.1.4 Power to exercise incidents of ownership over life insurance policies on the settlor's life.

6.1.5 Power to vote stock in closely held corporations.

6.2 *When the Settlor Wants Flexibility in Long Term Trusts:* Long term trusts, or perpetual trusts, are more common now that the rule against perpetuities has been repealed in many jurisdictions. Providing the trust protector the power to adjust dispositive and other provisions in the trust instrument can be useful as there are changes in the law that would potentially thwart the settlor's objectives and/or intent.

6.2.1 Power to amend the trust instrument to account for changes in law, financial circumstances, and social norms.

6.2.2 Power to adjust distributions to beneficiaries or grant powers of appointment.

6.3 *When the Settlor Wants Privacy:* Settlers who want to maximize privacy regarding the administration of a trust will find it useful to empower a trust protector to do things like settle disputes between the beneficiaries (or the beneficiaries and the trustee) or interpret terms of the trust instrument. Providing a trust protector with these types of powers will often increase efficiency, while decreasing costs that would otherwise be incurred in a trust administration where Court involvement would be required.

6.4 *When the Settlor wants to designate a corporate trustee to serve but wants distribution management, and/or investment decisions exercised by another individual (or group of individuals).*

6.4.1 In cases where a trust holds a special asset, like a closely-held business, a settlor may wish to appoint a trust protector who has specific expertise to manage the asset/investment rather than a family member or a corporate trustee. In this circumstance, the authority that the trust protector may have over the special asset/investment may include the power to direct/veto investment. In this case, the trust protector might have powers that would be similar to the powers of trustee, and for this reason, unless expressly exculpated by the terms of the trust instrument, the trust protector could be exposed, albeit narrowly, to fiduciary liability.

- 6.4.2 To allow for “easier” access to distributions include a power to make discretionary distributions for “best interests.”
- 6.5 *Anytime a Trust Protector is Included in a Trust Instrument, the Trust Protector Provisions Should Include:*
  - 6.5.1 Right to obtain trust information from the trustee;
  - 6.5.2 Power to enforce the trust protector's decisions/exercises;
  - 6.5.3 Right to be compensated for acting as trust protector;
  - 6.5.4 Right to be reimbursed for expenses incurred in acting as trust protector including reasonable attorney's fees;
  - 6.5.5 Right to be indemnified by trust assets if the trust protector is sued for acting within the scope of its duties; and
  - 6.5.6 Power to resign as trust protector.

## 7. **RECOMMENDATIONS FOR DRAFTING/REVIEWING TRUST PROTECTION PROVISIONS.**

- 7.1 *Clearly Defined Powers.* According to Arizona statute and U.S. case law, a trust protector will only have those powers expressly granted in the trust instrument. Do not rely on referring to *A.R.S. §14-10818*. Whatever powers are to be given to the trust protector should be very clearly set out in the trust instrument so that both the trust protector and the trustee know what is intended and expected.
  - 7.1.1 Some drafting attorneys like to include a provision that explicitly limits a trust protector's powers. For instance, the terms might state that the trust protector shall not participate in the exercise of a power or discretion conferred under this section that would cause the trust protector or trustee to possess a general power of appointment within the meaning of Sections 2041 and 2514 of the Internal Revenue Code.
- 7.2 *Clearly Defined the Capacity (i.e. fiduciary or non-fiduciary) in which the trust protector is acting, and the standard of care that applies.* Direction should be provided in the trust instrument as to who has the potential liability for carrying out the powers bestowed upon the trust protector. Some settlors may want to impose liability on the trust protector using the same standard of care that would apply to the trustee. Do the terms of the trust specifically require the trust protector to exercise powers in act in good faith? If the terms of the trust fail to set this standard, could a trust protector ever be liable for performing or failing to perform the powers described in the trust instrument?
  - 7.3.1 Some drafting attorneys even include a burden of proof in case a Court determines that certain duties exist despite the provisions or the trust or State law to the contrary.
- 7.4 *Clearly Defined Role of Trust Protector and Relationship to the Trustee.*

