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BASICS*

What Every Trustee Ought to Know

Synopsis

The job of trustee is an important and difficult one. It can be wrought with potential for personal liability, while offering little potential for personal benefit. The primary reward for someone entrusted with this responsibility is the knowledge that he or she complied with a friend's or family member's wishes–responsibly carrying out the duty of looking after a beneficiary's well-being. The keys to effectively managing this difficult position are understanding precisely what is required, identifying potential traps for the unwary, and avoiding these traps.

I. Introduction

A friend or family member is updating an estate plan and asks you whether you would be willing to serve as a trustee of a trust that is being created. Honored by the request, you agree to serve in the position. Perhaps a friend or family member recently passed away and you've just discovered that they have named you as a trustee. Regardless of how you came to be entrusted with this position, you're likely curious about the extent of your obligations, how much time they will demand, and where to go to seek help in fulfilling your role.

This outline is intended to give you an overview of the responsibilities with which all trustees in Texas are charged. While it should not be treated as a do-it-yourself manual or as a substitute for legal or tax advice, it should give you a feel for the duties you can personally perform, and it should make you a more informed client when you hire professional assistance.

II. Trustee Duties

In Texas, the rules concerning trust administration and trustee powers and duties are found in: (1) the trust instrument; (2) the Texas Trust Code ("Code"); and (3) court decisions interpreting trust law. The Code provides that trustees must administer trusts according to the terms of the trust instrument *and* the provisions of the Code. When one of these sources fails to address an issue, but the other does, the source addressing the issue controls. If the trust instrument conflicts with the Code, the trust instrument generally controls. When neither source addresses a particular issue, the trustee must look to court interpretations of Texas trust law to determine his or her duties.

A trustee is a "fiduciary." Fiduciaries must act with the utmost care and honesty in carrying out the wishes of the person who appointed the trustee to act. A number of specific duties are imposed upon trustees in Texas:

- ***Duty of Loyalty*.** You must administer the trust solely in the interest of the beneficiaries. You are not permitted to place yourself in a position where it would be beneficial for you to violate your duty to the beneficiaries.

- ***Duty Not to Delegate.*** You must personally administer the trust. Except in limited circumstances, you must not delegate to others acts that you should personally perform. The Code *does* permit you to hire professionals for legal, accounting and investment *advice*. Ultimately, however, decisions on all issues must be made by you.

- ***Duty to Keep and Render Accounts.*** You must keep full, clear and accurate accounts of the trust estate. The Code gives beneficiaries the right to demand a written statement of accounts covering the trust's transactions from the time of the inception of the trust, or from the time of the last accounting, and you must comply with that demand (but not more than once per year). The trust instrument may require you to provide annual or other accountings, even if they are not requested by the beneficiary.

- ***Duty to Furnish Information.*** You must provide complete and accurate information about the trust to the beneficiaries at reasonable times. You must keep the beneficiaries reasonably informed concerning the administration of the trust and provide them with all material facts necessary for them to protect their interests. The beneficiaries have a right to examine the trust property and accounts, receipts and other documents relating to trust administration.

- ***Duty to Exercise Reasonable Care and Skill.*** You must exercise the level of care and skill a person of ordinary prudence would exercise in dealing with his or her own property.

- ***Duty to Take and Retain Control of Trust Property.*** You must take all reasonable steps to secure and maintain control over the trust property.

- ***Duty to Preserve Trust Property.*** You must use the level of care and skill a person of ordinary prudence would use to preserve trust property.

- ***Duty to Enforce Claims.*** You must take reasonable actions to collect claims due to the trust estate.

- ***Duty to Defend.*** You must do what is reasonable under the circumstances to defend actions by third parties against the trust estate.

- ***Duty Not to Co-Mingle Trust Funds.*** You must designate trust property as such, and segregate it from your personal property. Likewise, you must keep the property separate from other trusts you may administer. Joint investments among several trusts are permitted, but each trust's interest must be separately identified.

- ***Duty With Respect to Bank Deposits.*** Although you may deposit trust funds in a bank, you are duty bound to use reasonable care in selecting the institution and you must designate all such deposits as trust deposits. You may not subject the property to unreasonable restrictions on withdrawal or leave it in non-interest bearing accounts for unduly long periods of time. Pending investment, distribution, or the payment of debts, the Code authorizes you to deposit trust funds in a bank that is subject to supervision by state or federal authorities.

