

The Beneficiary Flexible Trust

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**Designing and Drafting Flexible Trusts;
Modification of Existing Trusts; Directed Trusts**

By

John F. Bergner¹

I. Introduction

A. In General.

1. This paper deals with the contrast between freedom and constraint in the specific context of trusts. By definition, the purpose of the trust arrangement is to limit freedom and impose constraints on the use and enjoyment of property. Just as a straightjacket limits a person's freedom of movement in order to protect him and others, a trust limits the way in which property is held, managed, and enjoyed in order to protect those who have an interest in the property from themselves or from others. Harm can result to a confined person if a straightjacket is either too tight or too loose; a skilled caregiver will know how to adjust the straightjacket to increase the confined person's comfort without unduly compromising safety. Likewise, a trust can produce sub-optimal results if its terms are too flexible or too inflexible; a skilled lawyer will know how to make the trust arrangement more or less flexible, will understand that increasing flexibility inevitably affects the degree to which the trust protects those who have an interest in the trust property, and will know how to balance flexibility and constraint to achieve the best results. This is the art of estate planning.

2. Practicing this art requires skill, experience, and judgment. Regardless of whether a client's net worth is large enough to present transfer tax concerns, the estate planner will need to address the tension between freedom and constraint in each case. The ability to resolve that tension in the best way for the client is part of the value that the capable estate planner brings to the table.

3. Estate planning documents should reflect a client's goals and objectives, balanced with considerations of the costs of preparing and implementing the estate plan. Clients are often provided with "off-the-shelf" estate planning documents without detailed customization to address their particular goals – especially documents prepared by attorneys who do not specialize in estate planning or prepared by individuals using an on-line service such as LegalZoom™. Unfortunately for many clients, it is generally easier and faster for the attorney to draft "standard" estate planning documents rather than documents that meet the client's particular needs.

4. Working together as members of the estate planning team, the client's financial consultant, accountant, estate planning attorney and other advisors can provide valuable advice to the client regarding provisions that the client should consider including in his estate planning documents. Each member of the team has the opportunity to demonstrate the "value added benefit" of his involvement in the estate planning process.

¹ Cheryl Cain Crabbe, Alan B. Jones, Stephanie Loomis-Price, Trisha J. English, and Jeffrey D. Chadwick, all of Winstead PC, and Benjamin G. Carter, of Texas Capital Bank, contributed to the preparation of this paper.

5. The need for flexibility in drafting estate planning documents is greater than ever before. Our clients are living longer and thus have a greater need for estate planning documents that provide for management of their assets in the event of incapacity. Tax laws are likely to continue changing as frequently as in the past two decades. While tax laws are often changed under the guise of "simplification," the result is often more complexity. Personal family circumstances are certain to change. Further, investments that are appropriate today may not make sense in the future.

6. Except in unusual cases, clients will not know what level of flexibility can be incorporated into their estate plans. Some clients will simply refuse to use trusts because they want to provide beneficiaries with complete flexibility over their assets; others will be more open to giving up some flexibility in order to achieve the significant benefits that a trust arrangement can offer. It is our responsibility to advise our clients about the available options so that they can achieve the balance between freedom and constraint that is appropriate to them.

B. A Preliminary Definition.

1. We begin with a definition of a trust. Most readers already know what a trust is, and this definition will not present any new information to them. However, reminding us of the technical definition of a trust and its elements will help sharpen the focus of this paper and illuminate the approach it takes in dealing with the issue of flexibility.

2. "A trust . . . is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of . . . one or more persons, at least one of whom is not the sole trustee."²

3. This definition implicitly recognizes that the trust is a relationship with respect to property that involves three parties:

- a. The settlor—the person who creates the trust;
- b. The trustee—the person who holds property in trust; and
- c. The beneficiary—the person for whose benefit the property is held in trust.³

4. It should come as no surprise that tinkering with one element of the relationship affects the other elements. Giving the trustee greater flexibility to make investments has consequences for the beneficiary. Giving the beneficiary the power to remove and replace the trustee has consequences for the way the trustee discharges its responsibilities.

C. Sources of Constraint. Limitations on the parties' freedom of action mainly derive from the following sources:

² Restatement (Third) of Trusts § 2 (2003).

³ *Id.* § 3.

1. **The Settlor's Wishes.** The first, and most important, source of constraint is the settlor's wishes, as manifested in the trust instrument. Modern law allows the settlor considerable leeway in designing a trust. For the most part, the trust instrument will order the relationship between the three parties and their relationship to the trust property and, with only limited exceptions, it will override common law and statutory law to the contrary.⁴ The trust instrument may be rigid and inflexible, so that the relationship can be altered little if at all. Conversely, the trust instrument may be more adaptable, permitting one or more of the parties greater flexibility in dealing with the trust property or altering the trust relationship.

2. **Common and Statutory Trust Law.** While the trust instrument is the most important source for the terms of the trust, there are some provisions of common and statutory trust law that the trust instrument may not override.⁵ For example, in Texas the trust instrument may not alter the Trust Code's limitations on the scope of an exculpatory clause⁶ or the trustee's common law duty to keep certain beneficiaries informed.⁷

3. **Tax Law.** In general, tax law does not dictate the terms of the trust relationship. Nevertheless, tax law influences those terms by granting favorable tax results or imposing adverse tax results, depending upon those terms. Even if tax law does not prohibit the creation of a trust from which the settlor may borrow without adequate interest or adequate security, the settlor will not create such a trust if he wants to avoid being taxed on the trust's income⁸ or having the trust's assets included in his estate.⁹

4. **Marital Property Law.** Like tax law, marital property law generally does not directly dictate the terms of a trust relationship. However, it can influence the way a trust is structured in a number of ways. Is the proposed trust estate the settlor's separate property or community property of the settlor and his spouse? Are distributions of income to a beneficiary his separate property or community property of the beneficiary and his spouse? Does the settlor's or beneficiary's divorce affect beneficial interests or fiduciary appointments in the trust? Does the beneficiary's spouse have any claim on the trust estate or the beneficiary's interest in the event of death or divorce? How does the existence of the trust affect the division of other property upon the beneficiary's divorce? All of these issues and others may influence the settlor when he is deciding on the terms of the trust.

5. **Creditors' Rights Law.** The rights of creditors in a trust estate or in a beneficiary's interest can also indirectly influence the terms of a trust. To use only the most obvious example, a settlor who anticipates facing creditor claims in the future may choose to create a self-settled trust in one

⁴ See, e.g., Tex. Trust Code § 111.0035.

⁵ Unif. Trust Code § 105(b) (setting forth 14 matters that a trust instrument cannot override); see, e.g., Tex. Trust Code § 111.0035(b), (c); Va. Code § 64.2-703(B).

⁶ Tex. Trust Code § 111.0035(b)(2).

⁷ Tex. Trust Code § 111.0035(c).

⁸ Internal Revenue Code of 1986 (hereinafter, "IRC") § 675(2).

⁹ IRC § 2036.

jurisdiction rather than another in order to take advantage of the ability to create a self-settled spendthrift trust.¹⁰ In such a case, the law governing creditors' rights essentially dictates the situs of the trust.

To the extent that state law is relevant to the issues discussed below, this paper will draw primarily upon Texas law to illustrate our points. This paper also references relevant provisions of the Uniform Trust Code, the Virginia Trust Code (codified in Title 64.2, Chapter 7 of the Virginia Code), and the Restatement Third, Trusts. However, because the law of trusts, marital property rights, and creditors' rights varies state by state, practitioners should consult the laws of their own states on each issue.

D. Approach. The topic of this paper, then, is flexibility: when and to what extent we can loosen or tighten the straightjacket represented by the trust instrument and give the parties to the trust relationship more or less freedom of action, and what are the consequences of doing so.

1. We begin with the recognition that flexibility, as a goal, has its limits. A few aspects of the trust relationship simply cannot be altered; hence, flexibility on those issues is impossible. Even where possible, flexibility may not be desirable. Too much flexibility may cause undesirable tax consequences or fail to achieve the settlor's goals regarding the protection of the trust property or the beneficiaries.

2. This paper approaches the topic by exploring the constraints that must or should be imposed on the three parties to the trust relationship—the settlor, the trustee, and the beneficiary—if we are to achieve the objectives of the trust.

3. We posit a trust, in which the goal is to give the greatest degree of flexibility to the beneficiary in the trust relationship. For lack of better terminology, we call this trust the "Beneficiary Flexible Trust." A sample trust instrument for such a trust is attached as **Exhibit 1**. In the body of this paper, bracketed numbers in bold font refer to numbered provisions of this sample trust instrument.

4. For this trust, we describe some of the more important constraints on giving the beneficiary the greatest degree of flexibility. Sometimes constraints arise from substantive trust law. At other times constraints arise from adverse tax consequences or from the need to protect the trust estate from the claims of spouses or creditors.

5. One of the most important constraints on the beneficiary's flexibility arises from the nature of a trust and the trustee's fiduciary duties. The trustee, including a beneficiary serving as trustee, has a duty to administer the trust in good faith and in accordance with its terms and purposes.¹¹ The settlor cannot relieve the trustee of this duty.¹² While the trust instrument may grant the trustee broad discretion, it is not—and cannot be—unlimited; rather, the trustee must exercise any

¹⁰ See Richard W. Nenno, "Planning and Defending Domestic Asset-Protection Trusts," American Bar Association, Tax Section Meeting (January 24, 2014). "Qualified self-settled spendthrift trusts" are available under Virginia law pursuant to Va. Code § 64.2-745.1.

¹¹ Tex. Trust Code §113.051; Va. Code § 64.2-763.

¹² Tex. Trust Code § 111.0035(b)(4)(B); Va. Code § 64.2-703(B)(2).

discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.¹³

6. We organize the discussion of this trust around the following topics:

- a. Beneficiaries;
- b. Distributions;
- c. Trustees;
- d. Investments; and
- e. Administration.

7. The trust envisioned by and discussed in this paper is an irrevocable trust created by a settlor for the benefit of some other person. We have intentionally chosen not to discuss certain kinds of trusts for specific reasons:

a. Revocable trusts achieve great flexibility for the settlor but achieve few of the tax and asset protection goals that many settlors desire. This paper addresses the constraints that are necessary or appropriate to achieve the settlor's goals. Revocable trusts embody the absence of constraint and are not particularly applicable in discussing our topic. Of course, revocable trusts are frequently used as will substitutes and control the disposition of the settlor's property at death. In that case, they become irrevocable at the settlor's death. The comments made in this paper will be useful in designing such a trust to achieve flexibility for the beneficiary, but only after the settlor's death when the trust becomes irrevocable.

b. In a self-settled trust, the settlor and the beneficiary are the same person. One of our goals is to illustrate the way in which granting flexibility to or imposing constraints upon one party to the trust relationship affects the other parties. This goal is better achieved when the settlor and the beneficiary are different persons with different interests.

c. Certain specialized trusts (offshore trusts, charitable trusts, grantor retained annuity trusts, qualified personal residence trusts, etc.) are each subject to their own unique set of constraints. This paper's discussion of general trust issues certainly applies to those trusts, but we do not devote significant attention to the unique issues that these specialized trusts present.

8. This paper also does not address how to remedy a trust when it incorporates the wrong degree of flexibility, such as by decanting to another trust or securing a judicial modification or construction of the trust instrument. We suggest ways of designing a trust at the outset to make decanting easier, but as a general rule these post-creation remedies are outside of the scope of this paper.

¹³ See, e.g., Tex. Trust Code § 113.029(a) ("Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of terms such as 'absolute,' 'sole,' or 'uncontrolled,' the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.").

9. This paper does not assert that providing the beneficiary with greater flexibility is an unqualified good, always to be sought in the trust relationship. Rather, this paper explores various issues in which flexibility and constraint are in tension. Sometimes the problem results from too little flexibility; in those cases, we suggest how the straightjacket might be loosened to achieve desirable results without compromising the protection that the trust relationship affords. Other times the problem lies in too much flexibility; here we offer suggestions for ways in which the straightjacket can be tightened without overly compromising the goal of flexibility or for avoiding the risks that too much flexibility may create. In each case, we focus on the key elements of the trust relationship and illustrate how increasing or reducing flexibility affects the parties to that relationship and their interests.

10. The paper addresses several aspects of federal tax law, each of which could be a stand-alone presentation. Many aspects of the trust are determined by state law: creditors' rights; marital property rights; and fiduciary duties. The goal of the paper is to create an awareness of the issues, opportunities and problems presented when drafting irrevocable trusts designed to provide maximum flexibility to the beneficiary.

E. Disclaimer.

This paper is not intended to be, and should not be construed as constituting, the author's opinion with regard to any specific case or transaction or the author's legal or tax advice with respect to any specific case or transaction. The forms included in this paper are for illustrative purposes only and may not be appropriate for any particular client or for use in any particular case, transaction or state. These forms should be used only by competent counsel and only as illustrations.

II. The Beneficiary Flexible Trust

A. Introduction.

1. **When Appropriate.** Various situations might call for the Beneficiary Flexible Trust. Here are three fairly common situations that estate planners encounter:

a. **Proposed gift.** Parent wants to give or sell property to child and is prepared to transfer the property outright. The estate planner instead recommends that parent transfer assets to a trust for child's benefit, in order to obtain the transfer tax benefits and additional protections against claims of creditors and spouses that a trust may afford. Parent responds that he is willing to consider a trust, but only if it allows child to exercise an acceptable degree of control over the transferred property. This trust could be structured as a grantor trust as to parent for income tax purposes. Grantor trust status would prevent income tax recognition on a sale by parent to the trust, and parent's obligation to pay tax on trust income can effect an additional wealth shift.¹⁴

¹⁴ For recent and thorough discussions of grantor trusts, See Samuel A. Donaldson, *Burning Questions (and Even Hotter Answers) About Grantor Trusts* (2013); Stephen R. Akers, "Planning With Grantor Trusts-Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risk," (Jan. 14. 2009); Samuel A. Donaldson, *Grantors Are From Mars, Grantor Trusts Are From Venus*, 40th Annual Heckerling Institute on Estate Planning (2006).

b. **Potential Inheritance.** The client has completed his core estate planning and advises the estate planner that he anticipates receiving a significant inheritance from a family member. If the client receives the inheritance free of trust, the assets may be subject to transfer tax upon the beneficiary's death and exposed to greater risk of creditor and spousal claims. The estate planner suggests that the client visit with his family member to encourage that the inheritance be distributed to a Beneficiary Flexible Trust.¹⁵ To facilitate introducing the client to this kind of planning, consider sending the client a letter such as that found in **Exhibit 2**.

c. **Proposed Investment.** Client proposes to invest in a new business venture that he anticipates could substantially appreciate in value. Client is unwilling to shift the potential appreciation to other family members (via a gift, GRAT or installment sale) because client is concerned that he may need access to the assets for his future personal needs. The estate planner suggests that client identify a third-party who could serve as the settlor of a Beneficiary Flexible Trust. Once the trust has been created, the beneficiary may loan cash to the trust to facilitate the proposed investment. To eliminate income tax consequences resulting from the beneficiary's loan to the trust, consider structuring the trust as a grantor trust for income tax purposes with respect to the beneficiary under Code section 678. This can be accomplished by including withdrawal right provisions in the trust instrument and insuring that the trust is funded with no more than \$5,000. However, the IRS has recently announced that it will not issue letter rulings regarding whether the beneficiary of such a trust will be treated as the owner of the trust property for income tax purposes if the beneficiary sells assets to the trust in exchange for a promissory note.¹⁶ Care should also be taken so that the trust is not a grantor trust as to the settlor. A sample withdrawal right provision is attached as **Exhibit 3**. A sample withdrawal notice letter is attached as **Exhibit 4**.

2. **Goals.** In structuring the Beneficiary Flexible Trust, the settlor or beneficiary has the following specific goals:

- a. Removing property from the gross estates of both the settlor and the beneficiary;
- b. Allowing the beneficiary to control distributions of trust assets to himself and other parties during his lifetime and upon death;
- c. Protecting trust property from claims of the beneficiary's creditors;
- d. Protecting trust property from claims of the beneficiary's spouse in the event of death or divorce;
- e. Allowing the beneficiary, serving as trustee, to control investments; and

¹⁵ See Benjamin G. Carter, "The Inheritance Trust: Multigenerational Planning from the Bottom Up," (State Bar of Texas, 31st Annual Advanced Estate Planning and Probate Course, June 6-8, 2007, San Antonio, Texas); Sheryl Latham, "The Inheritance Trust: Upstream Multigenerational Planning," American Bar Association, Tax Section Meeting (2001).

¹⁶ Rev. Proc. 2013-3, 2013-1 IRB 113, § 4.01(43); for a detailed discussion of Section 678 trusts, See Jonathan G. Blattmachr, Mitchell M. Gans, and Alvina H. Lo, "A Beneficiary as Trust Owner: Decoding Section 678," 35 ACTEC Journal 106 (2009).

f. Minimizing administrative and fiduciary obligations while the beneficiary serves as trustee.

3. **Trust Attributes.** The primary attributes of the Beneficiary Flexible Trust are as follows:

a. The beneficiary is the family trustee and has the power to control who serves as family trustee in the future.

b. A third party is the independent trustee. The beneficiary has the power to remove the independent trustee and can replace the independent trustee, as long as he does so with someone who is not related or subordinate to the beneficiary.

c. The independent trustee is vested only with the power to (i) distribute trust assets to the beneficiary beyond the beneficiary's needs for health, education, maintenance, and support (the "HEMS standard"); (ii) terminate a small trust; and (iii) deal with insurance on the life of the beneficiary.

d. The beneficiary, as family trustee, has all other trustee powers, including the power to make distributions to himself and his descendants subject to the HEMS standard.

e. The beneficiary has the right to withdraw the greater of \$5,000 or 5% of the value of the trust's assets each year.

f. The beneficiary has the broadest lifetime and testamentary non-general powers of appointment over trust assets.

g. Administrative and investment provisions are structured to grant the beneficiary, serving as the family trustee, broad discretion to minimize fiduciary and administrative obligations.

4. **Trust Limitations.** We acknowledge that employing an irrevocable trust, even a Beneficiary Flexible Trust, will limit the beneficiary's control and flexibility as compared to an outright gift. Also, employing an irrevocable trust may impose certain other disadvantages: greater formalities; perhaps additional income tax returns and even additional income tax (if the trust is not a grantor trust); segregation of assets; fiduciary duties; etc. However, many clients consider that the benefits of the Beneficiary Flexible Trust greatly outweigh any such disadvantages.

B. State Law Considerations. The areas of law implicated by the Beneficiary Flexible Trust include federal and state transfer and income tax, creditors' rights, marital property rights, and general trust law. The law governing transfer and income tax consequences is typically more certain and influenced primarily by federal law. The remaining areas of law mentioned are typically state-specific, which raises a number of complications. First, ascertaining which state's law governs can be complicated because of changes in situs of the trust or the residence of the trustee or the beneficiary. Second, even after ascertaining which particular state's law governs, the law in these areas is frequently less clear and subject to conflicting state law judicial precedents. In the case of creditors' rights and marital property issues specifically, some general comments can be made:

1. **Creditors' Rights.** Spendthrift trusts are designed to prevent creditors from reaching the underlying assets of a trust to satisfy a claim against a beneficiary. Some commentators have observed a trend in several states of cases in which a creditor successfully reached a beneficiary's

interest in a spendthrift trust.¹⁷ Generally, the beneficiary's interest in the trust will be more secure from creditors' claims if (1) the beneficiary's rights are limited to an ability to receive discretionary distributions, as opposed to a fixed right to distributions; (2) the trust contains multiple current beneficiaries who may receive income and principal; and (3) the beneficiary is not serving as the sole trustee. Even if the beneficiary's creditors can reach his interest in the trust, these same trust attributes should reduce the value of the beneficiary's equitable interest in the trust and thus limit the amount of trust assets reachable by creditors.¹⁸

2. **Marital Property.** Marital property law varies between states, the most significant distinction being community property states versus common law states. In Texas, a community property state, the marital property character of a beneficiary's equitable interest in an irrevocable trust will depend upon the terms of the trust, the identity of the settlor, and the beneficiary's marital status at the time when the trust was created. The rules for classifying marital and separate property in Virginia, a common law state, are generally consistent with those in Texas and will largely depend on the unique facts and circumstances of the property interest. Importantly, however, if a Virginia court determines an award of spousal support is justified, the court will have broad discretion to consider a number of factors in setting the support amount, including the property interests of each spouse, which may or may not include income from a trust. Typically, assets held in a Beneficiary Flexible Trust should be considered trust assets and not marital property and the beneficiary's equitable interest in the trust should be the beneficiary's separate property. Generally, undistributed income has no marital property character and discretionary distributions of income should constitute the beneficiary's separate property. If the trust mandates periodic income distributions, the character of such distributions is less certain, with some cases suggesting the income is community property and others providing that the income is separate.¹⁹ A trust that incorporates the three attributes discussed above with respect to creditors' rights should also provide additional protection against spousal claims. Because of the uncertainty surrounding potential spousal claims against a beneficiary's interest in a trust, clients with these specific concerns should address them by entering into marital property agreement, in addition to any trust planning that may occur.

C. Beneficiaries.

1. **Generally.** If the settlor intends to make a completed gift and ensure that the trust's assets are excluded from his gross estate, he cannot retain the power to alter the identity of the trust's

¹⁷ See Mario A. Mata, "Asset Protection Planning for the Family Business Owner," State Bar of Texas – Essentials of Business Law (April 14-15, 2001), Ch. 11.2 at 11; see generally Richard W. Nenno, "Planning and Defending Domestic Asset-Protection Trusts," American Bar Association, Tax Section Meeting (January 24, 2014).

¹⁸ See Mark E. Osborne, "Asset Protection: Trust Planning," State Bar of Texas – 35th Annual Estate Planning and Probate Course (June 8-10, 2011), Ch. 28, at 9 – 11; Mario A. Mata, "Asset Protection Planning for the Family Business Owner," State Bar of Texas – Essentials of Business Law (April 14-15, 2001), Ch. 11.2, at 13.

¹⁹ See Thomas M. Featherston, Jr., "Integrating Family Law, Characterization and Marital (or Non-Marital) Status Issues in Estate Planning," State Bar of Texas – 21st Annual Estate Planning and Probate Drafting Course (October 28-29, 2010), Ch. 8.3, at 25, citing *Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. Civ. App. 1997), *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex. App. 1996), *In Re Marriage of Long*, 542 S.W.2d 712 (Tex. App. 1976) and *Wilmington Trust Company v. U.S.*, 753 F.2d 1055 (5th Cir. 1985).

beneficiaries.²⁰ Typically, an irrevocable trust must carefully define "beneficiaries" to adjust for changed circumstances, (such as subsequent divorces, marriages, or births/deaths of descendants). This attention to definitions can help ensure that the trust instrument meets the settlor's current objectives, while offering flexibility to address changing circumstances. However, because the Beneficiary Flexible Trust will grant the beneficiary broad non-general powers of appointment, identifying secondary and successor beneficiaries may not be as critical.

Even though the definition of secondary and successor beneficiaries may not be as critical in a Beneficiary Flexible Trust, they should be defined to ensure that the distribution of assets upon the beneficiary's death in the absence of the exercise of his non-general power of appointment reflects the settlor's and beneficiary's intentions. [1.5]

2. **Identifying the Beneficiaries.** The objective of the Beneficiary Flexible Trust is to give the primary beneficiary the maximum degree of control over the trust property without jeopardizing the tax, creditor's rights, and marital property benefits of the trust vehicle. One aspect of that control is the ability to use that property for the benefit of others (*e.g.*, the primary beneficiary's spouse or children). There are two ways of accomplishing this goal:

a. Give the primary beneficiary a non-general power of appointment over the trust property. This approach is probably the preferred method, although if the primary beneficiary is the sole beneficiary of the trust and he appoints trust property to someone else, at least in theory the primary beneficiary has made a gift equal to the value of his equitable interest in the appointed property.²¹

b. Include other persons (such as the primary beneficiary's descendants) as permissible beneficiaries and allow the primary beneficiary, as trustee, to make discretionary distributions to them pursuant to an ascertainable standard. This will have the following important consequences:

i. If descendants are beneficiaries, they will have rights against the trustee and the trustee will owe them fiduciary duties.

ii. If the descendants are beneficiaries, this approach may provide the trust assets with additional protection against the claims of the primary beneficiary's creditors and spouse.

iii. If the descendants are beneficiaries, this approach may reduce the likelihood that the primary beneficiary's exercise of his non-general lifetime power of appointment will result in a taxable gift.

iv. If the descendants are beneficiaries, this approach ensures that the descendants can benefit from the trust assets even if the primary beneficiary is incapacitated and cannot exercise a non-general power of appointment in their favor.

c. Including the primary beneficiary's descendants as beneficiaries may protect the trust assets against one group of claimants (creditors and spouse) but only at the expense of granting rights to

²⁰ See IRC §§ 2036, 2038; Treas. Reg. § 25.2511-2.