- 7.4.1 Carefully consider whether a power typically exercised by a trustee should be subject to any duties to the trustee or beneficiaries.
- 7.4.2 Include provisions directing the trustee regarding its responsibility/liability for implementing the trust protector's actions. Is a trustee relieved of all liability, or do they have a duty to inform the beneficiaries if the trust protector exercises its powers in a way that causes the trustee to violate its fiduciary duties? What happens if the trust protector fails to act when tasked with a power to direct or advise the trustee, or to approve trustee actions?
- 7.4.3 Include provisions regarding the communication of trust information and the exercise of the trust protector's powers between the trust protector and the trustee.
- 7.4.4 Consider a "Letter of Wishes" informing the trust protector of the settlor's intent with regard to trust investments and distributions.
- 7.5 *Include a plan for succession and appointment of alternate trust protectors in case of the death, incapacity, or resignation of the trust protector.*
  - 7.5.1 Consider the effect of who has the power to remove and/or fill vacancy in the office of trust protector.
  - 7.5.2 Consider what limitations should be placed on who may act as a trust protector.
- 7.6 *Select the applicable state law and restrict the power to change the applicable state law.* There is little consistency across state lines when comparing the state laws that govern trust protectors. For this reason, the terms of the trust should specifically identify the governing law applicable to the trust protector and consider under what circumstances (if any) would allow for the governing law to be changed.

## 8. **COMPARING A TRUST PROTECTOR'S POWER TO AMEND WITH DECANTING AND REFORMATION**

- 8.1 *Trust Protector's Power to Amend or Restate the Trust Instrument:*
  - 8.1.1 *Fiduciary or Non-Fiduciary.* In Arizona, trust protector is likely not a fiduciary and will be free to exercise its powers without regard to the duty of impartiality or loyalty to effectuate his/her/its discretion to implement the settlor's intent. However, the trust document should be very clear in this regard and the trust protector should not rely on the Arizona Statute.
  - 8.1.2 *Income Tax Consequences.*
    - 8.1.2.1 *Uncertainty over old EIN number for new trust.* PLR 200607015; PLR 200736002
      - 8.1.2.1.1 If the new or amended trust has substantially similar terms to the initial trust instrument, then no new EIN is required. What constitutes "substantially similar terms" is up to debate, but merely updating the administrative provisions and continuing the same

beneficiaries, the same standards for distribution, and the same timing for payments, would qualify.

8.1.2.1.2

If the second trust is treated as a new trust, the decanting may be treated as a distribution from the first trust to the second trust. §661 of the Code would permit the first trust to deduct the value of the distribution from its taxable income, and §662 of the Code would cause the second trust to realize that income. The trustee of the first trust would: (i) distribute all its assets to the trustee of the second trust; (ii) file a final return; and (iii) complete a Schedule K-1. The trustee of the second trust would: (i) receive all the assets of the first trust; (ii) apply for a new tax identification number; and (iii) file its first return. An advantage of this approach may be that the filing of the first trust's final return puts the IRS on notice of the decanting and termination of the first trust, which, in turn, begins tolling the statute of limitations on any arguments the IRS might raise about whether the decanting is a non-taxable event for income tax purposes.

8.1.2.1.3

If the second trust is treated as a continuation of the first trust, the assets of the first trust are retitled into the name of the second trust, the second trust continues to file returns under the tax identification number of the first trust, and the second trust reports the change of name, if any, on its next return. The advantage of this approach is simplicity. Moreover, this approach is consistent with PLR 200607015 and PLR 2007326002. In the latter, all the assets of one trust were to be divided and distributed into three successor trusts with substantially the same terms as the original trust. The IRS ruled, among other things, that for federal income tax purposes: (i) the successor trusts would be treated as a continuation of the original trusts; (ii) the transfer of assets would not be a distribution or termination under §661; and (iii) the transfer would not result in the realization of any income, gain or loss by the first trust, the successor trusts or any beneficiary of either of them.