- ***Duty to Diversify.*** Unless the trust instrument says otherwise, you are required to diversify the investments of the trust pursuant to an investment strategy having risk and return objectives reasonably suited to the trust.

- ***Duty to Deal Impartially With Beneficiaries*.** When there are multiple beneficiaries of a trust, they must be treated impartially.

III. Trust Management and Investment - The Prudent Investor Standard

A. The Texas Trust Code

The Code sets out a number of rules regarding a trustee's investment duties. In summary, the Texas's Uniform Prudent Investor Act provides that unless altered by the terms of the trust instrument, "*A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.*" The rule goes on to provide:

> "Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions or strategies; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; (5) the expected total return from income and the appreciation of capital; (6) other resources of the beneficiaries; (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries."

While Texas courts once evaluated the trustee's performance on an asset-by-asset basis, more recently, the trust's mix of assets is determinative. The Code now provides, "*A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust*." This rule incorporates into Texas trust law modern portfolio management theory, which recognizes that it may be appropriate in some portfolios to include some higher risk investments that have greater opportunity for higher returns. Thus, a prudent investor might make an investment of a small percentage of the trust estate in an asset that might not be suitable if it comprised the entire trust estate (or a large portion of the trust estate). Likewise, an otherwise prudent investment might *not* be prudent in the context of the entire trust. For example, a prudent person might invest in real estate if the projected returns justify the investment. If the trust estate is already comprised primarily of real estate, however, purchasing additional real estate may violate the prudent-person standard because of the lack of diversification. Likewise, certificates of deposit may be prudent to hold in a portfolio, but because they have no growth potential and may be eroded by inflation, it may be imprudent to hold a major portion of the trust estate in these investments.

B. The Prudent Investor Rule Under the Common Law

In 1992, the American Law Institute published its third edition of the RESTATEMENT OF THE LAW OF TRUSTS. This review of court cases and judicial reasoning had as its goal modernizing and clarifying the prudent person rule to take into account modern portfolio theory. The rationale behind this objective ranged from that of "liberating expert trustees to pursue challenging, rewarding, non-traditional strategies when appropriate to a particular trust, to that of providing other trustees with reasonably clear guidance to safe harbors that are practical, adaptable, readily identifiable and expectedly rewarding."

According to this review, the general standard of the prudent investor rule is as follows:

> "The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
>
> "a. This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.
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> "b. In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.
>
> "c. In addition, the trustee must:
>
> "(1) conform to fundamental fiduciary duties of loyalty and impartiality;
>
> "(2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and
>
> "(3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship."

Following is a summary of the principles of prudence that may be taken from the foregoing discussion. Trustees are advised to: (1) diversify the investments of the trust estate (in fact, the Code now provides, "*A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying*"); 2) analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trust; (3) avoid fees, transaction costs and other expenses not justified by needs and realistic objectives of the trust's investment program; and (4) balance the elements of return between production of current income and protection of purchasing power (because of the duty of impartiality). In some cases, trustees may have a duty to delegate some investment duties, as a prudent investor would.

IV. Evaluation of Trust Estate

A. Initial Evaluation

Upon accepting a trust, you should immediately undertake a thorough review of all trust investments. Although such evaluations may be time consuming, they are an invaluable way to spot potential problems and are a preliminary step to remedying them. In the words of the Code, "*Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this chapter.*" The Code does not define a "reasonable time," because the reasonableness of the time period depends upon the particular facts and circumstances of the trust in question. The best practice is to review the trust assets immediately upon accepting the trusteeship or receiving new assets.

B. Retention of Assets

Under prior law, a trustee was permitted to retain property owned by the trust when he or she first started serving as trustee, without regard to its suitability for original purchase. The adoption of the Prudent Investor Rule eliminates this protection, unless the trust instrument expressly grants that authority. Even if the trust instrument authorizes you to retain contributed assets, however, this provision does *not relieve you from liability for retaining an investment that it is imprudent to retain*. Rather, it allows you to *retain* an investment that would not have been prudent for original acquisition, *if its retention is prudent*.

