SELECTED ISSUES UNDER THE LOUISIANA TRUST CODE

17TH ANNUAL TULANE ESTATE PLANNING INSTITUTE
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In this paper all references to "Sections" are references to articles of the Louisiana Trust Code, La. R.S. 9:1721-2252.

A. A Reminder of Louisiana's Unique History Regarding Private Trusts

1. Introduction.

Under the influence of the civilian redactors of our Civil Code, private trusts for a long time were entirely prohibited in Louisiana. Trusts, as developed in the equity courts of England, involve a dual ownership: legal title in the trustee; beneficial rights in the beneficiary. The civil law countries of Europe have never been comfortable with that concept, and even in Louisiana, where we are greatly influenced by our trust-loving sister states, we were slow to permit trusts, and our law of trusts continues to be less flexible than the trust laws of the other states.

2. Civil Law Concepts Hostile to Private Trusts in Louisiana.

Trusts were deemed to be *fidei commissa* (a Roman-law concept understood to prohibit the dual ownership inherent in the trust) which were forbidden by law (Civil Code article 1520, prior to amendment in 1962);

Trusts often resulted in deferred vesting of ownership rights, contrary to the civilian requirement of immediate vesting (see, *e.g*., Civil Code article 935);

Trusts sometimes involved "willing through a third party", which is generally forbidden (see Civil Code article 1572).

Trusts seemed to violate the rule against substitutions (see Civil Code Article 1520).

3. Adoption of the Private Trust in Louisiana

In 1920 private trusts were first allowed, but for no more than 10 years after the donor's death or the beneficiary's majority. That law was repealed in 1935.

In 1938 the Trusts Estates Law was adopted, with the same 10-year restriction.

In 1952 trusts were allowed to continue for the life of the beneficiary.

In 1962 the Constitution was amended to delete the prohibition of *fidei commissa*, and to authorize substitutions in trust.

In 1964 the Louisiana Trust Code was enacted, a very modern trust law, similar (and in some respects superior to) the laws of other states, but differing from them in an important respect:

A primary rule of the Trust Code is that interests in trust must vest upon creation of the trust (no "contingent remainders" and no "powers of appointment"). See Sections 1803, 1971 and 2025. As a corollary rule, upon the death of a principal beneficiary his interest must pass to his heirs or legatees. Section 1972.

The Trust Code made an exception for "class trusts", where if a class member was in existence at the creation of the trust other members of the class born or adopted later could be added. Sections 1891, *et seq*. The history of the Trust Code since then has been largely a history of gradually carving out additional exceptions to the rule of immediate vesting of interests.

B. Proposals Being Developed by the Trust Code Committee of the Louisiana State Law Institute.

The Trust Code Committee of the Law Institute has been in continuous existence since the 1960s, meting from time to time to consider improvements in the Trust Code. Some improvements relate to the vesting issues, but many relate to other aspects of trust design and administration. The following are proposals that the Committee is preparing to present to the Council of the Law Institute. Comments on these proposals, and on other Louisiana Trust Code issues, are welcome.

1. <u>Duties of the Trustee of a Revocable Trust.</u>

Unlike donations free of trust, a donation in trust can revocable. Since the donation to a revocable trust is not really a completed gift, it seems that as long as the trust is revocable the duties of the trustee should be solely to the settlor of the trust. With that thought in mind, Section 2088A was amended in 2001 to provide that "If the trust is revocable, the trustee has a duty to account to the settlor only." But what about a beneficiary's right to obtain information (Section 2089), or to bring suit against the trustee (Section 2221)?

Believing that the rule of Section 2088A should have broader application, the Committee proposes to eliminate the specific rule in 2088A, and to replace it with a broader rule in a new Section 2047, reading as follows:

> Unless the trust instrument provides otherwise, while a trust is revocable the duties of the trustee are owed exclusively to the settlor.

This proposed rule would apply even if the settlor should be incompetent. In that situation the settlor's rights can be exercised by his agent or curator.