- 8.1.2.1.4 The lack of clarity on this issue leaves practitioners with at least two options and little guidance.
- 8.1.2.2 Income Recognition. Is a trust modification a taxable event?
  - 8.1.2.2.1 Who is the grantor? If the new trust is merely a continuation of the old trust, the original grantor remains the grantor of the new trust
  - 8.1.2.2.2 If the new trust is merely a continuation of the old trust, then a transfer from one grantor trust to another grantor trust should have no income tax effect. *Rev. Rul.* 85-13, 1985-1 C.B. 184.; *Rev. Rul.* 2007-13, 2007-11 I.R.B. 684. A transfer from a Non-grantor trust to a grantor trust should have no income tax effect. *Rev. Rul.* 85-13 and 2007-13; *Chief Counsel Advice* 200923024.
  - 8.1.2.2.3 The basic rule under §1001 of the Code is that a taxpayer only realizes gain or loss when the taxpayer sells or disposes of property in exchange for property that is materially different. *Treasury Reg.* § 1.1001-1(a); *Cottage Savings v. Commissioner*, 499 U.S. 504 (1991) *Cottage Savings v. Commissioner* concluded that property is materially different if its owners have legal entitlements that differ in kind or extent. Thus, a distribution from one trust to another might be a taxable exchange of an interest in the old trust for an interest in the new trust if the two interests are significantly different. However, whether or not the new/amended trust instrument is considered a continuation of the old trust or a new trust, the exercise by the Trust Protector of his/her power to amend the trust instrument should not result in gain recognition under *Treasury. Reg.* § 1.1001-1(h), because the beneficial interests were always subject to the possibility of that power being exercised.
- 8.1.3 *Gift Tax Consequences.*
  - 8.1.3.1 The Gift Tax attaches to a transfer of property for less than full and adequate consideration in money or money's worth.
  - 8.1.3.2 *Gift by beneficiary-Reduction in beneficial interest.* Under the broad language of *Treas. Reg.* §25.2512-8 when a beneficiary consents to or acquiesces to a reduction in his/her beneficial interest, the beneficiary has arguably made a taxable gift. Similarly, *Rev. Rul.*

81-264, holds that a taxable gift can occur when a taxpayer allows legal rights to expire. Unless the trust instrument provides otherwise, a beneficiary would not be required to consent to a Trust Protector's exercise of his/her power to amend the trust and should not be requested to do so.

8.1.3.3 *Gift by Trust Protector.*

8.1.3.3.1 *Beneficiary Trust Protector.* If the trust protector can benefit himself or herself or his or her creditors, then the trust protector has a general power of appointment and the exercise is a taxable gift under §2514.

8.1.3.3.2 *Settlor Trust Protector.* If the grantor is the Trust protector, then a power to amend may cause the initial contribution to be an incomplete gift and the exercise of the power could result in either a completed gift or continuation of the incomplete gift.

8.1.3.3.3 If the beneficiary or grantor can remove and replace the trust protector and is not prohibited from appointing himself or herself, then they will likely be deemed to hold the powers of the trust protector. *Bynum 408 U.S. 125, 72-2 (S. Ct., 1972).*

8.1.3.3.4 Avoid these issues by including a requirement that Trust Protector must be independent under §672(c) of the Code.

8.1.4 *Estate Tax: §2036 or §2038 of the Code.*

8.1.4.1 *Beneficiary Trust Protector.* A power of amendment granted to a trust protector who is also a beneficiary will result in estate inclusion for the beneficiary unless the trust protector is prohibited from amending the dispositive provisions.

8.1.4.2 *Settlor Trustee.* A power of amendment granted to a trust protector who is also the settlor will cause estate tax inclusion under §2036 or §2038.

8.1.4.3 If the beneficiary or settlor can remove and replace the trustee protector and is not prohibited from appointing himself or herself, then they will be deemed to hold the powers of the trust protector. *Bynum 408 U.S. 125, 72-2 (S. Ct., 1972).*

8.1.4.4 These issues can be avoided by including a requirement that if the settlor or beneficiary is acting as trustee, then the trustee is prohibited from exercising the power under A.R.S §14-10819 and include ascertainable standards for distributions by trustees. Since

the trustee is a fiduciary, the trustee is not required to be “independent.”

8.1.5 *Generation Skipping Transfer Tax (“GST Tax”) Consequences.*

8.1.5.1 *Constructive Addition to Grandfathered Trusts.* The GST Tax does not apply to generation-skipping transfers under trusts that were irrevocable on September 25, 1985 (a “Grandfathered Trust”). Treasury Regulations § 26.2601-1(b)(4) provides guidance on whether a trust retains its “grandfathered” status when certain types of modification occur.