Language in the trust instrument may further allow you to retain the initial trust corpus and property added to the trust, without regard to diversification of investments and without liability for any depreciation or loss resulting from retention. This provision does not protect successor trustees who are dealing with assets purchased by a predecessor trustee, but may give some protection to trustees who retain assets originally a part of the trust estate or later contributed to the trust. The ability to retain assets, formerly granted by statute in Texas, has been construed very narrowly by the courts. Courts frequently find exceptions for "reckless indifference" for retention of certain imprudent assets. Further, imprudent retention (usually) makes beneficiaries dissatisfied with the trust administration and judges and juries more willing to impose liability for other actions.

C. Review of Prior Trustee's Actions

If you are becoming the successor trustee of an existing trust, the Code provides that you are liable for breaches of trust by predecessor trustees only if you: "know or should know" of a situation constituting such a breach of trust and permit it to continue; fail to make reasonable efforts to compel the predecessor trustee to deliver trust property; or fail to make reasonable efforts to compel the predecessor trustee to redress a breach of trust. If you are taking over a trust in which there has been a history of disputes between the beneficiary and former trustee or other beneficiaries, you are strongly advised to obtain a judicial settlement of the trust accounts. Since obtaining such a settlement is a costly proposition, beneficiaries will frequently consent to signing a waiver, eliminating the need for such a finding. Securing such a waiver is a good practice, even when the trust instrument itself contains an exculpatory clause which authorizes you to accept a predecessor's accounts. Regardless of the circumstances, all successor trustees should review the predecessor's accounts to verify that there are no improper transactions. Judges or juries may find that you "should have known" of any breaches that you would have uncovered had you reviewed the prior trustee's accountings.

D. Periodic Evaluation

You should periodically review the trust estate. Such reviews (which should occur at least annually) should examine the trust's investments, performance, projected cash flow, distribution levels and needs of the beneficiaries. Regular and prudent review may protect you from liability. For example, in one New York case, a bank administering a trust which declined in value from $940,000 to $93,000 in a three-year period was found not liable for the loss. The bank was protected by its extensive records, which showed the trust was reviewed on over 40 occasions during that period, and several meetings were held with the beneficiaries.

E. Additional Information About Investments

For additional information about fiduciary responsibilities relating to various trust assets, you should review our *BASICS* memorandum entitled "Trust Investments."

V. Distribution Guidelines and Policies

A. Provisions of Trust Instrument

It is imperative that you *read* and *reread* the trust instrument provisions regarding distributions. You should thoroughly read the trust agreement when you begin serving, and then at each yearly review of the trust. Further, you should review the distribution provisions *each time you are considering a distribution request*. Not only should you review the distribution provisions -- also closely examine the entire instrument for statements and clauses indicating the trust creator's intent regarding distributions and the relative priority or preference to be given to beneficiaries.

B. Discretionary Distributions

Perhaps the most difficult issue you face as a trustee is determining the amount of discretion granted to you by the trust instrument to make or deny distributions. To many trustees' surprise, even when the trust instrument describes the level of discretion granted, using terms such as "absolute" or "uncontrolled", courts rarely permit total and unqualified discretion. Fortunately, where trustees have acted in good faith, with proper motives and within the boundaries of reasonable judgment, judges generally will not substitute their judgment for that of the trustee.

In cases where the trust permits or requires distributions for health, support, maintenance, and education, if the beneficiary agrees after consultation, it is often desirable to pay a monthly or quarterly allowance to him or her, rather than paying expenses as requested. In calculating the amount of the allowance, you might consider the beneficiary's other sources of income (the instrument may require such consideration), and you should make reasonable efforts to quantify his or her expenses. Additionally, you should consider whether the trust will be able to provide this level of support as long as the trust requires (e.g., for the beneficiary's life, or until the beneficiary reaches some specified age), or whether distributions will require invasions into corpus, depleting the trust's ability to provide for the beneficiary in the future. Document the facts and circumstances serving as your basis for making distributions at a specific level.

If the trust allows you to consider the beneficiary's needs in light of his or her accustomed standard of living, the budget may include items that are reasonable for that individual in light of his or her lifestyle (such as expensive vacations, clothing or club dues). Maintain records that indicate that these expenses are similar to those previously incurred by the beneficiary. Retain all beneficiary requests for disbursements, including the amount requested. Income tax returns, proof of expenses and budgets submitted by the beneficiary should also be retained. You should review the allowance periodically (at least annually), and confirm the actual expenses of the beneficiary over that time period. Updated information should be recorded in the file.