²¹ Treas. Reg. §§ 25.2514-1(b)(2), 25.2514-3(e), example 3; *Estate of Regester v. Comm'r*, 83 TC 1, 8 (1984); Ltr. Rul. 8535020 (May 30, 1985); Ltr. Rul. 9451049 (September 22, 1994) .

another group of claimants (the descendants). Therefore, the client and the estate planner must evaluate whether the benefit of protecting against one group of claimants is worth the risk of creating another group of claimants.

3. **Qualified Disclaimer.** A qualified disclaimer is an effective way of changing beneficiaries without tax risk. However, it is of limited utility in the case of the Beneficiary Flexible Trust because:

- a. The disclaimer must be made within 9 months of the creation of the trust (or within 9 months after the disclaimant reaches age 21, if later);²² and
- b. The primary beneficiary can just as easily accomplish a change of beneficiaries through the exercise of a non-general power of appointment with little, though perhaps some, tax risk.

D. Distributions.

1. **Discretionary Distribution Powers.** A settlor's primary goal in creating the Beneficiary Flexible Trust is to give the beneficiary the greatest degree of flexibility possible. That is, the settlor wants the beneficiary to have interests in and powers over the trust property that are as close as possible to the interests and powers the beneficiary would have if he owned the property outright. The settlor also wants to protect the property from transfer taxation and from the claims of the beneficiary's creditors and spouse. Achieving all of these goals is impossible, so the settlor must compromise. The first compromise the settlor must make deals with distribution powers. Here, the settlor must balance his desire for the beneficiary to serve as trustee with his desire for the beneficiary to enjoy the benefits of the trust property.

- a. The beneficiary serving as trustee cannot have unfettered control over whether, when, and in what amounts distributions will be made to himself or his creditors.
 - i. For transfer tax purposes, such a broad distribution power would constitute a general power of appointment.²³ The trustee's appointment of assets to someone else or ceasing to serve as trustee, would constitute the release of a general power of appointment and would be subject to gift tax.²⁴ If the beneficiary continued to serve as trustee until his death, the trust assets would be includible in his gross estate.²⁵
 - ii. Retaining such a broad distribution power would also make the trust income taxable to the beneficiary.²⁶

²² See IRC § 2518(b)(2).

²³ IRC §§ 2041(b)(1) and 2514(c).

²⁴ IRC § 2514(b).

²⁵ IRC § 2041(a)(2).

²⁶ IRC § 678(a). *But see* IRC § 678(b) (Section 678(a) does not apply if the grantor is otherwise treated as the owner of the trust property).

iii. Retaining such a broad distribution power would also render the trust assets subject to the claims of the beneficiary's creditors and could affect the marital property classification of trust assets or increase exposure to spousal claims.

iv. Avoiding these negative consequences would require that the distribution power held by the beneficiary serving as trustee be limited by the HEMS standard.²⁷ **[3.1(b)]**

v. Texas and Virginia trust law protect against incurring these negative consequences inadvertently. Unless the terms of the trust instrument expressly provide otherwise, if the beneficiary is the trustee and has the power to make discretionary distributions to himself, he may exercise that power only in accordance with an ascertainable standard relating to his health, education, maintenance, and support.²⁸ Such a power may be exercised beyond the HEMS standard by a majority of the remaining trustees or, if none, a court may appoint a special fiduciary with authority to exercise the discretionary distribution power.²⁹

b. Even if the beneficiary serving as trustee is limited to the HEMS standard, some additional level of flexibility over distributions may be obtained.

i. The trust instrument may provide that the trustee "may" (versus "shall") make distributions to the beneficiary pursuant to the HEMS standard. In either case, the beneficiary's power to distribute to himself would be limited to health, education, maintenance, and support, and this power should not be a general power of appointment regardless of whether the trust instrument uses the term "may" or "shall."³⁰ **[3.1(b)]**

ii. The trust instrument may also provide some additional flexibility over distributions by artfully describing the factors that the trustee should consider in making distribution decisions. **[3.1(b)(i)-(vi)]**

(a) The fact that the trustee has discretion to take into account the beneficiary's other sources of support apparently does not convert an ascertainable standard into an unascertainable standard.³¹

(b) Presumably, the factors governing the trustee's discretion could be worded so broadly that they would convert the HEMS standard into an unascertainable standard. For example, suppose that the trust assets are worth \$1 million, that the beneficiary serving as trustee may make distributions to himself pursuant to the HEMS standard, and the trust instrument provides that, in exercising his discretion, he will take into account the standard of living enjoyed by a billionaire. The trustee's power, even though subject to a HEMS standard, may constitute a general power of appointment.

²⁷ IRC §§ 2041(b)(1)(A), 2514(c)(1).

²⁸ Tex. Trust Code § 113.029(b)(1); Va. Code § 64.2-776(B)(1).

²⁹ Tex. Trust Code § 113.029(c); Va. Code § 64.2-776(C).

³⁰ See "What Language Should be Used to Avoid a General Power of Appointment Over a Trust," 36 Estate Planning Journal 40 (April 2009).

³¹ See Treas. Reg. §§ 20.2041-1(c)(2) and 25.2514-1(c)(2).

(c) Unintended consequences can result unless the trust instrument carefully describes the factors that the trustee should consider in exercising his discretion. For example:

(1) A trust for the benefit of a single current beneficiary that requires or permits distributions of income and principal for health, education, maintenance, and support but only after taking into account the beneficiary's other resources may result in a "frozen" trust whose assets can never be distributed because the beneficiary can otherwise support himself.

(2) A direction to maintain the beneficiary in his standard of living at the time the trust is created may lock the beneficiary into a lifestyle that is otherwise inappropriate for him.

(3) Problems such as these can be minimized by carefully designing the distribution standards and the factors that are to be considered by the trustee in making distribution decisions. In addition, these problems may be avoided by naming additional beneficiaries, granting non-general powers of appointment, or by giving an independent trustee the power to add beneficiaries or make distributions without regard to the HEMS standard. However, these approaches may reduce the control that the settlor wants the beneficiary to have.³²

c. If the settlor wants the trustee to have unfettered power to make distributions, someone other than the beneficiary must hold that power. The settlor could appoint someone other than the beneficiary as trustee. Alternatively, the settlor could appoint the beneficiary and some independent third party as co-trustees and vest the power to make distributions (or, alternatively, the power to make distributions beyond the HEMS standard) in the independent trustee. **[3.1(c)]** In any case, this solution requires the settlor to vest an important measure of control in someone other than the beneficiary. Even if the independent co-trustee is only granted the power to make distributions to the beneficiary beyond the HEMS standard, this approach entails some risk because the independent trustee may exercise (or not exercise) the power in a way that is contrary to the beneficiary's wishes. In drafting the Beneficiary Flexible Trust, the estate planner's challenge is to temper the non-beneficiary trustee's control over distributions with some measure of control over the non-beneficiary trustee.

i. If the beneficiary is not the trustee with the power to make distributions (or distributions beyond the HEMS standard), the beneficiary can still indirectly exercise control over, or at least influence, those distributions if he has the power to remove and replace the distribution trustee.

ii. If the beneficiary can both remove and replace the trustee who has the "broad" distribution power, the beneficiary should be prevented from appointing anyone who is "related or subordinate" to him within the meaning of Code section 672(c). Otherwise, the distribution powers of the trustee will be attributed to the beneficiary, potentially resulting in the adverse consequences discussed above.³³ **[4.2(d)]**

³² For a detailed discussion of structuring distribution provisions to achieve a settlor's objectives, see Benjamin H. Pruett, *Tales from the Dark Side: Drafting Issues from the Fiduciary Perspective*, American Bar Association, Section of Real Property, Trust and Estate Law; Section of Taxation 2011 Joint Fall Meeting, (October 22, 2011).

³³ See discussion at II.E.4.

iii. Alternatively, the beneficiary could have one of the two powers (the power to either remove the trustee or to appoint a successor trustee), while a third party (*e.g.*, a trust protector) is granted the power not given to the beneficiary. This structure could facilitate the removal of a trustee and appointment of a successor trustee who is related or subordinate to the beneficiary.

2. **Mandatory Distributions.**

a. The sample Beneficiary Flexible Trust included as **Exhibit 1** does not include any mandatory distributions provisions in favor of the beneficiary. Many estate planners structure trusts that require all income to be paid to the beneficiary at least annually or provide for required distributions of a fixed amount, possibly adjusted for inflation. Even though mandatory distribution provisions may provide the beneficiary with greater access to trust assets, such provisions force trust assets into the hands of the beneficiary, exposing them to potential transfer taxes, creditors' claims, and spousal claims, instead of providing the beneficiary with greater control and flexibility. Further, mandatory distribution provisions that distinguish between income and principal, may require the trustee to be especially sensitive to the allocation of receipts and disbursements between income and principal and heighten fiduciary concerns about the way the trust assets are invested. Failure to make mandatory distributions can cause the beneficiary to have made a transfer to the trust, creating transfer tax problems for the beneficiary and potentially subjecting trust assets to creditors' and spousal claims. Query: Can the beneficiary serving as trustee contribute all trust assets to an entity such as a corporation, limited liability company, or partnership, to control and perhaps eliminate trust accounting income?

3. **Five and Five Power.**

a. The trust instrument can provide the beneficiary with significantly greater flexibility by allowing the beneficiary each year to withdraw trust assets in the amount equal to the greater of \$5,000 or 5% of the value of the trust estate. Any amounts that are not withdrawn during the year will lapse.

b. Such power should not cause any significant adverse transfer tax consequences. By limiting the withdrawal right to these amounts, the failure to exercise the withdrawal right will not constitute a lapse of general power of appointment for gift tax purposes under Code section 2514.³⁴ However, if the beneficiary possesses the withdrawal right at the time of his death, the value of assets subject to the withdrawal right will be included in his gross estate under Code section 2041. To mitigate this potential estate tax inclusion, the withdrawal right should provide that it is only exercisable during one or more specific days of each calendar year. **[3.1(e)]**

c. In some jurisdictions, the failure to exercise such a withdrawal right may cause the beneficiary to be treated as a settlor of the trust and may thereby impair the protection of a spendthrift clause. This is not the case in Texas or in Virginia.³⁵

d. Care should be taken if the beneficiary has both a 5 and 5 power and an inter vivos special power of appointment. If the beneficiary exercises the special power of appointment, this may constitute a release of the 5 and 5 power as to the appointed property. Because a 5 and 5 power is

³⁴ See IRC § 2514(e).

³⁵ See Tex. Trust Code § 112.035(e); Va. Code § 64.2-747(B)(2)

a general power of appointment, the release could constitute a transfer by the beneficiary of a portion of the appointed property for gift tax purposes.³⁶

4. **Support Obligations.**

a. If the trustee has a legal obligation to support a beneficiary, the trust agreement should forbid the trustee from making distributions that satisfy or reduce his support obligation, as the ability to make distributions to satisfy such obligations would constitute a general power of appointment under Code sections 2514 and 2041, resulting in adverse gift and estate tax consequences for the trustee. **[6.8(a)]**

b. Texas and Virginia trust law also protect a trust from inadvertently incurring these consequences. Unless the terms of the trust expressly provide otherwise, a trustee may not exercise a power to make discretionary distributions to satisfy a legal obligation of support that the trustee personally owes to someone else.³⁷ Such a power may be exercised by a majority of the remaining trustees or, if none, a court may appoint a special fiduciary with authority to exercise the discretionary distribution power.³⁸

5. **Facility of Payment.** Most state trust statutes have a "facility of payment" provision that applies when a beneficiary is a minor or is incapacitated which allows the trustee to deliver that beneficiary's distribution to an alternate recipient on his behalf or to expend the distribution for the benefit of the beneficiary.³⁹ A trust instrument should contain an express facility of payment clause that also exculpates the trustee for making distributions other than directly to the beneficiary. **[5.4]**

6. **Spendthrift Clause.**

a. A "spendthrift trust" is a trust that provides that a beneficiary's interest in income or principal may not be voluntarily or involuntarily transferred to another person before the trustee of that trust pays or delivers the interest to the beneficiary.⁴⁰ In some states, a trust provision such as "the interest of a beneficiary shall be held subject to a spendthrift trust" is sufficient to restrain voluntary or involuntary alienation of the beneficiary's interest to the maximum extent permitted by law.⁴¹ **[5.2]**

b. In most states, including Texas, if the settlor creates a trust for his own benefit, a spendthrift clause will not shelter the assets of that trust from the claims of the settlor's creditors. In Virginia, a settlor may create a "qualified self-settled spendthrift trust" in accordance with Sections 64.2-745.1 and 64.2-745.2 of the Virginia Code, in which case a spendthrift clause should shelter

³⁶ IRC § 2514(b).

³⁷ Tex. Trust Code § 113.029(b)(2); Va. Code § 64.2-776(B)(2).

³⁸ Tex. Trust Code § 113.029(c); Va. Code § 64.2-776(C).

³⁹ See Tex. Trust Code § 113.021; Va. Code § 64.2-778(A)(21).

⁴⁰ See Tex. Trust Code § 112.035(a); Va. Code § 64.2-743(A), (C).

⁴¹ See Tex. Trust Code § 112.035(b); Va. Code § 64.2-743(B).

the trust assets from the claims of the settlor's creditors. A beneficiary is not treated as a settlor merely because he has the power to make distributions to himself based on an ascertainable HEMS standard.⁴² It is important to include a spendthrift clause in the Beneficiary Flexible Trust for two reasons:

- i. First, and most obviously, the spendthrift clause is the primary feature of the Beneficiary Flexible Trust that protects the trust property from the claims of the beneficiary's creditors.
 - ii. Second, if the trust instrument does not prevent the beneficiary from assigning his trust interest, the beneficiary could assign that interest to creditors, which may cause the interest to be included in the beneficiary's gross estate.
- c. Some states allow government agencies who have provided benefits to a beneficiary and persons with child support claims against the beneficiary to reach trust assets notwithstanding a spendthrift clause.⁴³ Further, in some states a beneficiary's creditors who provide goods or services for the beneficiary's support may be able to reach the assets of a trust that provides for distributions for the beneficiary's support.
- d. If a trust beneficiary has a heightened concern about potential creditors' claims, a trust that includes a spendthrift clause may provide additional creditor protection if (1) the beneficiary does not serve as the sole trustee, (2) distributions are discretionary, and (3) the trust benefits multiple current beneficiaries.

7. Marital Property Rights in Trusts.

- a. Most settlors and beneficiaries seek to protect trust assets from spousal claims and claims of a spouse's creditors. Under Texas and Virginia law, property acquired by gift or inheritance is separate property.⁴⁴ When property is transferred to an irrevocable trust, what is the nature of the gift to the beneficiary? Is it the beneficiary's equitable interest in the trust assets, or is it the distributions actually made from the trust that are attributable to that equitable interest?
- b. Texas law is not entirely clear or consistent in its treatment of the marital property character of income accumulated in a trust or of distributions from a trust.⁴⁵ The terms of the specific trust instrument are obviously important. However, in resolving these issues some cases also focus on the settlor's intent.⁴⁶

⁴² Tex. Trust Code § 112.035(f)(1)(A)(ii); Va. Code § 64.2-746(E).

⁴³ See, e.g., Tex. Fam. Code § 154.005; Va. Code § 64.2-744.

⁴⁴ Tex. Fam. Code § 3.001(2); Va. Code § 20-107.3(1).

⁴⁵ For a detailed discussion of the marital property rights in irrevocable trusts, See Thomas M. Featherston, Jr., "Integrating Family Law, Characterization and Marital (or Non-marital) Status Issues in Estate Planning," State Bar of Texas, 21st Annual Estate Planning and Probate Drafting Course (October 28-29, 2010).

⁴⁶ See *McClelland v. McClelland*, 37 S.W. 350 (Tex. Civ. App. 1896, writ ref'd) (classification of undistributed trust income as trust property and not beneficiary's community property complied with settlor's intent); *Comm'r. v Porter*, 148 F.2d 566 (5th Cir. 1945) (in trust context, to depart from generally

c. In order to bolster the argument that trust assets, prior to distribution, are not marital property and that distributions from the trust are the beneficiary's separate property, the trust instrument should contain language setting forth the settlor's intent that the gift to the beneficiary is the amount actually distributed to the beneficiary. [5.3]

d. As with creditors' claims, if a trust beneficiary has a heightened concern about potential marital property claims, a trust may provide additional protection if (1) the beneficiary does not serve as the sole trustee, (2) distributions are discretionary, and (3) the trust benefits multiple current beneficiaries. Perhaps the best solution is for the beneficiary and his spouse to execute a marital property agreement specifically addressing the spouse's interest in the trust.

8. Powers of Appointment.

a. Trusts often grant beneficiaries a non-fiduciary power to direct the distribution of assets to and among third parties during lifetime and at death. This "power of appointment," if broad enough, can cause the beneficiary's interest in the trust to closely resemble outright ownership without impairing the benefits of the trust structure. Powers of appointment can be inter vivos (exercisable during lifetime) or testamentary (exercisable at death). Powers of appointment can also be either general or non-general. A general power of appointment is exercisable in favor of the beneficiary, his creditors, his estate, or creditors of his estate. A non-general power of appointment is exercisable only in favor of other appointees.⁴⁷ If the settlor's goals include minimizing transfer taxes, the trust instrument will grant the beneficiary only a non-general power of appointment, because general powers of appointment have gift and estate tax consequences.

b. Typically a settlor elects to structure a non-general power of appointment so that the appointees are limited to a rather narrow class, such as descendants and charities. However, because one of the goals of the Beneficiary Flexible Trust is to provide the beneficiary with control and flexibility, the trust instrument will grant the broadest lifetime and testamentary non-general powers, which will allow the beneficiary to appoint to anyone other than himself, his creditors, his estate, or creditors of his estate. [3.1(d), 3.1(g)]

c. The broadest non-general power of appointment also allows the beneficiary to address changed circumstances among the named remainder beneficiaries, *e.g.*, one (or more) remainder beneficiaries has become disabled and relies on asset-based government assistance programs, has greater financial needs than the others, has creditor problems, has substance abuse problems, or needs third-party management over inherited assets. Therefore, the beneficiary is provided substantial freedom to determine who will benefit from trust assets.

d. In addition, giving the beneficiary broad non-general powers of appointment can minimize the risk of disputes and litigation between the beneficiary serving as trustee and the secondary and remainder beneficiaries. If the primary beneficiary did not have a power of appointment, the remainder beneficiaries would be vested in the right to receive assets upon the primary beneficiary's death. As a result, the remainder beneficiaries might view the assets as theirs and

prevailing rule that income from separate property is community property, language of trust instrument must use precise and definite language to illustrate that such is settlor's intent).

⁴⁷ IRC §§ 2041, 2514.

might be more critical regarding the trustee's investment of trust assets and distributions. The beneficiary's ability to alter the ultimate distribution of trust assets may discourage potential disputes and claims by other beneficiaries.

e. In designing irrevocable trusts for children (or other persons one generation below the settlor), the settlor's transfer tax goals often include minimizing generation-skipping transfer (GST) taxes when trust assets pass at the child's death to grandchildren or others so generationally aligned to the settlor. Estate planners often address this by including a conditional testamentary general power of appointment in the trust instrument. [3.4] The conditional general power is granted to the child and applies only if, by subjecting the trust assets to estate tax in the child/beneficiary's estate rather than to GST tax, the total transfer taxes imposed on the trust assets at the child/beneficiary's death will be lower.

f. Other planners design trust instruments to avoid GST tax at a child/beneficiary's death by designating a third party who has the power to grant a testamentary general power of appointment to the child/beneficiary. The thought is that the third party would grant the power only if, and to the extent, that total transfer taxes would thereby be reduced. Some of these planners may be concerned that the conditional general power of appointment may be considered a retention by the settlor of a power to amend the trust instrument because the settlor, by allocating GST exemption to the trust or not, could determine whether and to what extent the child/beneficiary has a general power, which might cause the trust property to be included in the settlor's gross estate.⁴⁸ We are not aware of any cases or rulings to the effect that such a conditional general power of appointment has negative tax consequences for the settlor. The conditional general power of appointment would also seem to be a more reliable method of granting a general power to the child/beneficiary, because lapse of time, delay, inattentiveness, and the unpredictability of events leading to the child/beneficiary's death could result in a third party failing to grant the child a general power, thereby exposing the trust estate to a higher level of taxation (GST tax). If the third-party approach is to be used, the cautious practitioner will urge the beneficiary to coordinate with the third party when the GST status of the trust is determined and seek the grant of a general power of appointment if the overall transfer tax at the beneficiary's death would be reduced.

E. Trustee.

1. **Generally.** A settlor who desires to give the beneficiary the maximum degree of control will appoint the beneficiary as sole trustee and will grant the beneficiary the power to appoint and remove successor trustees. However, as discussed above, if the beneficiary serves as trustee, certain trustee powers (*e.g.*, distribution powers) must be restricted to ensure that the trust accomplishes the settlor's other goals, such as avoiding inclusion of the trust's assets in the beneficiary's gross estate. A settlor, balancing the desire for control and flexibility, may decide to appoint a third-party trustee with limited authority to exercise more flexible powers that cannot be granted to the beneficiary serving as trustee.

2. **Resignation and Removal.** The trust instrument should include specific provisions governing the resignation and removal of trustees. While some states authorize a trustee to resign

⁴⁸ IRC § 2038.

without court approval,⁴⁹ others provide that if the trust instrument does not specify the terms upon which a trustee may resign, the trustee must petition a court for permission to resign.⁵⁰ If the trust instrument does not specify the terms for removal of a trustee, an interested party must petition a court to remove the trustee.⁵¹ Including non-judicial procedures for the resignation and removal of trustees in the trust instrument will provide flexibility by avoiding the expense and delay that can be associated with a judicial action.

a. The trust instrument should provide for automatic removal of a trustee if the trustee becomes incompetent or incapacitated to an extent that the trustee can no longer manage the trust affairs. **[4.12]** Care should be taken in describing the standard for incapacity and the procedure for determining it in order to avoid abuse, particularly if the beneficiary is serving as the trustee. **[8.4]**

b. The settlor may also want to give the beneficiary discretion to remove the trustee as a method of exercising influence over the trustee. **[4.4]**

3. **Appointment of Successor.**

a. The trust instrument should also include specific provisions governing the appointment of successor trustees if a trustee ceases to serve due to death, resignation, or removal. Unless the trust instrument provides otherwise, a trustee has no power to appoint his successor without court action or, in some states, the consent of all interested parties.⁵² The trust instrument should provide a non-judicial method for appointing a successor in order to avoid the expense, delay, and inconvenience of a court appointment.

b. The trust instrument should identify the person who holds the power to appoint a successor, or perhaps list several persons with that power and the order in which they can exercise it. Presumably, the settlor will want the beneficiary to exercise this power if he is living and not incapacitated. **[4.1(b), 4.2(b)]**

c. The trust instrument should address the qualifications for successor trustees.

i. If the trustee's ability to make distributions is limited by the HEMS standard, presumably the settlor will want to give the beneficiary broad discretion in deciding whom to appoint as

⁴⁹ Unif. Trust Code § 705(s) ("A trustee may resign upon at least 30 days' notice to the qualified beneficiaries, the settlor, if living, and all cotrustees"); *see, e.g.*, Va. Code § 64.2-758(A)(1).

