ATG LEGAL EDUCATION

New Illinois Laws on Directed Trusts and Decanting

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***Presented by*:**

- **Timothy S. Midura, C.P.A., J.D., LL.M.**
  Attorney
  Huck Bouma PC
  Wheaton, Illinois

Decanting Illinois Trusts

Decanting Illinois Trusts

- **Preview**
  - "Decanting" (the word) is a metaphor for transferring principal of irrevocable Trust No. 1 to irrevocable Trust No. 2 for the betterment of the purposes of Trust No. 1 and its beneficiaries.

Decanting Illinois Trusts, p. 1

Decanting Illinois Trusts

- **Distribution of Trust Principal in Further Trust,** *Effective January 1, 2013*
  - A trustee or "authorized trustee," who has discretion to distribute principal on such trustee's own initiative may distribute the principal of the first trust into the second trust.
  - The decanting distribution is in furtherance of the purposes of the first trust.

Decanting Illinois Trusts, p. 2

Decanting Illinois Trusts

- **Reasons and Opportunities for Decanting**
  - There will be numerous and varied reasons to decant a trust. Generally:
    - correction of express terms that are determined to be incorrect, frustrating, inappropriate, or insufficient to accomplish the settlor's intentions and trust purposes;
    - avoiding potential adverse effects; and
    - addressing change of circumstances.

Decanting Illinois Trusts, p. 2

Decanting Illinois Trusts

- **Important Recognitions**
  - Fiduciary Duties
    - The trustee is acting to decant pursuant to the trustee's fiduciary powers and duties.
  - Special Power of Appointment
    - Decanting is analogous to the trustee having a special or limited power of appointment and decanting being its fiduciary exercise to transfer all or a part of a trust to a second trust for the benefit of the beneficiaries in furtherance of the first trust's purposes.

Decanting Illinois Trusts, p. 3

Decanting Illinois Trusts

- **Important Recognitions**
  - Settlor Is the Same
    - The settlor of a first trust is considered to be the settlor of the second trust. § 16.4(t).
  - Decanting is Available for All Irrevocable Trusts
    - Exceptions:
      - § 16.4(v). Unless the *governing instrument expressly prohibits* use of Illinois decanting *by specific reference* to 760 ILCS 5/16.4.

Decanting Illinois Trusts, p. 6

Decanting Illinois Trusts

- **Decanting Is Highly Discretionary**
  - Need to Distribute Not Required.
    - An authorized trustee may decant whether or not there is a current need to distribute principal under the terms of the first trust. § 16.4(k).

Decanting Illinois Trusts, p. 9

Decanting Illinois Trusts

- **Decanting Is Highly Discretionary**
  - No Duty to Distribute.
    - The decanting law is not intended to create or imply a duty to exercise a power to distribute principal. No inference of impropriety will be made as a result of an authorized trustee not exercising the decanting power. § 16.4(1).

Decanting Illinois Trusts, p. 9

Decanting Illinois Trusts

- **Decanting Is Highly Discretionary**
  - No Duty to Inform Beneficiaries of Decanting Opportunity
    - A trustee has no duty to inform beneficiaries about the availability of decanting and no duty to review the trust to determine whether any decanting action should be taken. § 16.4(1).

Decanting Illinois Trusts, p. 10

Decanting Illinois Trusts

- **First Question**
  - Does an authorized trustee have *discretionary power to distribute principal*?

Decanting Illinois Trusts, p. 10

Decanting Illinois Trusts

- **Second Question**
  - Is decanting in furtherance of the *purposes of the trust* exercised in a *fiduciary capacity*? § 16.4(b)

Decanting Illinois Trusts, p. 10

Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - Express Prohibition
      - Cannot decant if the trust instrument expressly prohibits decanting, § 16.4(m), by specific reference to the Illinois decanting statute. § 16.4(v).

Decanting Illinois Trusts, p. 10

Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - Contrary to Vested Rights
      - Cannot decant if the effect reduces, limits, or modifies any beneficiary's current right to a mandatory distribution of income or principal, a mandatory annuity or unitrust interest, a right to withdraw a percentage of the value of the trust or a right to withdraw a specified dollar amount provided that such mandatory right has come into effect with respect to the beneficiary;
      - except with respect to a second trust which is a supplemental needs trust. § 16.4(n)(1).

Decanting Illinois Trusts, p. 10

ATG LEGAL EDUCATION New Illinois Laws on Directed Trusts and Decanting

Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - Trustee's Exoneration
      - Cannot decant to decrease or indemnify against a trustee's liability or exonerate a trustee from liability for failure to exercise reasonable care, diligence, and prudence.

Decanting Illinois Trusts, p. 11

Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - Remove or Replace Trustee
      - Cannot decant to eliminate a provision granting another person the right to remove or replace the authorized trustee exercising the decanting power

Decanting Illinois Trusts, p. 12

Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - Perpetuities Period
      - Cannot decant to reduce, limit, or modify the perpetuities provision specified in the first trust in the second trust, unless the first trust expressly permits the trustee to do so. § 16.4(n)(4).

Decanting Illinois Trusts, p. 12

Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - Special Tax Status
      - Cannot decant in a manner that will prevent the contribution to the first trust from qualifying for or would reduce the exclusion, deduction, or other tax benefit that was originally claimed in the first trust.

Decanting Illinois Trusts, p. 12

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Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - S Corporation Stock
      - Cannot decant during any period when the first trust owns subchapter S corporation stock and the second trust is not a permitted shareholder under IRC § 1361(c)(2). § 16.4(p)(2).

Decanting Illinois Trusts, p. 13

Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - Minimum Required Distributions
      - Cannot decant during any period when the first trust owns an interest in property subject to the minimum required distribution (MRD) rules of IRC § 401(a)(9) and the decanting would result in the shortening of the minimum distribution period. § 16.4(p)(3).

Decanting Illinois Trusts, p. 13

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Decanting Illinois Trusts

- **Third Question**
  - Are there any *bars from or restrictions* on decanting?
    - Trustee Compensation
      - Cannot decant if solely to change the provisions regarding the determination of the compensation of any trustee.

Decanting Illinois Trusts, p. 14

Decanting Illinois Trusts

- **Fourth Question**
  - Who can decant?
    - Authorized Trustee is Not Just a Trustee.
      - An "authorized trustee" means an entity or individual, other than the settlor, who has authority under the terms of the first trust to distribute the principal of the trust for the benefit of one or more current beneficiaries. § 16.4(a). This appears to include authorized roles expressed in the trust instrument.

Decanting Illinois Trusts, p. 14

Decanting Illinois Trusts

- **Fourth Question**
  - Who can decant?
    - Two Avenues
      - There are two avenues of decanting based on whether the authorized trustee's principal distribution discretion is:
        - Absolute (§ 16.4(c)); or
        - Not absolute (§ 16.4(d)).

Decanting Illinois Trusts, p. 15

Decanting Illinois Trusts

- **Fifth Question**
  - Which avenue of decanting is available, absolute or non-absolute?
    - **Absolute Discretion** means the right to distribute principal that is not limited or modified in any manner to or for the benefit of one or more beneficiaries of the trust, whether or not the term "absolute" is used.
      - A power to distribute principal that includes purposes such as best interests, welfare, or happiness constitutes absolute discretion. § 16.4(a).

Decanting Illinois Trusts, pp. 15-16

Decanting Illinois Trusts

- **Fifth Question**
  - Which avenue of decanting is available, absolute or non-absolute?
    - **No Absolute Discretion**. Distribution to second trust if no absolute discretion. § 16.4(d).
      - The second trust must include the same language authorizing the trustee distribute the income or principal of a trust as set forth in the first trust. § 16.4(d)(1).
      - Supplemental Needs Trust
        - Exception and facilitation for supplemental needs trusts for non-absolute decanting. § 16.4(d)(4).

Decanting Illinois Trusts, p. 17

Decanting Illinois Trusts

- **Fifth Question**
  - Which avenue of decanting is available, absolute or non-absolute?
    - **Divided Discretion.** If an authorized trustee has absolute discretion to distribute the principal of a trust and the same trustee or another trustee has the power to distribute principal under the trust instrument which power is not absolute discretion, such authorized trustee having absolute discretion may exercise the power to distribute under § 16.4(c) (the absolute discretion section). § 16.4(h).

Decanting Illinois Trusts, p. 19

Decanting Illinois Trusts

- **Sixth Question**
  - What procedures are required for the circumstances? Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?
    - Written Instrument
    - Notice

Decanting Illinois Trusts, p. 20

Decanting Illinois Trusts

- **Sixth Question**
  - What procedures are required for the circumstances? Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?
    - Later Discovered Assets
      - To the extent the authorized trustee does not expressly provide otherwise:
        - All Assets Transferred.

Decanting Illinois Trusts, p. 22

Decanting Illinois Trusts

- **Sixth Question**
  - What procedures are required for the circumstances? Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?
    - Later Discovered Assets
      - To the extent the authorized trustee does not expressly provide otherwise:
        - Partial Transfer. The distribution of part, but not all, of the assets comprising the principal of the first trust to the second trust will not include subsequently discovered assets of the first trust; such assets will remain the assets of the first trust. § 16.4(i)(2).

Decanting Illinois Trusts, p. 22

Decanting Illinois Trusts

- **Sixth Question**
  - What procedures are required for the circumstances? Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?
    - Remedies
      - Not Liable – Reasonable and in Good Faith
        - A trustee who reasonably and in good faith takes or omits to take any decanting is not liable to any person interested in the trust.

Decanting Illinois Trusts, p. 22

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Decanting Illinois Trusts

- **Sixth Question**
  - What procedures are required for the circumstances? Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?
    - Remedies
      - Presumption
        - An act or omission by a trustee to decant is presumed taken or omitted reasonably and in good faith unless it is determined by the court to have been an abuse of discretion.

Decanting Illinois Trusts, p. 22

Decanting Illinois Trusts

- **Sixth Question**
  - What procedures are required for the circumstances? Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?
    - Remedies
      - Time Bar
        - Any claim by any person interested in the trust that a decanting act or omission by a trustee was an abuse of discretion is barred if not asserted in a proceeding commenced by or on behalf of the person *within 2 years after the trustee has sent* to the person or the person's personal representative a notice or report in writing sufficiently disclosing facts fundamental to the claim such that the person knew or reasonably should have known of the claim.

Decanting Illinois Trusts, p. 23

Decanting Illinois Trusts

- **Seventh Question**
  - What are the tax implications? How is the second trust settled for tax purposes? Are there any adverse tax consequences lurking in the decanting transaction?
    - Income tax
    - Gift tax
    - Estate tax
    - Generation-skipping tax

Decanting Illinois Trusts, p. 25

Decanting Illinois Trusts

- **Summary of Tax Traps**
  - Create income or capital gain tax recognition through the change in the quality of the beneficiary's interest, through negative basis assets, or inadvertent creation of a foreign trust.
  - Create a taxable gift through beneficiary consent.
  - Create estate tax inclusion by some defect in the second trust.
  - Undermine a grandfathered or exempt GST trust by change, including violating the rule against perpetuities.

Decanting Illinois Trusts, p. 37

Decanting Illinois Trusts

- **How should Illinois' decanting law affect drafting trust instruments today?**

Decanting Illinois Trusts, p. 41

Decanting Illinois Trusts

- **The seven (plus one) big questions are:**
  - Does an authorized trustee have a discretionary power to distribute principal?

Decanting Illinois Trusts, p. 42

Decanting Illinois Trusts

- **The seven (plus one) big questions are:**
  - Is decanting in furtherance of the purposes of the trust?

Decanting Illinois Trusts, p. 42

Decanting Illinois Trusts

- **The seven (plus one) big questions are:**
  - Are there bars or restrictions to decanting?

Decanting Illinois Trusts, p. 42

Decanting Illinois Trusts

- **The seven (plus one) big questions are:**
  - Who can decant?

Decanting Illinois Trusts, p. 42

Decanting Illinois Trusts

- **The seven (plus one) big questions are:**
  - Which decanting pathway can be followed: absolute discretion or non-absolute?
    - This depends on the trust distribution provisions and who can be the "authorized trustee."

Decanting Illinois Trusts, p. 42

Decanting Illinois Trusts

- **The seven (plus one) big questions are:**
  - What procedures are required for the circumstances?
    - Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?

Decanting Illinois Trusts, p. 42

Decanting Illinois Trusts

- **The seven (plus one) big questions are:**
  - What are the tax implications?
    - How is the second trust settled for tax purposes?
    - Are there any adverse tax consequences lurking in the decanting transaction?

Decanting Illinois Trusts, p. 42

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Decanting Illinois Trusts

- **The seven (plus one) big questions are:**
  - Should statutory decanting be pursued or either (a) non-statutory decanting or (b) some other remedy?

Decanting Illinois Trusts, p. 42

Illinois Directed Trusts

Illinois Directed Trusts

- The directed trusts statute authorizes the governing instrument to *divide the trustee's duties* among the trustee (the trustee becoming an "excluded fiduciary") and a "directing party" or parties (being distribution trust advisor, investment trust advisor, trust protector, or similar roles or non-exclusive titles).

Illinois Directed Trusts, p. 2

Illinois Directed Trusts

- So we now have clear authority on how we can *slice the fiduciary pie into various autonomous pieces, while maintaining the whole of the pie*.

Illinois Directed Trusts, p. 2

Illinois Directed Trusts

- The Illinois directed trusts statute *does not provide any failsafe tax planning*.

Illinois Directed Trusts, p. 3

Illinois Directed Trusts

- Tax Cut Backs

Illinois Directed Trusts, p. 4

Illinois Directed Trusts

- **Applies to all existing, modified, and future trusts that appoint or provide for a directing party.**
- **Must be construed as pertaining to the administration of a trust.**

Illinois Directed Trusts, p. 4

Illinois Directed Trusts

- **Question:**
  - Are the players in a trust instrument strictly described a covered by the directed trusts statute or are they construed into it?

Illinois Directed Trusts, p. 4

Illinois Directed Trusts

- **Holy Grail = Trustee as an Excluded Fiduciary**
  - When a governing instrument provides for division of powers or bifurcation of roles, the Holy Grail of the trustee (or other non-directing party) will be to be clearly classified as an "excluded fiduciary."

Illinois Directed Trusts, p. 5

Illinois Directed Trusts

- **Bifurcated Roles or Slicing the Pie**
  - A trust (whether settlor created, court order, non-judicial settlement agreement, or decanted) can be drafted to bifurcate trustee duties and responsibilities among:
    - Trustee;
    - Distribution trust advisor;
    - Investment trust advisor;
    - Trust protector; or
    - Other title, task, or fiduciary role.

Illinois Directed Trusts, p. 5

Illinois Directed Trusts

- **Bifurcated Roles or Slicing the Pie**
  - Advantages:
    - Release trustee from unwanted responsibilities and potential risks.
    - Assign to directing party acceptable responsibilities where special talents, knowledge, and experience exist.
    - Possible reduction of trustee fees.

Illinois Directed Trusts, p. 6

Illinois Directed Trusts

- **Bifurcated Roles or Slicing the Pie**
  - Disadvantages:
    - Additional levels of coordination and communication – administration complexities.
    - Potential administration conflicts and ambiguities.
    - Potential for net greater fees and costs.

Illinois Directed Trusts, p. 6

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Illinois Directed Trusts

- **Duty and Liability of Directing Party – § 16.3(e)**
  - A directing party **is a fiduciary** of the trust subject to the same duties and standards applicable to a trustee of a trust as provided by applicable law **unless the governing instrument provides otherwise**.

Illinois Directed Trusts, p. 6

Illinois Directed Trusts

- **Duty and Liability of Excluded Fiduciary – § 16.3(f)**
  - The excluded fiduciary must act in accordance with the governing instrument and comply with the directing party's exercise of the powers granted to the directing party by the governing instrument.

Illinois Directed Trusts, p. 6

Illinois Directed Trusts

- Each directing party must keep the excluded fiduciary and any other directing party reasonably informed regarding the administration of the trust.

Illinois Directed Trusts, p. 7

Illinois Directed Trusts

- § 16.3 applies to all existing and future trusts that appoint or provide for a directing party.

Illinois Directed Trusts, p. 8

Illinois Directed Trusts

- **Definitions**
  - Directing Party
    - Any investment trust advisor, distribution trust advisor, or trust protector.

Illinois Directed Trusts, p. 10

Illinois Directed Trusts

- **Definitions**
  - Excluded Fiduciary
    - Any fiduciary that **by the governing instrument is directed to act in accordance with** the exercise of specified powers by a directing party, **in which case** such specified powers shall be deemed granted not to the fiduciary but to the directing party and such fiduciary shall be deemed excluded from exercising such specified powers. **If a governing instrument provides** that a fiduciary as to one or more specified matters **is to act, omit action, or make decisions only with the consent of a directing party, then** such fiduciary is an excluded fiduciary with respect to such matters.

Illinois Directed Trusts, p. 10

Illinois Directed Trusts

- **Drafting should have two fundamental parts.**
  - Part 1
    - Drafting the express powers (and limitations, if applicable, such as tax failsafe provisions) of the directing party.
  - Part 2
    - Directing the other fiduciary parties (the trustee in particular) to act in accordance with the specified powers of the subject directing party.
    - Playing off the title of the statute, the **directing** party is **directed** to act and the trustee is **directed** not to act but to take **directions** from the **directing** party.

Illinois Directed Trusts, p. 11

Illinois Directed Trusts

- **Powers of Investment Trust Adviser**
  - The powers of an **investment trust advisor** may be exercised or not exercised in the **sole and absolute discretion** of the investment trust advisor, and are **binding on all other persons**, including but not limited to each beneficiary, fiduciary, excluded fiduciary, and any other party having an interest in the trust.

Illinois Directed Trusts, p. 12

Illinois Directed Trusts

- **Default Powers of Investment Trust Advisor**

Illinois Directed Trusts, p. 13

Illinois Directed Trusts

- **Powers of Distribution Trust Advisor**
  - The powers of a **distribution trust advisor** may be exercised or not exercised in the **sole and absolute discretion** of the distribution trust advisor, and are **binding on all other persons**, including but not limited to each beneficiary, fiduciary, excluded fiduciary, and any other party having an interest in the trust.

Illinois Directed Trusts, p. 13

Illinois Directed Trusts

- **Default Powers of Distribution Trust Advisor**

Illinois Directed Trusts, p. 14

Illinois Directed Trusts

- **Powers of Trust Protector**
  - The powers of a **trust protector** may be exercised or not exercised in the **sole and absolute discretion** of the trust protector, and are **binding on all other persons**, including but not limited to each beneficiary, investment trust advisor, distribution trust advisor, fiduciary, excluded fiduciary, and any other party having an interest in the trust.

Illinois Directed Trusts, p. 14

Illinois Directed Trusts

- **Non-Exclusive, Non-Default Powers**

Illinois Directed Trusts, p. 14

Illinois Directed Trusts

- **Inherent Powers, Inherent Restrictions?**
  - Does the mere reference in a governing instrument to a "trust protector" or other directing power automatically empower such role with full powers articulated under the statute?
    - Yes, if an investment trust advisor. See § 16.3(b).
    - Yes, if a distribution trust advisor. See § 16.3(c).
    - No, if a trust protector. See § 16.3(d).

Illinois Directed Trusts, p. 17

Illinois Directed Trusts

- **What are possible or probable changes for a pre-1/1/13 directing party?**
  - **Fiduciary capacity** (and thus duties) is now applicable, unless the governing instrument had expressly provided otherwise.
    - If fiduciary capacity had been waived, then the directing party should endeavor to process and memorialize his or her good faith and action or non-action as in the best interests of the trust.
    - There should be a review of the statutory application of "sole and absolute discretion" and "binding on all other persons" and whether such creates practical (tax) issues.

Illinois Directed Trusts, p. 18

Illinois Directed Trusts

- **What are possible or probable changes for a pre-1/1/13 directing party?**
  - **Fiduciary processes** should now be undertaken in conformance with fiduciary capacity.
  - **Affirmatively** keep the excluded fiduciary and other directing parties **informed**.
  - **Responsively** provide information **as requested** by the excluded fiduciary or other directing parties.