In addition to periodic allowances, beneficiaries occasionally request discretionary distributions. These requests should be in writing and retained when made. If an emergency oral request is made and granted, obtain written confirmation of the request from the beneficiary as soon as possible. Further, it is a good practice to keep notes summarizing all telephone conversations in which such requests are made.

Although the trustee-beneficiary relationship is more comfortable (at least in the short term) if all distribution requests are granted, it may not be possible to accommodate every request. For example, if a beneficiary of a trust designed to provide support for life requests distributions that will ultimately deplete the trust estate, or if a current beneficiary requests distributions that will jeopardize the interests of the future beneficiaries, you may be required to reject one or more requests. Good communication can often avoid disappointment among beneficiaries. When you start your job, you should explain the purposes of the trust and disclose the amount of funds available to the beneficiaries. Such an explanation greatly increases the odds of the beneficiary accepting and understanding why certain distributions cannot be made. Unless he or

she is a minor, the beneficiary deserves (and ultimately will demand) to be treated as an adult. Accordingly, present such information in a non-condescending manner. Beneficiaries armed with the knowledge that your decisions are not arbitrary are more likely to make more reasonable requests and to react more rationally when their requests are denied. A recent study found a strong correlation between the amount of beneficiary communication and involvement and their satisfaction. *This is important -- satisfied beneficiaries are less likely to institute legal action **and** are more pleasant to deal with on a regular basis.*

Institute a policy for responding to distribution requests within a specific period of time. A long response time, coupled with little or no communication, will cause the beneficiary to believe you are not devoting adequate time and attention to your responsibilities. This negative impression is magnified if the request is ultimately denied. The importance of communication cannot be overemphasized. Although a major or otherwise unusual request admittedly takes time to evaluate (because of the necessity of obtaining documentation and/or analyzing the trust's ability to make the distribution and continue fulfilling its objective), channels of communication must remain open. Upon receiving such a request, immediately let the beneficiary know if additional information will need to be evaluated, and set a deadline for a definite decision.

If multiple trusts are being administered for one or more beneficiaries, consider the varying tax implications of making the distributions from the different trusts. For example, if trusts are created for children and grandchildren, and some are exempt from generation-skipping taxes while others are not, strive to make distributions for the children (and distributions to the grandchildren for tuition or medical expenses which are protected from those taxes) from non-exempt trusts, saving and growing the exempt trusts for the grandchildren. Likewise, where a traditional estate plan has been implemented, creating a marital deduction trust and a bypass trust after the first spouse's death, distributions to surviving spouses generally should be made from the marital trust instead of from the bypass trust. This is because the corpus of the bypass trust has already been subjected to estate tax in that generation, whereas the corpus in the marital trust has not. Accordingly, the trustee should deplete the marital trust corpus first. Because these issues are difficult for laymen (and many lawyers) to grasp, you are strongly advised to consult with an estate planning attorney or tax advisor familiar with trust matters to ascertain from which trust to make a particular distribution.

C. Proper Weighing of Beneficiaries' Interests

If you are the trustee of a trust with multiple beneficiaries, you must attempt to weigh the interests of the various beneficiaries properly. This is true whether the beneficiaries are all currently receiving distributions or if their interests are successive. If the creator of the trust provided that one beneficiary has priority (such as a surviving spouse) you must honor this request. In other trusts, keep in mind the size of the corpus, and its ability to provide for all of the beneficiaries. Carefully weigh each request in light of the beneficiaries' various interests. Document your reasons for making or denying distributions. Courts usually will not substitute their judgment for yours on questions of discretionary distributions. However, absent documentation *or* if there is a record reflecting poor or harsh communications with the beneficiary, courts are much more inclined to substitute their judgment for yours.

D. Loans to Beneficiaries

Unless the trust agreement prohibits loans, Trustees may generally loan funds to a beneficiary for certain purposes, rather than making a distribution. In multiple beneficiary or "pot" trusts, loans are often viewed as a way to satisfy a beneficiary's need, without giving him or her "too much" of the trust estate. For trusts that will divide into separate shares upon the occurrence of a triggering event (e.g., death of the surviving spouse, or when the youngest child reaches a certain age), the loan may be offset against the beneficiary's ultimate share. You should be as cautious about making loans as you are about making distributions. Before you consider making a loan, determine whether the trust instrument permits them. If

permitted, closely evaluate the security for the loan and the beneficiary's ability to repay. Frequently the decision to loan funds to a beneficiary is tantamount to making a distribution, since many cannot or will not repay. Accordingly, trustees must be prepared to deal with default, should it occur. All loans must be evidenced by a promissory note and any appropriate security agreement.