⁵⁰ Tex. Trust Code § 113.081.

⁵¹ *See* Unif. Trust Code § 706(a); Tex. Trust Code § 113.082; Va. Code § 64.2-759.

⁵² Unif. Trust Code § 704(c) (A vacancy in a trusteeship of a noncharitable trust that is required to be filled must be filled in the following order of priority: (1) by a person designated in the terms of the trust to act as successor trustee; (2) by a person appointed by unanimous agreement of the qualified beneficiaries; or (3) by a person appointed by the court."); Tex. Trust Code § 113.083(a) ("a successor trustee shall be selected according to the method, if any, prescribed in the trust instrument. If for any reason a successor is not selected under the terms of the trust instrument, a court may and on petition of any interested person shall appoint a successor"); Va. Code § 64.2-757 (adopting the Uniform Trust Code approach).

successor trustee, and the qualifications for service as successor trustee will consequently be few. **[4.1(e)]**

ii. If a trustee may make distributions beyond the HEMS standard, presumably the trust instrument will not have named the beneficiary as the initial trustee holding that power.⁵³ For the same reasons, the trust instrument should forbid the appointment of the beneficiary as successor trustee. **[4.2(d)]** As indicated above,⁵⁴ Texas and Virginia law contain helpful savings provisions that provide that, if the beneficiary is the trustee and has the power to make discretionary distributions to himself, he may exercise that power only in accordance with an ascertainable standard relating to his health, education, maintenance, and support and he may not exercise that power to satisfy a legal obligation that he owes to another person, unless the terms of the trust instrument indicate that these limitations do not apply.⁵⁵

d. The trust instrument should address the procedures by which the successor trustee is appointed. For example:

i. Is there a time limit within which the successor must be appointed? **[4.1(b), 4.2(b)]** Note that this provision may result in an inadvertent failure to exercise the non-judicial appointment power if the time limit is exceeded.

ii. Must the appointment be made in a particular form, such as in a written and acknowledged document? Where must such a document be delivered? Is the method of delivery specified? **[4.1(d), 4.2(c)]**

4. **Revolving Door Power.** Special care is required if the beneficiary has a "revolving door" power—that is, the unfettered power to both remove and replace the trustee.

a. If the beneficiary has a revolving door power, then the powers of the trustee will be attributed to the beneficiary even if the beneficiary is not serving as trustee.

b. If the trustee's power to make distributions to the beneficiary is limited by a HEMS standard (as it should be if the beneficiary serves as the trustee), then attributing the trustee's powers to the beneficiary is not problematic. Because the beneficiary could serve as trustee without tax risk, there is no greater risk from attributing the trustee's powers to the beneficiary through a revolving door power.

c. However, if a trustee has the power to make distributions to the beneficiary beyond the HEMS standard, the beneficiary's unfettered power to both remove and replace the trustee is equivalent to a general power of appointment.⁵⁶

⁵³ Otherwise trust assets may be includible in the beneficiary's estate under IRC §§ 2041(a)(2) and 2514(b). See discussion at II.D.1.

⁵⁴ See II.D.1.a.v.

⁵⁵ Tex. Trust Code § 113.029(b)(1); Va. Code § 64.2-776.

⁵⁶ Treas. Reg. §§ 20.2041-1(b)(1) , 25.2514-1(b)(1).

i. Therefore, the beneficiary will be deemed to have released a general power of appointment, resulting in a taxable transfer under Code section 2514, if (1) the trustee makes distributions to any person other than the beneficiary, (2) the beneficiary exercises an inter vivos power of appointment in favor of some other person, or (3) the beneficiary releases his power to remove and replace trustees so that it is no longer a revolving door power.

ii. Similarly, the trust property will be included in the beneficiary's gross estate under Code section 2041.

d. The solutions to this risk are:

i. Limit the trustee's distribution power to the HEMS standard;

ii. Allow the beneficiary to both remove and replace the trustee, but prohibit the beneficiary from appointing, as successor trustee, himself or anyone who is "related or subordinate" to the beneficiary within the meaning of Code section 672(c);⁵⁷ **[4.2(d)]** or

iii. Grant the beneficiary either a removal or a replacement power, but not both, and grant the other power to a different person, which would allow the appointment of a successor trustee who is not the beneficiary but who can be "related or subordinate" to the beneficiary.

e. For this purpose, "related or subordinate parties" include:

i. The beneficiary's spouse, if living with the beneficiary;

ii. The beneficiary's father, mother, issue, siblings, and employees;

iii. Any corporation and any employee of a corporation in which the stock holdings of the beneficiary and the trust are significant from the viewpoint of voting control; and

iv. Any subordinate employee of a corporation in which the beneficiary is an executive.⁵⁸

5. **Exculpation Clause.**

a. One of the goals of the Beneficiary Flexible Trust is to give the beneficiary maximum control and flexibility, while reducing the beneficiary's risk of incurring liability and the potential for litigation against the beneficiary.

b. Many of the duties imposed on trustees by statute and common law can be modified or eliminated by express provisions included in a trust instrument.⁵⁹ In Texas, a settlor may exculpate a trustee from all liability other than for a breach of trust committed intentionally, in bad faith, or with reckless indifference to the interest of a beneficiary, or for profit derived by the

⁵⁷ See Rev. Rul. 95-58, 1995-2 C.B. 191 (August 4, 1995) and Ltr. Ruls. 9607008 (February 16, 1996), 200404005 (January 23, 2004), 200404006 (January 23, 2004), and 200404007 (January 23, 2004).

⁵⁸ IRC § 672(c).

⁵⁹ Tex. Trust Code § 111.0035(a); Va. Code § 64.2-703(a).

trustee from a breach of trust.⁶⁰ In Virginia, a settlor may exculpate a trustee from all liability other than for a breach of trust committed in bad faith or with reckless indifference to the interest of a beneficiary, or unless the exculpatory provision was inserted as a result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.⁶¹ Some states limit the ability of a trust instrument to exonerate a trustee for failure to exercise reasonable care, diligence and prudence.⁶²

c. Exculpation clauses reduce the risk of serving as a trustee and lessen the potential for litigation.⁶³ If the settlor's goal is to reduce the potential for litigation and to provide the greatest level of flexibility to the trustee, a broad exculpation clause may be called for.

d. The trust instrument should include a broad exculpation clause with respect to the beneficiary serving as trustee as well as to successor individual trustees appointed by the beneficiary. **[4.8 and 3.6(d)]** Such a clause would reduce the chance that the beneficiary, serving as trustee, would be subjected to claims by other interested parties (such as remainder beneficiaries), while retaining the normal higher standard of care for other trustees (such as corporate fiduciaries).

6. Compensation.

a. A trustee is entitled to reasonable compensation for services as a trustee from the assets of the trust estate unless the terms of the trust instrument provide otherwise or the trustee agrees to forgo compensation.⁶⁴ Factors that may be considered in determining what constitutes "reasonable compensation" include local custom, the trustee's skill and experience, the time needed to devote to trust administration, the amount and character of the trust property, the degree of responsibility and risk assumed in administering the trust, the nature and cost of services rendered by others, and the quality of the trustee's performance.⁶⁵ The Virginia Trust Code does not list specific factors to be considered in determining reasonable compensation.

b. A settlor may provide for trustee compensation to be paid to some trustees but to not others. For example, the trust instrument might provide that the beneficiary serving as trustee shall not

⁶⁰ Tex. Trust Code §§ 114.007(a)(1), 111.0035(b)(2); Unif. Trust Code § 1008 ("A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it (1) 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 interest of the beneficiaries").

⁶¹ Va. Code § 64.2-799(A).

⁶² See N.Y. EPT. LAW § 11-1.7.

⁶³ See, e.g., *Corpus Christi Nat'l Bank v. Gerdes*, 551 S.W.2d 521, 523 (Tex. App.—Corpus Christi 1977, ref. n.r.e.) (holding broad exculpatory provision binding against trust beneficiaries and precluding action against trustee for negligence).

⁶⁴ Restatement (Third) of Trusts § 38(1); Unif. Trust Code § 708; Tex. Trust Code § 114.061; Va. Code § 64.2-1208.

⁶⁵ Restatement (Third) of Trusts § 38 cmt. c(1).

receive compensation, while others are entitled to compensation. This arrangement would preserve trust assets not needed by the beneficiary and perhaps reduce income tax liability. [4.6]

c. A beneficiary serving as trustee may waive all or a portion of the compensation to which he is entitled. If a timely waiver is made,⁶⁶ the amount of compensation waived should not be includible in the beneficiary/trustee's gross income and the foregone fees should not be deemed a gift to the trust.⁶⁷ However, if the beneficiary/trustee does not waive fees until long after the trustee services have been performed, the Service may seek to impute the waived compensation as taxable income to the beneficiary and as a gift by the beneficiary to the trust.⁶⁸ There must be a "fixed or definite intention to serve on a gratuitous basis" in order for the trustee to avoid incurring income or gift tax liability.⁶⁹ Therefore, the trust instrument should not permit the trustee to waive compensation in one year and receive compensation in another year.

d. In Texas and Virginia, unless the trust instrument provides otherwise, one-half of the trustee's regular compensation is charged to income and the other one-half is charged to principal.⁷⁰

7. Waiver of Bond.

a. The Uniform Trust Code and many states, including Virginia, provide that a trustee is not required to provide bond to secure performance of its duties as trustee unless required by the trust instrument or if a court determines a bond is needed to protect the interests of the beneficiaries.⁷¹ In Texas, unless the trust instrument provides otherwise, an individual trustee must provide a bond while a corporate trustee need not provide a bond.⁷²

b. The trust instrument for the Beneficiary Flexible Trust will generally waive the bond requirement in order to reduce the expense to the trust estate and the administrative inconvenience related to securing the bond. [4.7]

⁶⁶ As a general rule, the trustee should, within six months after appointment, deliver a formal waiver to the beneficiaries. Rev. Rul. 66-167, 1966-1 C.B. 20. An implied waiver may also be deemed if the trustee "fails to claim fees or commissions at the time of filing the usual accountings and if all the other attendant facts and circumstances are consistent with a fixed and continuing intention to serve on a gratuitous basis." *Id.*

⁶⁷ Rev. Rul. 66-167, 1966-1 C.B. 20 (An implied waiver may be deemed if the fiduciary "fails to claim fees or commissions at the time of filing the usual accountings and if all the other attendant facts and circumstances are consistent with a *fixed and continuing* intention to serve on a gratuitous basis.") (emphasis added).

⁶⁸ Rev. Rul. 64-225, 1964-2 C.B. 15.

⁶⁹ Rev. Rul. 66-167, 1966-1 C.B. 20.

⁷⁰ Tex. Trust Code §§ 116.201, 116.202; Va. Code §§ 64.2-1025, 64.2-1026.

⁷¹ Unif. Trust Code § 702; Va. Code § 64.2-755.

⁷² Tex. Trust Code § 113.058.

F. Investments

1. **Introduction.** The Beneficiary Flexible Trust is intended to provide the beneficiary serving as trustee with maximum control and flexibility while obtaining other important goals. Accordingly, the trust instrument should grant the trustee broad investment powers. For certain assets, however, the trust instrument must provide some limitations over the manner in which those assets are administered.

2. **Broad Discretion Over Investments.** The trust instrument should provide that a beneficiary serving as trustee can invest the trust estate in any kind of property without being limited by any state law addressing character, risk, productivity, diversification of, or otherwise concerning, investments by trustees. This language should allow the beneficiary serving as trustee to retain large concentrations of assets, including closely held business interests and legacy real property, without being subject to the traditional investment restrictions applicable to trustees under state law. These broad investment powers can also be extended to an individual trustee appointed by the beneficiary, while limiting the application of these broad powers to corporate trustees and other successor trustees. **[6.1(a) and 6.1(b)(i)]**

3. **Abandonment of Trust Property.** The trust instrument should authorize the trustee to abandon trust property when, in the trustee's discretion, such abandonment is in the best interest of the trust and its beneficiaries. For example, the trust might own an asset with a value that is less than or equal to current and future liabilities associated with it, and which the trustee may determine is unlikely to appreciate in value. The abandonment power could allow the trustee to surrender this asset, given that it could provide minimal value but significant administrative complications. **[6.1(k)]**

4. Considerations for Specific Assets.

a. **Insurance on the Life of the Beneficiary.** Generally, a Beneficiary Flexible Trust will not own an insurance policy on the beneficiary's life. If the trust will own such a policy, and the settlor and beneficiary intend the death benefit to be excluded from the beneficiary's gross estate, the trust instrument must be carefully drafted.

i. The trust instrument should designate a third party trustee to exercise all powers over trust-owned insurance policies on the life of a beneficiary serving as trustee. **[4.14]** The Service has ruled that a trustee will not possess incidents of ownership on a trust-owned policy on the trustee's life, but only if the trustee is not the settlor of the trust, the trustee did not furnish the consideration for maintaining the policy and the trustee could not exercise the powers for the trustee's personal benefit.⁷³ However, this ruling does not enable a beneficiary serving as trustee of a Beneficiary Flexible Trust to avoid Code section 2042 because the policy could benefit the beneficiary.

ii. The Beneficiary Flexible Trust typically grants the beneficiary the broadest possible non-general powers of appointment. However, if the trust owns insurance on the beneficiary's life, the trust instrument should provide that such powers of appointment do not extend to insurance policies on the beneficiary's life (or the proceeds of such policies). Otherwise, the beneficiary's

⁷³ Rev. Rul. 84-179, 1984-2 C.B. 195.

power of appointment could cause the insurance proceeds to be included in the beneficiary's gross estate under Code section 2042. [3.1(d) and 3.1(g)]

b. **S Corporation Stock.** Special planning and drafting is required if a trust will own S corporation stock. Only certain types of trusts are eligible to own qualified S corporation stock,⁷⁴ namely (i) a grantor trust for federal income tax purposes;⁷⁵ (ii) a trust that formerly was a grantor trust immediately prior to the deemed owner's death but only for two years following the deemed owner's death;⁷⁶ (iii) a trust that received stock pursuant to the terms of a Will, but only for two years from the date the stock was transferred to the trust;⁷⁷ (iv) a voting trust;⁷⁸ (v) an electing small business trust ("ESBT");⁷⁹ or (vi) a qualified subchapter S trust ("QSST").⁸⁰

i. Typically, shareholders will want to maintain S corporation status to avoid both the corporation and its shareholders being taxed on income. It may be appropriate for the trust instrument to require that a trustee of a trust that receives S corporation stock take all necessary steps to qualify as an S corporation shareholder. If the trust is not a grantor trust or a voting trust, the trust must qualify as either an ESBT or a QSST.

(a) A QSST election is made by the current beneficiary of the trust.⁸¹ A trust may qualify as a QSST only if (i) all of the income of the trust is distributed to a single beneficiary who is a U.S. citizen or resident; (ii) during the life of the current income beneficiary, there is only one income beneficiary of the trust; (iii) any corpus distributed during the income beneficiary's life must be distributed to that beneficiary; (iv) the income interest must terminate on the earlier of the beneficiary's death or termination of the trust, and (v) if the trust terminates during the income beneficiary's life, all assets must be distributed to that beneficiary upon termination.⁸² The result of a QSST election is that all income of the trust is taxable on the income beneficiary's personal income tax return at his or her marginal income tax rate.

(b) Unlike a QSST election, an ESBT election is made by the trustee of the trust⁸³ and results in the S corporation income of the trust being taxed to the trust at the highest trust income tax rate,

⁷⁴ IRC § 1361(c)(2).

⁷⁵ IRC § 1361(c)(2)(A)(i).

⁷⁶ IRC § 1361(c)(2)(A)(ii).

⁷⁷ IRC § 1361(c)(2)(A)(iii).

⁷⁸ IRC § 1361(c)(2)(A)(iv).

⁷⁹ IRC § 1361(c)(2)(A)(v).

⁸⁰ IRC § 1361(d).

⁸¹ IRC § 1361(d)(2)(A).

⁸² IRC § 1361(d)(3).

⁸³ IRC § 1361(e)(3).

regardless of whether the S corporation income is distributed to the beneficiary.⁸⁴ The only trusts ineligible to make an ESBT election are a QSST, a tax exempt trust, and a charitable remainder trust.⁸⁵ The only beneficiaries of an ESBT can be an estate, an individual, a charity under paragraphs (2) – (5) of Code section 170(c), or an organization under Code 170(c)(1) (but only if such organization has a contingent interest and is not a current income beneficiary).⁸⁶

(c) The trust instrument may facilitate income tax savings by permitting the trust to elect to be taxed as an ESBT (if the primary beneficiary is already in the top income tax bracket) or to qualify as a QSST (if the primary beneficiary would be in a lower income tax bracket if the S corporation income were distributed). Generally, a trust that qualifies as an S corporation shareholder by being a grantor trust or ESBT will provide more flexibility than a QSST. While an ESBT's S corporation income will be taxed at the highest income tax rate, unlike a QSST income distributed by the S corporation to the trust need not be paid to the beneficiary and the ESBT can have multiple beneficiaries. Further, if the primary beneficiary is subject to the highest income tax bracket, ESBT status may not result in additional income tax.

(d) Difficult issues are presented when a QSST would be preferable from an income tax savings standpoint, but the terms of the trust do not meet the requirements for a QSST. For example, the trust may provide discretionary distributions of income and principal to a primary beneficiary and his descendants. To address this possibility, the trust agreement could authorize S stock to be held in a separate trust (segregated from the other trust assets) that requires all income to be distributed to the beneficiary and otherwise meets the QSST requirements. The power to convert a trust to a QSST should be held by a trustee other than settlor, the beneficiary or his descendants. If the settlor retains the power to convert a discretionary trust for multiple beneficiaries to a mandatory income trust for only one beneficiary, such power could cause the trust assets to be included in the settlor's gross estate under Code section 2036. If the beneficiary or one of his descendants held this power, it could constitute a general power of appointment, the exercise or lapse of which could result in transfer tax.⁸⁷ Care should also be taken to ensure that an independent trustee's power to convert to a QSST-structure will not be attributable to the settlor or beneficiaries pursuant to powers to remove and replace trustees.⁸⁸

ii. It may be appropriate for the trust instrument to provide flexibility regarding the decision to elect to be a qualified S corporation shareholder. Circumstances can arise when the best interests of the trust beneficiaries are served by not qualifying as an S corporation shareholder. For example, assume a trust receives shares of an S corporation that represent a small minority interest in the company, which is not subject to a shareholder agreement that prevents transfers to trusts that are not qualified S corporation shareholders. Assume further that the corporation either

⁸⁴ IRC § 641(c).

⁸⁵ IRC § 1361(e)(1)(B).

⁸⁶ IRC § 1361(e)(1)(A).

⁸⁷ IRC §§ 2041(a)(2), 2514(b).

⁸⁸ Rev. Rul. 95-58, 1995-2 C.B. 191 (August 4, 1995) (power to remove without cause coupled with power to appoint successors will cause trustee powers to be attributed to the powerholder unless the powerholder cannot appoint himself or anyone related or subordinate to the powerholder as defined in IRC § 672(c)).

(i) does not make sufficient distributions to cover the income tax liability attributable to the stock or (ii) is not viewed as an appropriate or prudent investment. The trustee could approach the corporation and other shareholders requesting that the trust's shares be redeemed or liquidated. The company or other shareholders may be encouraged to facilitate the trust's liquidation of the S corporation stock at fair market value because the trustee and trust beneficiaries could cause the corporation to lose its S corporation status – resulting in adverse tax consequences for all shareholders. If the trust instrument mandated that a trustee take steps to qualify the trust as an S corporation shareholder, the trust might be unable to force a fair liquidation of the stock.

iii. The trust instrument should include specific language addressing the ownership of S corporation stock. The attached sample trust agreement provides that S corporation status must be maintained (and all appropriate elections made) only if it is in the best interests of the beneficiaries. [3.6]

iv. If a trust will own S corporation stock and the settlor, trustee and beneficiary desire to protect S corporation status, a shareholder agreement should be signed that limits the transferability of stock and requires that all shareholders ensure continued qualification of the corporation as an S corporation. [3.6(d)]

G. Administration.

1. **Minimizing Litigation Risk in General.** Drafting administrative provisions in such a way as to minimize the potential for litigation may sound ideal in theory; however, careful consideration should be given to whether a trust instrument intended to minimize litigation risk will best serve the settlor's goals. What are the settlor's reasons for creating the trust? Who (or what) is the settlor trying to protect — the trustee? the trust's assets? the beneficiaries? the settlor? or some combination?

The primary objective of the Beneficiary Flexible Trust is to provide the beneficiary, serving as trustee, with the maximum amount of control and flexibility without jeopardizing other goals, such as minimizing transfer taxes and potential creditor and spousal claims. Typically the trust instrument will be drafted to minimize the ability of other current and remainder beneficiaries to litigate over the terms and administration of the trust, thereby affording the beneficiary, serving as trustee, with more protection. The trust instrument may be drafted to provide similar protection to successor trustees that are specifically named in the trust instrument or appointed by a beneficiary.

2. **Allocation Between Principal and Income.** If principal and income beneficiaries are different, authorizing the trustee to allocate receipts and disbursements between principal and income may allow the trustee to effectively shift benefits between those beneficiaries. For example, if a beneficiary has the right to income and principal but the beneficiary's descendants may only receive distributions of principal, the trustee has the power to determine how much of the trust assets will be available for distribution to the beneficiary versus the beneficiary's descendants simply by exercising the power to allocate between principal and income.

a. A power to allocate receipts and disbursements between income and principal, exercisable in a fiduciary capacity, under which the holder of the power has no ability to enlarge or shift any of the beneficial interests in principal and income except as an incidental consequence of the

discharge of his fiduciary duties, is not a power of appointment.⁸⁹ Hence, such a power should not create estate or gift tax problems if the beneficiary serves as trustee.

b. A power to allocate receipts and disbursements between principal and income is not a power of disposition that causes grantor trust status under Code section 674(a), even if the power is expressed in broad language.⁹⁰ Accordingly, the Beneficiary Flexible Trust may allow the beneficiary serving as trustee to allocate receipts and disbursements between principal and income without impacting the income tax status of the trust.

c. Many states, including Texas and Virginia, have adopted a version of the Uniform Principal and Income Act, which authorizes a trustee to adjust between principal and income under appropriate circumstances when the trustee manages and invests trust assets as a prudent investor.⁹¹ The trust instrument for the Beneficiary Flexible Trust should reference the Trustee's authority to adjust between principal and income under state law. **[6.1(t)]**

d. The Texas and Virginia Uniform Principal and Income Acts prohibit a trustee who is a beneficiary from exercising the power to make an adjustment between income and principal.⁹² Because the beneficiary is the trustee of the Beneficiary Flexible Trust, the trust instrument should designate a third party (such as an independent Trustee) who can exercise the power to adjust. **[6.1(t)]**

3. **Power to Decant.** In general, "decanting" means that the trustee of one trust transfers the trust's assets to the trustee of a second trust. Decanting is a useful tool for modifying the administrative provisions of a trust or making other kinds of revisions.⁹³ Some state statutes expressly authorize decanting. In other states, common law decanting may be accomplished through the exercise of a power of appointment in a fiduciary capacity. In either case, settlors who contemplate decanting should plan for its potential use.

a. If the trust is governed by the laws of a state whose statutes expressly authorize decanting, such as Texas and Virginia,⁹⁴ the trust instrument should be drafted to allow the invocation of the decanting statute. For example, in Delaware the decanting statute can be invoked by a trustee who has authority to invade principal in order to make distributions to beneficiaries.⁹⁵ If the trust instrument permits only distributions of income, decanting will not be possible.

⁸⁹ Treas. Reg. §§ 20.2041-1(b)(1); 25.2514-1(b)(1).

⁹⁰ IRC § 674(b)(8).

⁹¹ Tex. Trust Code § 116.005; Va. Code § 64.2-1002.

⁹² Tex. Trust Code § 116.005(c)(6); Va. Code § 64.2-1002(C)(7).

⁹³ See generally Farhad Aghdami and Jeffrey D. Chadwick, "Decanting Comes of Age," (American Bar Association, Tax Section, May 6, 2011, Washington, D.C.).