Illinois Directed Trusts, p. 18

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Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - **Expressly empower** the directing party with **detailed powers** (whether all expressed in the governing instrument [recommended] or partially incorporated by reference to the statute). It can be further expressed that it is the **settlor's intention** that this person be a **directing party** [as applicable: distribution trust advisor, investment trust advisor, or trust protector] within the meaning of 760 ILCS 5/16.3.

Illinois Directed Trusts, p. 19

Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - **Direct the trustee** and other directing parties to follow (act or omit to act only upon) the directions of the subject directing party. It can be further **expressed that it is the settlor's intention that this non-directing person is to be** (and other directing parties are also by application) **an excluded fiduciary** within the meaning of 760 ILCS 5/16.3.

Illinois Directed Trusts, p. 19

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Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Express whether the directing party is acting in a **fiduciary capacity or non-fiduciary capacity**.
  - Provide for **different** trustees and directing parties for various **sub-trusts**.
  - Provide for **succession** of the directing party – just as is done for trustees.

Illinois Directed Trusts, p. 19

Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Provide for the **vacancy** of the directing party (of role or bifurcated power) that the trustee, in default, assumes those responsibilities and duties or some other procedure for successor appointment.

Illinois Directed Trusts, p. 19

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Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Provide for handling the circumstances in which the directing party is **not being timely responsive** (say, within 20 days of when the trustee sends written notice) to the requests or needs of the trustee, i.e., succession trigger or the trustee acting. Vise versa for the trustee being responsive to the directing party.

Illinois Directed Trusts, p. 19

Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Provide for any necessary **tax or other failsafe or cutback provisions** for the directing party (and also for the trustee should for any reason the trustee needs to act due to a vacancy of role or bifurcated power).

Illinois Directed Trusts, p. 19

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Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Express the **directing party's compensation** and ability to hire independent **counsel or agents** at the expense of the trust(s) involved. Merely authorizing reasonable fees and expense reimbursement should be sufficient. This should extend beyond the directing party's activity should the directing party be dragged back into trust matters.

Illinois Directed Trusts, p. 20

Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Express the directing party's entitlement to seek **judicial remedy or direction** at the expense of the trust.

Illinois Directed Trusts, p. 20

ATG LEGAL EDUCATION New Illinois Laws on Directed Trusts and Decanting

Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Express the **trustee's compensation**, considering any relief of responsibilities and risk and additional need to coordinate with the directing party. Merely authorizing reasonable fees and expense reimbursement should be sufficient.

Illinois Directed Trusts, p. 20

Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Have the **directing party** acknowledge acceptance of his or her role by **signing the instrument** – just as the trustee does.

Illinois Directed Trusts, p. 20

ATG LEGAL EDUCATION New Illinois Laws on Directed Trusts and Decanting

Illinois Directed Trusts

- **What are some specific drafting considerations?**
  - Consider whether the governing instrument should expressly **opt out** of the application of "the provisions of § 16.3 of the Trusts and Trustees Act and any corresponding provision of future law."

Illinois Directed Trusts, p. 20

Illinois Directed Trusts

- **Conclusion**
  - There are few safeguards built into the Illinois directed trusts law.
  - The statute increases fiduciary status and need for fiduciary processing.

Illinois Directed Trusts, p. 20

Illinois Directed Trusts

- **Conclusion**
  - It is the **Holy Grail** to be clearly classified as an excluded fiduciary.
  - We should be drafting more squarely and strictly into the directed trusts statute.
  - The mantra of the wise trustee has been and will continue to be better "process." The mantra of the wise "directing party'" should also be **process.**

Illinois Directed Trusts, p. 21

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Decanting Illinois Trusts

By: Timothy S. Midura, C.P.A., J.D., LL.M
of Huck Bouma PC – Wheaton
tmidura@huckbouma.com – www.TimothyMidura.com
630-221-1755

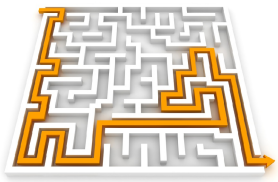

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Table of Contents

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Decanting Illinois Trusts

or, **Distribution of Trust Principal in Further Trust**

By: Timothy S. Midura, C.P.A., J.D., LL.M

of Huck Bouma PC – Wheaton

tmidura@huckbouma.com – www.TimothyMidura.com – 630-221-1755

1. Preview:
   a. "Decanting" (the word) is a metaphor for transferring principal of irrevocable trust no. 1 to irrevocable trust no. 2 for the betterment of the purposes of trust no. 1 and its beneficiaries.
   b. Decanting is a technique that will assist the betterment of irrevocable trusts where the trustee has a discretionary power to distribute principal – that do not have other avenues for betterment, such as empowered trust protectors. With a well empowered trust protector, the statutory decanting technique will probably be unnecessary.
   c. The Illinois decanting statute states a strong public policy favoring supplemental needs trusts.
   d. Although this paper focuses on Illinois **statutory** decanting, other alternatives for dealing with trust issues (including non-statutory decanting) makes this area ripe with opportunity and challenge. Illinois statutory decanting becomes a viable tool when the circumstances have developed by reason that original drafting flexibility has been insufficient and other techniques cannot handle the new facts and circumstances.
      i. The Illinois decanting statute expressly endorses non-statutory decanting equivalencies.
2. Wikipedia on Decanting Wine:
   a. "Liquid from another vessel is poured into the decanter in order to separate a small volume of liquid, containing the sediment, from a larger volume of "clear" liquid, which is free of such. In the process, the sediment is left in the original vessel, and the clear liquid is transferred to the decanter."
   b. "Another reason for decanting wine is to aerate it, or allow it to "breathe". The decanter is meant to mimic the effects of swirling the wine glass to stimulate the oxidation processes which trigger the release of more aroma compounds. In

addition it is thought to benefit the wine by smoothing some of the harsher aspects of the wine (like tannins or potential wine faults like mercaptans)."

3. 760 ILCS 5/16.4 – Distribution of Trust Principal in Further Trust, Effective January 1, 2013.

   a. A trustee or "authorized trustee," who has discretion to distribute principal, on such trustee's own initiative may distribute the principal of the first trust into the second trust.

      i. "Decanting" is not a legal term, but a metaphor or descriptive term. It is not used by § 16.4 of the Illinois Trust and Trustees Act.

   b. The decanting distribution is in furtherance of the purposes of the first trust.

      i. In other words, the second trust is not a blank piece of paper for the authorized trustee to do whatever the authorized trustee wants with the first trust.

   c. 20 states, including Illinois, authorize decanting by statute: Alaska, Arizona, Delaware, Florida, Indiana, Kentucky, Michigan, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island, South Dakota, Tennessee, Texas, Virginia, and Wyoming.

4. Reasons and Opportunities for Decanting. There will be numerous and varied reasons to decant a trust: Generally, correction of express terms that are determined to be incorrect, frustrating, inappropriate or insufficient to accomplish the settlor's intentions and trust purposes; avoid potential adverse effects; and address change of circumstances. More specifically:

   a. Administration adjustments for purposes of modernization, convenience, costs or waste, impractical or impossible; investment provisions for scope of transactions or selection for divided trusts with differing tastes or requirements; correcting drafting errors and ambiguities.

   b. Fiduciary provisions: Trustee successor, co-trustee coordination (such a deadlock breaking), and facilitating directing advisors (such as for investments, distributions, and trust protector pursuant to 760 ILCS 5/16.3).

   c. Change to beneficiary interests: reduce, eliminate, add, defer, accelerate; family circumstances and dynamics.

   d. Extend trust termination date.

   e. Grant or modify a power of appointment.

   f. Create supplemental needs trusts.

   g. Enhance asset or liability protection.

   h. Enhance or remove spendthrift provision.

i. Protect or achieve federal or state tax benefits.

j. Divide or sever a trust into separate trusts or combine trusts to address efficiencies, beneficiary interests and circumstances, investment opportunities, or state or federal tax issues.

k. Toggle to or from grantor trust status.

l. Change governing law.

m. Move trust situs/principal place of administration.

n. Other change of circumstances that warrant trust change that betters trust administration and beneficiary interests that furthers the purposes of the trust.

5. Important Recognitions:

a. Developing Law. Illinois and other states trust and property laws and federal tax laws are in process and developing to embrace and settle the emerging techniques of decanting.

b. Fiduciary Duties. The trustee is acting to decant pursuant to the trustee's fiduciary powers and duties.

i. It is a basic tenant of fiduciary administration that "better process" is the best practice and best defense to allegations of breach of fiduciary duty. Therefore, in decanting there should be a "sword and shield" approach: the process and memorialization should use (a) the proactive (sword) the furtherance of the trust purpose and (b) the defensive (shield) of reasonableness, good faith, and non-abuse of discretion.

c. Special Power of Appointment. Decanting is analogous to the trustee having a special or limited power of appointment and decanting being its fiduciary exercise to transfer all or a part of a trust to a second trust for the benefit of the beneficiaries in furtherance of the first trust's purposes.

i. Some other states' decanting statutes expressly state that a trustee's decanting is that of a special power of appointment. Illinois' statute is silent.

ii. For tax purposes particularly, this becomes helpful from a construction perspective.

d. Only the trustee or "authorized trustee," of an irrevocable trust, is moving for decanting, generally without prior court approval and without prior beneficiary consent.

i. The settlor is not moving, nor has authority to move, for decanting. The trust is irrevocable and the Illinois statute expressly prohibits the settlor from participation.

ii. The beneficiary is not moving, nor has authority to move, for or typically consenting to decanting.

iii. The trustee in exercising or not exercising decanting discretion does so within its fiduciary capacity. Accordingly, an interested party can seek judicial relief for the trustee's bad faith or abuse of discretion, within the limitations period allows by statute.

iv. There may be adverse transfer tax (a deemed gift) or income tax (gain recognition) consequences should there be beneficiary consent or court approval.

(1) This recognition assists in understanding some of the "why's" the decanting statute is structured as it is.

e. Not Exclusive. Statutory decanting by an authorized trustee is not exclusive to or preempt changes to or transmissions from irrevocable trusts by other persons expressly authorized in the irrevocable trust instrument, such as trust protectors, amendors, distribution trust advisors, individual donees of expressed powers of appointment, and the like. Statutory decanting permits another avenue of changes for a trustee that does not otherwise have expressed authority to transmit trust principal to another trust (non-statutory decanting).

i. In other words, while a trust protector, distribution trust advisor, amendor, or donee of a power of appointment may be within the decanting statute's definition of an "authorized trustee," the exercise of their express powers under the trust instrument very well may not subject them to the Illinois statutory decanting requirements (including decanting exercise as a fiduciary), particularly if there is not a transmission of trust principal to a second trust (such as a trust protector amending the existing trust).

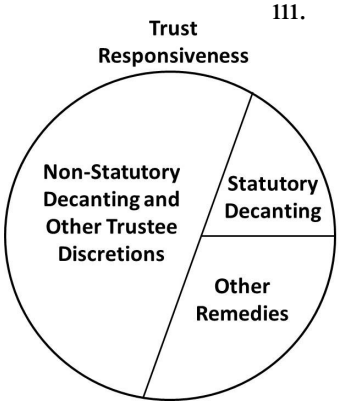
(1) However, if the trust protector, amendor, or distribution trust advisor effects a transmission of the first trust principal to a second trust, should then the provisions of the Illinois decanting statute be presumed to apply? See the express language of § 16.4(j) below.

(2) The operative question(s) here seems to be whether the change is: (a) to the existing trust, (b) a transmission to a beneficiary and not in further trust, or (c) into a second trust? Does the operative trust instrument give the "authorized trustee" or other similarly situation person sufficient authority to decant without the need of statutory authority?

(3) The author believes there is an inherent distinction with a donee of power of appointment in that such power is (a) individual and non-fiduciary in nature and (b) the class of appointees are typically not deemed beneficiaries of the trust.

(a) However, there is a certain relation back of an exercised power of appointment to the original grantor that may inherently deem the appointee a beneficiary of the settlor-grantor.

ii. See also ¶ 11.a for the **Who** of decanting and ¶ 15 for alternative **How** of decanting.



iii. Non-Statutory Decanting. § 16.4(j) expressly endorses other ways of decanting or its equivalency. So if the instrument grants the equivalent of the "authorized trustee" or authorized role the ability to decant outside of statutory authority, then the advantages of doing so includes (1) the avoidance of the statutory decanting procedures and (2) the ability to decant on a nonfiduciary basis should the trust instrument so provide.

(1) The benefit of statutory decanting include: (a) presumption of reasonableness and good faith, (b) clarity as to "absolute" discretion and option, (c) stated exclusive judicial remedy by the beneficiary, and (d) perhaps a shorter statute of limitations of 2 years.

(2) Turn on the Light! Non-statutory decanting with statutory endorsement! Think about it. It's really profound. Is it ground shaking or game changing? No. But it's like turning on a light in a room that has always been darkened. It begs us to explore non-statutory decanting methodologies and analyze all ways of trust modifications, draft expressly towards non-statutory decanting so it is an available option, and, in cases suitable for decanting, consciously evaluate whether the better path is statutory decanting or a non-statutory form.

(3) See pages 8-9 for more discussion.

iv. There appear to be "grays" in varying roles and facilitators of irrevocable trust changes should exercise certain cautioned until law and practice comfort is developed, especially when there is a transmission of principal into a second trust.

v. § 16.4(j), "This Section shall not be construed to abridge the right of any trustee to distribute property in further trust that arises under the terms of the governing instrument of a trust, any provision of applicable law, or a court order. In addition, distribution of trust principal to a second trust may be made by agreement between a trustee and all primary beneficiaries of a first trust, acting either individually or by their respective representatives in accordance with Section 16.1 of this Act."

f. Settlor Is the Same. The settlor of a first trust is considered to be the settlor of the second trust. § 16.4(t).

i. What if the second trust was settled by some other person? If the settlor of a first trust is not also the settlor of a second trust, then the settlor of the first trust is considered the settlor of the second trust, but only with respect to the portion of second trust decanted from the first trust. § 16.4(t).

g. Decanting Is Available for All Irrevocable Trusts:

i. In existence on January 1, 2013, or

ii. created on or after January 1, 2013. § 16.4(v), and

iii. administered in Illinois under Illinois law or that is governed by Illinois law with respect to the meaning and effect of its terms, including a trust whose governing law has been changed to the laws of Illinois.

(1) If a trust is being construed under Illinois law but is governed by the laws of another state for purposes of administration may still be decanted by Illinois statute.

(a) § 16.4(v)'s second sentence begins, "This Section shall be construed as pertaining to the administration of a trust and shall be available to any trust that is ..."

iv. Exceptions:

(1) § 16.4(v). Unless the governing instrument expressly prohibits use of Illinois decanting by specific reference to 760 ILCS 5/16.4.

(a) For example, "Neither the provisions of Section 16.4 of the Trusts and Trustees Act nor any corresponding provision of future law may be used in the administration of this trust" or a similar provision demonstrating that intent is sufficient to preclude the use of 760 ILCS 5/16.4.

(2) § 16.4(m). A decanting power may not be exercised if expressly prohibited by the terms of the governing instrument, but a general prohibition of the amendment or revocation of the first trust or a provision that constitutes a spendthrift clause will not preclude the exercise of a decanting power.

(3) There appears at first reading to be conflict between paragraphs (m) [being a broader expression] and (v) [being a strict and narrow application].

(a) If a trust generally provided that the trust could not be decanted under the laws of any state,

(i) (m) would seem to prohibit decanting under Illinois law.

(ii) However, (v) indicates that decanting should still be available because the specific reference to the Illinois decanting statute was not specific.

(iii) (m) seems, instead of blocking decanting, is a statement that general expressions of limitation does not block Illinois decanting and therefore (m) and (v) are reconciled.

(b) It seems that the specificity, subsequence, and context of (v) is the proper construction and application of any decanting prohibition.

(i) Although a specific reference to Illinois' decanting statute will only prohibit decanting, it appears that a specific, yet general, direction in a trust not to decant should be considered by the trustee in its discretion whether to decant and not decanting is one of the purposes of the trust.

1) An express articulation in the trust of "I, the settlor, do not want this trust to be decanted" is not a statutory block; however, it might be a direction to the trustee that it does not further the purposes of the trust to decant.

a) Having Authority. So, if there is such a declaration, the trustee may still find circumstances where decanting actually furthers the purposes of the trust and so can still decant.

b) Not Within the Trust Purpose. It is more likely that a trustee who chooses not to decant by a legally non-binding trust expression not to decant will be very protected as being reasonable in not decanting should a beneficiary criticize the trustee's non-action.

h. Common Law Decanting. Arguably, the power to decant has pre-existed under common law and statute now gives express structure to it.

i. *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782, 196 So. 299 (Fla. 1940), is the first known decision that seems to support that decanting power is held by trustees under the common law of all states. See also, *Wiedenmayer v. Johnson*, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969), *aff'd*, *Wiedenmayer v. Villanueva*, 259 A.2d 465 (N.J. 1969); and *In re Estate of Spencer*, 232 N.W.2d 491 (Iowa 1975).

ii. This may become an important perspective when it comes to application of generation-skipping tax regulations.

iii. There might be some circumstances where this argument could be used to bootstrap some form of non-statutory decanting.

i. Decanting by Other Names, Means, and Theory – Non-Statutory Decanting.

i. Certainly decanting can occur by specific statutory authorization* and perhaps under the theory of common law permissibility.

*The focus of this paper.

ii. The trust itself may have a provision that expressly authorizes a trustee to distribute principal in favor of another trust.

iii. It might also be argued that a trust that authorizes a distribution "for the benefit of" the beneficiary might be enough to distribute in favor of a second trust for the beneficiary.

iv. If there are choices of methods of decanting, one must ask, which is the more appropriate avenue for those facts and circumstances?

v. See page 5 and the prior discussion on non-statutory decanting.

6. Alternatives to Decanting:

a. Reformation or construction of trusts.

i. Court ordered.

ii. Non-judicial settlement agreements.

iii. For Charitable trusts:

(1) Cy Pres Doctrine.

(2) Equitable Deviation Doctrine.

(3) IRC § 2055(e)(3).

b. Other judicial declaratory actions.

c. Severance or consolidation of trusts. 760 ILCS 5/4.25.

d. Total return trust conversion. 760 ILCS 5/5.3.

i. Exercise power to adjust – in some states (not Illinois).

e. Amendment of trust terms by instrument provided trust protectors or amendors. 750 ILCS 5/16.3.

f. Termination of small trusts.

i. Non-charitable. 760 ILCS 5/4.26.

ii. Charitable.

(1) 760 ILCS 55/15.5.

(2) Common law considerations.

g. Change of situs subjecting the trust to another's state's laws that may be more conducive to the trust purposes or the best interests of the beneficiaries.

i. For example, a change of situs to New York will subject the trust to New York state's decanting and other trust laws.

h. Disclaimers of interests and renouncing and relinquishments of powers. 755 ILCS 5/2-7 and 760 ILCS 25/1. IRC § 2518.

i. Other authority to distribute in further trust. §16.4(j) expressly provides that the decanting statute does not hamper the right of any trustee to distribute property in further trust that arises under

i. the terms of the governing instrument of a trust,

ii. any provision of applicable law,

iii. a court order, or

iv. virtual representation and non-judicial settlement agreement pursuant to 760 ILCS 5/16.1.

7. Decanting Is Highly Discretionary.

a. Need to Distribute Not Required. An authorized trustee may decant whether or not there is a current need to distribute principal under the terms of the first trust. § 16.4(k).

b. No Duty to Distribute. The decanting law is not intended to create or imply a duty to exercise a power to distribute principal. No inference of impropriety will be made as a result of an authorized trustee not exercising the decanting power. § 16.4(l).

c. No Duty to Inform Beneficiaries of Decanting Opportunity. A trustee has no duty to inform beneficiaries about the availability of decanting and no duty to review the trust to determine whether any decanting action should be taken. § 16.4(l).

8. **FIRST QUESTION: Does an authorized trustee have a discretionary power to distribute principal?**

a. For example, an income-only trust is not a decanting candidate.

9. **SECOND QUESTION: Is decanting in furtherance of the purposes of the trust exercised in a fiduciary capacity?** § 16.4(b).