VI. Accounting

A. Duty to Prepare Accounts

The Code states that any person who has an interest in or against the trust has the right to demand written statements of accounts covering its transactions. When trustees fail or refuse to provide an accounting, these persons may ask the court to compel production. Except in unusual circumstances, trustees are not *required* to provide accountings more frequently than once every 12 months. Notwithstanding this fact, it is advisable to keep interested persons apprized of the trust's financial status to lessen the possibility of conflict. Simply forwarding monthly account statements to these persons should be sufficient to fulfill this purpose.

Although some legal claims against trustees may be subject to a two-year statute of limitations, interested persons generally have four years to initiate lawsuits against trustees. The statute of limitations may not begin running until the facts constituting a cause of action are discovered by the beneficiaries. Accordingly, it is important that you retain all trust records. Further, your annual accountings should contain enough detail about the trust's transactions to put interested persons on notice of your acts. If a specific transaction has been fully disclosed in an accounting, the accounting may start the clock running, effectively barring claims made as a result of the transaction, if four years have elapsed.

The Code demands that written statements of accounts show: (1) trust property received that has not been previously listed on an accounting; (2) a list of receipts and disbursements, allocated between income and principal; (3) a list and description of all property being administered; (4) cash accounts, their balance, and where they are deposited; and (5) a list of all liabilities. In the interest of providing full disclosure to the beneficiary, you may need to provide more than a "bare bones" accounting. The accounting should be in understandable form, incorporating information necessary for the recipient to get a complete picture of the trust administration during the relevant time period. The level of detail and the amount of time required to prepare an accounting depends largely on the nature of the trust's assets and its activity, including the receipts of income and the sales of assets and investments.

B. Accounting Systems and Programs

Accountings for trusts with few assets and distributions can be quite simple but should nevertheless be prepared and distributed to beneficiaries on an annual basis. Arguably, trusts holding property solely in a money market account or in mutual funds, may simply provide the beneficiary with the bank or mutual fund statements. If the bank or mutual fund sends out a yearly summary, this statement may be used. Otherwise, each month's account statements may be collected and sent. If expenses have been paid or distributions have been made, copies of checks may be included, with sufficient notation on the memorandum line describing the purpose of the disbursement. Alternatively, a brief schedule of disbursements and their purposes may be prepared. If you choose to hold multiple mutual funds, you may want to use a discount broker, so all accounts will be consolidated on one statement. If few transactions are involved, a simple handwritten or typewritten summary may be prepared.

For trusts that hold multiple properties, and/or those that engage in numerous transactions each year, the trustee must implement a system that adequately records and reflects all transactions. The trustee may consider hiring an accountant to prepare the annual accounting in these circumstances. Alternatively, the trustee may use a computer program to prepare the accounting. Even where an accountant is retained for tax

advice or report preparation, the trustee would be well advised to independently utilize a computerized accounting package to keep a record of the transactions.

A fairly user-friendly accounting program is "Quicken", published by Intuit,. It is a practical "non-accountant" programs. Unfortunately, it is not specifically designed for trust accounting. Accordingly, categories will need to be added (which is easily done) for distributions to beneficiaries and other items peculiar to trusts. Distributions will need to be placed in one of the "expense" categories, whereas in a true fiduciary accounting program, distributions would not be treated as an "expense." Take note that these programs are designed for personal use, and are not intended to provide protection from manipulation. Therefore, transactions that have been closed can be altered (although the program gives a warning to the user when that has been done). They will, however, help to make a useful record of trust transactions which can be used for accounting purposes.

C. Frequency and Distribution of Reports

Trustees should closely review the trust instrument for reporting requirements, and comply with any specific provisions regarding the timing and distribution of reports. Even if annual accounts are not specifically mentioned in the trust instrument or beneficiaries do not request one, trustees should prepare an annual accounting as a matter of course. For larger trust estates, with numerous transactions, quarterly or monthly reports may be advisable. This report should be delivered to the parent, guardian or person having custody of any minor or incapacitated beneficiary.