8.1.5.2 *Trustee Distributions.* Distribution of trust principal from an exempt trust to a new trust will not cause the new trust to be subject to the GST Tax if the terms of the new trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in the trust property beyond the later of: (i) 90 years; or (ii) 21 years after the death of the lives in being at the time the trust became irrevocable and if one of the following applies: 1. The terms of the governing instrument or state law authorized distributions to the new trust without the consent or approval of any beneficiary or court. *Treas. Reg. § 26.2601-1(b)(4)(i)(A).*

8.1.5.3 *Other Modifications.* Other modifications, whether made by judicial reformation or non-judicial reformation valid under state law, will likewise not affect the “grandfathered” status of a Grandfathered trust if: (i) the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (for GST Tax purposes) than the person who held the beneficial interest prior to the modification; and (ii) the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. *Treas. Reg. § 26.2601-1(b)(4)(i)(D).*

8.1.5.4 Examples under these Regulations include: change of trust situs, the merger of two grandfathered trusts where the merger does not shift any beneficial interests to a beneficiary occupying a lower generation and does not extend the time for vesting beyond the original trust period, and a “modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes)

8.2 *Trustee’s Power to Exercise Power to Appoint:*

8.2.1 When a trustee decants a trust, this exercise is deemed an exercise of a special power of appointment. Arizona’s decanting statute, *A.R.S. § 14-10819* provides that the trustee may appoint part or all of the trust estate to

another trust so long as the new trust: (i) does not reduce any non-discretionary income, annuity or unitrust distribution; (ii) is in favor of the beneficiaries of the initial trust; (iii) includes distribution standards at least as restrictive as the trust; (iv) does not “adversely” affect the tax treatment of the trust, the trustee, the settler, or the beneficiaries; and (v) does not violate the rule against perpetuities. The trustee may (but is never required to) seek court approval of the exercise. The trustee may exercise this power by restating the trust instrument.

8.2.2 *Fiduciary Duty*. Unlike a Trust Protector, a Trustee will be deemed to be a fiduciary and must exercise its powers consistent with its duty of impartiality, loyalty and utmost good faith and fair dealing.

8.2.3 *The IRS’ Position on Decanting* - Entering the land of the unknown:

8.2.3.1 *Rev. Proc. 2011-3* - The IRS placed decanting on its no-ruling list.

Section 5 of the *Rev. Proc.* provides a specific list of matters that it will not rule on including: (1) Decanting giving rise to a §661 deduction or inclusion in gross income under §662; (2) Decanting resulting in a taxable gift; and (3) Decanting causing the loss of GST exempt status or a taxable event under §2612 of the Code.

8.2.3.2 The IRS issued Notice 2011-101 (the “Notice”) requested comments from practitioners regarding the income, gift, estate and GST tax issues and consequences of a decanting that changes, terminates, or adds a beneficial interest in the second trust. The Notice then identifies thirteen facts and circumstances as potentially having tax consequences including where: (1) A beneficiary’s right to or interest in trust property is changed; (2) Trust beneficiaries are added; (3) Beneficial interests are added, deleted, or changed; (4) Assets are transferred from a grantor trust to a non-grantor trust or vice versa; (5) Beneficiaries of the first trust are required to consent or do consent even though consent is not required; (6) The identity of the transferor for gift and/or GST tax purposes changes; and (7) The first trust is a GST grandfathered trust or is exempt from GST tax.

8.2.3.3 Decanting was then put on the IRS’ 2011-2012 priority guidance plan but was later removed from the IRS’ 2012-2013 plan and omitted from the 2013- 2014 plan.

8.2.3.4 Current status: IRS is still working on these issues.

8.2.4 *Income Tax Consequences*. See 8.1.2 above.

8.2.5 *Gift Tax Consequences*.

8.2.5.1 The Gift Tax attaches to a transfer of property for less than full and adequate consideration in money or money’s worth.

8.2.5.2 Gift by beneficiary-Reduction in beneficial interest. A beneficiary is not required to consent to a Trustee's exercise under A.R.S. §14-10819 and should not be requested to consent.