⁹⁴ See Tex. Trust Code §§ 112.071-112.087; Va. Code § 64.2-778.1.

⁹⁵ 12 Del. Code § 3528.

b. If the trust is governed by the laws of a state whose statutes do not expressly authorize decanting, the trust instrument should incorporate a power of appointment that is sufficiently broad to permit decanting to a second trust. Drafting such a provision will be challenging if the settlor or the beneficiary will hold the decanting power. If the settlor holds the power, it may not be so broad that it results in inclusion of the trust assets in the settlor's estate under Code sections 2036(a)(2) and 2038(a)(1). Similarly, if the beneficiary holds the power, it may not be so broad that the beneficiary has a general power of appointment under Code sections 2041(a)(2) and 2514(b).

c. On January 3, 2011, the Service announced that it will not issue letter rulings or determination letters regarding certain income, gift and generation-skipping transfer tax consequences of decanting.⁹⁶ On December 27, 2011, the Service issued Notice 2011-101, in which it requested comments regarding when decanting that results in a change in the beneficial interests of a trust is subject to income, gift, estate, and/or GST taxes. According to Notice 2011-101, the Service is studying the tax implications of decanting and considering approaches to address some or all of the relevant tax issues in published guidance.

4. **Power to Lend.**

a. A trust can benefit a beneficiary in many ways. The trustee can distribute assets directly to the beneficiary or expend trust funds on the beneficiary's behalf. The trust can own assets, such a residence, that the beneficiary is allowed to use without cost. In addition, the trust can lend funds to the beneficiary to enable the beneficiary to acquire assets or otherwise spend.⁹⁷ **[6.1(g)]**

b. The trustee must ensure that the loan terms are in accordance with his fiduciary duty to the trust's beneficiaries. The interest rate should not be less than the applicable federal rate of interest under Code section 1274 based on the month and year of the loan, the term of the loan and the method of compounding interest.

c. Lending trust assets to the beneficiary can be more advantageous than the distribution of funds to a beneficiary pursuant to a distribution standard.

i. First, upon the beneficiary's death, the borrowed funds and assets acquired with borrowed funds may be included in the beneficiary's taxable estate but the value of such assets may be offset by the outstanding loan amounts payable to the trust.

ii. Second, if the trust's loan to the beneficiary is secured by a lien on one or more assets owned by the beneficiary and the beneficiary later experiences creditor's claims, the trust's secured position may protect and enhance the trust's position as a lender.

5. **Self-Dealing.**

a. A trustee owes trust beneficiaries a duty of loyalty, requiring the trustee to place the beneficiaries' interests above those of the trustee and prohibiting the trustee from using his

⁹⁶ Rev. Proc. 2011-3, 2011-1 IRB.

⁹⁷ Unif. Trust Code § 816(18).

position for his own benefit at the expense of a beneficiary.⁹⁸ A trustee cannot profit from serving as trustee except by way of compensation.⁹⁹ Under many states' laws, if a trustee makes a profit from the use of trust property, the profit becomes trust property, and the trustee must account to the beneficiaries for the profit.¹⁰⁰ The duty of loyalty, therefore, prohibits self-dealing. However, what constitutes "self-dealing" is not always clear. The Texas Trust Code specifically prohibits several transactions as self-dealing.¹⁰¹

b. Because the primary goal of the Beneficiary Flexible Trust is to provide the beneficiary serving as trustee with maximum control and flexibility, while protecting trust assets from transfer taxes and creditors and spousal claims, the trust instrument should specifically authorize the trustee to engage in certain self-dealing transactions. **[6.10]**

c. For example, the trust instrument may authorize arms-length transactions between the beneficiary serving as trustee and the trust, including (i) the purchase, sale or lease of assets, and (ii) the lending or borrowing of funds.

d. The trust instrument may extend self-dealing authorization to all trustees or could be limited to individuals specifically named in the trust instrument or individual trustees appointed by a beneficiary.

6. **Situs.**

a. The situs of the trust is the state whose law governs the administration, construction, and validity of the trust.¹⁰² Choosing the trust's situs has important consequences.

b. The sample Beneficiary Flexible Trust attached to this paper assumes that the situs of the trust will be Texas. Unlike Virginia, where the terms of a trust may provide that the rule against perpetuities shall not apply,¹⁰³ the rule against perpetuities applies to trusts in Texas.¹⁰⁴ Consequently, if Texas law governs the validity of the trust, it cannot last beyond the perpetuities period. If the settlor wishes to create a dynasty trust to last for a longer period, the settlor must locate the trust in a jurisdiction without the rule against perpetuities or with a longer perpetuities

⁹⁸ Unif. Trust Code §§ 801 and 802; *see generally* Va. Code § 64.2-764.

⁹⁹ *See* Slay v. Burnett Trust, 187 S.W.2d 377, 388 (Tex. 1945).

¹⁰⁰ *See id.*

¹⁰¹ *See, e.g.,* Tex. Trust Code §§ 113.052–113.055 (prohibiting loan of trust funds to trustee, purchase or sale of trust property by trustee, sale of property from one trust to another trust where trustee is acting as trustee of both trusts, and purchase of trustee's securities).

¹⁰² *See, e.g.,* Restatement (Second) of Conflict of Laws, §§ 267-269.

¹⁰³ Va. Code § 55-12.4(A)(8). Va. Code § 64.2-764 provides that the ability to waive the rule against perpetuities shall not extend to real property held in trust, although "real property" does not include a business entity, such as a corporation, limited liability company, or partnership, that owns an interest in real property.

¹⁰⁴ Tex. Trust Code § 112.036.

period. However, there must be a sufficient relationship between the trust and that jurisdiction in order for such a choice of situs to be respected. Typically, this entails appointing a co-trustee located in the preferred jurisdiction and granting that co-trustee certain non-trivial powers over the trust administration. So some measure of administrative inconvenience is the price the settlor must pay for securing exemption from the rule against perpetuities.

c. A trust instrument can provide additional flexibility by authorizing the trustee to change the situs of trust administration from one state to another. For example, the laws of the second state may provide greater flexibility in making trust investments or fewer burdens in terms of providing accountings or carrying out other duties of the trustee. However, care should be taken in exercising such a power to be certain that unintended consequences do not result from the change of situs, such as increased income taxes. **[8.1]**

7. **Merger of Trusts.**

a. The trustee of multiple trusts must keep accurate records and accounts, invest trust assets, and file separate income tax returns for each trust (unless the trust is a grantor trust). The administration of multiple trusts may be streamlined by merging multiple trusts for the same beneficiaries into a single trust. The Beneficiary Flexible Trust should authorize the trustee to merge a trust into another trust (or to accept assets from another trust) and cause only one trust to survive (and the other trust to terminate). **[6.2]**

b. The trust provision authorizing multiple trusts to merge should be drafted to ensure that a merger does not result in adverse transfer taxes. First, the terms of the trusts being merged should benefit the same beneficiaries and provide substantially the same distribution provisions for those beneficiaries. Second, the surviving trust should be required to terminate no later than the earliest maximum perpetuities term of the trusts so merged. Third, exercise caution if a trust to be merged is a grandfathered GST-exempt trust. In that case, the merger should not impair the trust's grandfathered status if (i) it does not shift any beneficial interest to a beneficiary who occupies a lower generation than the individuals who held the beneficial interest prior to the merger and (ii) does not extend the time for vesting beyond the perpetuities period in the original trust.¹⁰⁵

c. Many states provide statutory authority to merge trusts. In Texas, a trustee may combine two or more trusts without a judicial proceeding, provided the merger is not expressly prohibited by the trust instruments and will not impair the rights of any beneficiary or adversely affect achievement of the purposes of the trusts. Absent beneficiary waivers, the trustee must provide certain beneficiaries with written notice at least thirty days before the merger becomes effective.¹⁰⁶ In Virginia, after giving notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust if the result does not materially impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust.¹⁰⁷

¹⁰⁵ Treas. Reg. § 26.2601-1(b)(4)(i)(E), ex. 6.

¹⁰⁶ Texas Trust Code § 112.057(c).

¹⁰⁷ Va. Code § 64.2-735.

8. Division into Separate Trusts.

a. The trust instrument should authorize a trustee to divide a trust into two or more separate trusts. **[6.5]** The division of a trust is most frequently employed when planning for the GST tax. If a trust is funded with assets valued in excess of the transferor's exemption from the GST tax, (currently \$5,340,000), flexibility and tax savings can be achieved by dividing the trust into two separate trusts – one that is exempt from the GST tax and one that is fully subject to the GST tax.

b. Creation of the separate trusts will facilitate tax-free distributions from the GST-exempt trust to skip persons (generally grandchildren and their descendants) while distributions to non-skip persons may be paid from the GST-nonexempt trust. In addition, the GST-nonexempt trust may benefit skip persons without the imposition of GST tax through the direct payment of tuition and medical expenses.¹⁰⁸

c. Creation of separate trusts will enable the trustee to utilize different investment approaches for each trust, perhaps investing the GST-nonexempt trust in income producing assets while investing the GST-exempt trust in assets with long-term appreciation potential.

d. The division of a trust into a GST-exempt trust and a GST-nonexempt trust must meet the Code's requirements for a "qualified severance."¹⁰⁹ This includes the requirement that the qualified severance is specifically authorized by state law or the trust instrument.

e. Many states have statutes authorizing the division of trusts. In Texas, a trustee may divide a trust into two or more trusts without a judicial proceeding, provided the division (i) is not expressly prohibited by the trust instrument and (ii) will not impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust. Absent beneficiary waivers, the trustee must provide certain beneficiaries with written notice at least thirty days before the division becomes effective.¹¹⁰ In Virginia, after giving notice to the qualified beneficiaries, a trustee may divide a trust into two or more separate trusts if the result does not materially impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust.¹¹¹

f. If a trust has a situs in a state that does not have a statute authorizing the division of trusts and the trust instrument does not authorize division, consider decanting or changing the situs of the trust. **[8.1]**

9. Savings Clauses.

a. Careful practitioners routinely include savings clauses in trust instruments that attempt to correct inadvertent inclusion or exclusion of relevant trust provisions. **[3.6(c)]** Savings clauses provide a measure of security that the settlor's general desires are accomplished and that an entire trust instrument will not be disregarded. **[8.9]** Savings clauses are commonly used in trusts that

¹⁰⁸ IRC § 2503(e).

¹⁰⁹ IRC § 2642(a)(3); Treas. Reg. § 26.2642-6; Treas. Reg. §26.2654-1(a)(3).

¹¹⁰ Texas Trust Code § 112.057(a).

¹¹¹ Va. Code § 64.2-735.

are intended to qualify for the marital or charitable deductions. Such a provision may state that if the trustee is granted any power that will disqualify a trust for the marital or charitable deduction, such power is void.

b. Savings clauses will not always operate to save poorly-drafted trusts. The Service will give effect to a savings clause to resolve an ambiguity about whether the power or direction has been conferred.¹¹² In contrast, the Service will not respect a savings clause to negate a trustee power or direction that, apart from the savings clause, is unambiguously conferred upon the trustee.¹¹³

c. Many states have statutes that effectively are savings clauses.¹¹⁴ For example, Texas Trust Code section 112.059, which authorizes a trust with a value of less than \$50,000 to be terminated if the trustee determines that it would be uneconomical to continue administration, specifically provides that a trustee may not exercise the power to terminate the trust if it would cause the trust assets to be included in the trustee's estate for federal estate tax purposes.¹¹⁵

10. Controlling Who is Taxed on Trust Income. A grantor trust is a trust whose assets, for income tax purposes, are deemed to be owned by the grantor or another person and whose items of income, deduction, and credit are attributable to the grantor or other person rather than to the trust as a separate taxpayer.¹¹⁶ It may be appropriate to structure the Beneficiary Flexible Trust as a grantor trust as to the settlor or the beneficiary.

a. **Advantages of Grantor Trust.** Grantor trusts present several estate planning advantages:

i. Because transactions between the grantor and the trust are, essentially, transactions between the grantor and himself, those transactions do not have income tax consequences (*e.g.*, no capital gain on sale of appreciated assets and no ordinary income on interest payments).

ii. The grantor's payment of tax on the trust's income represents a discharge of the grantor's own liability and not a discharge of the trust's liability. Hence, there is no gift tax result, assuming the trust instrument does not require the trustee to reimburse the grantor for income tax payments.¹¹⁷ Payment of tax on the trust's income is, to that extent, a way for the settlor to augment the trust's assets outside of the transfer tax system. In Virginia, a trust instrument may provide for the discretionary reimbursement of a settlor for income tax paid on a grantor trust

¹¹² Rev. Rul. 75-440, 1975-2 C.B. 372.

¹¹³ *Commissioner v. Proctor*, 142 F.2d 824 (4th Cir. 1944), cert denied, 393 U.S. 756 (1944); Rev. Rule 65-144 1965-1 C.B. 442.

¹¹⁴ *See, e.g.*, Va. Code § 64.2-776.

¹¹⁵ Tex. Trust Code § 112.059(c). *See also* Tex. Trust Code § 113.029 (limiting distribution powers of beneficiary serving as trustee to avoid deemed general power of appointment).

¹¹⁶ IRC § 671.

¹¹⁷ *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

without such reimbursement being considered a distribution for the settlor's benefit and, therefore, subject to the claims of the settlor's credits.¹¹⁸

b. Methods to Obtain Grantor Trust Status as to Settlor. There are several methods of structuring a trust to cause grantor trust status as to the original settlor. However, the trust instrument should be carefully drafted to facilitate the settlor being deemed the owner for income tax purposes while not being considered the owner for federal transfer tax purposes.¹¹⁹ Three commonly used methods to trigger grantor trust status as to the settlor, without adverse transfer tax consequences, are discussed below:

i. Swap Power.

(a) The trust instrument could grant the settlor (or another person) the power, acting in a non-fiduciary capacity, to reacquire the trust assets by substituting assets of equivalent value.¹²⁰ This is commonly referred to as a "swap power." To insure the trust assets are not includable in the settlor's estate for federal estate tax purposes, the trustee must have a fiduciary duty to ensure that the assets acquired and substituted by the settlor are in fact of equivalent value.¹²¹

(b) A swap power offers a number of benefits:

(1) The swap power should cause the trust to be treated as a grantor trust as to the settlor for income tax purposes.¹²²

(2) The swap power should not cause estate tax inclusion under Code sections 2036 and 2038.¹²³

(3) The swap power can facilitate a "step-up" in the income tax basis of trust assets during the settlor's lifetime. If the trust has substantially appreciated assets, the settlor may substitute those assets for cash or high basis assets. As a result, if the settlor owns the appreciated assets upon his death, they should receive a new income tax basis equal to fair market value.¹²⁴

(4) If the settlor owns assets that he believes have greater income or appreciation potential, he can swap those assets in exchange for trust assets that may be more volatile or at greater risk of declining in value.

¹¹⁸ Va. Code § 64.2-747(A)(2).

¹¹⁹ See note 14.

¹²⁰ For a discussion of the swap power (as well other powers that produce grantor trust status), see Stephen R. Akers, *"Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks"* (January 14, 2009).

¹²¹ See Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

¹²² See IRC § 675(4).

¹²³ See Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

¹²⁴ IRC § 1014.

(c) A settlor's swap power with respect to a policy of insurance on his life will not cause the insurance proceeds to be included in his estate under Code Section 2042.¹²⁵ A cautious practitioner will restrict the settlor's swap power so that it will not apply to voting stock in a controlled corporation subject to Code section 2036(b).

ii. Settlor's Power to Borrow.

(a) If the trust instrument grants the settlor or his spouse the right to borrow trust assets without adequate security or adequate interest, the trust will be a grantor trust as to the settlor.¹²⁶ Further, if a non-adverse party can enable the settlor or his spouse to borrow trust assets without adequate interest or adequate security, the trust will be a grantor trust as to the settlor. Actual borrowing is not required to trigger grantor trust status. The ability of a trustee (other than the settlor) to lend to the settlor or his spouse pursuant to a trust instrument's general lending power to make loans to any person without interest or security will not cause grantor trust status.¹²⁷

(b) The trust instrument's lending power must be carefully drafted to ensure that it will not cause the trust assets to be included in settlor's gross estate under Code sections 2036 and 2038. While the lending power may safely permit loans without any security, the ability to borrow trust assets without adequate interest will likely cause the trust assets to be included in the grantor's estate for federal estate tax purposes.¹²⁸ Accordingly, the trust instrument should require that adequate interest be charged on any loan to the settlor or his spouse.

(c) To further minimize potential estate tax inclusion concerns, it may be preferable to structure the lending power as one exercisable by the settlor, in a fiduciary capacity, rather than permit the settlor, in a non-fiduciary capacity, to compel the trustee to lend trust assets to settlor.

(d) Code section 675(3) provides an alternative method of obtaining grantor trust status through a settlor's actual borrowing of trust assets. If the settlor or his spouse borrows trust assets (without adequate security) and has not fully repaid the loan prior to the end of the year, the trust

¹²⁵ Rev. Rul. 2011-28.

¹²⁶ IRC § 675(2).

¹²⁷ IRC § 675(2).

¹²⁸ See, e.g., Esperti, Peterson & Keebler, *Irrevocable Trusts: Analysis with Forms (WG&L)* ¶ 4.03[5][b] ("While there is no direct authority as to the estate tax effects of a power by a grantor or a nonadverse party to borrow trust income or principal, directly or indirectly, without adequate security or interest, there is a strong argument that a grantor who has done so has retained enough control to draw the trust into his or her estate under Sections 2036 or 2038."); Stephen R. Akers, *Transfer Planning, Including Use of GRATs, Installment Sales to Grantor Trusts, and Defined Value Clauses to Limit Gift Exposure*, 32nd Annual Advanced Estate Planning and Probate Course (June 11 -13, 2008), Ch. 30.1 at 56 ("To avoid an argument that the grantor has retained a discretionary beneficial interest in the trust that would cause estate tax inclusion, the lending power should be limited to the authority to make loans without security, and should not include the authority to make loans to the grantor without adequate interest."); Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis with Forms (WG&L)*, ¶ 12.07[3][a][ii] ("ability to borrow at less than . . . adequate interest . . . could be construed as a power to alter the beneficial enjoyment of the trust assets . . . [that] could cause all or part of the trust assets to be included in the grantor's gross estate under Section 2036(a)(2) or Section 2038(a).").

will be a grantor trust for that year. This method of obtaining grantor trust status may not be as useful as the Code section 675(2) borrowing power because it is not certain whether a settlor's borrowing of only a portion of the trust assets will result in grantor trust status for the entire trust.¹²⁹

iii. **Power to Add Beneficiaries.**

(a) Code section 674 provides an additional method to obtain grantor trust status without causing the trust assets to be included in the settlor's estate for federal estate tax purposes. For example, the trust instrument could grant a nonadverse third party the power to add one or more beneficiaries to the trust.¹³⁰

(b) If a settlor desires to limit the risk of potential abuse of the power to add beneficiaries, the trust instrument may provide:

- (1) The power to add beneficiaries will be exercisable only during the settlor's lifetime.
- (2) The class of potential additional beneficiaries will be limited to a defined set of individuals or entities (*e.g.*, charities).
- (3) The power to add additional beneficiaries and the power to make distributions to such beneficiaries will be bifurcated, granting an independent trustee the power to make distributions to those beneficiaries added by the nonadverse powerholder.

c. **Method to Obtain Grantor Trust Status as to the Beneficiary.** The Beneficiary Flexible Trust can also be structured as a grantor trust for income tax purposes as to the beneficiary under Code section 678.¹³¹

i. The trust instrument should grant the beneficiary a withdrawal right over the initial contribution of assets to the trust, which initial contribution should not exceed \$5,000. A sample withdrawal right provision is attached as **Exhibit 3**. A sample withdrawal notice letter is attached as **Exhibit 4**.

ii. If the Beneficiary Flexible Trust is intended to be taxed to the beneficiary under Code section 678, care should be taken to ensure that the trust does not contain provisions that would cause the trust to be a grantor trust as to the settlor.¹³² For example, the trust should specifically eliminate the power to make loans to the settlor without adequate interest and security and should

¹²⁹ See *Bennett v. Commissioner*, 79 T.C. 157 (2002) and *Benson v. Commissioner*, 76 T.C. 1040 (1981).

¹³⁰ IRC § 674(a); *see also* *Madorin v. Comm'r*, 84 T.C. 667 (1985) (power of nonadverse trustee to add charitable beneficiaries caused grantor trust status); IRC § 672(b) defines "nonadverse party" as any person who is not an "adverse party." IRC § 672(a) defines an "adverse party" as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respect the trust.

¹³¹ See note 16 for a detailed discussion of Section 678 trusts.

¹³² See I.R.C. § 678(b) (providing that 678 grantor trust status will not apply to power over income if settlor is otherwise treated as owner for income tax purposes).

not grant any person a nonfiduciary power to substitute assets with other assets of equivalent value.

11. Duty to Provide Accountings to Successor Trustees.

a. A successor trustee may demand a formal accounting from the predecessor trustee as a condition to accepting his appointment as successor trustee. The time and expenses of preparing such an accounting can make the transition to a successor trustee burdensome. Nevertheless, a potential successor trustee may be reluctant to accept his appointment without a complete understanding of the prior trust administration.

b. The concerns associated with the need for, and preparation of, a formal accounting as a prerequisite for changing trustees can be addressed by allowing a successor trustee to accept appointment without an accounting (absent a demand by a beneficiary) and absolving the successor trustee of any responsibility for damages caused by the actions of a predecessor fiduciary. [4.9] This approach provides the beneficiary with more control and flexibility. If the beneficiary is confident the trust has been properly administered, the change of trustees may be accomplished without the burdens of a formal accounting. Conversely, if the beneficiary has concerns about the prior administration of the trust, he can require a formal accounting.

12. Duty to Provide Accountings to Beneficiaries.

a. Trustees have a general duty to provide written accountings of trust assets and transactions if requested by the beneficiaries.¹³³ This duty to provide accountings extends to both current and remainder beneficiaries; however, it generally is only triggered upon the request of a beneficiary.

b. Trustees also have a common law duty to keep beneficiaries informed of certain matters with respect to trust administration.¹³⁴

c. A trust instrument may provide additional disclosure requirements, including prescribing the frequency with which disclosures must be made to beneficiaries. However, in Texas, unlike in

¹³³ See, e.g., Restatement (Third) of Trusts § 82(2) ("[A] trustee also ordinarily has a duty to promptly respond to the request of any beneficiary for information concerning the trust and its administration, and to permit beneficiaries on a reasonable basis to inspect trust documents, records, and property holdings."); Uniform Probate Code § 7-303(c) ("Upon reasonable request, a beneficiary is entitled to a statement of the accounts of the trust annually and on termination of the trust or change of the trustee."); Tex. Trust Code § 113.151(a) ("[A] beneficiary by written demand may request the trustee to deliver to each beneficiary of the trust a written statement of accounts"); Va. Code § 64.2-775(A) ("A trustee shall keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests. Unless unreasonable under the circumstances, a trustee shall promptly respond to a beneficiary's request for information related to the administration of the trust.")

¹³⁴ See C. Boone Schwartzel, "A Texas Trustee's New Duty to Inform: Beware of the Creeping Uniform Trust Code," 12th Annual Advanced Estate Planning and Strategies Course (State Bar of Texas, April 6-7, 2006).