D. Duty to Keep Beneficiaries Informed

You must keep the beneficiaries reasonably informed concerning the administration of the trust, and the material facts necessary for them to protect their interests. This duty extends at a minimum to all beneficiaries (i) who are currently entitled or permitted to receive distributions from the trust and (ii) all beneficiaries who would be entitled to receive distributions if the trust were terminated. You must fulfill this duty even if the beneficiaries do not ask for information. In addition, as of January 1, 2006, any language in the trust instrument that purports to waive this duty to a beneficiary who is 25 years of age or older is unenforceable. In other words, the trust instrument cannot absolve you of your duty to keep trust beneficiaries informed.

E. Audited Financial Statements

In most trust estates, the annual accountings will not be audited. For large trust estates, however, or for trust estates with litigious interested persons, you may decide that the expense of providing the interested persons with audited financials is justified.

F. Summary of Important Trust Transactions and Projections

When the accountings are distributed, include a written summary. Significant transactions (i.e., sales of major assets, significant changes in the trust estate, significant changes in value, etc.) that occurred during the trust year should be explained. Also include information detailing trust performance over the past year. You may want to include information about performance over a longer period of time. In addition to past performance, it is good practice to summarize actions you intend to take over the next year. For example, plans to sell a major asset or to make a major investment should be noted. If you are still in the process of implementing the trust's investment policy, inform the beneficiaries of the additional investments and sales that are likely to be made during the year in order to fully implement the policy.

VII. Record Keeping

A. Tickler Calendar for Important Dates

You should develop a reliable method to keep track of recurring events which require action. Such events include, but are not limited to, due dates of payments that must be made by the trust, tax returns or filings that must be made, mandatory distribution dates, and termination dates. In addition to monthly, quarterly or annual reminders, you should set up reminders for events to occur in future years. Absent implementation of a reliable system to provide reminders in future years, make notations of these dates on your current calendar (e.g., "10 years until trust terminates", then on the next year's calendar, note "9 years until trust terminates", etc.).

B. Receipts, Bank Statements and Canceled Checks

It is imperative that you save all receipts (or billing statements, with the check to be used as a receipt), bank statements and canceled checks. You may wish to use a checking account or money market account that returns canceled checks (or makes copies available on-line) for record keeping purposes. Canceled checks may serve the dual purpose of providing useful information if you use the memorandum line, while acting as proof of payment. Generally, beneficiaries are entitled to inspect trust bank accounts and "vouchers". In order to satisfy inspection rights, and to prove that amounts were properly paid, retain all receipts, copies of bills paid and other documents establishing the purpose and propriety of payments. Retaining these documents may also provide protection if a beneficiary criticizes the completeness of your annual account. Trust accountings generally can be reconstructed (albeit sometimes at a considerable cost), if all bills, bank statements, deposit slips, checks and other records are retained.

C. Written Broker's or Advisor's Reports and Recommendations

Reports and recommendations of brokers and investment advisors should be reduced to writing and retained. These reports will help document your prudence in buying or selling an investment. Copies of articles or other written information that has influenced your investment philosophies should also be retained.

D. Written Correspondence To and From Beneficiaries and Telephone Memoranda

You should retain written records of all communications with the beneficiaries concerning trust matters. Such records serve two valuable purposes. First, they assist in reconstructing the history of the trust, providing information not reflected in the accountings and other financial documents. In reviewing actions taken, and your rationale, these records may be used to refresh your memory and to establish your "prudence." Second, beneficiaries who become unhappy with trustees frequently develop a selective memory. Retaining written documentation of all communications can assist with refreshing such a beneficiary's memory, effectively keeping the peace. Always keep in mind, however, these records could *also* prove your bad judgment. Accordingly, approach all trust related conversations seriously and diplomatically. Hostile, arbitrary or poorly thought-out communications can and have been used against trustees.

VIII. Tax Reporting Requirements

In addition to reporting to the beneficiary, you have a duty to file tax returns with the Internal Revenue Service. There are several areas in which reporting may be required.