2. <u>Delegation of Right to Revoke and/or Amend.</u>

Consistent with the vesting rule, the Trust Code has long stated that a settlor may not delegate to another person the power to modify provisions of a trust instrument other than the administrative provisions. Section 2025. The Trust Code has also long stated that if the settlor has the power to revoke a trust, he thereby reserves the right to modify the trust. Section 2022.

Section 2045 was amended in 2001 to allow a settlor to delegate to a third party the right to revoke a trust. There was no intention to give to the delegate the power to amend the trust, but Section 2045, when read with Section 2022, could have been read to permit such a delegation. The Committee proposes to modify Section 2045 to make it clear that a delegated power to revoke does not include the power to amend.

3. Limited Power of Appointment.

In other states trust settlors routinely include in their trusts "powers of appointment", under which persons other than the settlor determine who will ultimately receive some of the benefits of the trust. Section 2025 of the Trust Code, consistent with Civil Code article 1572, generally does not permit powers of appointment, although the following may be seen as exceptions to that rule:

- Section 1961C allows the trust instrument to give a trustee (who is not a beneficiary) the authority to allocate income among the designated income beneficiaries, with or without objective standards.
- Section 2024 provides that "all surviving competent settlors must concur in a modification of the trust." This appears to permit the trust instrument to allow a surviving settlor to modify the provisions of a trust even as to the interest of a deceased settlor.
- Section 2045 allows delegation of the right to revoke, which can change who gets the corpus of the trust.

One type of power of appointment routinely drafted elsewhere is to make the surviving spouse the initial beneficiary, and give her the power to "appoint" the corpus; and in the absence of the exercise of the power the corpus goes to the descendants of the settlor. Many Louisiana individuals would like to give their surviving spouse their entire estate, but, in order to get the benefit of the "applicable credit amount' (a/k/a "the unified credit") under Section 2010 of the Internal Revenue Code ("IRC"), thereby reducing the overall U.S. estate tax, they give the spouse only an income interest in part of their estate. If the spouse were given a power to appoint among the descendants, the spouse would have something closer to full ownership without foregoing the use of the unified credit.

As a small step toward allowing powers of appointment, the Committee proposes to add to the Trust Code a new Section 2031, which would read as follows:

> §2031. Delegation of Right to Amend.
>
> A trust instrument may authorize a person other than the settlor to modify the provisions of the trust instrument in order to add or subtract beneficiaries, or modify their rights, if all the affected beneficiaries are descendants of the person given the power to modify.

Under this provision, for example, a married person could put property in trust for the surviving spouse as income beneficiary, and their joint children as principal beneficiaries, and could authorize the spouse to modify the trust to change the percentage interests of the children, even to add more remote descendants. In this manner the surviving spouse, if also named as trustee, has rights that come very close to full ownership but without losing the ability to exempt this part of the first spouse's estate from being taxed at either spouse's death.

4. Allowing a Class Trust When No Member of the Class is in Being.

As noted, the Trust Code, unlike the trust laws of the other states, requires that a principal beneficiary's interest be vested. *See* Sections 1971 and 1972. There are some exceptions to this requirement:

- If the trust is for the benefit of a class, persons born or adopted into the class after the creation of the trust become beneficiaries, and thereby dilute the interests of the original beneficiaries. Section 1891.

- If a principal beneficiary dies without descendants, the trust instrument can substitute others for him. Sections 1973, 1895.

A settlor can create a trust "in favor of a class consisting of some or all of his children, grandchildren, great-grandchildren, nieces, nephews, grandnieces, grandnephews, and great-grandnieces and great-grandnephews, or any combination thereof . . . ." Section 1891A.

To preserve the principle of immediate vesting, however, Section 1891A requires that upon the creation of the trust "at least one member of the class is then in being." This requirement is unique to Louisiana and presents some awkward design problems.