10. **THIRD QUESTION: Are there any bars from or restrictions on decanting?**

a. Express Prohibition. Cannot decant if the trust instrument expressly prohibits decanting, § 16.4(m), by specific reference to the Illinois decanting statute. § 16.4(v).

i. For example, "Neither the provisions of Section 16.4 of the Trusts and Trustees Act nor any corresponding provision of future law may be used in the administration of this trust" or a similar provision demonstrating such intent.§ 16.4(v).

ii. A general prohibition of the amendment or revocation of the first trust or a provision that constitutes a spendthrift clause shall not preclude the exercise of a decanting power. § 16.4(m).

iii. It appears the paragraph (v) trumps (m) by requiring a specific reference to 760 ILCS 5/16.4.

(1) Although a specific reference to Illinois' decanting statute will only prohibit decanting, it appears that a specific, yet general, direction in a trust not to decant should be considered by the trustee in its discretion whether to decant.

b. Contrary to Vested Rights. Cannot decant if the affect reduces, limits or modifies any beneficiary's current right to

i. a mandatory distribution of income or principal,

ii. a mandatory annuity or unitrust interest,

iii. a right to withdraw a percentage of the value of the trust or a right to withdraw a specified dollar amount provided that such mandatory right has come into effect with respect to the beneficiary,

iv. **except** with respect to a second trust which is a supplemental needs trust. § 16.4(n)(1).

(1) § 16.4(o) provides, "Notwithstanding the provisions of paragraph (1) of subsection (n) but subject to the other limitations in this

Section, an authorized trustee may exercise a power authorized by subsection (c) or (d) to distribute to a second trust; provided, however, that the exercise of such power does not subject the second trust to claims of reimbursement by any private or governmental body and does not at any time interfere with, reduce the amount of, or jeopardize an individual's entitlement to government benefits."

(2) Could this opportunity to establish a supplemental needs trust undermine the qualification of a tax sensitive trust, such as a marital deduction trust?

(a) No. § 16.4(p) provides a series of tax safeguards against this effect.

(b) So a marital deduction trust, for example, cannot be converted into a supplemental needs trust.

(c) There are similar protections and outcomes for Crummey trusts, charitable remainder trusts, QSSTs, conduit trusts for required minimum distributions, and the like.

(i) Presumably, a decanting could eliminate future Crummey withdrawal rights.

c. Trustee's Exoneration. Cannot decant to decrease or indemnify against a trustee's liability or exonerate a trustee from liability for failure to exercise reasonable care, diligence, and prudence.

i. Unbundling Exception: Decanting may arrange to indemnify or exonerate one party from liability for actions of another party with respect to distribution that unbundles the governance structure of a trust to divide and separate fiduciary and nonfiduciary responsibilities among several parties, including without limitation one or more trustees, distribution trust advisors, investment trust advisors, trust protectors, or other parties, provided however that such modified governance structure may reallocate fiduciary responsibilities from one party to another but may not reduce them. § 16.4(n)(2).

(1) This appears to be referencing roles acknowledged in 760 ILCS 5/16.3 – Directed Trusts – and thus decanting into a second trust that has directing roles pursuant to § 16.3.

(2) The totality of the responsibilities have been maintained and merely reallocated.

d. Remove or Replace Trustee. Cannot decant to eliminate a provision granting another person the right to remove or replace the authorized trustee exercising the decanting power.

i. Provided, however, such person's right to remove or replace the authorized trustee may be eliminated if a separate independent, non-subservient individual or entity, such as a trust protector, acting in a nonfiduciary capacity has the right to remove or replace the authorized trustee. § 16.4(n)(3).

(1) This appears to permit changing the identity of a trustee remover but not eliminate the role.

(2) "Separate independent" and "non-subservient" are not defined. Presumably these are in relationship to the trustee and not the settlor (if one were to draw a parallel to Internal Revenue Code § 672(c) – presuming a "related or subordinate party" being subservient).

(3) One should note the decanting statutory reference to "nonfiduciary" capacity which seems ironic given the directed trusts statutory default to fiduciary capacity. 755 ILCS 5/16.3(e).

e. Perpetuities Period. Cannot decant to reduce, limit or modify the perpetuities provision specified in the first trust in the second trust,

i. unless the first trust expressly permits the trustee to do so. § 16.4(n)(4).

f. Special Tax Status. Cannot decant in a manner that will prevent the contribution to the first trust from qualifying for or would reduce the exclusion, deduction, or other tax benefit that was originally claimed in the first trust:

i. qualified for the annual exclusion under IRC § 2503(b),

(1) Presumably, however, a decanting could eliminate future Crummey withdrawal rights.

ii. qualified for the marital deduction under IRC § 2056(a) or 2523(a), or

iii. qualified for the charitable deduction under IRC §:

(1) 170(a) – income tax charitable deduction,

(2) 642(c) – income tax deduction for amounts paid or permanently set aside for a charitable purpose,

(3) 2055(a) – estate tax charitable deduction or

(4) 2522(a) – gift tax charitable deduction,

iv. is a direct skip qualifying for treatment under IRC § 2642(c) – GST annual exclusion and exclusion for direct payment of tuition and medical care expenses, or

v. qualified for any other specific tax benefit that would be lost by the existence of the authorized trustee's decanting authority for income, gift, estate, or generation-skipping transfer tax purposes under the Internal Revenue Code. § 16.4(p).

(1) Exception for Toggling IDGTs. Toggling on or off trusts for income tax purposes that are commonly known as intentionally defective grantor trusts (IDGTs) is permissible. § 16.4(p)(1).

(2) The settlor of a first trust is considered to be the settlor of any second trust. § 16.4(t).

(a) If the settlor of a first trust is not also the settlor of a second trust, then the settlor of the first trust is considered the settlor of the second trust, but only with respect to the portion of second trust decanted from the first trust. § 16.4(t).

vi. Note that the above and the couple items that follow are expressed in § 16.4. However, there are other important tax considerations (see later in this paper), such as: income tax issues, gift tax issues for a trustee-beneficiary, estate tax issues, and GST grandfathering.

g. S Corporation Stock. Cannot decant during any period when the first trust owns subchapter S corporation stock and the second trust is not a permitted shareholder under IRC § 1361(c)(2). § 16.4(p)(2).

i. It appears that one can decant to/from QSST and ESBT.

ii. If the first trust and the second trust are both "grantor trusts" of the same settlor, one should be able to decant between them.

iii. One should be able to partially decant either (a) leaving the S corporation stock in a first trust qualified to hold S corporation stock or (b) S corporation stock to a second trust so qualified.

h. Minimum Required Distributions. Cannot decant during any period when the first trust owns an interest in property subject to the minimum required distribution (MRD) rules of IRC § 401(a)(9) and the decanting would result in the shortening of the minimum distribution period. § 16.4(p)(3).

i. One should be able to partially decant leaving the MRD property in the first trust or, possibly, decant to a second trust that does not reduce the MRD measuring life-beneficiary.

i. Trustee Compensation. Cannot decant if solely to change the provisions regarding the determination of the compensation of any trustee.

i. Unless there is court approval.

ii. However, an authorized trustee may exercise the decanting power in conjunction with other valid and reasonable purposes to bring the trustee's compensation into accord with reasonable limits in accord with Illinois law in effect at the time of the exercise. § 16.4(q)(1).

iii. Note: the first trust trustee cannot charge a special distribution or termination fee. § 16.4(q)(2).

(1) Should professional fiduciaries update their fee schedules to expressly address decanting?

(2) How do fiduciaries adequately charge for facilitating the significant process and due diligence of decanting and also guard themselves of potential allegations that they are charging a "termination fee?"

(a) One possible part of the process is to rely more heavily on the services of outside counsel.

11. **FOURTH QUESTION: Who Can Decant?**

a. Authorized Trustee is Not Just a Trustee. An "authorized trustee" means an entity or individual, other than the settlor, who has authority under the terms of the first trust to distribute the principal of the trust for the benefit of one or more current beneficiaries. § 16.4(a). This appears to include authorized roles expressed in the trust instrument, including:

i. Trustee.

ii. Distribution trust advisor.

iii. Trust protector.

iv. A role, such as a trust protector, who has the power to distribute principal or modify the trust by the terms of the governing instrument is not bound to the decanting parameters.

(1) § 16.4(j) states that distributions are not exclusive to decanting if otherwise authorized by the governing instrument or applicable law. § 16.4(h) also expressly provides for divided discretions.

(2) If a "trust protector" who can act under the express terms of the trust instrument and/or act pursuant to the § 16.4 (decanting statute) should make a decision of which path (statutory or non-statutory) to take and then adhere consistently to those parameters.

v. See also ¶ 5.e and ¶ 15.

b. Fiduciary Capacity. The decanting must be in a fiduciary capacity in furtherance of the purposes of the trust. § 16.4(b).

i. If the instrument expressly provides that the "trust protector" is not acting in a fiduciary capacity, then the instrument's express powers may be exercised not in a fiduciary capacity. However, if the trust protector takes the avenue of Illinois decanting as an "authorized trustee" then such trust protector will be subject to fiduciary duties of a trustee.

ii. If the desired result can be achieved by either an "authorized trustee" adhering to the decanting parameters or a trust instrument provided "trust protector" not subject to decanting rules, which is the better path for the facts and circumstances?

c. Can a Beneficiary Who Is Also a Trustee Effect Decanting as a Trustee? There is an express restriction of a settlor acting as a trustee for decanting within the statutory definition of "authorized trustee." However, there is no such express restriction for a beneficiary who is also a trustee.

i. However, § 16.4(b) references "An independent trustee has discretion to make distributions to the beneficiaries shall exercise that discretion in the trustee's fiduciary capacity, whether the trustee's discretion is absolute or limited to ascertainable standards, in furtherance of the purposes of the trust."

(1) This does not appear to create a restriction that an "authorized trustee" must also be "independent" of the settlor or the beneficiaries. Further no definition of "independent" is provided in § 16.4.

(2) Is this reference to "independent" erroneous and a statutory error?

ii. A trustee-beneficiary must also exercise some caution with respect to the potential of inadvertently creating a taxable gift.

12. Two Avenues: There are two avenues of decanting based on whether the authorized trustee's principal distribution discretion is:

a. Absolute (§ 16.4(**c**)), or

b. Not absolute (§ 16.4(**d**).

c. **FIFTH QUESTION: Which avenue of decanting is available, absolute or non-absolute?**

i. This is determined by the distribution provisions of the trust and who is the "authorized trustee."

13. Absolute Discretion. Distribution to second trust if absolute discretion. § 16.4(**c**).

a. Absolute discretion means the right to distribute principal that is not limited or modified in any manner to or for the benefit of one or more beneficiaries of the trust, whether or not the term "absolute" is used.

i. A power to distribute principal that includes purposes such as best interests, welfare, or happiness constitutes absolute discretion. § 16.4(a).

b. An authorized trustee who has the absolute discretion to distribute the principal of a trust may distribute part or all of the principal of the trust in favor of a trustee of a second trust for the benefit of

i. **one, more than one, or all** of the current beneficiaries of the first trust **and**

ii. for the benefit of **one, more than one, or all** of the successor and remainder beneficiaries of the first trust. § 16.4(c).

iii. If the beneficiary or beneficiaries of the first trust are described as a class of persons, the beneficiary or beneficiaries of the second trust may include **one or more persons** of such class who become includible in the class after the distribution to the second trust. § 16.4(c)(3).

c. Power of Appointment. The authorized trustee may grant a testamentary or lifetime power of appointment in the second trust to one or more of the current beneficiaries of the first trust, provided that the beneficiary granted a power to appoint could receive the principal outright under the terms of the first trust. § 16.4(c)(1).

i. The class of permissible appointees in favor of whom a beneficiary may exercise the power of appointment granted in the second trust may be broader than or otherwise different from the current, successor, and presumptive remainder beneficiaries of the first trust. § 16.4(c)(2).

(1) So although an authorized trustee with absolute discretion may not add a new beneficiary, a beneficiary nevertheless can be granted a current power of appointment that includes donees that are not beneficiaries of the first trust.

d. Supplemental Needs Trust. Decanting may be made, and the statute even seems to mandate, that it does not subject the second trust to claims of reimbursement by any private or governmental body and does not at any time interfere with, reduce the amount of, or jeopardize an individual's entitlement to government benefits. § 16.4(o).

14. No Absolute Discretion. Distribution to second trust if no absolute discretion. § 16.4(**d**).

a. An authorized trustee who has the power to distribute the principal of a trust but does not have the absolute discretion to distribute the principal of the trust may distribute part or all of the principal of the first trust in favor of a trustee of a second trust, provided that:

i. the current beneficiaries of the second trust must be the **same** as the current beneficiaries of the first trust **and**

ii. the successor and remainder beneficiaries of the second trust must be the **same** as the successor and remainder beneficiaries of the first trust. § 16.4(d).

b. The second trust must include the **same language** authorizing the trustee to distribute the income or principal of a trust as set forth in the first trust. § 16.4(d)(1).

c. The class of beneficiaries of the first trust must include **all** persons who are includible in the class of the second trust. § 16.4(d)(2).

d. Power of Appointment. If the authorized trustee decants and if the first trust grants a power of appointment to a beneficiary of the first trust, the second trust must have such power of appointment in the second trust and the class of permissible appointees must be the same as in the first trust. § 16.4(d)(3).

e. Supplemental Needs Trust. Exception and facilitation for supplemental needs trusts for non-absolute decanting. § 16.4(d)(4).

i. The authorized trustee may distribute part or all of the principal of a disabled beneficiary's interest in the first trust in favor of a second trust which is a supplemental needs trust if the authorized trustee determines that to do so would be in the best interests of the disabled beneficiary. § 16.4(d)(4)(i).

ii. Definitions. § 16.4(d)(4)(ii).

(1) "Best interests" of a disabled beneficiary include, without limitation, consideration of the financial impact to the disabled beneficiary's family.

(2) "Disabled beneficiary" means a current beneficiary, presumptive remainder beneficiary, or successor beneficiary of the first trust who the authorized trustee determines has a disability that substantially impairs the beneficiary's ability to provide for his or her own care or custody and that constitutes a substantial handicap, whether or not the beneficiary has been adjudicated a "disabled person".

(3) "Governmental benefits" means financial aid or services from any State, Federal, or other public agency.

(4) "Supplemental needs second trust" means a trust that

(a) relative to the first trust contains the necessary restrictions (whether greater or lesser) to distribute trust income or principal and would allow the disabled beneficiary to receive a greater degree of governmental benefits than the disabled beneficiary will receive if no distribution is made; **and** conforms to the following (b).

(b) Remainder beneficiaries. § 16.4(d)(iii).

(i) A supplemental needs second trust may name remainder and successor beneficiaries other than the disabled beneficiary's estate, provided

1) that the second trust names the same presumptive remainder beneficiaries and successor beneficiaries to the disabled beneficiary's interest, and

2) in the same proportions, as exist in the first trust.

(ii) Also, where the first trust was created by the disabled beneficiary or the trust property has been distributed directly to or is otherwise under the control of the disabled beneficiary, the authorized trustee may distribute to a "pooled trust" as defined by federal Medicaid law for the benefit of the disabled beneficiary or the supplemental needs second trust must contain pay back provisions complying with Medicaid reimbursement requirements of federal law.

iii. Reimbursement. A supplemental needs second trust will not be liable to pay or reimburse the State or any public agency for financial aid or services to the disabled beneficiary except as provided in the supplemental needs second trust. § 16.4(d)(4)(iv).

iv. Decanting may be made, and the statute even seems to mandate, that it does not subject the second trust to claims of reimbursement by any private or governmental body and does not at any time interfere with, reduce the amount of, or jeopardize an individual's entitlement to government benefits. § 16.4(o).

15. Divided Discretion. If an authorized trustee has absolute discretion to distribute the principal of a trust and the same trustee or another trustee has the power to distribute principal under the trust instrument which power is not absolute discretion, such authorized trustee having absolute discretion may exercise the power to distribute under § 16.4(c) (the absolute discretion section). § 16.4(h).

    a. Example: If the trustee's discretion is limited by ascertainable distribution standards of health and maintenance, but there is an independent trust protector who can effect further change of the trust without restrictions, then

        i. The trustee appears to be limited in avenue to decanting under the "no absolute discretion" provisions of § 16.4(d) while

        ii. The trust protector very well may be an "authorized trustee" and able to decant under the "absolute discretion" provisions of § 16.4(c).

        iii. The same should hold true when there are co-trustees where one is "interested" and has limitations while the other is "independent" and has broader absolute discretion. Then the independent trustee should be able to exercise its § 16.4(c) authority.

    b. See also ¶ 5.e and ¶ 11.a.

    c. If the desired result can be achieved by either an "authorized trustee" adhering to the decanting parameters or a trust instrument provided "trust protector" not subject to statutory decanting rules, which is the better path for the facts and circumstances?

16. Second Trust Term. The second trust may have a term that is longer than the term set forth in the first trust, including, but not limited to, a term measured by the lifetime of a current beneficiary; provided, however, that the second trust is limited to the same permissible period of the rule against perpetuities that applied to the first trust, unless the first trust expressly permits the trustee to extend or lengthen its perpetuities period. § 16.4(g).

    a. If the first trust is a qualified perpetual trust, 765 ILCS 305/4(a)(8) and 305/3(a-5), the then second trust should not be subject to the rule against perpetuities and may also be a qualified perpetual trust.

        i. One drafting take-away then is to have all trusts drafted as qualified perpetual trusts so as to permit the greatest potential for decanting when it comes to issues of rule against perpetuities.

            (1) However, one must consider generation-skipping tax implications before decanting.

    b. In drafting the decanting instrument and the second trust, the first trust Rule Against Perpetuities provision should be carried to and effectively applied to the second trust.

17. Procedures.

SIXTH QUESTION: What procedures are required for the circumstances?

Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?

a. Written Instrument. The decanting exercise must be made

i. by a written instrument,

ii. signed and acknowledged by the trustee, and

iii. filed with the records of the first trust and the second trust. § 16.4(r).

iv. The decanting instrument should specify

(1) the first and second trusts,

(2) the effective date of decanting,

(3) what assets will be transferred to the second trust (all or otherwise) and how to handle any later discovered assets (see § 16.4(i)), and

(4) the terms and provisions of the second trust.

v. The author suggests that if the trustee of the second trust is different from the first trust, the second trust trustee should also sign and acknowledge.

(1) The author suggests that if the second trust contains directing parties pursuant to § 16.3, they too should sign and acknowledge the second trust.

b. Notice. § 16.4(e).

i. Notice Decanting Without Court Approval. An authorized trustee may decant without the consent of the settlor or the beneficiaries and without court approval if:

(1) there are one or more legally competent current beneficiaries **and**

(2) one or more legally competent presumptive remainder beneficiaries **and**

(3) the authorized trustee sends written notice of the trustee's decision, specifying

(a) the manner in which the trustee intends to exercise the power **and**

(b) the prospective effective date for the distribution,

(4) to all of the legally competent

(a) current beneficiaries **and**

(b) presumptive remainder beneficiaries,

(c) determined as of the date the notice is sent and assuming non-exercise of all powers of appointment; **and**

(5) no beneficiary to whom notice was sent objects to the distribution in writing delivered to the trustee within 60 days after the notice is sent ("notice period").

(a) Note: The author suggests the notice should contain specifics of objecting, including addressee, address, in writing, and the time period required within to object. See § 16.4(f)(1)(a).

(i) The authorized trustee's process, records, and the notice should memorialize and build the record of the trust purposes for decanting.

(b) If no notice was sent to a beneficiary who was not legally competent and an objection was nevertheless filed on behalf of such beneficiary (for example by a minor's parent), a decanting should still be able to proceed without court approval.

ii. Unknown Beneficiary. A trustee is not required to provide a copy of the notice to a beneficiary who is known to the trustee but who cannot be located by the trustee after reasonable diligence or who is not known to the trustee.

iii. Charitable Beneficiary. If a charity is a current beneficiary or presumptive remainder beneficiary of the trust, the notice shall also be given to the Attorney General's Charitable Trust Bureau.

iv. Illinois Virtual Representation Law. 760 ILCS 5/16.1 (virtual representation) and the Illinois decanting law use the same definition for "presumptive remainder beneficiaries. However, the two statutes have different definitions and applications when referencing "current" and "primary" beneficiaries.

c. Court Involvement. § 16.4(f).

i. The trustee may petition the court to order the distribution

(1) for any reason (such as, the trustee wants the assurance as to the trustee's reasonable actions and reasons for decanting), including if the trustee's power to decant is unavailable due to:

(2) a beneficiary timely objects to the distribution in a writing delivered to the trustee within the time period specified in the notice; or

(3) there are no legally competent current beneficiaries or legally competent presumptive remainder beneficiaries. § 16.4(f)(1).

ii. Trustee or Beneficiary May Petition. If the trustee receives beneficiary's written objection within the notice period, either the trustee or the beneficiary may petition the court to approve, modify, or deny the exercise of the decanting.