A. Taxable Trusts vs. "Grantor" Trusts

Trusts are generally treated as taxpayers by the IRS and must file income tax returns annually on a calendar-year basis. However, not all trusts are taxpayers. Some trusts, over which the creator of the trust or others retain specified powers or interests, may be ignored for federal income tax purposes. Such a trust is referred to as a "grantor trust." So long as the trust is a grantor trust, he grantor of the trust (or the

beneficiary holding the specified power) is treated as the "owner" of all or a portion of the trust's property and may be liable to report all income, losses, deductions, and credits attributable to that portion on his or her income tax return. Consult with a qualified trust attorney or accountant to determine if the grantor-trust rules apply to your trust.

B. Taxpayer Identification Number

Form SS-4 is used to obtain a taxpayer identification number for a trust. In general, any trust that is not a grantor trust or that is otherwise required to file an income tax return must have a taxpayer identification number. The application may be made online. If the trust is wholly a grantor trust for income tax purposes, the Trustee need not obtain a taxpayer identification number for the Trust; the trustee may instead elect to use the grantor's social security number. In this case, whenever the trustee is asked to provide an IRS Form W-9 to a bank or other financial institution reporting the trust's taxpayer identification number, the form may be completed using the grantor's name and social security number, and all account income will be reported directly to the grantor. If the trust is a grantor trust, the trustee should obtain and keep a copy of a Form W-9 completed by the grantor to ensure that the trustee is providing the correct social security number when opening financial accounts or undertaking other trust business.

C. Notice of Fiduciary Relationship - Form 56

Form 56 is used by trustees to notify the Internal Revenue Service of the creation, change, or termination of a fiduciary relationship. Filing this form ensures that the IRS will have proper information on file and that you will receive the notices sent by the IRS (or will have a defense if the notice is sent improperly). The form should be filed at the Internal Revenue Service Center where the trustee will be required to file the trust's tax return.

D. Form 1041

Generally, trusts (other than grantor trusts) with $600 or more of gross income, or any taxable income, must file a Form 1041 (a fiduciary income tax return). However, certain so-called "grantor" trusts are not required to file a Form 1041. Trusts are grantor trusts if the person who created or contributed assets to it retained the right to receive trust principal or income, retained the power to control the enjoyment of trust principal or income, or retained the power to revoke the trust. Note that under the terms of the Texas Estates Code, all trusts are revocable by their creator unless the trust instrument expressly provides otherwise.

E. Form 1041ES

A Form 1041ES is used to make estimated payments for the trust. This form must be filed when the trust is required to make estimated tax payments. Trusts are required to make estimated tax payments when they: (i) expect to owe more than $500.00 in tax, after subtracting withholding and credits; and (ii) expect their withholding and credits to be less than the lesser of (i) 90% of the current year's tax; or (ii) 100% of the prior year's tax (within certain limitations).

F. Generation-Skipping Distributions Form 706GS(D-1)

If non-exempt distributions are made to a "skip person," as defined in Section 2613 of the Internal Revenue Code, you must report the distribution on Form 706GS(D-1), Notification of Distribution from a Generation-Skipping Trust. The application of the generation-skipping transfer tax to trusts is extremely technical and is subject to numerous exemptions and exclusions. You should consult with competent counsel whenever you suspect that a trust distribution or termination might involve a "generation skipping" transfer. Generally, the tax applies when a trustee transfers funds to a person who is two or more generations below the person who created the trust (measured by counting persons from the creator's

grandparents), or to an unrelated person who is more than 37½ years younger than the creator of the trust. Due to the application of certain exclusions, a generation-skipping distribution usually arises only if substantial assets have been placed into trust by the same person (the exemption for each transferor from this tax has varied from $1,000,000 for transfers in 1984, to $13,610,000 for transfers in 2024), but in many cases, a gift or estate tax return would have to be filed applying the transferor's generation-skipping transfer tax exemption for the exclusion to be available to the trust). If generation-skipping transfers are made, the Form 706GD(D-1) must be filed with the Internal Revenue Service (with Copy B to the distributee) by April 15th of the year following the calendar year of the distribution. Whenever distributions are made to grandchildren or younger descendants of the trust's creator, you should consult with the trust's attorney, accountant, or other tax advisor about the necessity of and procedure for preparing and filing this form.

G. Generation-Skipping Transfer Tax Return for Terminations - Form 706GS(T)

You must calculate and report the tax due from a trust termination subject to the generation-skipping tax on Form 706GS(T) by April 15th following the year in which a trust's termination occurs. Again, this tax is normally due only if substantial trusts terminate by making distributions to the grandchildren, great-grandchildren, or more remote descendants of the trust's creator. As with generation-skipping distributions, the trustee's attorney, accountant or other tax advisor should be consulted about the necessity of and procedure for preparing and filing this form.