Virginia, a trust instrument may not completely waive the trustee's duty to provide accountings¹³⁵ or the trustee's common law duty to keep certain beneficiaries informed.¹³⁶

d. The beneficiaries who are entitled to demand accountings include not only those who are currently entitled or permitted to receive distributions from the trust, but also those who would receive a distribution from the trust if it terminated (*i.e.*, remainder beneficiaries). Query: Is a remainder beneficiary entitled to receive accountings or other information if the current beneficiary could defeat the remainder interest by exercising a power of appointment? If the beneficiary has in fact exercised a testamentary power of appointment in his will, who is the remainder beneficiary with the power to demand accountings and other information?

e. To minimize administrative burdens on the beneficiary serving as trustee, the trust instrument creating the Beneficiary Flexible Trust should provide that the trustee must provide an annual accounting only upon the request of a beneficiary authorized to receive accountings under applicable state law. Further, to the extent allowable by law, the beneficiary serving as trustee should not be required to provide annual accountings. [4.10] This provision, while not valid in Texas, may be valid in other states, such as Virginia.

f. The trust instrument should contain provisions that facilitate the trustee's dealing with minor or otherwise incapacitated beneficiaries without the requirement of a court-appointed guardian. [4.11]

13. No-Contest Clauses.

a. The general purpose of a "no-contest" or "in terrorem" clause is to dissuade beneficiaries from challenging or defying a settlor's intentions as set forth in the governing trust instrument. A typical no-contest clause provides that if a beneficiary questions the terms of the trust in a court action, that beneficiary's interest (and, potentially, the interest of the beneficiary's descendants) in the trust will terminate or be forfeited.

b. In the Beneficiary Flexible Trust, the primary benefit of including an in terrorem provision is to dissuade the designated remainder beneficiaries from contesting the terms of the trust instrument.

c. Careful consideration should be given to how broad the forfeiture might be. The clause could terminate only the beneficiary's interest, or it could terminate the interests of the beneficiary and his or her descendants. Some settlors may be hesitant to disinherit grandchildren if a child contests trust provisions. However, the risk of forfeiting not only the contesting child's interest

¹³⁵ Tex. Trust Code §111.0035(b)(4)(A) ("The terms of a trust . . . may not limit . . . a trustee's duty . . . with regard to an irrevocable trust, to respond to a demand for accounting made under Section 113.151 if the demand is from a beneficiary who, at the time of the demand, (i) is entitled or permitted to receive distributions from the trust; or (ii) would receive a distribution from the trust if the trust terminated at the time of the demand").

¹³⁶ Tex. Trust Code § 111.0035(c). ("The terms of a trust may not limit any common-law duty to keep a beneficiary of an irrevocable trust who is 25 years of age or older informed at any time during which the beneficiary (1) is entitled or permitted to receive distributions from the trust; or (2) would receive a distribution from the trust if the trust were terminated.").

but also his descendants' interests may act as an additional deterrent to the beneficiary to contest the trust provisions.

d. No-contest clauses have become increasingly difficult to enforce in some jurisdictions.¹³⁷ For instance, in Texas, a provision in a trust instrument that would cause forfeiture of an interest as a result of bringing a court action, including contesting the provisions of a trust, is unenforceable if (i) just cause exists for bringing the action; and (ii) the action was brought and maintained in good faith.¹³⁸ This "good faith" exception has allowed many beneficiaries to commence lawsuits contesting the provisions of trusts without necessarily forfeiting their rights as beneficiaries. While a no-contest clause is not a fail-proof way to avoid litigation, it may deter some beneficiaries from filing contests, particularly if the contesting beneficiaries' descendants also risk forfeiture of their beneficial interests.

e. Sample provision #1:

If any beneficiary or any legal representative of such beneficiary contests the validity of the instrument creating this Trust:

(i) All of such beneficiary's gifts under this Trust Agreement shall be forfeited; and

(ii) For purposes of disposing of the gifts made to such beneficiary under this Trust Agreement, such beneficiary [and his or her Descendants] shall [all] be treated as if he [they] had failed to survive Settlor.

In order to assure a beneficiary's compliance with this condition precedent, the Trustee may require the beneficiary to execute an appropriate instrument waiving and/or releasing any right of contest that the beneficiary may have and/or indemnifying Settlor's estate and/or the trust estate against any loss as a result of any contest by the beneficiary or the legal representative of the beneficiary or the beneficiary's estate. A beneficiary's failure or refusal to execute any such instrument required by the Trustee shall be treated as the beneficiary's failure to comply with the condition precedent set forth herein and the beneficiary [and his/her descendants] shall [all] be treated as if he/she/they had failed to survive Settlor.

f. Sample provision #2:

(a) If any beneficiary institutes or becomes a party plaintiff to a Proceeding or acts in the interest of any person who institutes a Proceeding, all of the provisions set forth in this trust instrument in favor of that beneficiary or that beneficiary's Descendants shall immediately be revoked and the property that would otherwise pass under such provisions shall be distributed as if such beneficiary were deceased and had no living Descendants.

¹³⁷ For an excellent discussion of no-contest clauses in Virginia, see Matthew M. Farley, "Avoiding Will Contests," The Douglas W. Conner 33rd Annual Advanced Estate Planning and Administration Seminar (April 28, 2012).

¹³⁸ Tex. Trust Code § 112.038; *see also* Tex. Trust Code § 111.0035(b)(6) (providing that terms of trust may not limit applicability of Section 112.038).

(b) *As used in this provision, "Proceeding" means any action, suit, or other legal proceeding whose purpose is:*

(a) *to abrogate, set aside, or otherwise challenge any provision of this trust instrument; or*

(b) *to change the effect of any provision of this trust instrument.;*

(c) *This provision applies to any person who is entitled to any part of the trust estate (outright or in trust and whether as a current, contingent, or remainder beneficiary) or any legal representative of such person (including a guardian of the person, guardian of the estate, or guardian/attorney ad litem).*

14. Dispute Resolution Provisions.

a. In recent years, parties to legal disputes have looked to non-judicial means of resolving those disputes, such as mediation and arbitration. Mediation allows parties to work with a third party facilitator whose role is to help the parties reach a settlement of a dispute. In arbitration, the parties present arguments to a third party arbitrator, who then renders a decision that is binding on the parties. Non-judicial resolution of disputes offers a number of potential advantages over traditional litigation, such as reduced costs and confidentiality.

b. Some states may enforce provisions in a trust instrument that mandate that (1) all disputes among the trustee and beneficiaries be resolved through arbitration, or (2) the beneficiary and trustee participate in mediation as a precondition to initiating litigation of a dispute.¹³⁹ In Texas, a trust instrument may not limit the power of a court, in the interest of justice, to take action or exercise jurisdiction over trust matters.¹⁴⁰ Nevertheless, the Texas Supreme Court recently held that a provision in a trust agreement requiring submission of disputes regarding the trust to arbitration was binding upon a beneficiary asserting a claim against the trustee.¹⁴¹

15. Small Trust Termination.

a. In order to enhance flexibility, a trust instrument should provide the trustee with sufficient freedom to administer the trust in an economical manner. In that regard, the trust instrument should authorize the trustee to terminate a trust if the value of the trust estate becomes so small that continued administration would be uneconomical. **[5.6]**

b. Some states, including Texas and Virginia, have enacted statutes that authorize a trustee to terminate a trust that has insufficient property to justify the continued cost of administration.¹⁴²

¹³⁹ Unif. Trust Code § 111 (authorizing non-judicial settlement of trust matters).

¹⁴⁰ Tex. Trust Code § 111.0035(b)(5).

¹⁴¹ *Rachal v. Reitz*, 403 S.W.3d (Tex. 2013).

¹⁴² Tex. Trust Code § 112.059; Va. Code § 64.2-732.

c. A cautious practitioner will prohibit a settlor or beneficiary serving as trustee from exercising the power to terminate a small trust.¹⁴³

16. Judicial Construction or Modification of Trust.

a. A state court judicial construction or modification proceeding may allow a taxpayer to correct a problematic provision of a trust instrument. However, anyone pursuing a state court solution must be mindful of the interplay between state court decisions and federal tax treatment.

b. A state court “construction” of an ambiguous provision of a trust instrument seeks to conform the trust to the settlor’s original intent. As a result, it may apply retroactively, provided that the construction is consistent with state law. As discussed above, a savings clause may provide added support for construing an ambiguous provision in a manner that avoids negative tax consequences.

c. State law may allow judicial reformation of problematic trust provisions. State law generally permits a court to judicially modify a trust instrument to correct a scrivener’s error. Some states also permit courts to reform a trust in order to correct problematic provisions that did not result from a scrivener’s error. For example, Texas and Virginia law permit a court to reform a trust if the reformation is necessary or appropriate to achieve the settlor’s tax objectives and is not contrary to the settlor’s intent.¹⁴⁴ These Texas and Virginia laws allow the reformation to have retroactive effect.¹⁴⁵

d. The IRS generally has been reluctant to give retroactive effect to modifications of trust instruments that seek to cure tax defects.¹⁴⁶ However, the IRS has shown some willingness to allow retroactive effect when the reformation has been obtained to correct a scrivener’s error.¹⁴⁷

¹⁴³ See Tex. Trust Code § 112.059(c) (“A trustee may not exercise [the power to terminate a small trust] if the trustee’s possession of the power would cause the assets of the trust to be included in a trustee’s estate for federal estate tax purposes.”).

¹⁴⁴ Tex. Trust Code § 112.054(a)(4); Va. Code § 64.2-734.

¹⁴⁵ Tex. Trust Code § 112.054(c); Va. Code § 64.2-734.

¹⁴⁶ See, e.g., Rev. Rul. 93-79 (declining to grant retroactive relief to court reformation of a trust to allow it to hold S corporation stock).

¹⁴⁷ See, e.g., Ltr. Rul. 200144018 (Aug. 3, 2001). In this ruling, the beneficiary, as trustee, could distribute principal to herself for her “health, welfare and maintenance.” This power gave the beneficiary a general power of appointment over the trust assets. The IRS ruled that a court reformation that modified this language retroactively to “health, education, support and maintenance” would not be a release of a general power for gift tax purposes because the modification was based on a scrivener’s error and was consistent with state law. See also Ltr. Rul. 201132017 (Aug. 12, 2011) (Due to scrivener’s error, a couple’s revocable trust charged debts, expenses, and taxes at the surviving spouse’s death against the property of the bypass trust. After the first spouse’s death, the surviving spouse secured judicial modification of the trust agreement so as to charge those items against the survivor’s trust, consistent with the couple’s intent. The IRS recognized the modification and ruled that it had no adverse tax consequences.)

The result compares to the treatment of a construction suit, in that the reformation restores the trust instrument to the settlor's original intent.¹⁴⁸

e. Anyone who intends to rely on a state court construction or modification of a trust instrument to cure a tax defect must be mindful of the ability of that decision to impact federal tax treatment. Unless the IRS is a party to the state court action, the IRS and federal courts generally are bound only by state court decisions from the highest court in the state.¹⁴⁹ In most cases, a petition seeking judicial construction or modification of a trust will not be opposed. Hence, in most states there is no way to secure a decision from the highest state court because there is no procedure for seeking review of the trial court's decision. Some states (such as Massachusetts) have a procedure under which the state's highest court can certify the decision of a lower court modifying or construing a trust, even though no error in the lower court's judgment is claimed. If the trust instrument permits, consider changing the situs of the trust to such a jurisdiction, appointing a local trustee (if necessary), and pursuing the judicial proceeding in that state.

f. Even without securing a decision of the state's highest court, state law proceedings may still offer the opportunity to avoid negative tax consequences from problematic trust provisions. In a federal tax controversy, the federal court must independently determine whether the state court properly applied applicable state law in reforming or construing the trust instrument.¹⁵⁰ If the federal court determines that the state court properly applied state law and state law allows for retroactive effect of the court decision, a favorable state court decision may cure the tax defect in the trust instrument.

g. Because of these uncertainties, anyone pursuing a judicial construction or modification to address a problematic trust provision should strongly consider seeking a private letter ruling as to the tax implication of the proposed court proceeding.

17. Directed Trusts.

a. Sometimes it will make sense for the settlor to vest control over certain trust issues in some person or group of persons other than the trustee (e.g., a trust protector, investment advisor, distribution advisor, etc.). The settlor might want to do this if, for example, the person designated to serve as trustee were uncomfortable with exercising certain powers or duties, or another person were better able to intelligently resolve those issues than the trustee, or the trustee's control over those issues created tax, creditor's rights, or other problems for the trustee. In such a case, the settlor may wish to use a directed trust.

¹⁴⁸ For a thorough discussion of the consequences of court modifications and constructions, see Carlyn S. McCaffrey, "Fix-Ups for Estate Planning Documents," (2002).

¹⁴⁹ See *Commissioner v. Bosch*, 387 U.S. 456 (1967).

¹⁵⁰ *Bosch*, 387 U.S. 456, at 465 ("If there be no decision by that court then federal authorities must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court.").

b. A thorough discussion of directed trusts is beyond the scope of this outline.¹⁵¹ However, in general a directed trust is one in which the settlor has given some person or persons, other than the trustee, the power to direct certain actions of the trustee.

c. Directed trusts most often involve granting another person the power to direct the trustee's actions in one or more of the following areas:

- i. Investments (e.g., whether to diversify or concentrate);
- ii. Distributions to beneficiaries (e.g., how much is required for a beneficiary's support and what other resources of the beneficiary should be included);
- iii. Valuation issues (e.g., how property is valued for purposes of non-prorata distributions in kind);
- iv. Tax matters (e.g., whether to make an S election or an ESBT election);
- v. Management of a closely held business;
- vi. Change in the trust situs or governing law;
- vii. Modification of the trust instrument; and
- viii. Termination of the trust.

d. When the settlor uses a directed trust, two of the most important questions are:

- i. Whether the trustee is liable to the beneficiary for carrying out the direction; and
- ii. Whether the party with the power to direct the trustee is liable to the beneficiary.

e. Many states have enacted statutes dealing with directed trusts, and their provisions regarding the liability of the trustee vary. For example:

- i. Some states permit a complete bifurcation of responsibilities. The trustee's only duty is to follow the directions of the directing party. The trustee has no duty to monitor the directing party, to advise or consult with the directing party, to inquire into the directing party's actions, or to advise or warn the beneficiaries that the trustee would have exercised its discretion differently

¹⁵¹ For a thorough discussion of directed trusts, see Dennis Belcher, "Not My Fault - The Devil Made Me Do It! Responsibilities and Duties of a Delegating or Directed Trustee," Section 11, 2007 University of Miami School of Law: Heckerling School on Estate Planning; Belcher, Pankey, Wernz, "Directed Trustees Co-Trustees, and Successor Trustees - Fiduciary and Regulatory Issues," Section III-C, 2007 University of Miami School of Law: Heckerling School on Estate Planning; John B. Brescher, Jr., "Fiduciary Duties of Directed Trustees (ERISA)," *Probate & Property* at 50 (July/August 2002); Gordon, "Directed Trusts: The Use of Trust Advisors and Protectors: Can Fiduciaries Limit Liability, Through Directed Trusts? Empowering Trust Protectors While Minimizing Their Liability, or Can A House Divided Long Stand?," § 18, 2006 Notre Dame Tax Estate Planning Institute; Richard Nenko, "Directed Trusts: Can Directed Trustees Limit Their Liability?," Chapter RWN 18, 2006 Notre Dame Tax and Estate Planning Institute.

from the directing party. If the trustee acts as directed by the directing party, the trustee is liable only in the case of willful misconduct.¹⁵²

ii. Some states permit the trustee to follow the directions of the directing party unless the direction is manifestly contrary to the terms of the trust or would constitute a serious breach of a fiduciary duty that the directing party owes to the beneficiaries.¹⁵³

iii. Some states permit the trustee to follow the directions of the directing party unless the trustee acts in bad faith or with reckless indifference.¹⁵⁴

iv. Other states, such as Virginia, employ a hybrid approach where the terms of the trust instrument (as executed by the settlor or as incorporated by non-judicial settlement agreement), provide optionality regarding the relationship amongst directed trustees and trust directors.¹⁵⁵

v. Each of the statutes cited above makes the directing party a fiduciary who owes duties to the beneficiaries.

f. Practitioners who are considering the use of a directed trust should consult the law governing the trust to determine which issues can be the subject of direction and the resulting fiduciary duties and liabilities of the trustee and the directing party.

H. Conclusion.

The tension between flexibility and control manifests itself in virtually every provision of a trust instrument, from beneficiary designations to distributions to trustee selection to administrative powers. Some of both is necessary in every instrument; too much of either can be disastrous. The competent practitioner will know how to balance flexibility and control in order to achieve his client's goals. That is the art of estate planning.

¹⁵² *See, e.g.*, 12 Del. C. § 3313.

¹⁵³ *See, e.g.*, Uniform Trust Code § 808; Texas Trust Code § 114.003; Fla. Stat. § 736.0808.

¹⁵⁴ *See, e.g.*, Ariz. Rev. Stat. § 14-10808.

¹⁵⁵ *See* Va. Code § 64.2-770.

Exhibit 1

ROBERT DOE IRREVOCABLE TRUST

This Trust Agreement ("Trust Agreement") is executed on _____, 2014, by JOHN DOE as Settlor and ROBERT DOE as Trustee.

I. DEFINITIONS

The following terms, as used in this Trust Agreement, have the meanings set forth below, unless another meaning is clearly indicated by context:

- 1.1 **Settlor.** "Settlor" means JOHN DOE.
- 1.2 **Trustee.** The initial trustee of each trust created under this Trust Agreement is ROBERT DOE. Unless otherwise indicated by the context, "Trustee" and the pronoun "it" used in reference to the "Trustee" mean all persons or entities who are at any time serving as trustee, whether original or successor and whether one or more in number. However, use of the singular noun "Trustee" and the singular pronoun "it" shall not alter any division of the Trustee's powers made in subsequent provisions of this Trust Agreement. "Individual Trustee" means a Trustee who is not a corporate fiduciary. "Family Trustee" means ROBERT DOE in his capacity as Trustee, and any successor Family Trustee appointed in accordance with section 4.1. "Independent Trustee" means RICHARD ROE (upon his acceptance as set forth in section 4.2) in his capacity as Trustee, and any successor Independent Trustee appointed in accordance with section 4.2.
- 1.3 **Robert.** "Robert" means ROBERT DOE.
- 1.4 **Children.** "Children" means Robert's children, JIMMY DOE, MARY DOE, and SUSIE DOE. "Child" means one of the Children.
- 1.5 **Descendants.** "Descendants" means the legitimate children of the person designated and the legitimate lineal descendants of such children, and includes any person adopted before attaining age fifteen (15) and the adopted person's legitimate lineal descendants. A posthumous child shall be considered as living at the death of his parent.
- 1.6 **Code.** "Code" means the Internal Revenue Code of 1986, as amended, and corresponding provisions of future federal tax law.
- 1.7 **Per Stirpes.** "Per Stirpes," when used with respect to a distribution of property among a class of beneficiaries, shall mean by representation; that is, the Descendants of a deceased ancestor take the share such ancestor would have received had he or she been living, and the issue of a living ascendant would not take in competition with such ascendant. The per stirpital allocation shall commence with the most senior generation that has a living representative.

II. FUNDING

- 2.1 **Initial Trust Estate.** Settlor has transferred to the Trustee out of Settlor's separate property, without consideration, the property described in Schedule A attached to this Trust Agreement. The Trustee shall administer the initial trust estate as a separate trust, known as Robert's Trust, for the primary benefit of Robert pursuant to section 3.1 hereof.
- 2.2 **Additional Contributions.** Settlor or any other person or entity may contribute additional property to the Trustee, to be administered and distributed in accordance with the terms of this Trust Agreement. Additional contributions shall be allocated among the trusts created hereunder as follows:
- (a) **Direction by Donor.** A donor, by written instrument delivered to the Trustee simultaneously with a contribution, may specify one or more of the trusts created hereunder to which the contribution shall be allocated and the respective shares. If the donor does so, the additional property transferred to the Trustee shall be allocated in the manner specified by the donor.
 - (b) **No Direction by Donor.** In the absence of any express direction by the donor, additional property transferred to the Trustee shall be allocated as provided in this subsection 2.2(b).
 - (i) If Robert is then living, such property shall be added to Robert's Trust and administered pursuant to section 3.1 hereof.
 - (ii) If Robert is not then living but one or more of Robert's Descendants are then living, the following provisions shall apply:
 - (1) If one or more of the Children are then living, the Trustee shall divide such property into separate equal shares, one for each then living Child and one for each deceased Child with one or more Descendants then living. The Trustee shall further divide each deceased Child's share among that Child's then living Descendants, Per Stirpes. The Trustee shall administer each living Child's share as a separate trust for the primary benefit of that Child pursuant to section 3.2 hereof. The Trustee shall distribute the share of each Descendant of a Child to that Descendant, subject to further retention in trust under section 3.5.
 - (2) If none of the Children are then living, the Trustee shall divide such property among Robert's then living Descendants, Per Stirpes. The Trustee shall distribute the share of each Descendant to that Descendant, subject to further retention in trust under section 3.5.
 - (iii) If neither Robert nor any of Robert's Descendants are then living, the Trustee shall distribute such property pursuant to section 3.3 hereof.

III. FUNDAMENTAL TRUST PROVISIONS

The following provisions shall govern the administration and distribution of trusts created under this Trust Agreement:

- 3.1 **Robert's Trust.** Robert's Trust shall be administered and distributed for the benefit of Robert and Robert's Descendants upon the following terms:
- (a) **Primary Purpose.** The primary purpose of Robert's Trust is to provide for Robert.
 - (b) **Distributions to Robert.** The Trustee may distribute to Robert so much of the net income and principal of Robert's Trust as the Trustee deems necessary to provide for Robert's reasonable health, education, maintenance, and support. In exercising its discretion, the Trustee shall take into account the following factors:
 - (i) The primary purpose of Robert's Trust.
 - (ii) The standard of living equivalent to that which a reasonably prudent person, having an estate comparable in size to Robert's Trust plus Robert's own estate, would enjoy under the circumstances.
 - (iii) The Trustee shall take into consideration in determining Robert's needs any other income or resources known upon reasonable inquiry by it to be available to Robert for these purposes. It is not Settlor's intention, however, that such other income or resources be entirely exhausted before distributions are made under this provision.
 - (iv) Settlor's intention to assist or enable Robert to obtain and furnish a home commensurate with the standard of living equivalent to that which a reasonably prudent person, having an estate comparable in size to Robert's Trust plus Robert's own estate, would enjoy under the circumstances.
 - (v) Settlor's intention to assist or enable Robert to obtain capital to enter a business or profession.
 - (vi) The Trustee shall be as liberal in making distributions to Robert as existing circumstances and Robert's reasonable needs may justify.
 - (c) **Distributions by Independent Trustee.** The Independent Trustee may, in its sole and absolute discretion, distribute to Robert so much of the income and principal of the trust as the Independent Trustee shall deem appropriate or advisable. It is Settlor's intention to give the Independent Trustee the broadest discretion possible in determining the amount and timing of distributions of income and principal hereunder and Settlor recognizes that the Independent Trustee may, in the exercise of its discretion, determine to distribute the entire trust estate to Robert or to make no distributions to Robert during Robert's disability, or for so long as Robert shall have a judgment outstanding, or for so long as any distribution might be lost to Robert's creditors.

- (d) **Robert's Power of Appointment.** During Robert's lifetime, Robert may appoint any part or all of Robert's Trust to such one or more persons and entities, in such amounts and proportions and upon such terms and conditions, as Robert shall determine. However, (1) such power of appointment shall not extend to any life insurance policies insuring the life of Robert that constitute a part of the trust estate, (2) Robert shall not have the power to appoint to or for the benefit of Robert or Robert's creditors, and (3) Robert shall not have the power to appoint to any other individual or entity if such appointment has the effect of satisfying a contractual or legal obligation of Robert.
- (e) **Withdrawals by Robert.** The Trustee shall pay to Robert from the principal of the Trust in any year such amount or amounts not exceeding Five Thousand Dollars (\$5,000) in the aggregate as Robert shall request during such year prior to the last day thereof. If Robert is living on the last day of such year, the Trustee shall also pay to Robert upon request that amount, if any, by which Five Percent (5%) of the then net value of the Trust exceeds the aggregate amount previously withdrawn by Robert during that year. Such powers of withdrawal may be exercised only by written instrument signed by Robert and delivered to the Trustee prior to the close of such year. The amounts so requested by Robert shall be paid to Robert within thirty (30) days after receipt by the Trustee of the written request, or, as to any withdrawal in excess of Five Thousand Dollars (\$5,000), within thirty (30) days after the close of such year. The aggregate amounts which may be withdrawn are not cumulative from year to year. Furthermore, such powers of withdrawal shall be exercisable only as to property actually held in trust and shall be determined by reference only to such property and not to property which the Trust may thereafter receive from any other source. Any compensation payable to the Trustee as a result of a withdrawal under this provision shall be charged entirely to the property withdrawn. For purposes of this subsection, the word "year" shall mean the calendar year. Notwithstanding any other provision of this Trust Agreement, the Trustee may not satisfy any withdrawal made by Robert under this subsection by distributing to Robert any life insurance policies insuring Robert's life that constitute a part of the trust estate.
- (f) **Distributions to Descendants.** The Trustee may distribute to the Children and their Descendants so much of the net income and principal of Robert's Trust as the Trustee deems necessary to provide for their reasonable maintenance, support, health and education. In exercising its discretion, the Trustee shall take into account the following factors:
- (i) The primary purpose of Robert's Trust.
 - (ii) The respective needs of each beneficiary.
 - (iii) The Trustee shall take into consideration, in determining a beneficiary's needs, any other income or resources known upon reasonable inquiry by it to be available to the beneficiary for these purposes.
 - (iv) Settlor's intention to enable or assist each beneficiary to pursue vocational, college, graduate, and/or professional education as long as in

the Trustee's judgment it is pursued to the beneficiary's advantage, and to receive an excellent earlier education.