(1) Burden of Proof. The trustee has the burden of proving the proposed exercise of the power furthers the purposes of the trust. § 16.4(f)(2).

iii. Trustee's Duty of Impartiality. In a judicial proceeding, the trustee may, but need not, present the trustee's opinions and reasons for supporting or opposing the proposed distribution, including whether the trustee believes it would enable the trustee to better carry out the purposes of the trust.

(1) A trustee's actions in accordance with the decanting statute will not be deemed improper or inconsistent with the trustee's duty of impartiality unless the court finds from all the evidence that the trustee acted in bad faith. § 16.4(f)(3).

18. Later Discovered Assets. To the extent the authorized trustee does not expressly provide otherwise:

a. All Assets Transferred. The distribution of all of the assets comprising the principal of the first trust to the second trust will be deemed to include subsequently discovered assets of the first trust. § 16.4(i)(1).

b. Partial Transfer. The distribution of part, but not all, of the assets comprising the principal of the first trust to the second trust will not include subsequently discovered assets of the first trust; such assets will remain the assets of the first trust. § 16.4(i)(2).

19. Remedies. § 16.4(u).

a. Not Liable - Reasonable and in Good Faith. A trustee who reasonably and in good faith takes or omits to take any decanting is not liable to any person interested in the trust.

b. Presumption. An act or omission by a trustee to decant is presumed taken or omitted reasonably and in good faith unless it is determined by the court to have been an abuse of discretion.

c. Objector's Exclusive Remedy is Court. If a trustee reasonably and in good faith takes or omits to decant and a person interested in the trust opposes the act or omission, the person's exclusive remedy is to obtain an order of the court directing the trustee to exercise statutory decanting authority in such manner as the court determines necessary or helpful for the proper functioning of the trust, including without limitation prospectively to modify or reverse a prior exercise of such authority.

d. Time Bar. Any claim by any person interested in the trust that a decanting act or omission by a trustee was an abuse of discretion is barred if not asserted in a proceeding commenced by or on behalf of the person within 2 years after the trustee has sent to the person or the person's personal representative a notice or report in writing sufficiently disclosing facts fundamental to the claim such that the person knew or reasonably should have known of the claim.

i. It appears that if all beneficiaries are competent and notice has been sent to all beneficiaries, that any one of them still have two years to bring a court action against the decanting.

(1) This argues in favor or obtaining consents where possible.

(a) Potential tax issues may arise by reason of a beneficiary's consenting, should the decanting affect in any way beneficial interests – versus mere administration.

(b) Non-judicial family settlement agreements may have potential issues of not having a bona fide dispute.

(i) 760 ILCS 6/16.1(d)(4), in its non-exclusive list, provides, "Matters that may be resolved by a nonjudicial settlement agreement include but are not limited to: (A) interpretation or construction of the terms of the trust; (B) approval of a trustee's report or accounting; (C) exercise or nonexercise of any power by a trustee; (D) the grant to a trustee of any necessary or desirable administrative power; (E) questions relating to property or an interest in property held by the trust; (F) resignation or appointment of a trustee; (G) determination of a trustee's compensation; (H) transfer of a trust's principal place of administration; (I) liability or indemnification of a trustee for an action relating to the trust; (J) resolution of disputes or issues related to administration, investment, distribution or other matters; (K) modification of terms of the trust pertaining to administration of the trust; and (L)

termination of the trust, provided that court approval of such termination must be obtained in accordance with subsection (d)(5), and the court must conclude continuance of the trust is not necessary to achieve any material purpose of the trust; upon such termination the court may order the trust property distributed as agreed by the parties to the agreement or otherwise as the court determines equitable consistent with the purposes of the trust."

(c) Issues and coverage of virtual representation should be considered.

ii. The 2-year limitations period will not apply to a person who was under a legal disability at the time the notice or report was sent and who then had no personal representative.

(1) Considerations:

(a) No notice is required to be given to a beneficiary under legal disability even if he or she has a personal representative.

(b) Such (formerly) legally disabled beneficiary will have two years until after he or she effectively receives notice of the decanting to petition the court for relief.

(c) The trustee should send notice to any court appointed guardian or conservator of the beneficiary's estate, even though such notice is not required. This will start the two-year bar period.

(d) When a beneficiary attains legal capacity, the trustee should send legal notice of the decanting in order to start the running of the limitations period.

(i) It may be desirable to then obtain the beneficiary's consent and waiver of the decanting.

1) However, potential tax issues may exist if the beneficiary consents to the disclaimer or waives the time limitations.

(e) The trustee may desire to seek court approval of the decanting in order to gain advantages of the court's determination of the reasonableness of the trustee's actions and approval of reasons to decanting. This should make it much less likely that a subsequent critical review will

determine that the trustee's actions were an abuse of discretion.

(2) Virtual Representation and Non-Judicial Settlement Agreement. However, the extended limitations period will not apply for decanting made by an agreement by virtual representation (760 ILCS 5/16.1).

(a) § 16.1(d)(6) provides, "An agreement entered into in accordance with this Section [16.1] shall be final and binding on the trustee and all beneficiaries of the trust, both current and future, as if ordered by a court with competent jurisdiction over all parties in interest."

(i) The effect of this will be to shorten the time bar provided by the decanting statute (two years or longer if a beneficiary is under legal disability).

(b) However:

(i) Non-judicial family settlement agreements may have potential issues of not having a bona fide dispute or not sufficient coverage of administrative matters.

(ii) Issues and adequate coverage of virtual representation should be considered.

(iii) There may be potential tax issues of active beneficiary participation consents and waivers.

iii. Personal Representative. For these purposes, a personal representative refers to a court appointed guardian or conservator of the estate of a person.

20. Tax Implications. There is little developed law on the tax consequences of decanting. The following are practical and important considerations that are not even mentioned in the Illinois decanting statute.

SEVENTH QUESTION: What are the tax implications? How is the second trust settled for tax purposes? Are there any adverse tax consequences lurking in the decanting transaction?

a. Current IRS Guidance. The IRS has no authoritative guidance on decanting.

i. In 2011, decanting was added to the IRS "no ruling list." Rev.Proc. 2011-3.

(1) However, the IRS may continue to rule where (1) there are no change of beneficial interests and (2) the rule against perpetuities period is unchanged.

ii. The IRS issued Notice 2011-101 in which it requested comments on the tax implications of trust decantings.

b. Trust Taxpayer or Employer Identification Number (EIN).

i. All Assets Transferred into New Second Trust. If all the assets of the first trust are being transferred to the second trust and the second trust is a new creation, the second trust should be considered a continuation of the first trust for income tax purposes and the first trust's EIN should be used for the second trust.

(1) The IRS should be notified of the change of the trust name and the continued usage of the assigned EIN.

(2) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. Treas.Reg. § 1.671(e)(5).

(3) The settlor of a first trust is considered to be the settlor of the second trust. § 16.4(t).

ii. Grantor Trust to Grantor Trust. If both the first trust and the second trust are grantor trusts for income tax purposes (IRC §§ 671-679) for the same settlor and all the first trust's assets are being transferred to the second trust, then the second trust should be able to use the first trust's EIN or continue to use any existing EIN of the second trust.

iii. Partial Transfer. If only a portion the first trust's assets are being transferred to the second trust, the second trust should acquire a new EIN or, if pre-existing, use its existing EIN.

iv. Transfer into Existing Non-Grantor Trust. If the second trust is a non-grantor trust of the first trust's settlor (such as the second trust having a different settlor), the second trust's EIN should continue to be used.

c. Income Tax.

i. Distributable Net Income (DNI). The income tax treatment of decanting distributions should be similar to that of a trustee's exercise of a discretionary distribution.

(1) Generally, distributions from a trust will carry out DNI to the extent of the lesser of DNI or the distribution – DNI from the first trust to the second trust, with a deduction for the first trust and matching receipt of income for the second trust. IRC § 662(a).

(a) Exceptions for gifts of specific sums and specific property – which really are not an applicable issue for decanting.

(b) It may be a distinction without a difference, but the second trust is not a "beneficiary" of the first trust but another trust to which DNI is being distributed.

(2) If a the first trust wholly decants into the second trust, the second trust receives all the DNI by reason of either (a) theoretical continuation of the first trust or (b) total distribution of the first trust in its year of termination. In either case, the tax attributes from the first trust should carry over to the second trust. IRC §§ 661(b), 662(b).

(a) Continuation of the first trust for income tax purposes seems more logical when there is a whole decanting into the second trust which is created by decanting by the trustee of the first trust rather than a second trust created by another settlor.

(b) IRC § 642(h) provides that in the final year of a trust, its capital loss and net operating loss carry forward and its deductions in excess of gross income for the year will be allowed as deductions to the beneficiaries who receive the trust property.

(3) If a distribution of appreciated assets is made from the first trust to the second trust, IRC § 643(e) should protect the distributing trust from recognizing gain unless the trustee of the first trust elects to recognize the gain.

(4) State or local taxation might become important as to identity, especially if the trust's situs changes by reason of decanting – to or from a more or less favorable local income tax situation.

(a) Note: § 16.4(t) expressly states that the settlor of the first trust, for all purposes, is considered the settlor of the second trust and apparently thereby attempting to secure taxation privileges on the second trust.

ii. Cottage Savings Doctrine. It's possible that the beneficiary recognizes gain if the quality of the beneficiary's interest changes when the beneficiary consents to the decanting (or possibly also with the court's approval). *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991).

(1) Generally, a beneficiary not participating in a beneficial interest change and such change being made pursuant state law should not result in gain recognition. A switch from an income interest to a

unitrust interest pursuant to state statute is a classic example of a non-recognition event.

(2) Treas.Reg. § 1.1001-1(h), dealing with trust severance (including qualified severance under GST regulations, § 26.2642-6) seem to point that when an action by the trustee is authorized by the governing instrument or state law and is done without court order or beneficiary consent that there is no recognition of gain.

(a) In general, gain or loss is realized if (1) an action involving a trust represents a sale or exchange of property and (2) the property received is materially different from the property surrendered. Treas.Reg. §1.1001-1(a).

iii. Negative Basis Assets. Assets that have liabilities that exceed their income tax basis (encumbered property or a partnership or LLC interest with a negative capital account) *may* recognize gain to the extent liabilities exceed basis when:

(1) Decanting such asset.

(a) Option: Leave negative basis assets in the first trust.

(b) It is not a settled tax law whether an estate or trust realizes gain by distributing a negative basis asset to a beneficiary.

(2) Conversion of a grantor trust to a non-grantor trust during grantor's lifetime.

(a) Conversion from a non-grantor trust to a grantor trust should not have income tax effect.

iv. Foreign Trust. Conversion from a domestic trust to a foreign trust may result in gain recognition. IRC § 684. For example, if not all persons participating in the second trust is a United States citizen (for example beneficiary, fiduciary, advisor, manager, trustee remover, trust protector, amendor, or other role).

d. Gift Tax.

i. Consent, Approval or Waiver by Beneficiary. Prior to decanting, notice is required to the legally competent beneficiaries. If the beneficiary's beneficial interest is reduced or eliminated and the beneficiary consents, approves or waives his or her interests, then it's possible that such may be viewed by the IRS as a taxable gift. In other words, gift tax is imposed on voluntary transfers and if there's an agreement between the trustee and the beneficiary, then a shift of wealth to other beneficiaries generally results in a taxable event for gift tax purposes. An exception to this is when there is

a compromised wealth shift derived from a settlement in a bona fide dispute situation.

(1) Gift tax is imposed on a donor's act of transfer of a property interest.

(a) Treas.Reg. §25.2511-2(a) provides, "The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable."

(b) IRC § 2512(b). "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."

(c) There should be no taxable gift if the act of transfer is not voluntary.

(d) The beneficiary's mere passive acquiescence to the decanting should not give rise to a taxable gift.

(i) However, beware if the beneficiary actively consents to the decanting that reduces or eliminates his or her interests.

(2) Illinois' decanting statute provides that a court may effectively intervene with the trustee's discretion to decant only if it is determined that the trustee did not act reasonably and in good faith and abused its discretion. § 16.4(u). Therefore, so long as the trustee is acting consistent with state law and is not abusive in exercising discretion, a beneficiary should be unsuccessful in opposing a trustee's discretion to decant and such hurdle making a non-objection by a beneficiary a distant likelihood of being a taxable gift.

(3) Also possible is that the IRS may view, based on facts and circumstances, that the beneficiary's failure to object is also a taxable gift.

(a) GST regulations infer that sometimes implied consents or acquiescence to changes by court actions or nonjudicial settlement agreements can have tax consequences, especially when the fiduciary is not independent. Treas.Reg. § 26.2601-1(b)(4).

(4) Note, that an incompetent beneficiary to whom no notice is required and none is given will not have these issues at the time of decanting. However, when and if such beneficiary becomes competent, then the same issues are resurrected.

(5) Logically, if a decanting only affects administration provisions, then there will be no taxable gifts, i.e., removing a spendthrift provision.

(a) However, some administrative provisions might affect beneficial interests, such as an extraordinary ability to change investments.

(b) Consider in an analogous way the GST Treasury Regulations that provide modifications safe harbor.

ii. Decanting by a Trustee Who Is Also a Trust Beneficiary. There could be a taxable gift by a trustee, who is also a trust beneficiary, who decants and gives up property interests, because the decanting exercise is discretionary and voluntary, although taken in a fiduciary capacity.

(1) Assuming that an interested trustee (a trustee who is also a beneficiary or has an individual legal obligation to support a beneficiary) is restricted by the governing instrument to distributions limited to ascertainable standards (non-absolute discretion), then the power to decant as restricted under § 16.4(d) should generally provide adequate protection to such interested trustee.

(a) The Illinois Trust and Trustees Act, and the decanting statute in particular, does not have tax safeguard cutback provisions. To the extent that the first trust has not been drafted sufficiently to provide tax protections to the trustee-beneficiary, then the gift tax issues will continue to be problematic in decanting.

(2) However, even if the decanting power is similar to a special power of appointment, taxable gifts are potentially recognized. Treas.Reg.

§ 25.2511-1(g)(2); Rev.Rul. 67-370, 1967-2 C.B. 324; Rev.Rul. 75-550, 1975-2 C.B. 357.

(a) There are subtleties here. When there is a trustee-beneficiary with the power to spray income or principal among a class of beneficiaries of whom that trustee is also a beneficiary (even if pursuant to an ascertainable standard), there could be a taxable gift. Treas.Reg. § 25.2514-1(b)(2); Rev.Rul. 79-327, 1979-2 C.B. 342; *Est. of Regester v. Comm'r.*, 83 T.C. 1 (1984).

(b) Whenever a trustee is also a beneficiary, caution should be exercised in the analysis and implementation of decanting.

(i) If there are alternative methods of achieving a similar outcome or there is an alternative "authorized trustee" to effect the decanting, then those alternatives may be preferable.

(3) Giving the beneficiary of the second trust a special power of appointment should nullify the argument of a taxable gift upon decanting by reason of the special power of appointment creating an incomplete gift for tax purposes. Treas.Reg. § 25.2511-2(c).

(a) However, see below on probable inclusion for estate tax purposes.

e. Estate Tax.

i. Inclusion Circumstances. If the beneficiary's interest is reduced or eliminated, it's possible that facts and circumstances may draw inclusion of such interest into the beneficiary's gross estate by reason of IRC §§ 2035, 2036, 2037, 2038, 2039 or 2042. For example, § 2036(a) may apply if the beneficiary of the first trust with the reduced or eliminated interest in the first trust to the second trust is the trustee of the second trust (perhaps with a deemed gift of the reduced interest) and can make discretionary distributions from the second trust.

(1) If the decanted interest, being an incomplete gift by reason of a special power of appointment, would probably be includible in the gross estate by reason of IRC §§ 2036(a)(2) or 2038.

ii. If the beneficiary has the power to remove and replace the trustee and even appoint himself or herself, the powers of the trustee, including decanting, might to attributed to the beneficiary as a general power of appointment – should the trustee have "absolute discretion" pursuant to §16.4(c). Rev.Rul. 95-58, 1995-2 C.B. 191.

(1) This makes it all the more important to draft instruments carefully to restrict interested trustee's powers to ascertainable standards and independent trustees and their successors to those not related or subordinate pursuant to IRC § 672(c).

(a) Note: Illinois' decanting statute does not contain any "failsafe cutback" provisions (as does some other states' statutes). If the trust instrument doesn't protect the beneficiary or fiduciary from adverse consequences, then neither does the decanting statute.

f. Generation-Skipping Tax (GST).

i. Grandfathered Trusts – Before 9/26/85. Generally, trusts irrevocable before September 26, 1985 are grandfathered from federal generation-skipping tax (the grandfathered exempt trust – GFET). Also grandfathered is a will or revocable trust executed before October 22, 1986, if the decedent died before January 1, 1987. Additions, actual or constructive, to the GFET will result in the loss of the grandfathering. Treas.Reg. § 26.2601-1(b)(4).

(1) Treas.Reg. § 26.2601-1(b)(4)(i)(A) – the "Discretionary Distribution Safe Harbor." Decanting will not lose grandfathered status of the GFET if, either (a) **or** (b) **and** (c):

(a) The terms of the governing instrument authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; **or**

(b) At the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of the principal in the continuing trust, without the consent or approval of any beneficiary or court; **and**

(c) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation.

(i) If the trust does not otherwise comply with the historical rule against perpetuities, the exercise of a

trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period.

(ii) If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(d) Paragraph (a) does not appear to prohibit a trustee from obtaining beneficiary consent or court approval for the decanting – just that it's not required, which is the case with the Illinois decanting statute. However, most trust instruments do not contain such a provision and thus paragraph (b) must be relied upon.

(e) Paragraph (b) above is problematic in that Illinois GFETs arguably do not have the ability for this exemption because the Illinois decanting statute was not in effect on 9/25/85 (nor any other states' decanting statute – New York being the first enacted decanting statute in 1992). However,

(i) Could there be an argument that Illinois, similar to Florida, has had a common law ability to decant? Perhaps there will be developing Illinois case law to this end.

(ii) Does § 16.4(v)'s wording provide a boot strap for application to GFETs? "This Section is available to trusts in existence on the effective date of this amendatory Act ... or created on or after the effective date of this amendatory Act ... This Section shall be construed as pertaining to the administration of a trust and shall be available to any trust that is administered in Illinois under Illinois law or that is governed by Illinois law with respect to the meaning and effect of its terms, ..."

(iii) It appears through private letter rulings that the IRS has not construed the regulations strictly. So there

could be allowances to be explored and developments to be looked for.

(f) To comply with paragraph (c) above, it will be best practice for the decanting instrument drafting person to ensure that the second trust contains a provision limiting the vesting period to comply with the federal perpetuities period – even to cite the Treasury Regulation and state the intention to comply with such federal perpetuities period.

(g) Changing purely administrative terms should not result in jeopardizing the trust's GST exempt status.

(i) But be cautious of what provisions are merely administrative in nature or might otherwise affect the substantive or beneficial terms of the trust, such as modifications that change the quality, value, or timing of any of the beneficial interests, rights, or expectancies.

(2) Treas.Reg. § 26.2601-1(b)(4)(i)(D) – "Trust Modification or 'Other Changes' Safe Harbor." In the alternative (**this appears to be the "failsafe" or "catch all" position**) to the foregoing, grandfathering will not be lost by a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction by judicial reformation, or nonjudicial reformation that does not meet the requirements of paragraph (1) above [the Discretionary Distribution Safe Harbor]) that is valid under applicable state law if (a) the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in IRC § 2651) than the person or persons who held the beneficial interest prior to the modification **and** (b) the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(a) Note for (a) in the preceding, beneficial interests can be shifted across the same generational level or to a higher generational level than the person holding the interest in the first trust.