IX. Self-Dealing and Other Conflicts of Interest

A. Texas Trust Code Provisions

The Code prohibits trustees from engaging in many transactions where he or she is acting in more than one capacity. For example, unless expressly permitted by the trust instrument, the Code prohibits a trustee from loaning funds to himself; to an affiliate, director, officer or employer of himself or an affiliate; to a relative; or to his employer, employee, partner, or other business associate. The Code also prohibits trustees from selling trust property to, or purchasing trust property from, the persons listed above. However, trustees may comply with the terms of a written contract signed by the person who established the trust. Additionally, the Code prohibits trustees from selling assets from one trust to another of which he or she is also trustee, unless the assets are bonds, notes, bills or other obligations fully guaranteed by the United States and sold for fair market value.

B. Trust Instrument Provisions Authorizing Self-Dealing

Generally speaking, trust instruments may relieve individual trustees of certain duties, liabilities and restrictions, but they may not relieve corporate fiduciaries of the self-dealing restrictions promulgated by the Texas Trust Code. Be wary, however, of relying on language in trust instruments that purports to authorize self-dealing. If a trustee enters into a financial transaction with the trust, it should be on terms such that the trustee can establish that the consideration exchanged in the transaction is fair and reasonable to the trust estate and is on terms comparable to those for transactions between disinterested persons. In addition, any such transaction should be disclosed in advance to the trust's beneficiaries.

C. Some Common-Sense Advice to the Trustee

Issues related to self dealing are best summarized by the rule, "If you have to ask if it creates a conflict of interest, don't do it." If you will get a benefit (or if someone *could think* you will) that you would not get if you weren't trustee, don't do it. If the action is something you would rather not fully disclose in advance to all beneficiaries, don't do it. If a beneficiary objects, and a potential conflict exists, don't do it. *Poor judgment is sometimes forgiven by a judge or jury. Self-interest **never** is*.

X. Rights and Liabilities to Third Parties

A. Torts

As trustee, you are *personally* liable for torts you, your agents or employees commit in the course of their employment. Examples of torts include "wrongful action" or "failure to act". Generally, trustees may be exonerated or reimbursed from the trust estate if: (1) they were properly engaged in business activities and the tort is one that is common in that business activity; (2) they were properly engaged in a business activity and neither the trustee nor his employee or agent is guilty of actionable negligence or intentional misconduct; or (3) the tort increased the value of the trust property. However, if the trustee is entitled to exoneration or reimbursement because of an increase in value to the trust property, the amount of the exoneration or reimbursement is limited to the increased value of the trust property.

B. Contracts of the Trustee

If in your capacity as trustee you enter into a contract on which a legal claim later arises, the plaintiff may sue you in your *representative capacity* and may collect the judgment against the trust estate. However, **you *may* be sued individually, if the contract does not *exclude your personal liability***. The Code provides that use of the word "Trustee" or "as Trustee" after your signature is evidence of intent to exclude personal liability. Accordingly, whenever an act on behalf of the trust requires your signature, follow your name with the word "Trustee" or "as Trustee".

XI. Summary

Assets of trust estates and the circumstances of their beneficiaries are not static. Accordingly, your duties are constantly changing. Notwithstanding this fact, you can avoid most of the problems associated with the trustee-beneficiary relationship if you do the following things:

1. View yourself as responsible to all of the beneficiaries *and* to the terms of the trust;
2. Attempt to see issues from the beneficiaries' perspective (even if you do not ultimately come down on the issue in a way they like);
3. Devote the time, energy and expertise necessary for the trust estate in question;
4. Direct the trust estate in a way you would like if you were the beneficiary, *but also* as the creator of the trust would expect, and as a prudent investor would;
5. Set and follow appropriate policies and procedures; and
6. Communicate plainly, politely, and frequently with the beneficiaries.

If you fail to develop adequate procedures and policies, *or* if you fail to follow them, you are likely to find that you have effectively personally guaranteed the success of your decisions. Conversely, if you faithfully fulfill your responsibilities, you can be confident you have lived up to the "trust" your loved one or friend placed in you by selecting you to serve in this important role.