- (v) Settlor's intention that the trust distributions not serve as a disincentive to a beneficiary's motivation to provide for the beneficiary's own needs in life, and Settlor's instructions to the Trustee to terminate or lessen distributions to a beneficiary if that objective, in the judgment of the Trustee, would be served by doing so.

Distributions under this provision need not be equal among the beneficiaries, and the Trustee may make distributions to one or more beneficiaries to the exclusion of others. Distributions shall be charged against the trust estate as a whole and not against the ultimate distributive share of any beneficiary upon termination of Robert's Trust.

- (g) **Termination of Robert's Trust.** If not earlier terminated by distribution of the entire trust estate under the foregoing provisions, Robert's Trust shall terminate upon the death of Robert. Upon termination, and subject to the provisions of section 3.4 hereof, the Trustee shall distribute the trust estate then remaining, or any part thereof, to such one or more persons and entities, in such amounts and proportions and upon such terms and conditions, as Robert shall appoint by will or codicil which specifically refers to this power of appointment and expresses the intention to exercise it; provided that such power of appointment shall not extend to any life insurance policies insuring the life of Robert that constitute a part of the trust estate; and provided, further, that Robert may not appoint to Robert, Robert's creditors, Robert's estate, or creditors of Robert's estate. The Trustee shall administer the property of Robert's Trust not appointed by Robert in accordance with this special power of appointment or pursuant to section 3.4 hereof as follows:

- (i) If one or more of Robert's Descendants are then living, the following provisions shall apply:
 - (1) If one or more of the Children are then living, the Trustee shall divide the remaining trust estate into separate equal shares, one for each then living Child and one for each deceased Child with one or more Descendants then living. The Trustee shall further divide each deceased Child's share among that Child's then living Descendants, Per Stirpes. The Trustee shall administer each living Child's share as a separate trust for the primary benefit of that Child pursuant to section 3.2 hereof. The Trustee shall distribute the share of each Descendant of a Child to that Descendant, subject to further retention in trust under section 3.5.
 - (2) If none of the Children are then living, the Trustee shall divide the remaining trust estate among Robert's then living Descendants, Per Stirpes. The Trustee shall distribute the share of each Descendant to that Descendant, subject to further retention in trust under section 3.5.

- (ii) If none of Robert's Descendants are then living, the Trustee shall distribute the remaining trust estate pursuant to section 3.3 hereof.

3.2 **Separate Trusts for Children.** Each Child's Trust shall be administered and distributed for the benefit of the Child and the Child's Descendants upon the following terms:

- (a) **Distributions to Child.** The Trustee may distribute to the Child so much of the net income and principal of the trust as the Trustee deems necessary to provide for the Child's reasonable maintenance, support, health and education. In exercising its discretion, the Trustee shall take into account the following factors:

- (i) The standard of living equivalent to that which a reasonably prudent person, having an estate comparable in size to the Child's Trust plus the Child's own estate, would enjoy under the circumstances.
- (ii) The Child is the primary beneficiary of the trust.
- (iii) The Trustee shall take into consideration, in determining the Child's needs, any other income or resources known upon reasonable inquiry by it to be available to the Child for these purposes.
- (iv) Settlor's intention to enable or assist the Child to pursue vocational, college, graduate, and/or professional education as long as in the Trustee's discretion it is pursued to the Child's advantage, and to receive an excellent earlier education.
- (v) Settlor's intention to assist or enable the Child to obtain and furnish a home commensurate with the standard of living equivalent to that which a reasonably prudent person, having an estate comparable in size to the Child's Trust plus the Child's own estate, would enjoy under the circumstances.
- (vi) Settlor's intention to assist or enable the Child to obtain capital to enter a business or profession.
- (vii) Settlor's intention that the trust distributions not serve as a disincentive to the Child's motivation to provide for his own needs in life, and Settlor's instructions to the Trustee to terminate or lessen distributions to the Child if that objective, in the judgment of the Trustee, would be served by doing so.

- (b) **Distributions to Child's Descendants.** The Trustee may distribute to the Descendants of the Child so much of the principal of the trust as the Trustee deems necessary to provide for their reasonable maintenance, support, health and education. In exercising its discretion, the Trustee shall take into account the following factors:

- (i) The primary purpose of the trust.
- (ii) The respective needs of each Descendant.

- (iii) The Trustee shall take into consideration, in determining each Descendant's needs, any other income or resources known upon reasonable inquiry by it to be available to that Descendant for these purposes.
- (iv) Settlor's intention to enable or assist the Descendant to pursue vocational, college, graduate, and/or professional education as long as in the Trustee's discretion it is pursued to the Descendant's advantage, and to receive an excellent earlier education.
- (v) Settlor's intention to assist or enable the Descendant to obtain and furnish a home commensurate with the Descendant's standard of living.
- (vi) Settlor's intention to assist or enable the Descendant to obtain capital to enter a business or profession.
- (vii) Settlor's intention that the trust distributions not serve as a disincentive to the Descendant's motivation to provide for his own needs in life, and Settlor's instructions to the Trustee to terminate or lessen distributions to the Descendant if that objective, in the judgment of the Trustee, would be served by doing so.

Distributions under this provision need not be equal among the Descendants, and the Trustee may make distributions to one or more Descendants to the exclusion of others. Distributions shall be charged against the trust estate as a whole, and not against the distributive share of any Descendant upon termination of the trust. In making distributions under this provision, Settlor recommends that the Trustee consider the generation-skipping transfer tax consequences of any such distribution.

- (c) **Distributions by Independent Trustee.** The Independent Trustee may, in its sole and absolute discretion, distribute to the Child so much of the income and principal of the trust as the Independent Trustee shall deem appropriate or advisable. It is Settlor's intention to give the Independent Trustee the broadest discretion possible in determining the amount and timing of distributions of income and principal hereunder and Settlor recognizes that the Independent Trustee may, in the exercise of its discretion, determine to distribute the entire trust estate to the Child or to make no distributions to the Child during the Child's disability, or for so long as the Child shall have a judgment outstanding, or for so long as any distribution might be lost to the Child's creditors.
- (d) **Termination.** If not earlier terminated by distribution of the entire trust estate under the foregoing provisions, the trust shall terminate upon the death of the Child. Upon termination, and subject to the provisions of section 3.4 hereof, the Trustee shall distribute the trust estate then remaining, or any part thereof, to such one or more members of the limited class consisting of Robert's Descendants, in such amounts and proportions and upon such terms and conditions, as the Child shall appoint by will or codicil which specifically refers to this power of appointment and expresses the intention to exercise it. However, the Child may not appoint to the Child, the Child's creditors, the Child's estate, or

creditors of the Child's estate. The Trustee shall distribute the trust property not appointed by the Child in accordance with this special power of appointment or pursuant to section 3.4 hereof to the Child's then living Descendants, Per Stirpes, subject to further retention in trust under section 3.5. If there are no Descendants of the Child then living, the Trustee shall distribute the remaining trust estate to Robert's then living Descendants, Per Stirpes. Any property distributable to a Child shall be added to any existing trust created under this Trust Agreement for that Child or, if there is no such existing trust, it shall be held in a separate trust for that Child and administered under the provisions of this section. Any property distributable to a Descendant of a Child shall be distributed to that Descendant, subject to further retention in trust under section 3.5. If no Descendant of Robert is then living, the Trustee shall administer or distribute the remaining trust estate pursuant to section 3.3 hereof.

3.3 **If Robert and All of Robert's Descendants Are Deceased.** If Robert and all of Robert's Descendants are deceased and no other disposition of the trust estate is called for in this Trust Agreement, the trust estate then remaining shall be distributed to those persons other than creditors who, under the laws of Texas in force at that time, would have taken the personal property of Settlor had Settlor died intestate, a single person without Descendants, domiciled in the State of Texas, the moment after the event causing the distribution, the shares and proportions of taking to be determined by Texas law.

3.4 **General Power of Appointment for Certain Beneficiaries.**

- (a) Any provision of this Trust Agreement to the contrary notwithstanding, at the death of any individual ("such beneficiary") at whose death the generation-skipping transfer tax would, but for the provisions of this section, be applicable with respect to any trust created under this Trust Agreement, the Trustee shall pay out of the principal of such trust such amount as such beneficiary, by express provision referring to this Trust Agreement and this power of appointment in his or her will, appoints, to or among such beneficiary's creditors, up to but not in excess of the amount, if any, above which any further addition to the amount subject to the power of appointment would increase the Net Death Taxes (as hereinafter defined) by an amount equal to or greater than the decrease in the generation-skipping transfer tax that would result from such further addition. Unless such beneficiary's will otherwise provides by express reference to this Trust Agreement and the above power of appointment, the increase in the Net Death Taxes resulting from such power shall be paid from that amount of the principal of such trust over which such power is exercisable. The foregoing provisions of this section shall be effective only if the Trustee makes a determination that the generation-skipping transfer tax would not be applicable with respect to the amount of such trust over which such power is exercisable. As used in this section, the term "Net Death Taxes" shall mean the aggregate death taxes (including, without limitation, federal, state, local and other estate taxes and inheritance taxes but exclusive of interest and penalties), after taking into account all applicable credits, payable with respect to the estate of such beneficiary.
- (b) If under the will of any individual or individuals and/or any other trust instrument or instruments, such beneficiary has one or more other general powers of

appointment exercisable and measured substantially as provided in subsection 3.4(a) above, the amount such beneficiary may appoint under subsection 3.4(a) shall be reduced proportionally, based on the net fair market values of the principal of the trusts with respect to which such powers are exercisable as of the date of death of such beneficiary, so that the aggregate of the amount so appointable under this Trust Agreement and the amount or amounts so appointable pursuant to such other power or powers together shall be no greater than the amount otherwise appointable under subsection 3.4(a) above.

3.5 **Postponement of Distribution.** Upon termination of any trust established under this Trust Agreement, if any property is distributable free of trust to a beneficiary who is then under age twenty-five (25), or who is Incapacitated, the Trustee shall retain such property in a separate trust for the benefit of that beneficiary, until the beneficiary attains age twenty-five (25) and is not Incapacitated. At that time, the remaining trust property shall be distributed to the beneficiary and the separate trust shall terminate. During the term of the trust, the Trustee shall distribute to the beneficiary so much of the net income and principal as the Trustee deems necessary to provide for the beneficiary's health, support, maintenance and education. If the beneficiary dies before the termination of the trust, the then remaining trust estate shall be distributed to the beneficiary's estate. For purposes of this section, the determination of whether a beneficiary is Incapacitated shall be made by the Trustee, acting in its sole discretion, and the Trustee shall incur no liability for acting in accordance with this section.

3.6 **Special Provisions Regarding S Corporation Stock.** Notwithstanding anything in this Trust Agreement to the contrary, this section applies if any property of a trust administered under this Trust Agreement consists of interests in any one or more entities (such entity referred to as an "Applicable Entity") that have elected to be taxed as an S Corporation pursuant to subchapter S of the Code (such interests in an Applicable Entity hereinafter referred to as "Subchapter S Stock").

(a) **Qualified S Corporation Shareholder.** If a trust owns Subchapter S Stock (such trust referred to as the "Applicable Trust"), the Trustee, in its discretion and consistent with its fiduciary duties, shall determine whether the interests of the beneficiaries of the Applicable Trust are best served by the Applicable Entity being taxed as an S corporation for income tax purposes. If the Trustee concludes that the Applicable Entity should continue to be taxed as an S corporation, the Trustee shall take all necessary steps to ensure that the Applicable Trust is an eligible S Corporation shareholder under Code section 1361(c)(2), subject to the provisions of paragraph 3.6(b)(ii) below (which addresses a beneficiary's election to treat an Applicable Trust as a QSST).

(b) **Trust Elections.** This subsection 3.6(b) applies if the Trustee concludes that the Applicable Entity in which the Applicable Trust owns Subchapter S Stock should continue to be taxed as an S corporation for income tax purposes.

(i) **Generally.** This subsection 3.6(b) applies if an Applicable Trust would only qualify as an eligible S Corporation shareholder upon either of the following:

- (1) the current beneficiary elects to treat such trust as a qualified subchapter S trust ("QSST") under Code section 1361(d) or
 - (2) the Trustee elects for such trust to be taxed as an electing small business trust ("ESBT") under Code section 1361(e).
- (ii) **QSST.** If an Applicable Trust meets all requirements of a QSST under Code section 1361(d), the current beneficiary (who must be a citizen or resident of the United States) may elect for such trust to be treated as a QSST by making a timely election with the Internal Revenue Service to treat such trust as a QSST under Code section 1361(d)(2). The Trustee may segregate the S Corporation stock in a parallel trust, the terms of which shall be identical to the Applicable Trust, so that the QSST election may be made only as to such parallel trust.
- (iii) **ESBT.** If an Applicable Trust would not meet the requirements of a QSST or the Trustee, in its discretion, determines that the current beneficiary of the Applicable Trust will not timely file a QSST election to cause the Applicable Trust to be treated as a QSST as set forth in paragraph 3.6(b)(ii), the Trustee shall file a timely election with the Internal Revenue Service to treat the Applicable Trust as an ESBT. The Trustee may segregate the S Corporation stock in a parallel trust, the terms of which shall be identical to the Applicable Trust, and only make the ESBT election as to such parallel trust.
- (c) **Savings Clause.** All provisions of this Trust Agreement shall be construed and applied so that if any Subchapter S Stock is allocable to any trust, such trust may qualify as a permissible shareholder of such corporation, if an appropriate election is made. Any provisions incapable of being so construed or applied shall be inapplicable to that trust. In no event shall the Trustee take any action or have any power that will impair the ability of any trust to so qualify, if an appropriate election is made.
- (d) **Special Administrative Powers.** In furtherance of the directives in subsection 3.6(c) above, the Trustee shall have the power to enter into agreements with other shareholders of Subchapter S Stock and with the corporation itself, granting other shareholders and/or the corporation special rights to purchase any Subchapter S Stock held in trust and reserving special rights to purchase any Subchapter S Stock held by others and shall have the power to exercise all rights arising out of such agreements, all in such manner as the Trustee in its discretion shall determine to be in the best interests of the trust. In connection with the powers granted under this subsection 3.6(d), a Trustee who is a beneficiary and an Individual Trustee who was appointed by a beneficiary shall only be liable for willful misconduct or gross negligence and not for breach of fiduciary duty by virtue of mistake or error in judgment in connection with the exercise of these powers.

IV. THE TRUSTEE

4.1 Appointment and Succession of Family Trustees.

- (a) **Initial Family Trustee.** Robert is the initial Family Trustee of every trust created under this Trust Agreement.
- (b) **Successor Family Trustee.** If a Family Trustee ceases to serve, the following provisions will apply:
 - (i) A successor Family Trustee may be appointed by Robert, if Robert is living and not Incapacitated.
 - (ii) If a successor Family Trustee is not appointed pursuant to paragraph 4.1(b)(i) within thirty (30) days of a vacancy arising, the following provisions shall apply:
 - (1) _____ shall be the Family Trustee.
 - (2) If _____ fails to serve, _____ shall be the Family Trustee.
 - (3) If _____ also fails to serve, _____ shall be the Family Trustee.
 - (iii) If a successor Family Trustee is not appointed pursuant to previous provisions of this subsection 4.1(b) within forty-five (45) days of a vacancy arising, a successor Family Trustee may be appointed by the following:
 - (1) The Family Trustee last serving; and
 - (2) A majority in number of the beneficiaries to whom the Family Trustee is to or may distribute income at that time.

A successor Family Trustee appointed by the persons named in subparagraph 4.1(b)(iii)(2) will become Family Trustee only if the person or entity named in subparagraph 4.1(b)(iii)(1) does not appoint a successor Family Trustee who accepts the trust and agrees to serve.
 - (iv) If a successor Family Trustee is not appointed pursuant to previous provisions of this subsection within sixty (60) days of a vacancy arising, the Family Trustee last serving or any beneficiary of the trust may secure the appointment of a successor Family Trustee by a court of competent jurisdiction at the expense of the trust estate.
- (c) **Children's Trusts.** Notwithstanding the provisions of subsection 4.1(b), at any time after attaining age thirty (30) a Child may elect to serve as Co-Family Trustee of any trust created under this Trust Agreement of which such Child is the primary beneficiary. At any time after attaining age thirty-five (35), the

Child may elect to serve as sole Family Trustee of any such trust and, if a Child makes such an election, any other Family Trustee of such trust shall cease to serve as Family Trustee of that trust. Except as provided in the immediately preceding sentence, if the Family Trustee of a trust for the primary benefit of a Child ceases to serve, the Child may appoint a successor Family Trustee, if the Child is age thirty-five (35) or older. If a successor Family Trustee is not so appointed within thirty (30) days of a vacancy arising, the provisions of subsection 4.1(b) shall apply. An election under this subsection 4.1(c) shall be by a signed, acknowledged instrument delivered to any person or institution other than the Child who is then serving as a Family Trustee of the trust.

- (d) **Manner of Appointment.** Appointment, other than by a court, shall be by a signed, acknowledged instrument delivered to the appointed Family Trustee. An appointment may be made before a vacancy arises, to become effective in the event of the vacancy, with the last such instrument to control. An appointment made before a vacancy arises shall be made by the person or persons holding the power to appoint a successor Family Trustee at the time the instrument of appointment is executed. An appointment made before a vacancy arises may be revoked by a signed, acknowledged instrument delivered to the successor or by the later valid appointment of a different successor, executed in either case by the person or persons holding the power to appoint a successor Family Trustee at the time the instrument of revocation or of later appointment is executed.
- (e) **Permissible Family Trustees.** The successor Family Trustee appointed by Robert, by a Child who has attained age thirty-five (35), or by a Trustee may be one or more persons and/or entities. Any other successor Family Trustee, not designated as such by name in this Trust Agreement, shall be a trust company or a bank in the United States having trust powers with not less than Fifty Million Dollars unimpaired capital and surplus.
- (f) **Acceptance.** A successor Family Trustee shall have a reasonable time after a vacancy occurs in which to accept the office by signed, acknowledged instrument delivered to those making the appointment, if living, or to the then current beneficiaries to whom the Family Trustee is to or may make distributions.

4.2 **Appointment and Succession of Independent Trustee.**

- (a) **Initial Independent Trustee.** RICHARD ROE is the initial Independent Trustee of every trust created under this Trust Agreement. He shall begin serving as such upon delivery of a written acknowledged instrument to the Family Trustee in which he accepts the trust and agrees to serve as Independent Trustee.
- (b) **Successor Independent Trustee.** If RICHARD ROE fails to serve, or if an Independent Trustee ceases to serve, the following provisions will apply:
 - (i) A successor Independent Trustee may be appointed by Robert, if Robert is living and not Incapacitated.
 - (ii) If Robert is either deceased or Incapacitated, or if a successor Independent Trustee is not appointed pursuant to paragraph 4.2(b)(i)

within thirty (30) days of a vacancy arising, the following provisions shall apply:

- (1) _____ shall be the Independent Trustee.
 - (2) If _____ fails to serve, _____ shall be the Independent Trustee.
 - (3) If _____ also fails to serve, _____ shall be the Independent Trustee.
- (iii) If a successor Independent Trustee is not appointed pursuant to previous provisions of this subsection 4.2(b) within forty five (45) days of a vacancy arising, a successor Independent Trustee may be appointed by the following:
- (1) The Independent Trustee last serving; and
 - (2) A majority in number of the beneficiaries to whom the Independent Trustee is to or may distribute income at that time.

A successor Independent Trustee appointed by the persons named in subparagraph 4.2(b)(iii)(2) will become Independent Trustee only if the person or entity named in subparagraph 4.2(b)(iii)(1) does not appoint a successor Independent Trustee who accepts the trust and agrees to serve.

- (iv) If a successor Independent Trustee is not appointed pursuant to previous provisions of this subsection 4.2(b) within sixty (60) days of a vacancy arising, the Independent Trustee last serving or any beneficiary of the trust may secure the appointment of a successor Independent Trustee by a court of competent jurisdiction at the expense of the trust estate.
- (c) **Manner of Appointment.** Appointment, other than by a court, shall be by a signed, acknowledged instrument delivered to the appointed Independent Trustee. An appointment may be made before a vacancy arises, to become effective in the event of the vacancy, with the last such instrument to control. An appointment made before a vacancy arises shall be made by the person or persons holding the power to appoint a successor Independent Trustee at the time the instrument of appointment is executed. An appointment made before a vacancy arises may be revoked by a signed, acknowledged instrument delivered to the successor or by the later valid appointment of a different successor, executed in either case by the person or persons holding the power to appoint a successor Independent Trustee at the time the instrument of revocation or of later appointment is executed.
- (d) **Permissible Independent Trustees.** The successor Independent Trustee may be one or more persons and/or entities. However, Settlor, Robert, and Robert's Descendants shall never serve as Independent Trustee and an Independent Trustee appointed by Robert or a Descendant of Robert may not be a person who is a "related or subordinate party" with respect to the person making the

appointment, as the quoted term is used in Code section 672(c) with respect to a trust grantor.

- (e) **Acceptance.** A successor Independent Trustee shall have a reasonable time after a vacancy occurs in which to accept the office by signed, acknowledged instrument delivered to those making the appointment, if living, or to the then current beneficiaries to whom the Independent Trustee is to or may make distributions.

4.3 **Resignation of Trustee.** Any Trustee may resign as to any one or more of the trusts created under this Trust Agreement by giving written notice to:

- (a) the Co-Trustee then serving, if any;
- (b) Robert, if living; otherwise to the beneficiaries to whom the Trustee is to or may distribute income at that time;
- (c) The person or persons, if any, who have the power to appoint a successor Trustee; and
- (d) The person or persons designated to serve as successor Trustee in the absence of an appointment.

4.4 **Removal of Trustee.** Robert may remove any Trustee without cause. After Robert's death, the primary beneficiary of a trust may remove any Trustee, without cause. Removal shall be effected by delivering to the Trustee a signed acknowledged instrument which is effective thirty (30) days from its receipt (unless a shorter period is agreed to by the Trustee).

4.5 **Succession of Corporate Trustee.** If any corporate Trustee before or after qualification changes its name, becomes consolidated or merged with another corporation, or otherwise reorganizes, any resulting corporation which succeeds to the fiduciary business of such corporate Trustee shall become a Trustee in lieu of such corporate Trustee.

4.6 **Trustee's Fees.** Each Trustee other than Robert shall be entitled to reasonable fees commensurate with its duties and responsibilities, taking into account the value and nature of the trust estate and the time and work involved. The Trustee shall be reimbursed for reasonable costs and expenses incurred in connection with its fiduciary duties.

4.7 **Bond.** The Trustee shall not be required to furnish bond or other security.

4.8 **Liability of Trustee.** A Trustee who is a beneficiary and an Individual Trustee who was appointed by a beneficiary shall only be liable for a breach of trust committed in bad faith, intentionally, or with reckless indifference to the interest of a beneficiary and for profit derived by the Trustee from a breach of trust. Such a Trustee shall not be liable for breach of fiduciary duty by virtue of mistake or error in judgment.