(i) Caution: GST exempt status can be lost if either there is (a) an increase in the amount of a GST transfer or (b) a creation of a new GST transfer. These will be deemed to be a shift in a beneficial interest to a lower generation.

(ii) Caution: If the effect of a modification cannot be determined immediately after the modification is made, there is a deemed shift in a beneficial interest to a lower generation.

(b) Treas.Reg. § 26.2601-1(b)(4)(i)(D). A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.

(i) To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification.

(ii) If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification.

(iii) A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

(iv) In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)–1.

(3) Beneficiary's Exercised Power of Appointment Preserves GFET. Treas.Reg. § 26.2601-1(b)(1)(v)(B)(2). In the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period).

(a) If the trust does not otherwise comply with the historical rule against perpetuities, then the exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership or the power of alienation beyond the perpetuities period.

(b) If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(c) It might be argued that if decanting is tantamount to an exercise of a special power of appointment, then as long as the vesting of beneficial interests in the second trust is within the proscribed perpetuities period, the second trust can differ substantially from the first trust without loss of GST exemption status.

ii. GST Exempt Trusts. If a trust is not a GFET and has a GST inclusion ratio of zero or less than 1 by reason of application of the GST exemption, then the inclusion ratio (the GST exempt status) should not change by decanting if the rules applicable to GFET are respected.

(1) The trust was created after 1/1/13 (the effective date of the Illinois decanting statute) and the decanting did not extend the time for vesting.

(a) Again, the author muses over the possibility of development of a historic Illinois common law argument for decanting.

(i) Does § 16.4(v)'s wording provide a boot strap for application to GST exempt trusts? "This Section is available to trusts in existence on the effective date

of this amendatory Act ... or created on or after the effective date of this amendatory Act ... This Section shall be construed as pertaining to the administration of a trust and shall be available to any trust that is administered in Illinois under Illinois law or that is governed by Illinois law with respect to the meaning and effect of its terms, ..."

(2) The decanting does not shift a beneficial interest to a beneficiary in a lower generation and does not extend the time for vesting.

(3) Note: there are no Internal Revenue Code sections or Treasury Regulations that deal directly with decanting or modifications of GST exempt non-grandfathered trusts.

iii. GST and Power of Appointment Analogy. Although the GST regulations do not explicitly treat decanting as a power of appointment, it seems likely that such is the best analogy to use to analyze the issues.

iv. Severed Trusts. Decanting may create severed trusts. Therefore, IRC § 26.2642-6 rules for qualified severance should be considered as to whether second trusts will be treated as separate trusts for GST purposes.

(1) If state law recognizes post-severance as separate trusts, then the GST tax regulations will also treat the trusts as separate even though the severance is not qualified. Treas.Reg. § 26.2642-6(h).

(a) The resulting severed trusts will have the same GST inclusion ratio as the original trust.

v. What Happens When a Trust Loses Its GST Exempt Status? If a trust loses its GST exempt status, there should be no immediate gift tax implications. The grantor of the trust will become the transferor for GST tax purposes and a GST tax should be imposed only when a distribution is made to someone that could not have received a distribution from the first trust without being subject to GST tax.

g. Summary of Tax Traps.

i. Create income or capital gain tax recognition through the change in the quality of the beneficiary's interest, through negative basis assets, or inadvertent creation of a foreign trust.

ii. Create a taxable gift through beneficiary consent.

iii. Create estate tax inclusion by some defect in the second trust.

iv. Undermine a grandfathered or exempt GST trust by change, including violating the rule against perpetuities.

21. Global Questions.

a. Beneficiary-Trustee and Decanting. Does a beneficiary who is a trustee have the ability to decant?

i. The definition of "authorized trustee" does not expressly excluded a beneficiary, as it does a settlor.

ii. However, § 16.4(b) does reference an "independent" trustee, but there is no definition of "independent."

(1) This does not appear to create a restriction that an "authorized trustee" must also be "independent" of the settlor or the beneficiaries. Further no definition of "independent" is provided in § 16.4.

iii. The author's present opinion is that if the legislators wanted to restrict a beneficiary-trustee from acting, they would have expressly done so as they did the settlor.

iv. **Caution should be taken for the possibilities for gift tax implications to the trustee-beneficiary**.

(1) ***This, perhaps, will be the most significant issue in practically managing decanting cases***.

b. Non-Fiduciary as "Authorized Trustee." Can a "distribution trust advisor" or "trust protector" who is expressly stated not to be acting in a fiduciary capacity still decant?

i. Note: § 16.4(b) states "... shall exercise that discretion in the trustee's fiduciary capacity ..."

ii. § 16.4(j) states that distributions are not exclusive to decanting if otherwise authorized by the governing instrument or applicable law. § 16.4(h) also expressly provides for divided discretions.

iii. Could the non-fiduciary trust protector decant under common law principles?

(1) There does not presently seem to be Illinois cases recognizing common law decanting.

(2) Does the Illinois decanting statute by public policy take the place of any common law decanting?

iv. Could the non-fiduciary distribution trust advisor or trust protector decant under the principle that the distribution to the second trust is not pursuant to statute but under the express or implicit ("for the benefit of") terms of the trust?

v. The author's present opinion is that a non-fiduciary distribution trust advisor or trust protector is still an "authorized" trustee. Prudence will require the same diligence and process and memorialization as any fiduciary would.

(1) Further, one might look to the Directed Trustee statute, 760 ILCS 16.3 to now impute the trust protector or other directing party now with fiduciary duties or suitable standards of conduct.

(a) 760 ILCS 16.3(e), "A directing party is a fiduciary of the trust subject to the same duties and standards applicable to a trustee of a trust as provided by applicable law unless the governing instrument provides otherwise, but the governing instrument may not, however, relieve or exonerate a directing party from the duty to act or withhold acting as the directing party in good faith reasonably believes is in the best interests of the trust."

vi. Bottom line: If a distribution trust advisor or trust protector who can act under the express terms of the trust instrument and/or act pursuant to the § 16.4 (decanting statute) must make a decision of which path to take (statutory decanting or its alternative) and then adhere consistently to those parameters. The author encourages a process that replicates any fiduciary process, even though not specifically acting in a fiduciary capacity.

c. Trust Protector vs. Authorized Trustee.

i. What is the difference between a "trust protector" named in a document and an "authorized trustee"?

ii. Can a trust protector acting within the authority of his or her stated trust protector role, especially if expressly authorized by the instrument to act in a non-fiduciary capacity, inadvertently fall prey to the provisions of the Illinois decanting statute?

(1) If the trust instrument expressly states that a trust protector acts in a non-fiduciary capacity, does the trust protector's ability to decant in a non-fiduciary capacity exist after 2012?

iii. See the immediately foregoing section b.

d. Same Trustees. Does the trustee of the second trust have to be the same trustee as of the first trust?

i. This is not expressly addressed.

ii. Note that § 16.4(t) acknowledges that the first trust may be distributed to a trust that the settlor did not create. Therefore, there seems to be an acceptance that the trustees need not be the same.

iii. The author's present opinion is that the trustee of the second trust may be different from that of the first trust.

e. Remainder Beneficiaries. Sometimes the statute uses the terms "presumptive remainder beneficiaries" and other times "remainder beneficiaries," is there a difference?

i. The author's present opinion is that the different references is a legislative scrivener's oversight or inconsistency and the terms are synonymous.

ii. Note that "presumptive remainder beneficiaries" is the same definition for both decanting (§ 16.4) and virtual representation (§ 16.1) of the Illinois Trust and Trustees Act.

f. Supplemental Needs Trust. Can the favored ability to establish a supplemental needs trust (§§ (d)(4), (n)(1), (o)) undermine the qualification of a tax sensitive trust, such as a marital deduction trust?

i. No. § 16.4(p) provides a series of safeguards against this effect.

ii. So a marital deduction trust, for example, cannot be converted into a supplemental needs trust.

iii. There will be similarly protected outcomes for Crummey trusts, charitable remainder trusts, QSSTs, conduit trusts for required minimum distributions, and the like.

(1) Presumably, a decanting could eliminate future Crummey withdrawal rights.

g. Quandary of (o). § 16.4(o) provides, "Notwithstanding the provisions of paragraph (1) of subsection (n) but subject to the other limitations in this Section, an authorized trustee may exercise a power authorized by subsection (c) or (d) to distribute to a second trust; provided, however, that the exercise of such power does not subject the second trust to claims of reimbursement by any private or governmental body and does not at any time interfere with, reduce the amount of, or jeopardize an individual's entitlement to government benefits."

i. Read strictly, this limits any decanting that so that it cannot interfere with governmental entitlements and thus dramatically restricts many applications of decanting.

ii. The author's present opinion is that the best construction of this provision is that it applies only to decanting towards supplemental needs trusts.

(1) Could it also be articulating a public policy that third party settled trusts that are decanted should not be wasted or be decanted to the detriment of a beneficiary otherwise qualifying for government entitlements and so goes any construction?

iii. Should every second trust contain language that accommodates (o)?

(1) For example, "Notwithstanding anything herein to the contrary, there shall be no distributions that the exercise of such power does not subject the second trust or its beneficiaries to claims of reimbursement by any private or governmental body and does not at any time interfere with, reduce the amount of, or jeopardize an individual's entitlement to government benefits. However, this shall not apply to beneficial interests that qualify for the annual exclusion under Code § 2503(b), the marital deduction under Code §§ 2056(a) or 2523(a), the charitable deduction under Code §§ 170(a), 642(c), 2055(a) or 2522(a), or is a direct skip qualifying for treatment under Code § 2642(c)."

h. How should Illinois' decanting law affect drafting trust instruments today?

i. Should decanting be explained to each client and expressly opting out of decanting be a decided drafting option?

ii. Should all trusts now waive the Rule Against Perpetuities and use perpetuity trusts?

iii. Should the independent trustee, distribution trust advisor, or independent trust protectors be given express powers to decant outside of the decanting statute?

(1) Should the capacity of the distribution trust advisor and trust protector be stated as non-fiduciary in consideration that the decanting statute requires the statutory decanting be made in a fiduciary capacity?

iv. The trustee-beneficiary has increased gift tax exposure via decanting. Therefore, proactive use of independent trustees, independent distribution trust advisors, and independent trust protectors along with greater care in "interested trustee" drafting is in order.

(1) There should be greater usage of "failsafe" provision drafting for the interested trustee and interested directing party along with the ability of the interested trustee and interested directing party to appointment an independent substitute to act in events the interested trustee's or interested directing party's inability to act.

v. One should be mindfully drafting trusts in a fashion where Illinois *statutory* decanting is a secondary option (such as the prudent and empowered usage of trust protectors) and statutory decanting should not be necessary.

(1) Remember that the Illinois decanting statute expressly endorses non-statutory decanting equivalencies.

(2) Drafting is more complex than ever.

22. Conclusion.

a. Just as the Illinois Powers of Attorney Act was amended several times after its effective date, it's probable that the decanting statute will need some tweaking.

b. The seven (plus one) big questions are:

i. Does an authorized trustee have a discretionary power to distribute principal?

ii. Is decanting in furtherance of the purposes of the trust?

iii. Are there bars or restrictions to decanting?

iv. Who can decant?

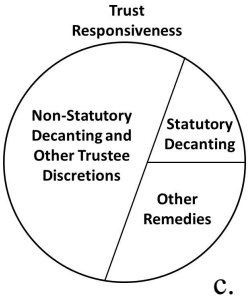
v. Which decanting pathway can be followed: absolute discretion or non-absolute?

(1) This depends on the trust distribution provisions and who can be the "authorized trustee."

vi. What procedures are required for the circumstances?

Most particularly, are there sufficient qualified beneficiaries available to perform a non-judicial decanting?

vii. What are the tax implications?



(1) How is the second trust settled for tax purposes?

(2) Are there any adverse tax consequences lurking in the decanting transaction?

viii. Should statutory decanting be pursued or either (a) non-statutory decanting or (b) some other remedy?

c. There are a few safeguards built into the Illinois decanting law:

i. Perpetuities period is carried forward.

ii. Non absolute discretionary powers are carried forward.

iii. Preferences for availability of supplemental needs trusts are evident.

d. Care must be taken by a trustee who also has a beneficial interest not to trigger adverse tax consequences to himself or herself.

e. There are many specifics of tax law implications and tax consequences that are yet to be forthcoming with any certainty.

f. Statutory decanting is a new important administration tool. However, it will be of lesser usage importance as estate planners draft trust instruments for greater flexibility within them (such as terms and provisions that facilitate affects of non-statutory decanting).

g. Decanting should be viewed like a black box or the fabled Pandora's Box and should be opened (exercised) with very thoughtful caution.

h. The mantra of the wise trustee has been and will continue to be better "process." The mantra of the wise "authorized trustee" should also be *process*. If later questioned or criticized, your explanation and defense is not just the what and why, but the methodology and process.

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EXHIBIT

Illinois Trust and Trustees Act

760 ILCS 5/16.4 – Distribution of Trust Principal in Further Trust

(a) Definitions. In this Section:

"Absolute discretion" means the right to distribute principal that is not limited or modified in any manner to or for the benefit of one or more beneficiaries of the trust, whether or not the term "absolute" is used. A power to distribute principal that includes purposes such as best interests, welfare, or happiness shall constitute absolute discretion.

"Authorized trustee" means an entity or individual, other than the settlor, who has authority under the terms of the first trust to distribute the principal of the trust for the benefit of one or more current beneficiaries.

"Code" means the United States Internal Revenue Code of 1986, as amended from time to time, including corresponding provisions of subsequent internal revenue laws and corresponding provisions of State law.

"Current beneficiary" means a person who is currently receiving or eligible to receive a distribution of principal or income from the trustee on the date of the exercise of the power.

"Distribute" means the power to pay directly to the beneficiary of a trust or make application for the benefit of the beneficiary.

"First trust" means an existing irrevocable inter vivos or testamentary trust part or all of the principal of which is distributed in further trust under subsection (c) or (d).

"Presumptive remainder beneficiary" means a beneficiary of a trust, as of the date of determination and assuming non-exercise of all powers of appointment, who either (i) would be eligible to receive a distribution of income or principal if the trust terminated on that date, or (ii) would be eligible to receive a distribution of income or principal if the interests of all beneficiaries currently eligible to receive income or principal from the trust ended on that date without causing the trust to terminate.

"Principal" includes the income of the trust at the time of the exercise of the power that is not currently required to be distributed, including accrued and accumulated income.

"Second trust" means any irrevocable trust to which principal is distributed in accordance with subsection (c) or (d).

"Successor beneficiary" means any beneficiary other than the current and presumptive remainder beneficiaries, but does not include a potential appointee of a power of appointment held by a beneficiary.

(b) Purpose. An independent trustee who has discretion to make distributions to the beneficiaries shall exercise that discretion in the trustee's fiduciary capacity, whether the trustee's

discretion is absolute or limited to ascertainable standards, in furtherance of the purposes of the trust.

(c) Distribution to second trust if absolute discretion. An authorized trustee who has the absolute discretion to distribute the principal of a trust may distribute part or all of the principal of the trust in favor of a trustee of a second trust for the benefit of one, more than one, or all of the current beneficiaries of the first trust and for the benefit of one, more than one, or all of the successor and remainder beneficiaries of the first trust.

(1) If the authorized trustee exercises the power under this subsection, the authorized trustee may grant a power of appointment (including a presently exercisable power of appointment) in the second trust to one or more of the current beneficiaries of the first trust, provided that the beneficiary granted a power to appoint could receive the principal outright under the terms of the first trust.

(2) If the authorized trustee grants a power of appointment, the class of permissible appointees in favor of whom a beneficiary may exercise the power of appointment granted in the second trust may be broader than or otherwise different from the current, successor, and presumptive remainder beneficiaries of the first trust.

(3) If the beneficiary or beneficiaries of the first trust are described as a class of persons, the beneficiary or beneficiaries of the second trust may include one or more persons of such class who become includible in the class after the distribution to the second trust.

(d) Distribution to second trust if no absolute discretion. An authorized trustee who has the power to distribute the principal of a trust but does not have the absolute discretion to distribute the principal of the trust may distribute part or all of the principal of the first trust in favor of a trustee of a second trust, provided that the current beneficiaries of the second trust shall be the same as the current beneficiaries of the first trust and the successor and remainder beneficiaries of the second trust shall be the same as the successor and remainder beneficiaries of the first trust.

(1) If the authorized trustee exercises the power under this subsection (d), the second trust shall include the same language authorizing the trustee to distribute the income or principal of a trust as set forth in the first trust.

(2) If the beneficiary or beneficiaries of the first trust are described as a class of persons, the beneficiary or beneficiaries of the second trust shall include all persons who become includible in the class after the distribution to the second trust.

(3) If the authorized trustee exercises the power under this subsection (d) and if the first trust grants a power of appointment to a beneficiary of the trust, the second trust shall grant such power of appointment in the second trust and the class of permissible appointees shall be the same as in the first trust.

(4) Supplemental Needs Trusts.

(i) Notwithstanding the other provisions of this subsection (d), the authorized trustee may distribute part or all of the principal of a disabled beneficiary's interest in the first trust in favor of a trustee of a second trust which is a supplemental needs trust if the authorized trustee determines that to do so would be in the best interests of the disabled beneficiary.

(ii) Definitions. For purposes of this subsection (d):

"Best interests" of a disabled beneficiary include, without limitation, consideration of the financial impact to the disabled beneficiary's family.

"Disabled beneficiary" means a current beneficiary, presumptive remainder beneficiary, or successor beneficiary of the first trust who the authorized trustee determines has a disability that substantially impairs the beneficiary's ability to provide for his or her own care or custody and that constitutes a substantial handicap, whether or not the beneficiary has been adjudicated a "disabled person".

"Governmental benefits" means financial aid or services from any State, Federal, or other public agency.

"Supplemental needs second trust" means a trust that complies with paragraph (iii) of this paragraph (4) and that relative to the first trust contains either lesser or greater restrictions on the trustee's power to distribute trust income or principal and which the trustee believes would, if implemented, allow the disabled beneficiary to receive a greater degree of governmental benefits than the disabled beneficiary will receive if no distribution is made.

(iii) Remainder beneficiaries. A supplemental needs second trust may name remainder and successor beneficiaries other than the disabled beneficiary's estate, provided that the second trust names the same presumptive remainder beneficiaries and successor beneficiaries to the disabled beneficiary's interest, and in the same proportions, as exist in the first trust. In addition to the foregoing, where the first trust was created by the disabled beneficiary or the trust property has been distributed directly to or is otherwise under the control of the disabled beneficiary, the authorized trustee may distribute to a "pooled trust" as defined by federal Medicaid law for the benefit of the disabled beneficiary or the supplemental needs second trust must contain pay back provisions complying with Medicaid reimbursement requirements of federal law.

(iv) Reimbursement. A supplemental needs second trust shall not be liable to pay or reimburse the State or any public agency for financial aid or services to

the disabled beneficiary except as provided in the supplemental needs second trust.

(e) Notice. An authorized trustee may exercise the power to distribute in favor of a second trust under subsections (c) and (d) without the consent of the settlor or the beneficiaries of the first trust and without court approval if:

(1) there are one or more legally competent current beneficiaries and one or more legally competent presumptive remainder beneficiaries and the authorized trustee sends written notice of the trustee's decision, specifying the manner in which the trustee intends to exercise the power and the prospective effective date for the distribution, to all of the legally competent current beneficiaries and presumptive remainder beneficiaries, determined as of the date the notice is sent and assuming non-exercise of all powers of appointment; and

(2) no beneficiary to whom notice was sent objects to the distribution in writing delivered to the trustee within 60 days after the notice is sent ("notice period").

A trustee is not required to provide a copy of the notice to a beneficiary who is known to the trustee but who cannot be located by the trustee after reasonable diligence or who is not known to the trustee.