8.2.5.3 Gift by Trustee.

8.2.5.3.1 Beneficiary Trustee. If the Trustee is also a beneficiary and can benefit himself or herself or can reduce his or her beneficial interest, then the Trustee may have a general power of appointment (the exercise of which is a taxable gift under §2514) or may make a gift by reducing his or her beneficial interest as described above.

8.2.5.3.2 Settlor Trustee. If the grantor is the trustee, then the power under A.R.S. §14-10819 may cause the initial contribution to be an incomplete gift and the exercise of the power could result in either a completed gift or continuation of the incomplete gift.

8.2.5.3.3 If the beneficiary or grantor can remove and replace the trustee and is not prohibited from appointing himself or herself, then they are deemed to hold the powers of the trustee. *Bynum 408 U.S. 125, 72-2 (S. Ct., 1972)*.

8.2.5.3.4 Avoid these issues by including a requirement that if the settlor or beneficiary is acting as trustee, then the trustee is prohibited from exercising the power under A.R.S. §14-10819 and include ascertainable standards for distributions by trustees. Since the trustee is a fiduciary, the trustee is not required to be "independent."

8.2.6 *Estate Tax §2036 or §2038 of the Code.*

8.2.6.1 *Beneficiary Trustee.* The power under A.R.S. §14-10819 should not result in estate inclusion for federal estate tax purposes unless: (i) the decanting results in the beneficiary making a gift; and (ii) the beneficiary's exercise was treated as an incomplete gift, then when the beneficiary dies the gift is complete and inclusion results under §2036 or §2038.

8.2.6.2 *Settlor Trustee.* If the power under A.R.S. §14-10819 results in the settlor's initial contribution to the trust being an incomplete gift, then upon the settlor's death the gift becomes complete and inclusion results under §2036 or §2038.

8.2.6.3 Again, if the beneficiary or grantor can remove and replace the Trustee and is not prohibited from appointing himself or herself,

then they are deemed to hold the powers of the trustee. *Bynum* 408 U.S. 125, 72-2 (S. Ct., 1972).

8.2.6.4 Again, these issues can be avoided by including a requirement that if the settlor or beneficiary is acting as trustee, then the trustee is prohibited from exercising the power under A.R.S §14-10819 and include ascertainable standards for distributions by trustees. Since the trustee is a fiduciary, the trustee is not required to be “independent.”

8.2.7 *Generation Skipping Tax Consequences.* See 8.1.4 above.

## 9. CONCLUSIONS:

- 9.1 The role of “trust protector” is often misunderstood because states, courts and scholars define this role differently. Case law is still developing, but court rulings and statutory provisions suggest that the terms of the trust instrument itself will govern the interpretations of the trust protector’s scope of authority and liability. As a result, the role of trust protector will vary depending on the terms of the trust.
- 9.2 A trust protector’s exposure to liability may be defined by the trust terms. In Arizona, unless the terms of the trust expressly state otherwise, a trust protector will not be considered a fiduciary or held to a fiduciary standard. One exception to this rule may be if the trust protector holds a power to direct pursuant to *A.R.S. §14-10808*. If the trust protector is given a duty to direct investments or take an action that would otherwise be the trustee’s responsibility, settlors may want to consider including a specific standard of care that applies to the trust protector.
- 9.3 A settlor may elect to use a trust protector, when the settlor wants the trust protector to have powers that beneficiaries, grantor(s) and or trustees cannot have without triggering tax or fiduciary implications, or when the settlor wants the trust protector to have powers of direction that will enable the trust protector to manage special assets that are outside the trustee’s level of expertise. It is important for settlors and drafting attorneys to have these circumstances in mind when selecting a trust protector and when drafting the powers may be exercised by the trust protector.
- 9.4 Good drafting makes all the difference. The terms that address the role of the trust protector and the powers that are provided will shape the interaction between the trust protector and the trustee, beneficiaries and others. Even in instances where the powers granted to the trust protector are broad, case law suggests that Courts rely on the terms of the trust to interpret these powers.
- 9.5 The terms of a trust may be changed by amending, restating or decanting the trust instrument. Depending on the terms of the trust, either a trustee or trust protector may be able to exercise this authority, without Court oversight. While this can be of tremendous benefit to settlors and beneficiaries alike, actors must be alert to unintended tax consequences.