4.9 **Predecessor Fiduciary.** The Trustee may accept the accounts rendered and the property delivered by the representatives of a decedent's estate, predecessor Trustee, or other

fiduciaries, without requiring an audit or other independent review of the acts of such fiduciaries, contesting the accounts or requiring the fiduciaries to rectify any default, unless otherwise directed in writing by Settlor or the primary beneficiary (or, if more than one, a majority of the primary beneficiaries) of a trust. The Trustee, by so acting, shall not be responsible for damages caused by the predecessor fiduciaries' actions.

- 4.10 **Periodic Accounting.** The Trustee upon request shall make reports at least annually to beneficiaries who are permitted by law to demand an accounting. Such reports shall reflect the property held in trust, the receipts, disbursements, and distributions made during the accounting period, and such other information as may be necessary to convey the condition of and changes to the trust estate. This provision shall not apply so long as Robert or another beneficiary is serving as Trustee.
- 4.11 **Beneficiary under Disability.** A parent, custodian, or guardian of a minor or Incapacitated beneficiary may, in carrying out the provisions of this Trust Agreement, act and receive notice in the beneficiary's stead, and sign any instrument for the beneficiary. For purposes of this section, the determination of whether a beneficiary is Incapacitated shall be made by the Trustee, acting in its sole discretion, and the Trustee shall incur no liability for acting in accordance with this section.
- 4.12 **Incapacity of Individual Trustee.** If an Individual Trustee is determined to be Incapacitated, that Trustee shall cease to serve as if the Trustee had resigned, effective immediately.
- 4.13 **Action by the Trustees.**
- (a) **In General.** Unless otherwise provided in this Trust Agreement, in situations where more than one person or entity is serving as Trustee, any action by the Trustee shall require the approval of (i) both Trustees if two are serving, or (ii) at least a majority of the Trustees if more than two are serving.
- (b) **Division of Powers between Family Trustee and Independent Trustee.** The Independent Trustee alone shall exercise those powers expressly conferred on the Independent Trustee by this Trust Agreement and the Independent Trustee may exercise only those powers and none others. The Family Trustee alone shall exercise all other powers of the Trustee.
- 4.14 **Insurance on the Life of Family Trustee.** If an insurance policy on the life of any Family Trustee becomes an asset of the trust, the Independent Trustee shall exercise all incidents of ownership with respect to such policy. For purposes of this section, the term "incidents of ownership" means the power to own and hold legal title to the policy, to designate the beneficiary of the policy, to surrender the policy, to obtain the cash or loan value of the policy, to pledge the policy, and to exercise any other right, privilege, or power with respect to the policy that constitutes an "incident of ownership" within the meaning of Code section 2042.
- 4.15 **Stock in a Controlled Corporation.** If shares of stock of a corporation that, with respect to Settlor, would be a controlled corporation, as defined under Code section 2036, become an asset of the trust, Settlor may not vote such stock, either directly or indirectly.

If the terms of this Trust Agreement would otherwise vest the right to vote such stock in Settlor, the right to vote such stock shall instead be held by the Independent Trustee.

V. PROVISIONS AFFECTING DISTRIBUTION

- 5.1 **Maximum Duration of Trusts.** If not sooner terminated pursuant to the other provisions hereof, each trust created under this Trust Agreement shall terminate not later than twenty-one (21) years after the death of the last survivor of Settlor, Robert, Robert's Descendants living at the execution of this Trust Agreement, and any other individual beneficiaries who are identified by name in this Trust Agreement. In the event of termination, the Trustee shall distribute each trust to its income beneficiaries determined at the time of distribution in the proportions to which they are entitled to receive income. If at that time rights to income are not fixed by the terms of the trust, distribution shall be made to the persons to whom the Trustee may then distribute income, in proportions determined in the Trustee's discretion, exercised consistently with the trust's purposes.
- 5.2 **Restriction upon Alienation.** To the extent permitted by law, every trust created under this Trust Agreement shall be a spendthrift trust. No beneficiary may anticipate, by assignment or otherwise, the beneficiary's beneficial interest in the principal or income of the trust estate. No beneficiary may sell, transfer, encumber, or in any way charge the beneficiary's interest in trust income or principal prior to actually receiving it. Neither the income nor the principal of any trust shall be subject to any execution, garnishment, attachment, bankruptcy, claims for alimony or support, other legal proceeding of any character, legal sequestration, levy or sale, or in any other event or manner be applicable or subject, voluntarily or involuntarily, to the payment of a beneficiary's debts. The Trustee shall make distributions to or for each beneficiary according to the terms hereof, notwithstanding any purported sale, assignment, hypothecation, transfer, attachment, or judicial process.
- 5.3 **Distributions Constitute Separate Property.** Settlor intends to make a gift to each beneficiary of only that portion of the income and principal of a trust that is in fact distributed to such beneficiary. Inasmuch as the amounts actually distributed to a beneficiary constitute the gift Settlor contemplated making, such distributions, whether they be income or principal, shall constitute the separate property of such beneficiary and not the community property of the beneficiary and the beneficiary's spouse. Furthermore, it is Settlor's intention that no beneficiary shall have any interest in any undistributed income or principal until the distribution of such income or principal and, accordingly, such undistributed income and principal shall not be deemed the separate property of any such beneficiary or the community property of the beneficiary and the beneficiary's spouse. For purposes of this section, "beneficiary" includes both an individual who is a direct beneficiary of a trust and an individual who is an indirect beneficiary of a trust by virtue of being a beneficiary of a second trust that itself is a beneficiary of the first trust.
- 5.4 **Method of Payment.** The Trustee, in its discretion, may make distributions to any beneficiary, including a beneficiary who is a minor or Incapacitated, in any one or more of the following ways: directly to the beneficiary without the intervention of any legal guardian or other legal representative; as expenditures in the beneficiary's behalf; to the guardian, committee, conservator, or other similar official acting for the beneficiary; to a custodian for the beneficiary under a Uniform Gifts to Minors Act or Uniform Transfers to Minors Act; to a relative of the beneficiary or to any suitable person with whom the

beneficiary resides or who has care or custody of the beneficiary; and in all ways provided by law for gifts or other transfers to or for minors or other persons under disability. In each case, receipt by the beneficiary or other person to whom payment is made or a distribution entrusted shall be a complete discharge of the Trustee with respect to that payment or distribution. The Trustee may act upon such evidence as it deems appropriate and reliable in determining a beneficiary's ability to manage property and identifying a proper recipient of trust funds hereunder. For purposes of this section, the determination of whether a beneficiary is Incapacitated shall be made by the Trustee, acting in its sole discretion, and the Trustee shall incur no liability for acting in accordance with this section.

- 5.5 **Evidence of Need.** In exercising its discretion under this Trust Agreement, the Trustee shall be entitled to rely upon the written certification of a beneficiary or of another as to the nature and extent of a beneficiary's needs, and the adequacy of the beneficiary's resources apart from the trust to meet those needs. The Trustee may, but shall not be required to, make inquiry into the accuracy of the information it receives.
- 5.6 **Termination of Small Trust.** Notwithstanding any provision of this Trust Agreement to the contrary, the Trustee may at any time terminate any trust when in its judgment the trust is so small that it would be inadvisable or uneconomical to continue the trust administration. In the event of termination, the Trustee shall distribute the trust to the income beneficiaries of the trust determined at the time of distribution in the proportions to which they are entitled to receive income. If at that time rights to income are not fixed by the terms of the trust, distribution shall be made to the persons to whom the Trustee may then distribute income, in proportions determined in the Trustee's discretion, exercised consistently with the trust's purposes. Distribution of trust funds in the manner herein provided shall relieve the Trustee of any further responsibility with respect to such funds. This section shall not apply to Settlor or Robert as Trustee, or to a Trustee with respect to any trust of which such Trustee is a beneficiary, or if the Trustee has a duty to support the beneficiary, or to any Trustee who may be removed and replaced by a beneficiary of the trust.
- 5.7 **Generation-Skipping Transfer Taxes and Payment.** If the Trustee considers any distribution or termination of an interest or power in a trust to be a taxable distribution (a "Distribution") or a taxable termination (a "Termination"), or a direct skip (a "Direct Skip") for generation-skipping transfer tax purposes, the Trustee may exercise the following authorities. In the case of a Distribution, the Trustee may increase the amount to be distributed by an amount estimated to be sufficient to permit the beneficiary receiving such Distribution to pay the estimated generation-skipping tax attributable to such Distribution. Generally, however, the Trustee is not expected to augment any partial terminating Distribution in order to pay generation-skipping transfer taxes attributable to such partial terminating Distribution from a trust. In the case of a Termination or Direct Skip, the Trustee shall pay the generation-skipping transfer tax attributable to such Termination or Direct Skip; such tax shall be a charge against the property involved in the Termination or Direct Skip and shall decrease the trust property distributable to the beneficiary. The Trustee may postpone final termination of any trust or the complete funding of any Direct Skip, and may withhold all or any portion of the distributable trust property, until the Trustee is satisfied it no longer has any liability to pay any generation-skipping transfer tax with reference to the Termination or Direct Skip. If a generation-

skipping transfer tax is imposed in part by reason of property held in trust under this Trust Agreement and in part by reason of other property, the Trustee may pay only the portion of such tax that is fairly attributable to the Distribution, Termination, or Direct Skip occurring under a trust created under this Trust Agreement, taking into consideration deductions, exemptions, credits and other factors which the Trustee deems appropriate. The Trustee shall make such equitable adjustments among beneficiaries of a trust as are necessary to avoid substantial inequities as a consequence of additional distributions or generation-skipping transfer tax payments made with respect to a Distribution, Termination or Direct Skip.

VI. TRUST ADMINISTRATION

- 6.1 **General Powers.** Subject to any limitation stated elsewhere in this Trust Agreement and any division of powers provided for in this Trust Agreement, the Trustee shall have, in addition to all powers granted to trustees by the common law and by the Texas Trust Code, as amended from time to time, the following powers with respect to each trust established under this Trust Agreement:
- (a) **Retain Property.** To retain any property received from any source, including any corporate Trustee's securities, regardless of lack of diversification, risk, or nonproductivity. The provisions of subsection 6.1(b)(ii) shall be construed in a manner consistent with this provision.
 - (b) **Invest.**
 - (i) A Trustee who is a beneficiary and an Individual Trustee who was appointed by a beneficiary shall have the power to invest the trust estate in any kind of property, including common trust funds administered by a corporate Trustee or by others, without being limited by any statute or any rule of law dealing with the character, risk, productivity, diversification of, or otherwise concerning, investments by trustees.
 - (ii) Any other Trustee shall have the power to invest the trust estate in accordance with the standard for trust management and investment provided under the Texas Trust Code.
 - (c) **Sell.** By public offering or private negotiation, to sell, exchange, assign, transfer, or otherwise dispose of all or any real or personal trust property and give options for these purposes, for such price and on such terms, with such covenants of warranty and such security for deferred payment as the Trustee deems proper. To partition between the trust and any other owner, as the Trustee deems proper, any property in which the trust owns an undivided interest.
 - (d) **Lease.** To lease trust property for terms within or extending beyond the term of the trust, for any purpose.
 - (e) **Real Estate.** To operate, maintain, repair, rehabilitate, alter, erect, improve, or remove any improvements on real estate; to subdivide real estate; to grant easements, give consents, and enter into contracts relating to real estate or its use; and to release or dedicate any interest in real estate.

- (f) **Borrow.** To borrow money for any purpose either from the banking department of any corporate Trustee or from others; to grant a security interest in trust property by mortgage, deed of trust, security agreement, or otherwise; and to maintain, renew, or extend any indebtedness upon such terms as the Trustee deems appropriate.
- (g) **Loans.** To lend money to any person or entity upon such terms and with such security as the Trustee deems advisable.
- (h) **Conserve Estate.** To take any action to conserve the trust estate.
- (i) **Litigation.** To commence or defend at the expense of the trust such litigation with respect to the trust estate as the Trustee deems advisable.
- (j) **Claims.** To collect, pay, contest, compromise, settle, renew, or abandon any claims or demands of or against the trust estate without court authority on whatever terms the Trustee deems advisable.
- (k) **Abandon Property.** To abandon any property or interest in property belonging to the trust when, in the Trustee's discretion, such abandonment is in the best interest of the trust and its beneficiaries.
- (l) **Documents.** To execute contracts, notes, conveyances, and other instruments containing covenants, representations, or warranties binding upon and creating a charge against the trust estate or containing provisions excluding personal liability, or any other written instrument of any character appropriate to any of the powers or duties conferred upon the Trustee.
- (m) **Agents.** To employ attorneys, auditors, investment advisors, depositaries, and agents with or without discretionary powers, to employ a bank with trust powers as agent for the purpose of performing any ministerial duties incident to the administration, and to pay all expenses and fees so incurred.
- (n) **Securities.** To engage in all actions necessary to the effective administration of securities including, but not limited to, the authority to: vote securities in person or by proxy; engage in a voting trust or voting agreement; and consent to or participate in mergers, consolidations, sales of assets, recapitalizations, reorganizations, dissolutions, or other alterations of corporate structure affecting securities held by the Trustee.
- (o) **Nominee.** To hold securities and other property in bearer form or in the name of a trustee or nominee with or without disclosure of any fiduciary relationship.
- (p) **Additional Property.** To receive additional property from any source and add it to the trust estate.
- (q) **Insurance.** To carry insurance of such kinds and in such amounts as the Trustee deems advisable.

- (r) **Business Powers.** To engage in any lawful business including, but not limited to, the power to continue the operation of any business which may become a part of the trust estate, and to sell, liquidate, or otherwise terminate any business interest, including, but not limited to, the fulfillment of any agreement for the disposition of any such business interest.
- (s) **Income and Principal.** Except as otherwise specifically provided herein, to determine in accordance with the provisions of the Texas Trust Code the manner in which receipts and disbursements are to be allocated as between principal and income, and what shall constitute income, net income, and principal.
- (t) **Adjustments Between Principal and Income.** The Trustee shall have the power to make adjustments between principal and income in accordance with the provisions of section 116.005 of the Texas Trust Code. If no Trustee is permitted to make such adjustments under the terms of section 116.005, the Independent Trustee may make such adjustments. If the Independent Trustee also is not permitted to make such adjustments under the terms of section 116.005, the Trustee may appoint a special Trustee whose powers shall be limited to making such adjustments. Appointment shall be by a signed, acknowledged instrument delivered to the appointed special Trustee. If a special Trustee is appointed pursuant to this subsection 6.1(t), the Trustee may remove such special Trustee at any time, without cause. If a special Trustee appointed pursuant to this subsection 6.1(t) ceases to serve for any reason, the Trustee may appoint a successor special Trustee. The special Trustee may be one or more persons or entities. However, the special Trustee may not be another Trustee, a beneficiary of the trust, or any person or entity who is "related or subordinate" to the Trustee or any beneficiary of the trust within the meaning of Code section 672(c).
- (u) **Tax Elections.** Except as otherwise specifically provided herein, to exercise any tax option or election permitted by law as the Trustee determines in its sole discretion, even though the effect is to treat beneficiaries differently, or to favor some at the expense of others. The Trustee shall make such compensating adjustments among beneficiaries as are necessary to avoid substantial inequities, considering the nature of the tax election and the amounts involved.
- (v) **Reliance.** To rely upon any notice, certificate, affidavit, or other document or evidence believed by the Trustee to be genuine and accurate, in making any payment or distribution. The Trustee shall incur no liability for a disbursement or distribution made in good faith and without actual notice or knowledge of a changed condition or status affecting any person's interest in the trust or any other matter.
- (w) **Commingling.** To commingle and invest as one fund, or make joint investments with, the property of two or more separate trusts established under this Trust Agreement, with each trust having an undivided interest therein.
- (x) **Division and Distribution.** To make all allocations, distributions, or divisions contemplated by this Trust Agreement; to allocate, distribute and divide different kinds or disproportionate shares of property or undivided interests in property among the beneficiaries or trusts, in cash or in kind, or both, without regard to the

income tax basis of specific property allocated to any beneficiary or trust, even though shares may as a result be composed differently, and to determine the value of any property so allocated, divided or distributed. The Trustee shall make such compensating adjustments among beneficiaries or trusts as are necessary to avoid substantial inequities, considering the nature of the allocation, distribution, or division and the amounts involved.

- (y) **Withholding of Distribution.** To withhold from distribution all or any part of the trust property as long as the Trustee in its discretion determines that such property may be subject to conflicting claims, to tax deficiencies, or to liabilities, contingent or otherwise, properly incurred in the administration of the trust.
- (z) **Mineral Powers.** To retain or acquire interests in oil, gas, or other mineral resources; to execute as to those interests any agreements, assignments, contracts, deeds, grants or leases for any term (even though the term may extend beyond the termination of the trust); to manage, control, operate, explore, mine, develop, or take any action for the production, recovery, sale, treatment, storage, or transportation of any such interest; to drill, rework, or recomplete wells of any type; to conduct or participate in secondary recovery operations; to enter into agreements for pooling or unitization; and to install, operate, or participate in the operation of any plant, mine, or other facility.
- (aa) **Environmental Hazards.** To use and expend the trust income and principal to (1) take all appropriate action to prevent, identify, or respond to actual or threatened violations of any environmental law or regulation for which the Trustee may have responsibility, including the authority to conduct environmental assessments, audits, and site monitoring to determine compliance with any environmental law or regulation; (2) take all appropriate remedial action to contain, cleanup, or remove any environmental hazard including a spill, release, discharge, or contamination, either on its own accord or in response to an actual or threatened violation of any environmental law or regulation; (3) institute legal proceedings concerning environmental hazards or contest or settle legal proceedings brought by any local, state, or federal agency concerned with environmental compliance, or by a private litigant; and (4) comply with any local, state, or federal agency order or court order directing an assessment, abatement, or cleanup of any environmental hazards.
- (bb) **Miscellaneous Powers.** Generally, to do and perform any and all acts, things, or deeds which in the judgment of the Trustee may be necessary or proper for the protection, preservation, and promotion of the trust estate.

6.2 **Merger of Trusts.** If at any time a Trustee of any trust created under this Trust Agreement shall also be acting as a Trustee of any other trust created by trust instrument or by will for the benefit of the same beneficiary or beneficiaries and upon substantially the same terms and conditions, the Trustee is authorized and empowered, if in the Trustee's discretion such action is in the best interest of the beneficiary or beneficiaries of the trust created under this Trust Agreement, to merge all of the assets then held under such trust created pursuant to this Trust Agreement with such other trust and to terminate the trust created pursuant to this Trust Agreement. The Trustee is further authorized to accept the assets of the other trust which may be transferred to the Trustee of the trust

created under this Trust Agreement and to administer such assets in accordance with the provisions of this Trust Agreement. If the component trusts differ as to contingent beneficiaries and the contingency occurs, the funds shall be distributed in such shares as the Trustee, in its sole discretion, deems necessary to create a fair ratio between the various sets of contingent beneficiaries. If any trust created under this Trust Agreement is merged with a trust created under any other instrument, such merged trust shall not continue beyond the date on which the earliest maximum term of the trusts so merged would, without regard to such merger, have been required to terminate. If the laws of any state require that the trust terminate as to any property prior to the termination date specified under this Trust Agreement, the trust shall terminate as to that property at the time required by law.

- 6.3 **Certain Powers and Rights Limited.** This section applies to every trust administered under this Trust Agreement and to every person who is a beneficiary of each such trust (a "Beneficiary"). Settlor intends that the property of the trust shall not be included in the Beneficiary's gross estate for estate tax purposes unless, pursuant to an express provision of this Trust Agreement, the Beneficiary has or is given a general power of appointment over some or all of the trust estate. All issues in connection with the interpretation of this Trust Agreement and the administration of the trust shall be resolved accordingly. Unless the Beneficiary has or is given a general power of appointment pursuant to an express provision of this Trust Agreement, neither the Beneficiary nor the Trustee shall have any power, right, duty, or obligation that would result in inclusion of the trust estate, or any part thereof, in the Beneficiary's gross estate.
- 6.4 **GST Inclusion Ratio.** If property not having an inclusion ratio for purposes of the generation-skipping transfer tax equal to zero is directed to be added to a trust which has an inclusion ratio equal to zero, the Trustee may decline to make the addition and may, instead, administer the property as a separate trust with provisions identical to the trust having an inclusion ratio equal to zero. If property having an inclusion ratio for purposes of the generation-skipping transfer tax equal to zero is directed to be added to a trust which has an inclusion ratio not equal to zero, the Trustee may decline to make the addition and may, instead, administer the property as a separate trust with provisions identical to the trust having an inclusion ratio not equal to zero.
- 6.5 **Division of Trusts.** The Trustee may divide any trust established under this Trust Agreement into two or more separate trusts as provided in this section. Settlor exonerates the Trustee from any liability arising from the exercise or failure to exercise any powers granted herein, provided the Trustee acts in good faith.
- (a) **Division and Funding of Separate Trusts.** The Trustee may divide any trust established by this Trust Agreement into two or more separate trusts so that the generation-skipping transfer tax inclusion ratio for each trust shall be either zero or one. Any such division shall comply with applicable regulations under Chapter 13 of the Code.
- (b) **Administration of Separate Trusts.** Such separate trusts shall have the identical provisions as the original trust. However, with respect to each separate trust, the Trustee may: (1) make different tax elections (including the allocation of Settlor's GST exemption) with respect to each separate trust, (2) expend principal and income and exercise any other discretionary powers with respect to

such separate trusts differently, (3) invest such separate trusts differently, and (4) take all other actions consistent with such trusts being separate trusts.

- 6.6 **Out-of-State Properties.** If any trust property is situated in a jurisdiction in which a Trustee is unable or unwilling to act, any other Trustee then serving may act in such jurisdiction. If no Trustee is able and willing to act, the Trustee may appoint an ancillary trustee for such jurisdiction and may confer upon the ancillary trustee such administrative powers, exercisable without court order, to act with respect to such property as the Trustee deems proper. The ancillary trustee shall be accountable to the Trustee for all property it administers. The Trustee may pay the ancillary trustee reasonable compensation and may waive bond or other security.
- 6.7 **No Court Supervision.** Except in the case of a judicial appointment of a successor Trustee under paragraph 4.1(b)(iv), the Trustee shall not be required to qualify before or be appointed by any court. The Trustee shall not be required to obtain court approval to exercise any power or discretion.
- 6.8 **Limitation of Powers.** Settlor intends that no person shall have any power that would cause the trust to be a "grantor trust" whose income is taxable to Settlor under Code sections 671 through 679, and this Trust Agreement shall be construed accordingly. Without limiting the generality of the previous sentence, the following limitations apply notwithstanding any other provision of this Trust Agreement:
- (a) **Support Duty.** The Trustee may not make distributions from the trust estate that discharge Settlor's or a Trustee's personal legal obligation to support, educate, or otherwise provide for any other trust beneficiary. When determining these legal obligations, the existence of the trust estate shall not be taken into consideration.
 - (b) **Adequacy of Consideration.** No party may, through purchase, exchange, or otherwise, deal with or dispose of the principal or the income of the trust estate for less than adequate consideration in money or money's worth.
 - (c) **Insurance.** The Trustee shall not apply trust property to the payment of premiums on an insurance policy on the life of Settlor or the Trustee.
 - (d) **Borrow.** The Trustee shall not allow Settlor to borrow trust principal or income, directly or indirectly, without adequate interest or security.
 - (e) **Powers of Administration.** No person, acting in a nonfiduciary capacity, may exercise any of the following powers without the approval or consent of the Trustee acting in a fiduciary capacity:
 - (i) A power to vote or direct the voting of stock or other securities of a corporation in which the holdings of Settlor and the trust are significant from the viewpoint of voting control;
 - (ii) A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or

securities of corporations in which the holdings of Settlor and the trust are significant from the viewpoint of voting control; or

- (iii) A power to reacquire the trust corpus by substituting other property of an equivalent value.