If a charity is a current beneficiary or presumptive remainder beneficiary of the trust, the notice shall also be given to the Attorney General's Charitable Trust Bureau.

(f) Court involvement.

(1) The trustee may for any reason elect to petition the court to order the distribution, including, without limitation, the reason that the trustee's exercise of the power to distribute under this Section is unavailable, such as:

(a) a beneficiary timely objects to the distribution in a writing delivered to the trustee within the time period specified in the notice; or

(b) there are no legally competent current beneficiaries or legally competent presumptive remainder beneficiaries.

(2) If the trustee receives a written objection within the notice period, either the trustee or the beneficiary may petition the court to approve, modify, or deny the exercise of the trustee's powers. The trustee has the burden of proving the proposed exercise of the power furthers the purposes of the trust.

(3) In a judicial proceeding under this subsection (f), the trustee may, but need not, present the trustee's opinions and reasons for supporting or opposing the proposed distribution, including whether the trustee believes it would enable the trustee to better carry out the purposes of the trust. A trustee's actions in accordance with this Section shall not be deemed improper or inconsistent with the trustee's duty of impartiality unless the court finds from all the evidence that the trustee acted in bad faith.

(g) Term of the second trust. The second trust to which an authorized trustee distributes the assets of the first trust may have a term that is longer than the term set forth in the first trust, including, but not limited to, a term measured by the lifetime of a current beneficiary; provided, however, that the second trust shall be limited to the same permissible period of the rule against perpetuities that applied to the first trust, unless the first trust expressly permits the trustee to extend or lengthen its perpetuities period.

(h) Divided discretion. If an authorized trustee has absolute discretion to distribute the principal of a trust and the same trustee or another trustee has the power to distribute principal under the trust instrument which power is not absolute discretion, such authorized trustee having absolute discretion may exercise the power to distribute under subsection (c).

(i) Later discovered assets. To the extent the authorized trustee does not provide otherwise:

(1) The distribution of all of the assets comprising the principal of the first trust in favor of a second trust shall be deemed to include subsequently discovered assets otherwise belonging to the first trust and undistributed principal paid to or acquired by the first trust subsequent to the distribution in favor of the second trust.

(2) The distribution of part but not all of the assets comprising the principal of the first trust in favor of a second trust shall not include subsequently discovered assets belonging to the first trust and principal paid to or acquired by the first trust subsequent to the distribution in favor of a second trust; such assets shall remain the assets of the first trust.

(j) Other authority to distribute in further trust. This Section shall not be construed to abridge the right of any trustee to distribute property in further trust that arises under the terms of the governing instrument of a trust, any provision of applicable law, or a court order. In addition, distribution of trust principal to a second trust may be made by agreement between a trustee and all primary beneficiaries of a first trust, acting either individually or by their respective representatives in accordance with Section 16.1 of this Act.

(k) Need to distribute not required. An authorized trustee may exercise the power to distribute in favor of a second trust under subsections (c) and (d) whether or not there is a current need to distribute principal under the terms of the first trust.

(l) No duty to distribute. Nothing in this Section is intended to create or imply a duty to exercise a power to distribute principal, and no inference of impropriety shall be made as a result of an authorized trustee not exercising the power conferred under subsection (c) or (d). Notwithstanding any other provision of this Section, a trustee has no duty to inform beneficiaries about the availability of this Section and no duty to review the trust to determine whether any action should be taken under this Section.

(m) Express prohibition. A power authorized by subsection (c) or (d) may not be exercised if expressly prohibited by the terms of the governing instrument, but a general

prohibition of the amendment or revocation of the first trust or a provision that constitutes a spendthrift clause shall not preclude the exercise of a power under subsection (c) or (d).

(n) Restrictions. An authorized trustee may not exercise a power authorized by subsection (c) or (d) to affect any of the following:

(1) to reduce, limit or modify any beneficiary's current right to a mandatory distribution of income or principal, a mandatory annuity or unitrust interest, a right to withdraw a percentage of the value of the trust or a right to withdraw a specified dollar amount provided that such mandatory right has come into effect with respect to the beneficiary, except with respect to a second trust which is a supplemental needs trust;

(2) to decrease or indemnify against a trustee's liability or exonerate a trustee from liability for failure to exercise reasonable care, diligence, and prudence; except to indemnify or exonerate one party from liability for actions of another party with respect to distribution that unbundles the governance structure of a trust to divide and separate fiduciary and nonfiduciary responsibilities among several parties, including without limitation one or more trustees, distribution trust advisors, investment trust advisors, trust protectors, or other parties, provided however that such modified governance structure may reallocate fiduciary responsibilities from one party to another but may not reduce them;

(3) to eliminate a provision granting another person the right to remove or replace the authorized trustee exercising the power under subsection (c) or (d); provided, however, such person's right to remove or replace the authorized trustee may be eliminated if a separate independent, non-subservient individual or entity, such as a trust protector, acting in a nonfiduciary capacity has the right to remove or replace the authorized trustee;

(4) to reduce, limit or modify the perpetuities provision specified in the first trust in the second trust, unless the first trust expressly permits the trustee to do so.

(o) Exception. Notwithstanding the provisions of paragraph (1) of subsection (n) but subject to the other limitations in this Section, an authorized trustee may exercise a power authorized by subsection (c) or (d) to distribute to a second trust; provided, however, that the exercise of such power does not subject the second trust to claims of reimbursement by any private or governmental body and does not at any time interfere with, reduce the amount of, or jeopardize an individual's entitlement to government benefits.

(p) Tax limitations. If any contribution to the first trust qualified for the annual exclusion under Section 2503(b) of the Code, the marital deduction under Section 2056(a) or 2523(a) of the Code, or the charitable deduction under Section 170(a), 642(c), 2055(a) or 2522(a) of the Code, is a direct skip qualifying for treatment under Section 2642(c) of the Code, or qualified for any other specific tax benefit that would be lost by the existence of the authorized trustee's authority under subsection (c) or (d) for income, gift, estate, or generation-skipping transfer tax purposes under the Code, then the authorized trustee shall not have the power to distribute the principal of a trust pursuant to subsection (c) or (d) in a manner that would prevent the contribution to the

first trust from qualifying for or would reduce the exclusion, deduction, or other tax benefit that was originally claimed with respect to that contribution.

(1) Notwithstanding the provisions of this subsection (p), the authorized trustee may exercise the power to pay the first trust to a trust as to which the settlor of the first trust is not considered the owner under Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of the Code even if the settlor is considered such owner of the first trust. Nothing in this Section shall be construed as preventing the authorized trustee from distributing part or all of the first trust to a second trust that is a trust as to which the settlor of the first trust is considered the owner under Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of the Code.

(2) During any period when the first trust owns subchapter S corporation stock, an authorized trustee may not exercise a power authorized by paragraph (c) or (d) to distribute part or all of the S corporation stock to a second trust that is not a permitted shareholder under Section 1361(c)(2) of the Code.

(3) During any period when the first trust owns an interest in property subject to the minimum distribution rules of Section 401(a)(9) of the Code, an authorized trustee may not exercise a power authorized by subsection (c) or (d) to distribute part or all of the interest in such property to a second trust that would result in the shortening of the minimum distribution period to which the property is subject in the first trust.

(q) Limits on compensation of trustee.

(1) Unless the court upon application of the trustee directs otherwise, an authorized trustee may not exercise a power authorized by subsection (c) or (d) solely to change the provisions regarding the determination of the compensation of any trustee; provided, however, an authorized trustee may exercise the power authorized in subsection (c) or (d) in conjunction with other valid and reasonable purposes to bring the trustee's compensation into accord with reasonable limits in accord with Illinois law in effect at the time of the exercise.

(2) The compensation payable to the trustee or trustees of the first trust may continue to be paid to the trustees of the second trust during the terms of the second trust and may be determined in the same manner as otherwise would have applied in the first trust; provided, however, that no trustee shall receive any commission or other compensation imposed upon assets distributed due to the distribution of property from the first trust to a second trust pursuant to subsection (c) or (d).

(r) Written instrument. The exercise of a power to distribute principal under subsection (c) or (d) must be made by an instrument in writing, signed and acknowledged by the trustee, and filed with the records of the first trust and the second trust.

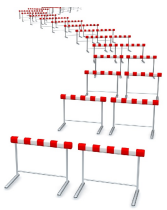
(s) Terms of second trust. Any reference to the governing instrument or terms of the governing instrument in this Act includes the terms of a second trust established in accordance with this Section.

(t) Settlor. The settlor of a first trust is considered for all purposes to be the settlor of any second trust established in accordance with this Section. If the settlor of a first trust is not also the settlor of a second trust, then the settlor of the first trust shall be considered the settlor of the second trust, but only with respect to the portion of second trust distributed from the first trust in accordance with this Section.

(u) Remedies. A trustee who reasonably and in good faith takes or omits to take any action under this Section is not liable to any person interested in the trust. An act or omission by a trustee under this Section is presumed taken or omitted reasonably and in good faith unless it is determined by the court to have been an abuse of discretion. If a trustee reasonably and in good faith takes or omits to take any action under this Section and a person interested in the trust opposes the act or omission, the person's exclusive remedy is to obtain an order of the court directing the trustee to exercise authority in accordance with this Section in such manner as the court determines necessary or helpful for the proper functioning of the trust, including without limitation prospectively to modify or reverse a prior exercise of such authority. Any claim by any person interested in the trust that an act or omission by a trustee under this Section was an abuse of discretion is barred if not asserted in a proceeding commenced by or on behalf of the person within 2 years after the trustee has sent to the person or the person's personal representative a notice or report in writing sufficiently disclosing facts fundamental to the claim such that the person knew or reasonably should have known of the claim. Except for a distribution of trust principal from a first trust to a second trust made by agreement in accordance with Section 16.1 of this Act, the preceding sentence shall not apply to a person who was under a legal disability at the time the notice or report was sent and who then had no personal representative. For purposes of this subsection (u), a personal representative refers to a court appointed guardian or conservator of the estate of a person.

(v) Application. This Section is available to trusts in existence on the effective date of this amendatory Act of the 97th General Assembly or created on or after the effective date of this amendatory Act of the 97th General Assembly. This Section shall be construed as pertaining to the administration of a trust and shall be available to any trust that is administered in Illinois under Illinois law or that is governed by Illinois law with respect to the meaning and effect of its terms, including a trust whose governing law has been changed to the laws of this State, unless the governing instrument expressly prohibits use of this Section by specific reference to this Section. A provision in the governing instrument in the form: "Neither the provisions of Section 16.4 of the Trusts and Trustees Act nor any corresponding provision of future law may be used in the administration of this trust" or a similar provision demonstrating that intent is sufficient to preclude the use of this Section.

Effective Date: 1/1/2013



Illinois Directed Trusts

By: Timothy S. Midura, C.P.A., J.D., LL.M
of Huck Bouma PC – Wheaton
tmidura@huckbouma.com – www.TimothyMidura.com
630-221-1755

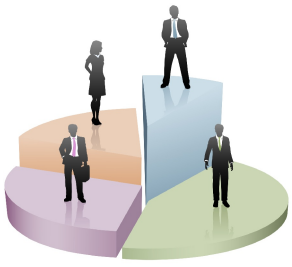


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Table of Contents

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Illinois Directed Trusts

By: Timothy S. Midura, C.P.A., J.D., LL.M
of Huck Bouma PC – Wheaton
tmidura@huckbouma.com – www.TimothyMidura.com
630-221-1755

1. Preview:

   a. The Illinois directed trusts statute is not a game changer. However, it shadows every situation in which the trust instrument provides someone to whom the trustee needs to look to for direction or advice. Also, the approach of drafting bifurcation of fiduciary responsibilities should be critically examined.

      i. We have long drafted trusts with investment advisors, trust protectors, distribution advisors, management committees, and the like. However, we have not been certain as to their ultimate authority and generally the trustee continued to be, at some level, responsibility for the whole of the trust management and outcomes. The Illinois directed trusts statute brings statutory authority to bifurcating these roles.

      ii. The statute creates a "square" peg. We should now be drafting more strictly "square holes" that will best receive the statutory square peg.

   b. Strict or Construed and The Mandate: The Illinois directed trusts statute mandates its application onto all Illinois trusts. Therefore is application will be "construed" upon many trusts. However, as we better draft for the directed trusts statute, the statute will be better "strictly" applied to trusts.

      i. Note: These terms "construed" and "strict" are descriptions of the author and not a part of the statute.

      ii. More drafting effort will be necessary to bifurcate fiduciary duties and not create gaps and ambiguities.

   c. The Illinois directed trusts statute creates statutory application and clarity to bifurcating, or slicing the pie, of fiduciary duties.

   d. The *Holy Grail* will be achieve "excluded fiduciary" status for non-directing parties – most often the trustee as the "excluded fiduciary."

      i. So an "excluded fiduciary" will be more interested that the directed trusts statute "strictly" apply rather than be construed upon such person.

ii. An "excluded fiduciary" will not want an ambiguity or vacancy to cloud over and possibly attach to it.

e. There needs to be continued care of safeguarding and failsafe drafting for "directing parties" to avoid adverse tax implications.

i. The same failsafe planning and restrictions that we traditionally do for an "interested" trustee (such as a trustee who is also a beneficiary) must be done for each of the directing parties.

ii. The statute has zero tax planning protections and has even added grease to the walkway of potential adverse tax consequences.

f. The Illinois directed trusts statute broadens fiduciary application and processing.

i. It may be a surprise to an advisor that prior to January 1, 2013, such advisor arguably was not acting in a fiduciary capacity but now is charged to act in a fiduciary capacity.

2. 760 ILCS 5/16.3 and 16.7 created the directed trusts statute, effective January 1, 2013.

a. The directed trusts statute authorizes the governing instrument to divide the trustee's duties among the trustee (the trustee becoming an "excluded fiduciary") and a "directing party" or parties (being distribution trust advisor, investment trust advisor, trust protector, or similar roles or non-exclusive titles).

i. So a settlor might want to grant authority to a specific person the right to manage and direct as to a specific asset (while having the trustee administer the balance of the trust) or to have a family friend (who knows family circumstances, personalities, and relationships) direct distributions.

ii. Directed Versus Delegated. Generally, if a trustee delegates tasks, the trustee is still responsible for the trustee's delegated agent and the trust administration by such agent. Now comes the opportunity to relieve the trustee of some responsibility by directing the exclusion of the trustee and by empowering another party.

iii. So we now have clear authority on how we can slice the fiduciary pie into various autonomous pieces, while maintaining the whole of the pie.

b. In the author's opinion this is not a "game changer" but a quick and large step (neither evolutionary or revolutionary) in modern drafting and trust design. It puts authoritative structure to what we've been doing in practice for some time. It creates clarity in an evolving practice area and technique usage.

i. However, it should change the way we draft the trust or other governing instrument provisions. Think of the directed trusts statute as a square peg and practitioners until now have been making holes of all kinds of shapes

and sizes. We should start to drafted our instrument holes to better accommodate the square peg of statutory directing parties.

c. We've been drafting for various advisors for some time now: advisors, special asset managers, investment managers, committees, distribution advisors, and trust protectors or trust amendors. More or different titles can be included with the implication that the settlor can have someone other than the trustee participate in or influence the trust administration matters and the trustee is to take direction from, rely on, receive consent from, or heavily consider the advisors.

i. However, it has been uncertain as to what extent that the trustee was relieved of its own ultimate fiduciary responsibilities with regard to those allocated assignments.

ii. For example, "trust protectors" have never before been formally recognized in Illinois law, although the practice is wide spread.

iii. To varying degrees, the author has been utilizing "distribution trustees," "administration trustees," "distribution advisors," "managers," "management committees," "trust protectors," and "amendors" in most trust instruments and in every irrevocable trust.

iv. The only place of some certainty in "delegation" has been if the trustee made an investment delegation to a non-trustee in conformance with 760 ILCS 5/5.1(b) – which the author believes in practice is rarely utilized and is cumbersome to effect. And even in delegation, the trustee is not wholly relieved of fiduciary responsibilities and processing.

(1) § 5.1(a) provides, "The trustee has a duty not to delegate to others the performance of any acts involving the exercise of judgment and discretion, except acts constituting investment functions that a prudent investor of comparable skills might delegate under the circumstances. The trustee may delegate those investment functions to an investment agent as provided in subsection (b)."

3. Critical Overview Caveat Regarding Tax Issues. This is so important as to put it first before the substance of the presentation.

a. The Illinois directed trusts statute does not provide any failsafe tax planning.

b. A person appointed as a "directing party" and who is "interested" in the trust must have the same failsafe analysis and drafting cutbacks and limitations as an acting trustee who is "interested."

i. "Interested" for this discussion (but not a term of § 16.3) is a directing party who (a) is also a beneficiary or (b) has an individual legal obligation to support a beneficiary.

ii. An "interested party" can inadvertently be given a gift or estate tax inclusion general power of appointment pursuant to IRC §§ 2514 or 2041.

c. You will note when reviewing the statute each of the directing parties are given "sole and absolute discretion" that is "binding on all other persons." Facts and circumstances may easily create a taxable general power of appointment for the interested directing party.

d. Tax Cut Backs. So if there is an interested directing party, one should be drafting the governing instrument so the directing party's powers:

i. Are within IRC §§ 2514 and 2041 ascertainable standards;

ii. Are legally enforceable (the author would cut back from "sole and absolute" and "binding" and more accessible to judicial review);

iii. Cannot be used to discharge the individual legal obligation of the interested directing party;

iv. Cannot make administrative changes, allocations, and elections that shift beneficial interests; and

v. Cannot remove and appoint an independent trustee (or other independent directing party) to one other than independent within the meaning of IRC § 672(c).

vi. In other words, all the failsafe provisions and limitations we use when a trustee is also a beneficiary we need to keep in mind when a directing party is also a beneficiary. The directed trusts statute pushes the directing party's discretions further to (or possibly over) the "tax edge" by granting sole, absolute, and binding discretion.

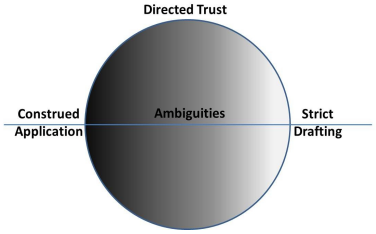
4. Overview Regarding the Excluded Fiduciary – Strict or Construed – the Square Peg into the Hexagonal Hole – **the Mandate** for Application and Construction.

a. Applicability and Application – §§ 16.3(j) and 16.7. The directed trusts statute:

i. Applies to all existing, modified, and future trusts that appoint or provide for a directing party, including but not limited to a party granted power or authority effectively comparable in substance to that of a directing party (§ 16.3(j)); and

ii. Must be construed as pertaining to the administration of a trust and must be available to any trust that is administered in Illinois under Illinois law or that is governed by Illinois law with respect to the meaning and effect of its terms, except to the extent the governing instrument expressly prohibits its application in accordance with § 16.7.

iii. Question: Are the players in a trust instrument **strictly** described and covered by the directed trusts statute or are they **construed** into it?



(1) Most or all pre-1/1/13 trusts with directing parties (advisors, trust protectors, and the like) will be *construed* into the application of the directed trusts statute – the statute being the new square peg and all the pre-1/1/13 trusts being a variety of shaped holes.

(2) Going forward, it should be our goal to draft governing instruments so they are now square holes to better accommodate the square peg of the directed trusts statute.

b. Holy Grail = Trustee as an Excluded Fiduciary. When a governing instrument provides for division of powers or bifurcation of roles, the Holy Grail of the trustee (or other non-directing party) will be to be clearly classified as an "excluded fiduciary." The excluded fiduciary is relieved from the duties and responsibilities associated with and assigned to the directing party, gaining liability protections for the excluded fiduciary. As one will find below, the definition of an excluded fiduciary has some strict language. Not drafting into the strict language may create some outcome ambiguity as to construed application.

i. Again, and for quite some time, most qualifying excluded fiduciary-trustees will be construed rather than be strictly defined.

c. Clear Mandate to Construe Application of Excluded Fiduciaries. This is not a huge deal – but not a small one either. Prior to 1/1/13, we have routinely and comfortably drafted trust protectors, investment advisors, and distribution advisors without the benefit of statutory authority. Most often we know that we were trying to accomplish what the directed trusts statute now expressly authorizes. We know that the mandate of the directed trusts statute is to construe its application onto these directing advisor situations. So we construe as necessary the application of § 16.3 and, importantly, we start to draft so there is less need for construing and towards more strict compliance with the statute.

i. See ¶ 16.g of this paper in which the author raises some drafting considerations for drafting more strictly.