If a settlor has at least one child in being, presumably a trust could be set up for the settlor's children, grandchildren and great-grandchildren, with the division of the interests in the trust being done in such a way as to favor the youngest generation. (Support for the concept that the interests of the members of a class trust do not have to be equal, by heads or by roots, is found in Section 1891B.) Presumably, however, any person who starts out being a member of the class would have to remain a member of the class to some meaningful degree (1%?).

If a person wishes to establish a class trust for descendants, and has not yet had a child (or wants to favor only a younger generation that has not yet come into being), he can not create the trust under Louisiana law and has to set it up in another state.

The Trust Code Committee has wrestled with this issue and come up with the concept of an "empty class". This builds on the following concepts:

- As long as there is a valid designation of an income beneficiary, a trust is valid. *See* Section 1802, Comment (c).

- Section 1900 provides that if a class is the sole beneficiary of income, and the class becomes empty, "the income of a trust shall be accumulated until there is a member of the class or the class closes. If the class closes and there is no member of the class, the accumulated income shall be distributed to the beneficiaries of principal."

- Sections 2011 *et seq*. now permit a revocable trust to defer the designation of a beneficiary until the trust becomes irrevocable. If, at the time the trust becomes irrevocable, there is no effectively designated principal beneficiary, the settlor's estate is the principal beneficiary.

The following is a possible two-step approach towards creating an empty class trust. (This has not been blessed by the Council or even the Trust Code Committee of the Law Institute.)

Step One: Amend Section 1891A by restating the first sentence by the addition of the words that appear in italics below:

> Notwithstanding the provisions of R.S. 9:1803, R.S. 9:1831 through 1835, and R.S. 9:1845 through 1847, but subject to restrictions stated in this Subpart, a person may create an inter vivos or testamentary trust in favor of a class consisting of some or all of his children, grandchildren, great grandchildren, nieces, nephews, grandnieces, grandnephews, and great grandnieces and great grandnephews, or any combination thereof, *by blood or adoption*, although some members of the class are not yet in being at the time of the creation of the trust. *Except as provided in R.S. 9:1892, at least one member of the class must be in being upon the creation of the trust.* Such trust is called a class trust. If the trust instrument so provides, the interest of each beneficiary in the class shall be held as a separate trust after the class has closed.

Current Section 1892 states that beneficiaries of the class can include descendants "whether by blood or adoption". Since the Committee's proposal would require usurping Section 1892 for another purpose, the words "by blood or adoption" would be inserted above in Section 1891.

Step Two: Restate Section 1892 to read as follows:

> **§1892. Empty Class Permitted**
>
> A class trust may be the beneficiary of trust principal even though none of the persons identified as members of the class are yet in being. There must, however, be someone entitled to trust income at all times, subject to R.S. 9:1900. So long as it is possible for a person to be born or adopted into the designated class, the trust shall not terminate. If there is but one member of the class and he dies under circumstances where the trust instrument provides for substituting other members of the class, the trust instrument may provide that the class is temporarily empty until another member of

> the class comes into being. If there are no members of the class at the time when it becomes impossible for any class member to be born or adopted into the class, the principal beneficiaries of the trust shall be determined as follows: pursuant to the trust instrument; or, if the trust instrument is silent, to the heirs or legatees of the most recently deceased member of the class, if any; otherwise, the heirs or legatees of the settlor. The person or persons substituted by the trust instrument for the class must meet the requirements for a substitute under R.S. 9:1973-1978.

Note the estate tax exposure where a member of the class dies and there is no substitution: The value of the deceased class-member's interest in the trust is included in his taxable estate, but if the class is not yet closed the interest could be reduced by later additions and there is no way to get the estate tax out of the trust. The proposed change does not create this problem but could make it worse, in the unlikely event that the deceased beneficiary has a taxable estate.