6.9 **Delegation of Powers or Duties.** If more than one Trustee is serving, any Trustee, with the written consent of the other Trustee, may be relieved of any powers or duties as a Trustee by delivering to such other Trustee a signed, acknowledged instrument, identifying and delegating such powers or duties to such other Trustee. Delegation may be for a period of time or until revoked by similar instruction. The delegating Trustee shall be fully protected and held harmless from the consequences of any action taken or omitted by the other Trustee as to which the delegating Trustee has not participated pursuant to a delegation. Any person dealing in good faith with a Trustee may rely upon the Trustee's certificate regarding the existence of any delegation. Notwithstanding previous provisions of this section, the powers expressly conferred on an Independent Trustee may be exercised only by an Independent Trustee and may not be delegated to a Family Trustee unless such Family Trustee is also serving as an Independent Trustee.

6.10 **Dealing with Fiduciaries and Others.** The Trustee may enter into any transaction otherwise authorized under this Trust Agreement even though the other party to such transaction is a Trustee or a beneficiary under this Trust Agreement, acting in an individual capacity or in another fiduciary capacity, or any person or entity that is in any way related to or affiliated with the Trustee or a beneficiary. This authorization includes, but is not limited to, the power to enter into a transaction with (i) a trust of which a beneficiary or Trustee under this Trust Agreement is a beneficiary or trustee, whether such trust is created under this Trust Agreement or otherwise, (ii) an estate of which a beneficiary or Trustee under this Trust Agreement is a representative or beneficiary, and (iii) a business or charitable entity of which a beneficiary or Trustee under this Trust Agreement is a director, officer, employee, owner, or trustee.

6.11 **Life Insurance and Retirement Benefits.**

- (a) **Retention of Ownership.** The owner of a life insurance policy that is not owned by the trust but of which the trust is beneficiary shall retain all ownership rights in the policy during the insured's lifetime, including but not limited to the right to change the beneficiary and assign or borrow against the policy. If the policy is surrendered, lapses, or otherwise is not kept in force, or if the beneficiary of the policy is changed, this trust shall be revoked as to it. During the lifetime of the insured, the Trustee shall have no responsibility to pay premiums or other charges necessary to keep such a policy in force or to notify any person of the nonpayment of such premiums or other charges or to take any other action to keep the policy in force.
- (b) **Collection of Proceeds.** Upon maturity, the Trustee shall collect the proceeds of any life insurance policy or retirement plan known to be payable to the Trustee as beneficiary. The Trustee shall exercise any payment right, election, or option in any life insurance policy or retirement plan in such manner as it deems to be in the best interest of the trust. The Trustee shall make such compensating

adjustments between beneficiaries as are necessary to avoid substantial inequities as a result of any such right, election, or option.

- (c) **Payor Protected.** No insurance company and no trustee or administrator of a retirement plan shall be under any duty to inquire into the terms of this Trust Agreement or see to the application of any funds payable to the Trustee. A receipt of the Trustee evidencing payment shall be a full and complete acquittance of the payor and shall be binding upon all persons interested herein.

VII. IRREVOCABILITY

This Trust Agreement and each of its provisions may not be revoked, amended, or modified.

VIII. MISCELLANEOUS PROVISIONS

- 8.1 **Applicable Law.** Texas is the situs of each trust created under this Trust Agreement and Texas law shall govern the validity, construction, and administration of each trust. However, if the Trustee, in its sole discretion, determines that a change of situs would be beneficial to the purposes of a trust, the Trustee may change the situs of that trust to another state. To do so, the Trustee shall sign and acknowledge a written statement to that effect, file it in the trust records, and deliver a copy of it to each beneficiary who is then entitled or permitted to receive distributions from the trust and to each beneficiary who would receive a distribution from the trust if the trust terminated on the date of delivery. If the Trustee changes the situs of a trust to another state, the laws of that state shall, prospectively, govern the construction and administration of the trust, while Texas law shall continue to govern the validity of the trust and the construction and administration of the trust as to acts or transactions occurring prior to the change of situs. The Trustee may not change the situs of a trust if that change would result in a termination of the trust for federal tax purposes.
- 8.2 **Gestation.** For purposes of determining whether a person is a member of a class of beneficiaries defined with reference to those who are living at a particular time, a child in gestation who is born alive shall be considered a child in being throughout the period of gestation.
- 8.3 **Survivorship.** Except as otherwise expressly provided herein, any person must survive by five (5) days for a gift made in this Trust Agreement which directly or indirectly requires such person's survival of another to be effective.
- 8.4 **Provisions Regarding Incapacity.**
 - (a) **Definition.** For purposes of this Trust Agreement, a person will be deemed to be "Incapacitated" if that person, as a result of accident, illness, physical or mental disability, deterioration, or disorder, addiction or dependency, or any other physical, mental, or emotional condition is unable to give prompt and intelligent consideration to financial matters, to intelligently exercise any rights granted to such person under this Trust Agreement, or to properly discharge any duties imposed on that person under this Trust Agreement.

- (b) **Determination.** If this Trust Agreement provides a method for determining whether a person is Incapacitated in a specific situation or for a specific purpose, that method shall control for that situation or purpose. Otherwise, a person shall be deemed Incapacitated if two physicians certify that they have examined such person and have determined that such person is Incapacitated within the meaning of subsection 8.4(a). Settlor and each Trustee authorize any physician to use or disclose the following information to any Intended Person: (1) any information regarding Settlor's or such Trustee's physical or mental condition, (2) Settlor's or such Trustee's individually identifiable protected health information pursuant to the Health Insurance Portability and Accountability Act ("HIPAA"), and (3) Settlor's or such Trustee's medical records. For purposes of this section, "Intended Person" means any person who has a power, right, interest, or office under this Trust Agreement that is determined by reference, in whole or in part, to whether such Settlor or Trustee is Incapacitated.

8.5 **Release of Powers and Interests.** Any person, including a beneficiary and a Trustee, shall have the power to disclaim, release, or restrict, irrevocably, in whole or in part, any interest, right, power, or discretion granted to such person with respect to any trust by signed instrument delivered to the Trustee, or in any other manner permitted by law. Any person designated or appointed as a Trustee may, prior to accepting the trust, by written instrument decline to accept any right, power, or discretion with respect to the trust and may accept the trust without such right, power, or discretion.

8.6 **Powers of Appointment.**

- (a) **Capacity in Which Exercisable.** Every power of appointment granted to a beneficiary under this Trust Agreement is exercisable by that beneficiary in the beneficiary's individual capacity, notwithstanding the fact that the beneficiary may also be serving as a Trustee of the trust.
- (b) **Manner of Appointment.** Every power of appointment granted herein: (1) shall be personal to the donee of such power and may not be exercised on behalf of the donee by any other person, including an attorney-in-fact, a guardian, or any other court appointed representative, and (2) may be exercised in whole or in part and in favor of one or more potential beneficiaries to the exclusion of others. Appointment may be outright or in further trust, with all provisions determined by the donee of the power, and may confer a power of appointment upon the beneficiary or others, if within the constraints imposed by any applicable rule against perpetuities and any other law which is applicable to the appointment.
- (c) **Exercise of Inter Vivos Power.** An inter vivos power of appointment granted in this Trust Agreement may be exercised only by a written instrument, executed and acknowledged by the donee and delivered to the Trustee during the donee's lifetime, which specifically refers to the power of appointment and expresses the intention to exercise it. If no such instrument is delivered to the Trustee during the donee's lifetime, upon the donee's death the Trustee may distribute the property subject to the power in the manner provided in this Trust Agreement for distribution in default of exercise.

- (d) **Determination of the Exercise of a Testamentary Power.** The Trustee may rely upon any instrument admitted to probate as a donee's will or codicil in determining whether a testamentary power of appointment granted herein has been exercised. If no will or codicil is brought to the Trustee's attention within ninety (90) days of a donee's death to indicate the exercise of a testamentary power, the Trustee may distribute the property subject to the power in the manner provided in this Trust Agreement for distribution in default of exercise. The Trustee will be protected from liability for its actions as authorized in this subsection 8.6(d), but this subsection 8.6(d) does not affect an appointee's rights in the property subject to the power of appointment.
 - (e) **Tax Consequences.** The exercise of a power of appointment may have important tax consequences. The donee of any power of appointment should consult with counsel before exercising such power of appointment.
- 8.7 **Liability of Third Party.** No person paying money or delivering property to the Trustee need see to the application of such money or property. No person dealing with the Trustee need inquire into the propriety of any transaction or the Trustee's authority to enter into and consummate the same. A Trustee may certify as to the identity of the then acting Trustee or as to any other fact material to the trust, by written instrument signed by the Trustee. The certificate may be accepted by all persons as conclusive of the matters stated in it, without duty of further inquiry.
- 8.8 **Use of Words.** As used in this Trust Agreement, the masculine, feminine, and neuter gender, and the singular or plural of any word, includes the others unless the context indicates otherwise. The use of an article (such as "a," "an," or "the") or an adjective (such as "any") before a defined term does not change the meaning of the defined term.
- 8.9 **Unenforceable Provision.** If any provision of this Trust Agreement is unenforceable, the remaining provisions shall be given effect, unless to do so would produce an unreasonable result.
- 8.10 **Titles, Headings, and Captions.** All titles, headings, and captions used in this Trust Agreement have been included for administrative convenience only and should not be construed in interpreting this Trust Agreement.
- 8.11 **Trust Name.** The initial trust established by this Trust Agreement shall be known as the "Robert Doe Irrevocable Trust". The name of every other trust created under this Trust Agreement shall be determined by the Trustee.

JOHN DOE has executed this Trust Agreement as Settlor and ROBERT DOE, in acceptance of this trust, has executed this Trust Agreement as Trustee, effective as of the date shown on page 1. The Trustee agrees to administer the trust estate in accordance with the terms of this Trust Agreement.

JOHN DOE,
Settlor

ROBERT DOE,
Trustee

STATE OF TEXAS §
 §
COUNTY OF _____ §

BEFORE ME, the undersigned authority, on this day personally appeared JOHN DOE, Settlor known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same for the purposes and consideration therein expressed.

GIVEN UNDER MY HAND AND SEAL OF OFFICE this ____ day of _____, 2014.

Notary Public

STATE OF TEXAS §
 §
COUNTY OF _____ §

BEFORE ME, the undersigned authority, on this day personally appeared ROBERT DOE, Trustee, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same for the purposes and consideration therein expressed.

GIVEN UNDER MY HAND AND SEAL OF OFFICE this ____ day of _____, 2014.

Notary Public

SCHEDULE A
ROBERT DOE IRREVOCABLE TRUST

Exhibit 2

_____, 2014

[MR. AND MRS. CLIENT]

Re: Inheritance Trust

Dear _____:

One of the chief goals in preparing your estate plan is to minimize estate taxes at your death. In addition to planning for your existing assets, it is important to plan for any potential inheritance which you may receive upon the deaths of your parents. You have advised me that [CLIENT-HUSBAND] may inherit substantial assets from his parents. To ensure that estate taxes on any potential inheritance will be minimized, I recommend that property not be transferred to [CLIENT-HUSBAND], individually, but to a trust for [CLIENT-HUSBAND]'s benefit or for the benefit of his children (the "Inheritance Trust").

Broadly stated, the purpose of the Inheritance Trust is to ensure that any inheritance from [CLIENT-HUSBAND]'s parents' estates will be protected from [CLIENT-HUSBAND]'s creditors and estate tax. If properly administered, the assets held by the Inheritance Trust should be protected from [CLIENT-HUSBAND]'s existing or future creditors.

The Inheritance Trust could be structured so that [CLIENT-HUSBAND] is the sole trustee with authority to manage the trust assets. In addition, [CLIENT-HUSBAND] can be the sole beneficiary during his lifetime and, upon his death, he can direct the disposition of the remaining trust assets. Even though [CLIENT-HUSBAND] will have substantial rights in the trust assets, the assets remaining in the Inheritance Trust at [CLIENT-HUSBAND]'s later death should be free of transfer taxes.

There are two ways in which [CLIENT-HUSBAND]'s parents can provide that assets distributable to [CLIENT-HUSBAND] individually will be distributed instead to the Inheritance Trust. First, [CLIENT-HUSBAND]'s parents can request the estate planning attorneys who draft their estate planning documents to update their documents to provide that any assets distributable to [CLIENT-HUSBAND] will be administered in trust for [CLIENT-HUSBAND]'s benefit (the terms of which would need to be included in [CLIENT-HUSBAND]'s parents' documents). Alternatively, we can prepare a separate agreement which creates the Inheritance Trust. This should enable [CLIENT-HUSBAND]'s parents to execute simple amendments to their estate planning documents to direct that [CLIENT-HUSBAND]'s share of their estates be distributed to the Inheritance Trust.

Initially, the Inheritance Trust will be nominally funded and will be dormant until the death of a parent of [CLIENT-HUSBAND]. Upon a parent's death, the Inheritance Trust will receive the property [CLIENT-HUSBAND] would have otherwise directly inherited and will become "active."

Prior to [CLIENT-HUSBAND]'s parents' deaths, the Inheritance Trust will not be subject to federal income tax and will not be required to file an annual income tax return. Once the Inheritance Trust becomes "active," it will become subject to federal income tax and will be required to file an annual income tax return. The Inheritance Trust will be assigned a taxpayer identification number for this purpose.

[CLIENT-HUSBAND] will be the initial trustee of the Inheritance Trust and will have substantial access to the net income and principal of the Inheritance Trust during [CLIENT-HUSBAND]'s lifetime. If [CLIENT-HUSBAND] is not serving as trustee, a third party may be appointed successor trustee with broad distribution powers, including the power to withhold distributions which would otherwise be collected by [CLIENT-HUSBAND]'s creditors.

Upon [CLIENT-HUSBAND]'s death, unless [CLIENT-HUSBAND] directs otherwise, the Inheritance Trust property will be distributed in trust for [CLIENT-WIFE], for [CLIENT-WIFE's] lifetime, and upon [CLIENT-WIFE's] death, to trusts for the benefit of the children and their descendants. The terms of the beneficiaries' trusts would substantially mirror the terms of the trusts created under [CLIENT-HUSBAND]'s estate plan.

Please give me a call if you have any questions.

Sincerely,

John F. Bergner

Exhibit 3

- 2.3 **Withdrawal Rights.** All transfers of property to the Trustee that are to be added to Robert's Trust, including both the initial trust estate and any additional contributions, shall be subject to the withdrawal rights granted under Section 5.1.

* * * * *

- 5.1 **Withdrawal Rights.** Each time a Contribution is made to Robert's Trust during Robert's lifetime, Robert shall have the right to withdraw property of Robert's Trust to the extent, and on the terms, set forth in this section.

- (a) **Power of Transferor to Alter Withdrawal Rights.** Any person making a Contribution may do so on the condition that no Withdrawal Right is to be granted, or that an alternative Withdrawal Right is to be granted, with respect to the Contribution. If the transferor does so, then Robert's Withdrawal Right shall be governed by the transferor's instructions to the extent of the Contribution. Otherwise, Robert's Withdrawal Right with respect to that Contribution shall be governed by subsequent provisions of this section. A transferor may not grant a Withdrawal Right in excess of the amount of the Contribution.
- (b) **Creation of Withdrawal Rights.** Each Contribution shall create its own Withdrawal Right, and a separate Withdrawal Right shall attach to each separate Contribution.
- (c) **Contribution by a Married Person.** If a transferor is married at the time of the Contribution, such Contribution shall be treated as two separate Contributions having been made one-half ($\frac{1}{2}$) by the transferor and one-half ($\frac{1}{2}$) by the transferor's spouse, regardless of whether the property contributed is community property and regardless of whether they elect to treat such Contribution as having been made one-half by each of them for Federal gift tax purposes.
- (d) **Amount of Withdrawal Right.** Robert's Withdrawal Right with respect to each Contribution shall be the lesser of the following amounts:
- (i) the Annual Exclusion Amount, less the cumulative value of all previous known gifts to or for the benefit of Robert by the same transferor during the same calendar year which would qualify for the present interest exclusion;
 - (ii) Robert's Unused Five and Five Amount immediately prior to the Contribution; or
 - (iii) the value of the Contribution.
- (e) **Notice, Withdrawal Period, and Lapse.**
- (i) **Notice.** Unless directed to the contrary by the transferor, the Trustee shall promptly provide Robert with a Withdrawal Notice following a Contribution to the trust by that transferor.

- (ii) **Withdrawal Period.** Robert may exercise the Withdrawal Right at any time during the Withdrawal Period.
- (iii) **Lapse of Withdrawal Right.** If Robert does not exercise the Withdrawal Right before the expiration of the Withdrawal Period, the unexercised right shall lapse on the Lapse Date.
- (f) **Exercise of Withdrawal Right.** Robert may exercise a Withdrawal Right by giving written notice to the Trustee.
- (g) **Payment of Withdrawal Amount.** If Robert exercises a Withdrawal Right, the Trustee shall immediately pay to Robert cash in the amount of the Withdrawal Right. The Trustee shall make payment first from any gifts made to Robert's Trust prior to the exercise of such Withdrawal Right, but during the same calendar year in which the Withdrawal Right is exercised. If such gift or gifts do not consist of sufficient cash to satisfy the exercised Withdrawal Right, the Trustee shall use other liquid assets of Robert's Trust for such purpose. If Robert's Trust does not hold sufficient liquid assets to satisfy an exercised Withdrawal Right, the Trustee shall borrow funds in order to satisfy the Withdrawal Right and shall, if necessary, pledge trust property to secure the loan.
- (h) **Limitations on Distributions During Withdrawal Period.** If any Contribution is made subject to a Withdrawal Right, the Trustee shall not make any distributions under any other provision of this Trust Agreement which would prevent the Trustee from being able to satisfy fully any unexpired right of withdrawal.
- (i) **Definitions.** The following definitions apply for purposes of this Section 5.1.
 - (i) **Annual Exclusion Amount.** "Annual Exclusion Amount" means the maximum present interest exclusion amount permitted, under Section 2503(b) of the Code or any similar succeeding statute (such amount being \$14,000 at the date of execution of this Trust Agreement).
 - (ii) **Contribution.** "Contribution" means any cash or other property which is transferred to Robert's Trust as part of the trust estate and also includes premiums on policies of life insurance (or interests therein) owned by the trust which are paid directly to the issuers of the policies. If a premium is paid directly to an issuer, the date of the Contribution shall be the date on which the premium payment is transmitted. The value of any Contribution to the trust estate shall be its value for federal gift tax purposes.
 - (iii) **Five and Five Amount.** "Five and Five Amount" means the greater of (A) five thousand dollars (\$5,000), or (B) five percent (5%) of the total value of Robert's Trust determined as of the date the current Withdrawal Right is to lapse (such value may be estimated by the Trustee), or (C) any greater Withdrawal Right, the lapse of which would not constitute a release of such Withdrawal Right under Sections 2041(b)(2) and 2514(e) of the Code or any similar subsequent statute.

- (iv) **Withdrawal Period.** "Withdrawal Period" means the period starting on the date of a Contribution and ending thirty (30) days after the earlier of Robert's receipt of the Withdrawal Notice or such time that Robert has actual or constructive notice of the Withdrawal Right.
- (v) **Lapse Date.** "Lapse Date" means the date when the Withdrawal Period ends.
- (vi) **Unused Five and Five Amount.** "Unused Five and Five Amount" means the amount remaining after subtracting Robert's cumulative Withdrawal Rights with respect to any other gifts from any transferor that are either currently outstanding or that have previously lapsed (but not including the present right of withdrawal) during the same calendar year from the Five and Five Amount.
- (vii) **Withdrawal Notice.** "Withdrawal Notice" means a written notice from the Trustee to Robert that, with respect to a Contribution, states the name of the transferor, the value of the properties contributed, and the amount of the Robert's Withdrawal Right.
- (viii) **Withdrawal Right.** "Withdrawal Right" means Robert's right to withdraw trust property that arises as a result of a Contribution.

Exhibit 4

**Robert Doe, Family Trustee
Robert Doe Irrevocable Trust**

_____, 2014

Robert Doe

Re: Robert Doe Irrevocable Trust (the "Trust")

Dear Robert:

In my capacity as Trustee, I am sending this letter to you as a beneficiary of the above referenced Trust.

Please be advised that on _____, 2014, John Doe transferred property to the Trust. As a beneficiary of the Trust, you have a noncumulative right to withdraw a portion of such property. Your withdrawal rights are set forth in Section 5.1 of the Trust Agreement. A copy of said Section 5.1 is attached to this letter. The description of the property added to the Trust, the amount or portion thereof over which you have a present right of withdrawal, and the date of expiration of this right are described below:

1. **Description of property and value:** Five Thousand and No/100 Dollars (\$5,000.00).
2. **Amount over which you hold a right of withdrawal:** The lesser of (i) the present interest exclusion amount under Section 2503(b) of the Internal Revenue Code (currently \$13,000 per transferor) reduced by the cumulative value of all previous known gifts for your benefit by the same transferor for such calendar year that qualify for the present interest exclusion, or (ii) \$5,000 or 5% of the value of the trust estate, whichever is greater, or (iii) the value of the contribution.
3. **Date of expiration of right of withdrawal:** 30 days from the date you receive this letter.

You may withdraw all or any portion of the amount over which you hold a right of withdrawal at any time prior to the date of expiration. In the event you wish to make a withdrawal, please advise me in writing at the above address of the amount you wish to withdraw. To be effective, such exercise of a right of withdrawal must be postmarked or received by me no later than the date of expiration. In the event this notice is received by a natural or appointed guardian of an incompetent, whether because of minority or some other infirmity, and this right of withdrawal is to be exercised, the guardian shall obtain the signature of the minor or ward in addition to his or her own, if at all possible and after explaining the rights contained herein.

This notice is a condition to the contribution to the Trust of the above described property. The amount subject to this withdrawal right is payable in cash immediately upon receipt by myself, as Trustee, of your demand in writing. Should the Trust not contain sufficient liquid assets to satisfy a demand when made, I can and will borrow funds (from Settlor or another source) in order to satisfy the withdrawal and can, if necessary, pledge trust property to secure the loan.

Whether or not this withdrawal right is exercised, please sign and date the bottom of this letter and return a copy to me for my records. The natural or appointed guardian may sign and date the bottom of this letter on behalf of an incompetent, whether because of minority or some other infirmity. If possible, the guardian should obtain the signature of the minor or ward in addition to his or her own in acknowledging receipt of this notice.

You should be aware that the withdrawal rights granted to you under the Trust Agreement have important tax consequences (which are summarized below). Please note, however, that the following summaries are intended for informational purposes only and should not be relied upon as legal or tax advice with respect to your withdrawal rights. You are encouraged to consult your tax advisor regarding the tax implications associated with your withdrawal rights.

- (a) **Federal Gift and Estate Tax Consequences.** If you release a withdrawal right granted to you under the Trust Agreement, you will be deemed to have made a contribution to the Trust pursuant to Section 2514 of the Internal Revenue Code and a portion, if not all, of the Trust estate will be included in your gross estate for Federal Estate Tax purposes upon your death.

If instead of releasing your withdrawal right you simply allow the withdrawal rights to lapse, you should not be deemed to have made a contribution to the Trust pursuant to Section 2514 of the Internal Revenue Code and the Trust estate should not be included in your gross estate for Federal Estate Tax purposes.

- (b) **Federal Income Tax Consequences.** If you release a withdrawal right granted to you under the Trust Agreement, you will be deemed the owner of the Trust assets for Federal Income Tax purposes, meaning that all items of income, gain, loss and deductions will be reported on your personal income tax return, even if no distributions are made from the Trust.

The IRS currently treats a lapse of a withdrawal right as a "release" for purposes of Section 678(a) of the Internal Revenue Code. Accordingly, if you allow a withdrawal right granted to you under the Trust Agreement to lapse, I will treat you as the owner of the Trust assets for Federal Income Tax purposes, meaning that all items of income, gain, loss and deductions will be reported on your personal income tax return, even if no distributions are made from the Trust.

Sincerely,

Robert Doe, Family Trustee

I hereby acknowledge receipt of the foregoing notice and recognize that the withdrawal rights granted to me under the Trust Agreement have important tax consequences. I further acknowledge that in the event I allow the withdrawal right granted to me to lapse, I will be treated as the "owner" of the Trust, or a portion thereof, for Federal Income Tax purposes.

Date: _____, 2014.

Robert Doe, Beneficiary

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