5. Bifurcated Roles or Slicing the Pie. A trust (whether settlor created, court order, non-judicial settlement agreement or decanted) can be drafted to bifurcate trustee duties and responsibilities among:

a. Trustee,

b. Distribution trust advisor,

c. Investment trust advisor,

d. Trust protector, or

e. Other title, task or fiduciary role.

f. The person who is expressly directed (or construed) from not having a specific fiduciary role or duty is an "excluded fiduciary."

g. Slicing the Pie Pieces. So the whole "pie" of trustee duties and responsibilities remains. Now we have statutory authority to cleanly slice the pie into various pieces ... the pie slices not oozing into each other.

h. Advantages:

i. Release trustee from unwanted responsibilities and potential risks.

ii. Assign to directing party acceptable responsibilities where special talents, knowledge, and experience exist.

iii. Possible reduction of trustee fees.

i. Disadvantages:

i. Additional levels of coordination and communication – administration complexities.

ii. Potential administration conflicts and ambiguities.

iii. Potential for net greater fees and costs.

6. Duty and Liability of Directing Party – §16.3(e). A directing party **is a fiduciary** of the trust subject to the same duties and standards applicable to a trustee of a trust as provided by applicable law **unless the governing instrument provides otherwise**.

a. If Fiduciary Capacity Waived. However if the government instrument relieves the directing party from fiduciary capacity, it may not relieve or exonerate a directing party from the duty to act or withhold acting as the directing party in good faith reasonably believes is in the best interests of the trust.

7. Duty and Liability of Excluded Fiduciary – § 16.3(f). The excluded fiduciary must act in accordance with the governing instrument and comply with the directing party's exercise of the powers granted to the directing party by the governing instrument.

a. Unless otherwise provided in the governing instrument, an excluded fiduciary has no duty to monitor, review, inquire, investigate, recommend, evaluate, or warn with respect to a directing party's exercise or failure to exercise any power granted to the directing party by the governing instrument, including but not limited to any power related to the acquisition, disposition, retention, management, or valuation of any asset or investment.

b. Except as otherwise provided elsewhere in § 16.3 or the governing instrument, an excluded fiduciary is **not liable**, either individually or as a fiduciary, for any action, inaction, consent, or failure to consent by a directing party, including but not limited to any of the following:

i. If a governing instrument provides that an excluded fiduciary is to follow the direction of a directing party, and such excluded fiduciary acts in accordance with such a direction, then except in cases of willful misconduct on the part of the excluded fiduciary in complying with the direction of the directing party, the excluded fiduciary is **not liable** for any loss resulting directly or indirectly from following any such direction, including but not limited to compliance regarding the valuation of assets for which there is no readily available market value.

ii. If a governing instrument provides that an excluded fiduciary is to act or omit to act only with the consent of a directing party, then except in cases of willful misconduct on the part of the excluded fiduciary, the excluded fiduciary is **not liable** for any loss resulting directly or indirectly from any act taken or omitted as a result of such directing party's failure to provide such consent after having been asked to do so by the excluded fiduciary.

iii. If a governing instrument provides that, or for any other reason, an excluded fiduciary is required to assume the role or responsibilities of a directing party, or if the excluded party appoints a directing party or successor to a directing party, then the excluded fiduciary shall also assume the **same fiduciary and other duties and standards** that applied to such directing party.

iv. ***Important author's note***: Notice the recognized graduated levels. The purported "excluded fiduciary" needs to be cognizant that he or she may not be totally relieved of responsibilities. For example, what if the governing instrument language does not strictly direct the trustee to act in conformance the directing party or the duties of the directing party are somewhat ambiguous? What if the governing instrument says the trustee "may rely" or "may seek the counsel of"? These seem to leave the primary fiduciary duty still with the trustee. Especially when the excluded fiduciary-trustee is construed, instead of strictly, there could be gray areas. Thus the trustee, as a construed excluded fiduciary, may have at the least a duty (if not for mere prudent process) to more closely monitor the construed directing party to adhere to its construed fiduciary duties and the trustee then also may have an affirmative duty to protect the trust from inappropriate actions or inactions by the construed directing party. Of course, this may itself embellish the gray area and also create aggravation between the parties.

8. Duty to Inform Excluded Fiduciary – § 16.3(h). Each directing party must

a. keep the excluded fiduciary and any other directing party reasonably informed regarding the administration of the trust with respect to any specific duty or function being performed by the directing party to the extent that the duty or function would normally be performed by the excluded fiduciary or

b. to the extent that providing such information to the excluded fiduciary or other directing party is reasonably necessary for the excluded fiduciary or other directing party to perform its duties, and

c. the directing party must provide such information as reasonably requested by the excluded fiduciary or other directing party.

d. Neither the performance nor the failure to perform of a directing party's duty to inform as provided in § 16.3(h) affects the limitation on the liability of the excluded fiduciary as provided in § 16.3.

9. Reliance on Counsel - § 16.3(i). An excluded fiduciary may, but is not required to, obtain and rely upon an opinion of counsel on any matter relevant to § 16.3.

a. On the other hand, this does not expressly authorize the directing party to also obtain counsel (paid for by the trust). However, since the directing party is a presumed fiduciary, just as is the trustee, it is logical that a directing party can obtain counsel as an expense of the trust.

i. 760 ILCS 5/4.09 provides authority for a trustee, "To appoint attorneys, auditors, financial advisers and other agents and to pay reasonable compensation to such appointees. If the trustee uses reasonable care, skill, and caution in the selection of the agent, the trustee may rely upon the advice or recommendation of the agent without further investigation and, except as may otherwise be provided in subsection (b) of Section 5.1 with respect to investment agents, shall have no responsibility for actions taken or omitted upon the advice or recommendation of the agent."

10. Applicability and Application.

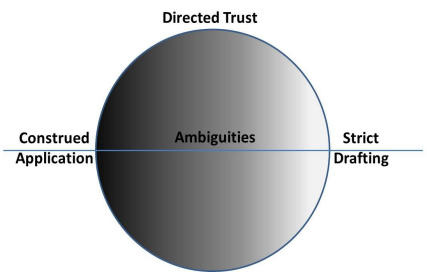
a. Applicability – § 16.3(j). On and after January 2, 2013, § 16.3 applies to:

i. all existing and future trusts that appoint or provide for a directing party, including but not limited to a party granted power or authority effectively comparable in substance to that of a directing party as provided in § 16.3; or

ii. any existing or future trust that:

(1) is modified in accordance with applicable law or the terms of the governing instrument to appoint or provide for a directing party; or

(2) is modified to appoint or provide for a directing party, including but not limited to a party granted power or authority effectively comparable in substance to that of a directing party, in accordance with (i) a court order, or (ii) a nonjudicial settlement agreement made in accordance with 760 ILCS § 16.1, whether or not such order or agreement specifies that § 16.3 governs the



responsibilities, actions, and liabilities of persons designated as a directing party or excluded fiduciary.

b. Application – § 16.7. § 16.3 applies to all trusts in existence on January 1, 2013, or created after thereafter. § 16.3 must be construed as pertaining to the administration of a trust and must be available to any trust that is administered in Illinois under Illinois law or that is governed by Illinois law with respect to the meaning and effect of its terms.

   i. Note that the tone of this is a statutory mandate. From this comes the comfort that all the pre-1/1/13 "hexagonal holes" of directed advisor situations have the inherent bending towards protections of excluded fiduciary status and directing party responsibilities as now provided in § 16.3.

c. **The Mandate**. The above appears to create a mandate for application.

   i. From the author's perspective: If a trust is drafted expressly with § 16.3 in mind, then the § 16.3 can be "strictly" applied with its benefits. This will make the "excluded fiduciary" most happy. If a trust is not drafted strictly to § 16.3 (such as all those trusts predating 1/1/13), then § 16.3 will be "construed" upon the trust – with its benefits and responsibilities.

   ii. 6 of 1, Half Dozen of Another? Is the outcome the same? Drafting strictly will take any shades of gray away, cover vacancy issues, and cover numerous other issues that will other create ambiguities of administration.

      (1) See ¶ 16.g of this paper in which the author raises some drafting considerations for drafting more strictly.

d. Express and Specific Opt Out. § 16.3 will apply to each and every trust as provided above, except to the extent the governing instrument expressly prohibits that 760 ILCS 5/16.3 by specific reference to that Section. § 16.7.

   i. Example provision in the governing instrument, in the form: "The provisions of Section 16.3 of the Trusts and Trustees Act and any corresponding provision of future law may not be used in the administration of this trust" or a similar provision demonstrating that intent is sufficient to preclude the use of § 16.3.

   ii. Why opt out?

      (1) So a directing advisor will not be subject to the jurisdiction of Illinois courts. See § 16.3(g) – "... even if investment advisory agreements or other related agreements provide otherwise..."

      (2) If the duties to inform or provide information, for some reason, are too burdensome. See § 16.3(h).

(3) Back away from the mandate of the fiduciary capacity or other statutory standard of the directing party. See § 16.3(e).

(4) Back away from the "sole and absolution discretion" and "bind on all other persons" provided by the statute.

(5) Where, for whatever other reason, one does not want the statutory applications. For example, one wants the instrument to wholly contain its own rules and procedures among the trust instrument parties and also be portable to various state situs without differing affect.

11. Submission to Court Jurisdiction; Effect on Directing Party – § 16.3(g). By accepting an appointment to serve as a directing party of a trust that is subject to the laws of Illinois, the directing party submits to the jurisdiction of the courts of Illinois even if investment advisory agreements or other related agreements provide otherwise, and the directing party may be made a party to any action or proceeding if issues relate to a decision or action of the directing party.

a. Could it be that an investment firm given investment discretion by a trustee may now come under Illinois jurisdiction even though the investment advisory agreement provides otherwise?

b. A possible solution is to amend or decant the trust to opt out of the Illinois directed trusts statute in whole or perhaps (if this is even possible) with respect to this specific statutory provision.

12. Definitions – § 16.3(a).

a. "Directing party" means any investment trust advisor, distribution trust advisor, or trust protector.

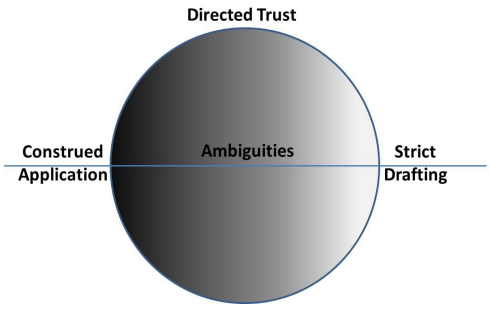
b. "Distribution trust advisor" means any one or more persons given authority by the governing instrument to direct, consent to, veto, or otherwise exercise all or any portion of the distribution powers and discretions of the trust, including but not limited to authority to make discretionary distribution of income or principal.

c. "Excluded fiduciary" means any fiduciary that **by the governing instrument is directed to act in accordance with** the exercise of specified powers by a directing party, **in which case** such specified powers shall be deemed granted not to the fiduciary but to the directing party and such fiduciary shall be deemed excluded from exercising such specified powers. **If a governing instrument provides** that a fiduciary as to one or more specified matters **is to act, omit action, or make decisions only with the consent of a directing party, then** such fiduciary is an excluded fiduciary with respect to such matters.

i. ***Author's note***:

(1) It appears that the plain reading here is that there should be an affirmative direction to the trustee and other directing parties to act in accordance with the specified powers of the subject directing party in order to achieve *strict* status as an "excluded fiduciary" – otherwise, "excluded fiduciary" status is applied by construction.

(a) Note: The concepts of "strict" or "construed" status are provided by the author.



(i) "**Strict**" has the perspective that the drafting person has used language and technique for both the directing party and excluded fiduciary that is derived from the directed trusts statute.

(ii) "**Construed**" has the perspective that there are many directed party situations to which that the directed trusts statute now applies and how these situations play out is through interpretative construction.

(2) So it appears that drafting should have two fundamental parts or aspects:

(a) Part 1: Drafting the express powers (and limitations if applicable, such as tax failsafe provisions) of the directing party; and

(i) This also includes a clearly acknowledged acceptance by the directing party (just as a trustee would accept).

(b) Part 2: Directing the other fiduciary parties (the trustee in particular) to act in accordance with the specified powers of the subject directing party.

(c) Playing off the title of the statute, the **directing** party is **directed** to act and the trustee is **directed** not to act but to take **directions** from the **directing** party.

(d) Of course, the directing party has to accept his or her fiduciary role just as would any trustee.

(i) So if a trust currently activates the trustee and directing parties, the settlor and each trustee and each directing party needs to sign the trust instrument as an acceptance.

(3) Notice how the last sentence in § 16.3(a)(3) conforms with § 16.3(f)(1) & (2) – relating to duty and liability relief of the excluded fiduciary.

§ 16.3(a)(3), "*** If a governing instrument provides that a fiduciary as to one or more specified matters is to act, omit action, or make decisions only with the consent of a directing party, then such fiduciary is an excluded fiduciary with respect to such matters."

§ 16.3(f)(1), "if a governing instrument provides that an excluded fiduciary is to follow the direction of a directing party, and such excluded fiduciary acts in accordance with such a direction, then except in cases of willful misconduct on the part of the excluded fiduciary in complying with the direction of the directing party, the excluded fiduciary is not liable ***"

§ 16.3(f)(2), "if a governing instrument provides that an excluded fiduciary is to act or omit to act only with the consent of a directing party, then except in cases of willful misconduct on the part of the excluded fiduciary, the excluded fiduciary is not liable ***"

d. "Fiduciary" means any person expressly given one or more fiduciary duties by the governing instrument, including but not limited to a trustee.

e. "Governing instrument" refers to the instrument stating the terms of a trust, including but not limited to any court order or nonjudicial settlement agreement establishing, construing, or modifying the terms of the trust in accordance with § 16.1, 16.4, or 16.6 or other applicable law.

f. "Investment trust advisor" means any one or more persons given authority by the governing instrument to direct, consent to, veto, or otherwise exercise all or any portion of the investment powers of the trust.

g. "Power" means authority to take or withhold an action or decision, including but not limited to an expressly specified power, the implied power necessary to exercise a specified power, and authority inherent in a general grant of discretion.

h. "Trust protector" means any one or more persons given any one or more of the powers specified in § 16.3(d), whether or not designated with the title of trust protector by the governing instrument.

13. Powers of Investment Trust Advisor – § 16.3(b).

a. An investment trust advisor may be designated in the governing instrument of a trust.

b. The powers of an investment trust advisor may be exercised or not exercised in the **sole and absolute discretion** of the investment trust advisor, and are **binding on all other persons**, including but not limited to each beneficiary, fiduciary, excluded fiduciary, and any other party having an interest in the trust.

i. The emphasis has been author supplied to highlight what might contribute to tax implications, in particular whether the granted power might become a taxable general power of appointment.

(1) This could become possible if investment decisions start to affect the beneficial interests and particularly that of an investment trust advisor who is also a beneficiary.

c. The governing instrument may use the title "investment trust advisor" or any similar name or description demonstrating the intent to provide for the office and function of an investment trust advisor.

d. Default Powers. Unless the terms of the governing instrument provide otherwise, the investment trust advisor has the authority to:

i. direct the trustee with respect to the retention, purchase, transfer, assignment, sale, or encumbrance of trust property and the investment and reinvestment of principal and income of the trust;

ii. direct the trustee with respect to all management, control, and voting powers related directly or indirectly to trust assets, including but not limited to voting proxies for securities held in trust;

iii. select and determine reasonable compensation of one or more advisors, managers, consultants, or counselors, including the trustee, and to delegate to them any of the powers of the investment trust advisor in accordance with 760 ILCS 5/5.1(b) (investment delegation); and

iv. determine the frequency and methodology for valuing any asset for which there is no readily available market value.

14. Powers of Distribution Trust Advisor – § 16.3(c).

a. A distribution trust advisor may be designated in the governing instrument of a trust.

b. The powers of a distribution trust advisor may be exercised or not exercised in the **sole and absolute discretion** of the distribution trust advisor, and are **binding on all other persons**, including but not limited to each beneficiary, fiduciary, excluded fiduciary, and any other party having an interest in the trust.

i. The emphasis has been author supplied to highlight what might contribute to tax implications, in particular whether the granted power might become a taxable general power of appointment.

(1) Even if the distribution trust advisor's distribution powers are limited to ascertainable standards, such "binding sole and absolute discretion" may make it less judicially enforceable and thus create

a taxable general power of appointment. See Treas.Reg. § 25.2514-1(b)(2).

c. The governing instrument may use the title "distribution trust advisor" or any similar name or description demonstrating the intent to provide for the office and function of a distribution trust advisor.

d. Default Powers. Unless the terms of the governing instrument provide otherwise, the distribution trust advisor has authority to direct the trustee with regard to all decisions relating directly or indirectly to discretionary distributions to or for one or more beneficiaries.

15. Powers of Trust Protector – § 16.3(d).

a. A trust protector may be designated in the governing instrument of a trust.

b. The powers of a trust protector may be exercised or not exercised in the **sole and absolute discretion** of the trust protector, and are **binding on all other persons**, including but not limited to each beneficiary, investment trust advisor, distribution trust advisor, fiduciary, excluded fiduciary, and any other party having an interest in the trust.

i. The emphasis has been author supplied to highlight what might contribute to tax implications, in particular whether the granted power might become a taxable general power of appointment.

c. The governing instrument may use the title "trust protector" or any similar name or description demonstrating the intent to provide for the office and function of a trust protector.

d. Non Exclusive, Non-Default Powers List. The powers granted to a trust protector by the governing instrument **may include** but are not limited to authority to do any one or more of the following:

i. modify or amend the trust instrument to achieve favorable tax status or respond to changes in the Internal Revenue Code, federal laws, State law, or the rulings and regulations under such laws;

ii. * increase, decrease, or modify the interests of any beneficiary or beneficiaries of the trust;

iii. * modify the terms of any power of appointment granted by the trust; provided, however, such modification or amendment may not grant a beneficial interest to any individual, class of individuals, or other parties not specifically provided for under the trust instrument;

iv. * remove, appoint, or remove and appoint, a trustee, investment trust advisor, distribution trust advisor, another directing party, investment

committee member, or distribution committee member, including designation of a plan of succession for future holders of any such office;

v. * terminate the trust, including determination of how the trustee shall distribute the trust property to be consistent with the purposes of the trust;

vi. * change the situs of the trust, the governing law of the trust, or both;

vii. appoint one or more successor trust protectors, including designation of a plan of succession for future trust protectors;

viii. interpret terms of the trust instrument at the request of the trustee;

ix. advise the trustee on matters concerning a beneficiary; or

x. amend or modify the trust instrument to take advantage of laws governing restraints on alienation, distribution of trust property, or to improve the administration of the trust.

xi. ***Important Note***: **These are not default powers**. The trust protector only has powers expressly granted within the governing instrument.

e. Charity. *If a charity is a current beneficiary or a presumptive remainder beneficiary of the trust, a trust protector must give notice to the Attorney General's Charitable Trust Bureau at least 60 days before taking any of the actions authorized under items ii-vi immediately above.

i. The Attorney General's Charitable Trust Bureau may, however, waive this notice requirement.

16. Global Questions.

a. Should a directing party sign a trust instrument the same as would a trustee?

i. Yes. The governing instrument should be acknowledged and accepted by the directing party. The directing party should acknowledge receipt of the governing instrument, if separate.

(1) If the trustee would sign the instrument, then a contemporaneously acting directing party should also sign the instrument.

(2) Should the directing party acknowledgment also include his or her reading, understanding of the governing instrument, roles, and fiduciary duties and responsibilities, and opportunity to seek independent counsel?