5. Can a Non-Class Member Share in a Trust That Has a Class As Its Beneficiary?

Obviously, the sole point of a class trust is that the interest is set aside for a statutorily defined group. No one outside the permitted group can be allowed to share in that portion of the trust. However, if a single trust is created that provides separate shares for a class and for one or more other beneficiaries, the trust should be valid. In order to make that clear, the Committee is recommending a restatement of Section 1893 so that it would read as follows:

> A class trust may be created with respect to all or a portion of income or principal, or both, but the members of the class must always be the sole beneficiaries as to the portion of the trust of which they are beneficiaries.

6. Non-Exercise of Withdrawal Right.

The Trust Code allows a trust instrument to permit beneficiaries to have a withdrawal right. Section 2068A. Many trusts grant limited rights to withdraw amounts donated to the trust. This could be a "Crummey" power designed to qualify the gifts to the trust for the annual exclusion from taxable gifts, under IRC §2503. Or it might be a "5 and 5 power" – blessed by IRC §2041(b)(2) and §2514(e)– under which a beneficiary has a power to withdraw up to 5% of the trust during a limited period of time each year without causing the unwithdrawn funds to be taxable.

The question has arisen whether a withdrawal power makes the beneficiary a donor to the trust, so that any spendthrift protection would not apply to the amount that was available to withdraw. In order to allow spendthrift protection to apply to the funds not withdrawn, the Committee proposes to amend Section 2004 to add the following sentence:

A beneficiary will not be deemed to have donated property to a trust merely because he fails to exercise a right of withdrawal from the trust.

7. Early Termination of a Trust.

A present Sections 2026 through 2028 of the Louisiana Trust Code provide as follows:

§2026 Change of Circumstances:

The proper court may order the termination or modification of a trust, in whole or in part, if:

(1) The continuance of the trust unchanged would defeat or substantially impair the purposes of the trust.

(2) [lengthy provisions for terminating when the value of the trust is less than $100,000].

§2027 Accomplishment of purposes becoming impossible or illegal

The proper court may order the termination or modification of the trust if the purpose for which it is created becomes impossible of accomplishment or illegal.

§2028 Concurrence of settlors in termination

The consent of all settlors, trustees, and beneficiaries shall not be effective to terminate the trust or any disposition in trust, unless the trust instrument provides otherwise.

Before a 1997 amendment, Section 2026 allowed an early termination to occur only if the trust purpose was impaired due to "circumstances not known to a settlor and not anticipated by him." The apparent intention in 1997 was to modify this section to eliminate the reference to a change not being anticipated by the settlor, but a change in circumstances was still to be required. Thus the title of Section 2026 remains "Change of Circumstances", and the comment to the 1997 revision states that "Under the revision a petitioner for modification or termination must still show a change of circumstances." However the Legislature ultimately amended Section 2026 so that it no longer refers to a change of circumstances.

It is common for a court to order an early termination of a trust if all the interested parties – all living settlors, if any, all beneficiaries, and all trustees – agree. The Committee recommends changing Section 2026 again, not only to eliminate the residual reference to "change of circumstances", but also to more liberally allow termination when all parties agree, thus making the law match more closely the practice.

In addition, the Committee recommends eliminating current Section 2027, as being unnecessary, moving the provision on termination of small trusts into Section 2027, and permitting the termination of small trusts in some circumstances to occur by agreement, without having to go to the trouble of getting a court order. Section 2028 would not change, except to make the title clearer, and to recognize the exception that Section 2027 would set forth.