(a) The author thinks not. We don't have trustees do this. But there may be circumstances where this could make sense. There probably will be circumstances where the directing party has a lulled sense of complacency or that his or her

role is “no big deal,” whereas they are a full fledged bifurcated fiduciary. Most individuals who begin acting as trustees don’t understand what they’re getting themselves into or what the true roles, responsibilities, and processes entail. This is probably more so for a directing party.

ii. Since a directing party is a fiduciary and is acting in one of the bifurcated responsibilities and duties of the trustee, the directing party should sign the trust agreement or otherwise formally accept such role as would a trustee.

iii. If a directing party does not accept, then there is no directing party acting and the trustee, arguably, may not be an excluded fiduciary with its protected status.

(1) What does the trust instrument and facts and circumstances provide when there is a vacancy of the directing party?

iv. § 16.3(g) references a directing party’s “accepting” one’s role but does not define it.

b. Powers of Appointment. Does the directed trusts statute apply to a granted power of appointment?

i. No.

ii. The directed trusts statute attaches to the making of “discretionary distribution of income or principal” to trust beneficiaries in the context of a trustee’s fiduciary discretion.

iii. A donee of a power of appointment is not a fiduciary and does not have fiduciary duties. The class of appointees of the power of appointment are not trust beneficiaries.

iv. The tension, if there is one, will that the donee of the power of appointment (if construed as a distribution trust advisor or trust protector) will be deemed to be in a fiduciary capacity but whose exercise or non-exercise will nevertheless have “sole and absolute discretion ... and binding on all other persons.”

(1) However, unfettered, sole and absolute discretion, binding on all others, in a fiduciary sense is still always review able by a court for bad faith or abuse of discretion.

v. Admittedly there are some blurs and grays here. But most of us will recognize a power of appointment when we see it ... being as plain as day and so expressly stated within the governing instrument. No doubt though that there will be someone at sometime pounding his or her chest over this one. So a certain degree of caution may be dictated by the particular facts and circumstances and possibly even seeking a declaratory judgment.

(1) It also behooves the drafting person to always plainly state when a power of appointment is such and affirmatively state whether it's intended to be special and limited or general power of appointment.

c. Inherent Powers, Inherent Restrictions? Does the mere reference in a governing instrument to a "trust protector" or other directing power automatically empower such role with full powers articulated under the statute?

i. Yes, if an investment trust advisor. See § 16.3(b).

ii. Yes, if a distribution trust advisor. See § 16.3(c).

iii. No, if a trust protector. See § 16.3(d).

iv. The powers of the directing party should always be carefully designed and expressly drafted. This is similar to trustee powers in trust instruments where the trust instrument has its string of expressed powers and also an incorporation by reference of statutory powers.

(1) However, care should be taken, especially with the trust protector, before incorporating by reference statute (possible) powers.

(2) If the statutory powers for the investment and distribution directing parties are satisfactory, the author intends to expressly articulate them into the governing instrument and not merely have an incorporation by reference.

(a) The author prefers to have all powers and relationships well defined within the trust instrument so a party can be advised by the document itself without major deficiencies.

v. No doubt there will be powers that should be granted that are beyond the "statutory list" or should be articulated in a different manner.

vi. *Of huge significance* will be

(1) Practical limitations a settlor will want to be placed on a directing party; and

(2) Tax safeguard limitations for an interested directing party.

d. What does one do when there is apparent ambiguity with respect to the statutory status or scope of an excluded fiduciary and directing party?

i. Of course these situations will be so varied and dependent on the facts and circumstances.

ii. There should be significant comfort of the public policy mandate of application of the statute. See § 16.7.

iii. The excluded fiduciary is expressly authorized to seek counsel. § 16.3(i). Counsel can recommend further potential remediation: reliance on counsel's opinion, declaratory court order, non-judicial settlement agreement, or decanting.

e. What are possible or probable changes for a pre-1/1/13 directing party?

i. Fiduciary capacity (and thus duties) is now applicable, unless the governing instrument had expressly provided otherwise.

(1) If fiduciary capacity had been waived, then the directing party should endeavor to process and memorialize his or her good faith and action or non-action as in the best interests of the trust.

(2) There should be a review of the statutory application of "sole and absolute discretion" and "binding on all other persons" and whether such creates practical (tax) issues.

ii. Fiduciary processes should now be undertaken in conformance with fiduciary capacity.

iii. Affirmatively keep the excluded fiduciary and other directing parties informed.

iv. Responsively provide information as requested by the excluded fiduciary or other directing parties.

f. If there is an express opt out of the directed trusts statute in conformance with § 16.7, can the trustee decant (§ 16.4) into a second trust that nevertheless provides for directing parties?

i. Probably not, but will only be more clear when based on the actual facts and circumstances.

ii. The decanting statute is meant to make any trust "better."

iii. § 16.4(b) provides, "An independent trustee who has discretion to make distributions to the beneficiaries shall exercise that discretion in the trustee's fiduciary capacity, whether the trustee's discretion is absolute or limited to ascertainable standards, in furtherance of the purposes of the trust."

(1) One would think that a clear opt out of § 16.3 (the sister statute of § 16.4) would dictate to the trustee that a second trust with directing parties is not "in furtherance of the purposes of the [first] trust."

g. What are some specific drafting considerations?

i. Expressly empower the directing party with detailed powers (whether all expressed in the governing instrument [recommended] or partially incorporated by reference to the statute). It can be further expressed that it is the settlor's intention that this person be a directing party [as applicable: distribution trust advisor, investment trust advisor, or trust protector] within the meaning of 760 ILCS 5/16.3.

(1) Note: distribution trust advisors and investment trust advisors (but not a trust protector) have default powers under the statute, unless the terms of the governing instrument provide otherwise.

ii. Direct the trustee and other directing parties to follow (act or omit to act only upon) the directions of the subject directing party. It can be further expressed that it is the settlor's intention that this non-directing person is to be (and other directing parties are also by application) an excluded fiduciary within the meaning of 760 ILCS 5/16.3.

iii. Express whether the directing party is acting in a fiduciary capacity or non-fiduciary capacity.

(1) This could differ for each kind of directing party. For example, the investment trust advisor could be a fiduciary while the nonfiduciary capacity being assigned to the distribution trust advisor and trust protector.

iv. Provide for different trustees and directing parties for various sub-trusts.

v. Provide for succession of the directing party – just as is done for trustees.

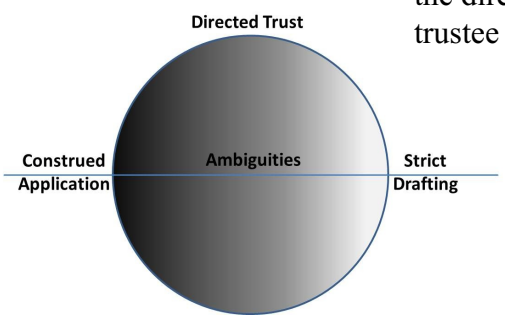
vi. Provide for the vacancy of the directing party (of role or bifurcated power) – that the trustee, in default, assumes those responsibilities and duties or some other procedure for successor appointment.

(1) In certain cases and powers, the successor should always be an independent new directing party.

(2) In other cases and powers, the successor could be the trustee.

vii. Provide for handling the circumstances in which the directing party is not being timely responsive (say, within 20 days of when the trustee sends written notice) to the requests or needs of the trustee., i.e., succession trigger or the trustee acting. Visa versa for the trustee being responsive to the directing party.

viii. Provide for any necessary tax or other failsafe or cutback provisions for the directing party (and also for the trustee should for any reason the trustee needs to act due to a vacancy of role or bifurcated power).



ix. Express the directing party's compensation and ability to hire independent counsel or agents at the expense of the trust(s) involved. Merely authorizing reasonable fees and expense reimbursement should be sufficient. This should extend beyond the directing party's activity should the directing party be dragged back into trust matters.

x. Express the directing party's entitlement to seek judicial remedy or direction at the expense of the trust.

xi. Express the trustee's compensation, considering any relief of responsibilities and risk and additional need to coordinate with the directing party. Merely authorizing reasonable fees and expense reimbursement should be sufficient.

(1) Consider whether the trust boilerplate states that a corporate trustee shall be paid based on its fee schedule, but now its responsibilities are lessened due to the directing party bifurcations.

xii. Have the directing party acknowledge acceptance of his or her role by signing the instrument – just as the trustee does.

xiii. Consider whether the governing instrument should expressly opt out of the application of "the provisions of § 16.3 of the Trusts and Trustees Act and any corresponding provision of future law."

17. Conclusion.

a. Just as the Illinois Powers of Attorney Act was amended several times after its effective date, it's probable that the Directed Trusts Act will need some tweaking.

b. There are few safeguards built into the Illinois directed trusts law. It will be very easy for poor design or drafting to create problematic issues of ambiguity, bifurcated conflict, and adverse tax issues for the interested directing party.

i. Arguably, the United States has the best form of government designed by man: three branches of government with checks and balances. However, the beauty of the government comes with a mess of process and difficulties of consensus and governing. Just as two or more trustees can be deadlocked or provide safeguards, for good and bad bifurcating trustee roles between directing parties can be genius or curse. The genius will be bettered with better drafting. The curse will be worsened by poor design and poor drafting.

c. The statute increases fiduciary status and need for fiduciary processing.

i. This will be especially acute for pre-1/1/13 trusts where the sleepy "advisor" is now elevated to directing party status with fiduciary capacity.

d. We will be learning many lessons in applying and construing excluded fiduciary status and situations. It is the *Holy Grail* to be clearly classified as an excluded fiduciary.

e. We should be drafting more squarely and strictly into the directed trusts statute.

f. Bifurcating trustee powers of directed trusts should be viewed like a black box or the fabled Pandora's Box and should be opened (exercised) with very thoughtful caution of creating strict directing parties and excluded fiduciaries or then acceptance of what it may mean to be a construed structure.

g. The mantra of the wise trustee has been and will continue to be better "process." The mantra of the wise "directing party" should also be *process* – after all, a directing party is just a trustee with a split personality. If later questioned or criticized, your explanation and defense is not just the what and why, but the methodology and process.

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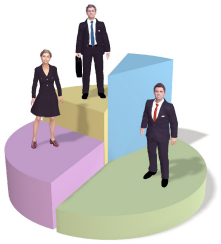

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EXHIBIT

Illinois Trust and Trustees Act

760 ILCS 5/16.3 and 16.7 – Directed Trusts

§ 16.3(a) Definitions. In this Section:

(1) "Directing party" means any investment trust advisor, distribution trust advisor, or trust protector as provided in this Section.

(2) "Distribution trust advisor" means any one or more persons given authority by the governing instrument to direct, consent to, veto, or otherwise exercise all or any portion of the distribution powers and discretions of the trust, including but not limited to authority to make discretionary distribution of income or principal.

(3) "Excluded fiduciary" means any fiduciary that by the governing instrument is directed to act in accordance with the exercise of specified powers by a directing party, in which case such specified powers shall be deemed granted not to the fiduciary but to the directing party and such fiduciary shall be deemed excluded from exercising such specified powers. If a governing instrument provides that a fiduciary as to one or more specified matters is to act, omit action, or make decisions only with the consent of a directing party, then such fiduciary is an excluded fiduciary with respect to such matters.

(4) "Fiduciary" means any person expressly given one or more fiduciary duties by the governing instrument, including but not limited to a trustee.

(5) "Governing instrument" refers to the instrument stating the terms of a trust, including but not limited to any court order or nonjudicial settlement agreement establishing, construing, or modifying the terms of the trust in accordance with Section 16.1, 16.4, or 16.6 or other applicable law.

(6) "Investment trust advisor" means any one or more persons given authority by the governing instrument to direct, consent to, veto, or otherwise exercise all or any portion of the investment powers of the trust.

(7) "Power" means authority to take or withhold an action or decision, including but not limited to an expressly specified power, the implied power necessary to exercise a specified power, and authority inherent in a general grant of discretion.

(8) "Trust protector" means any one or more persons given any one or more of the powers specified in subsection (d), whether or not designated with the title of trust protector by the governing instrument.

(b) Powers of investment trust advisor. An investment trust advisor may be designated in the governing instrument of a trust. The powers of an investment trust advisor may be exercised or not exercised in the sole and absolute discretion of the investment trust advisor, and are

binding on all other persons, including but not limited to each beneficiary, fiduciary, excluded fiduciary, and any other party having an interest in the trust. The governing instrument may use the title "investment trust advisor" or any similar name or description demonstrating the intent to provide for the office and function of an investment trust advisor. Unless the terms of the governing instrument provide otherwise, the investment trust advisor has the authority to:

(1) direct the trustee with respect to the retention, purchase, transfer, assignment, sale, or encumbrance of trust property and the investment and reinvestment of principal and income of the trust;

(2) direct the trustee with respect to all management, control, and voting powers related directly or indirectly to trust assets, including but not limited to voting proxies for securities held in trust;

(3) select and determine reasonable compensation of one or more advisors, managers, consultants, or counselors, including the trustee, and to delegate to them any of the powers of the investment trust advisor in accordance with subsection (b) of Section 5.1; and

(4) determine the frequency and methodology for valuing any asset for which there is no readily available market value.

(c) Powers of distribution trust advisor. A distribution trust advisor may be designated in the governing instrument of a trust. The powers of a distribution trust advisor may be exercised or not exercised in the sole and absolute discretion of the distribution trust advisor, and are binding on all other persons, including but not limited to each beneficiary, fiduciary, excluded fiduciary, and any other party having an interest in the trust. The governing instrument may use the title "distribution trust advisor" or any similar name or description demonstrating the intent to provide for the office and function of a distribution trust advisor. Unless the terms of the governing instrument provide otherwise, the distribution trust advisor has authority to direct the trustee with regard to all decisions relating directly or indirectly to discretionary distributions to or for one or more beneficiaries.

(d) Powers of trust protector. A trust protector may be designated in the governing instrument of a trust. The powers of a trust protector may be exercised or not exercised in the sole and absolute discretion of the trust protector, and are binding on all other persons, including but not limited to each beneficiary, investment trust advisor, distribution trust advisor, fiduciary, excluded fiduciary, and any other party having an interest in the trust. The governing instrument may use the title "trust protector" or any similar name or description demonstrating the intent to provide for the office and function of a trust protector. The powers granted to a trust protector by the governing instrument may include but are not limited to authority to do any one or more of the following:

(1) modify or amend the trust instrument to achieve favorable tax status or respond to changes in the Internal Revenue Code, federal laws, State law, or the rulings and regulations under such laws;

(2) increase, decrease, or modify the interests of any beneficiary or beneficiaries of the trust;

(3) modify the terms of any power of appointment granted by the trust; provided, however, such modification or amendment may not grant a beneficial interest to any individual, class of individuals, or other parties not specifically provided for under the trust instrument;

(4) remove, appoint, or remove and appoint, a trustee, investment trust advisor, distribution trust advisor, another directing party, investment committee member, or distribution committee member, including designation of a plan of succession for future holders of any such office;

(5) terminate the trust, including determination of how the trustee shall distribute the trust property to be consistent with the purposes of the trust;

(6) change the situs of the trust, the governing law of the trust, or both;

(7) appoint one or more successor trust protectors, including designation of a plan of succession for future trust protectors;

(8) interpret terms of the trust instrument at the request of the trustee;

(9) advise the trustee on matters concerning a beneficiary; or

(10) amend or modify the trust instrument to take advantage of laws governing restraints on alienation, distribution of trust property, or to improve the administration of the trust.

If a charity is a current beneficiary or a presumptive remainder beneficiary of the trust, a trust protector must give notice to the Attorney General's Charitable Trust Bureau at least 60 days before taking any of the actions authorized under item (2), (3), (4), (5), or (6) of this subsection. The Attorney General's Charitable Trust Bureau may, however, waive this notice requirement.

(e) Duty and liability of directing party. A directing party is a fiduciary of the trust subject to the same duties and standards applicable to a trustee of a trust as provided by applicable law unless the governing instrument provides otherwise, but the governing instrument may not, however, relieve or exonerate a directing party from the duty to act or withhold acting as the directing party in good faith reasonably believes is in the best interests of the trust.

(f) Duty and liability of excluded fiduciary. The excluded fiduciary shall act in accordance with the governing instrument and comply with the directing party's exercise of the powers granted to the directing party by the governing instrument. Unless otherwise provided in the governing instrument, an excluded fiduciary has no duty to monitor, review, inquire, investigate, recommend, evaluate, or warn with respect to a directing party's exercise or failure to exercise any power granted to the directing party by the governing instrument, including but not limited to any power related to the acquisition, disposition, retention, management, or valuation of any asset or investment. Except as otherwise provided in this Section or the governing

instrument, an excluded fiduciary is not liable, either individually or as a fiduciary, for any action, inaction, consent, or failure to consent by a directing party, including but not limited to any of the following:

(1) if a governing instrument provides that an excluded fiduciary is to follow the direction of a directing party, and such excluded fiduciary acts in accordance with such a direction, then except in cases of willful misconduct on the part of the excluded fiduciary in complying with the direction of the directing party, the excluded fiduciary is not liable for any loss resulting directly or indirectly from following any such direction, including but not limited to compliance regarding the valuation of assets for which there is no readily available market value;

(2) if a governing instrument provides that an excluded fiduciary is to act or omit to act only with the consent of a directing party, then except in cases of willful misconduct on the part of the excluded fiduciary, the excluded fiduciary is not liable for any loss resulting directly or indirectly from any act taken or omitted as a result of such directing party's failure to provide such consent after having been asked to do so by the excluded fiduciary; or

(3) if a governing instrument provides that, or for any other reason, an excluded fiduciary is required to assume the role or responsibilities of a directing party, or if the excluded party appoints a directing party or successor to a directing party, then the excluded fiduciary shall also assume the same fiduciary and other duties and standards that applied to such directing party.

(g) Submission to court jurisdiction; effect on directing party. By accepting an appointment to serve as a directing party of a trust that is subject to the laws of this State, the directing party submits to the jurisdiction of the courts of this State even if investment advisory agreements or other related agreements provide otherwise, and the directing party may be made a party to any action or proceeding if issues relate to a decision or action of the directing party.

(h) Duty to inform excluded fiduciary. Each directing party shall keep the excluded fiduciary and any other directing party reasonably informed regarding the administration of the trust with respect to any specific duty or function being performed by the directing party to the extent that the duty or function would normally be performed by the excluded fiduciary or to the extent that providing such information to the excluded fiduciary or other directing party is reasonably necessary for the excluded fiduciary or other directing party to perform its duties, and the directing party shall provide such information as reasonably requested by the excluded fiduciary or other directing party. Neither the performance nor the failure to perform of a directing party's duty to inform as provided in this subsection affects whatsoever the limitation on the liability of the excluded fiduciary as provided in this Section.

(i) Reliance on counsel. An excluded fiduciary may, but is not required to, obtain and rely upon an opinion of counsel on any matter relevant to this Section.

(j) Applicability. On and after its effective date, this Section applies to:

(1) all existing and future trusts that appoint or provide for a directing party, including but not limited to a party granted power or authority effectively comparable in substance to that of a directing party as provided in this Section; or

(2) any existing or future trust that:

(A) is modified in accordance with applicable law or the terms of the governing instrument to appoint or provide for a directing party; or

(B) is modified to appoint or provide for a directing party, including but not limited to a party granted power or authority effectively comparable in substance to that of a directing party, in accordance with (i) a court order, or (ii) a nonjudicial settlement agreement made in accordance with Section 16.1, whether or not such order or agreement specifies that this Section governs the responsibilities, actions, and liabilities of persons designated as a directing party or excluded fiduciary.

(Source: P.A. 97-921, eff. 1-1-13.)

§ 16.7. Application. Section 16.3 applies to all trusts in existence on the effective date of this amendatory Act of the 97th General Assembly or created after that date. Section 16.3 shall be construed as pertaining to the administration of a trust and shall be available to any trust that is administered in Illinois under Illinois law or that is governed by Illinois law with respect to the meaning and effect of its terms, except to the extent the governing instrument expressly prohibits that Section by specific reference to that Section. A provision in the governing instrument in the form: "The provisions of Section 16.3 of the Trusts and Trustees Act and any corresponding provision of future law may not be used in the administration of this trust" or a similar provision demonstrating that intent is sufficient to preclude the use of Section 16.3.

(Source: P.A. 97-921, eff. 1-1-13.)