The result is that Sections 2026 through 2028 would be restated to read as follows:

> **§2026 Termination or Modification by the Court**
>
> The proper court may order the termination or modification of the trust, in whole or in part, if the court determines that the action is in the best interest of the beneficiaries taking into account the purposes of the trust. All beneficiaries, living settlors and trustees must agree to the action or be notified and given the opportunity to object.
>
> **§2027 Termination of Small Trusts**
>
> Except as otherwise provided by the trust instrument, the proper court may order the termination of a trust if the trustee has determined that the market value of the trust's assets is less than $100,000 and that, in relation to the cost of administration of the trust, the continuation of the trust unchanged would defeat or substantially impair the purposes of the trust. All beneficiaries, living settlors and trustees must agree to the action or be notified and given the opportunity to object. If the trustee and all settlors and beneficiaries are in agreement, the termination may occur without the intercession of the court.
>
> **§2028 Termination by agreement not permitted**
>
> Except as provided in R.S. 9:2027, the consent of all settlors, trustees, and beneficiaries shall not be effective to terminate the trust or any disposition in trust, unless the trust instrument provides otherwise.

C. Other Issues

1. <u>Can a Person Be Both the Sole Beneficiary and the Sole Trustee of a Trust?</u>

There is no question that a beneficiary of a trust can be a trustee of the trust. Section 1783A(1). But can he be both the sole beneficiary and the sole trustee of the trust?

By its very nature, a trust is a relationship, where one person, the trustee, holds title to assets for the benefit of another person, the beneficiary. Section 1731 reads as follows:

> A trust, as the term is used in this Code, is the relationship resulting from the transfer of title to property to a person to be administered by him as a fiduciary for the benefit of another.

Two people could be both the sole trustees and the sole beneficiaries of the trust; they have fiduciary duties to each other. But one person being the sole beneficiary and the sole trustee has no fiduciary duties; therefore, if the trust instrument designates him as such, his situation is equivalent to that of an outright owner. See Bogert, *Trusts and Trustees* §129.

In practice, this is rarely going to be an issue:

During the life of the trustee/beneficiary, that person will be signing all documents in any event so that he not only binds the trust but also himself personally.

After the death of the person who is the sole beneficiary and trustee, and if the trust is to continue, at that point there is a separate trustee. Even if he is not yet appointed, the trust may have validity from that point forward. *See* Section 1785.

However, during the time that a person is both sole beneficiary and sole trustee, is the property of the trust subject to seizure by creditors despite any spendthrift language in the instrument?

2. <u>Substitution of Beneficiary's Children As Principal Beneficiaries</u>

As mentioned, the general rule under the Trust Code is that the principal beneficiary is determined when the trust is created, and when the principal beneficiary dies his interest in the trust "vests in his heirs or legatees". Sections 1971 and 1972.

As an exception to that rule, Section 1973 states that a trust instrument can provide that if an original principal beneficiary dies intestate and without descendants, or (if the forced portion is not in trust) dies without descendants, someone else designated in the trust instrument is substituted for that beneficiary. The successors can even be determined at the death of the original beneficiary (not at creation of the trust), if the substitute beneficiaries are descendants of the settlor. Section 1978. See also R.S. 9:1895, for substitutions in class trusts.

If, however, the original principal beneficiary dies <u>with</u> descendants, there is no authority in the Trust Code for a substitution. Therefore the interest of the principal beneficiary must, under Section 1972 or Section 1895, pass through the beneficiary's estate to his heirs or legatees. This raises two issues: (1) What happens if a trust instrument tries to substitute the children of the deceased beneficiary; and (2) Should the law be changed to allow such a substitution?

Issue One. Despite the lack of authority for such a provision in the Trust Code, it is not uncommon to see a Louisiana trust instrument provide, upon the death of a principal beneficiary during the term of the trust with one or more children surviving him, that those children are automatically substituted as the beneficiaries.

What is the effect of such an invalid provision?

Is the trust entirely invalid? In *Chrichton v. Succession of Gredler,* 235 So. 2d 911 (La. Sup. Ct. 1970), a trust with a similar design was entirely invalidated. The decision was criticized (Note, 31 La. L. Rev. 404). The Court failed to take notice of comment (c) to Section 1802, which mentions that a trust is valid as long as it has a validly identified income beneficiary or principal beneficiary. Although not entirely clear, it is possible that the income provisions of the trust were valid, in which event the trust should not have been entirely invalidated.

Is the trust valid but the designation of principal beneficiary is entirely invalid? This is a possible but unlikely result. A court reaching this result would reason that the trust provisions have the earmarks of a prohibited substitution, in that one person is instituted as principal beneficiary, and another beneficiary is substituted, and since the substitution is not authorized by the Trust Code it fails under Civil Code article 1520. (Compare Section 1723, which validates a substitution that might be otherwise prohibited, *if* it is authorized by the Trust Code.) Thus, while the income provisions might be given effect, there is no effectively-designated principal beneficiary. The result, presumably, would be that the settlor, or the settlor's legal heirs, would be the principal beneficiaries.

Will the court simply invalidate the shift? This seems the most likely result, based on Section 2251, which states that "if a provision in the trust instrument is invalid for any reason, the intended trust does not fail, unless the invalid provision can not be separated from the other provisions without defeating the purpose of the trust." See, further, Martin, *Louisiana's Law of Trusts 25 Years After Adoption of the Trust Code,* 50 La. L. Rev. 501, at 526 (1989). If only the substitution is invalidated, the original principal beneficiary's interest in the trust passes through his estate to his heirs or legatees. Those heirs or legatees might be the children of the original principal beneficiary, but not necessarily so.

Issue Two. Should the Trust Code be amended to allow a shift from a principal beneficiary to the descendants of the beneficiary? For 3 reasons, it seems that the Trust Code should allow such a shift:

i. First, it seems that disallowing a shift only if the beneficiary has descendants is designed to protect the beneficiary's issue. But since the beneficiary can leave it to whomever he wishes, the protection is by no means guaranteed. Thus, a shift is forbidden only in the one case where it seems most beneficial to preserve the Trust Code's policy of protecting children.

ii. Second, in 1964, when the Trust Code was enacted, and even in 1974 when Section 1973 was added, forced heirship was still a strong force in Louisiana, and therefore provided some assurance that the children of the beneficiary would benefit no matter what the beneficiary's will provided.

iii. Third, it appears that if a substitution is allowed under every circumstance, that is, whether the beneficiary has issue or not, the interest of the beneficiary can be excluded from his taxable estate. The only exception would be the now-unusual case where the beneficiary is a forced heir of the settlor, so that a substitution would not be allowed if the beneficiary dies testate.

Such a substitution could be permitted by amending Section 1973 to add a Paragraph C that reads as follows (a similar change could be made in Section 1895):

> The trust instrument may provide that the interest of a principal beneficiary who dies survived by one or more descendants of his passes to some or all of the beneficiary's descendants, each of whom shall be a substitute beneficiary. If the substitute beneficiaries are descendants of the settlor, they can be determined as of the date of the deceased beneficiary's death.

3. Can a Trust Exist Without Assets?

It is not uncommon in other states for a trust settlor to sign a document establishing a trust, and sign separately a document that actually delivers assets to the trust. Can a trust be established that way in Louisiana?

Section 1731 reads as follows:

> **§1731. Trust Defined**
>
> A trust, as the term is used in this Code, is the relationship resulting from the *transfer* of title to property to a person to be administered by him as a fiduciary for the benefit of another. (emphasis added)

Thus, the very definition of a trust contemplates that there is a transfer of title to property in order to create the trust. It could very well be that a purported creation of a trust without an asset is not a valid trust, so that nothing can be added to it. Section 1731 allows additions "to an existing trust".

Section 1881 specifically allows a trust for proceeds of a life insurance policy, implying that the trust is valid even though the trustee has no title to the insurance policy and the trust has no other assets. This appears to be an exception to the general rule that there has to be a transfer in order to create the trust.

Perhaps the trust is valid if the transfer occurs at the same time as the trust document is signed, so that the two documents can be read together as creating a valid trust.

4. Should a Conduit Trust Be Used For IRA Benefits?

Distributions from an individual retirement account (IRA) or an account in a qualified plan are generally taxable to the recipient as ordinary income. IRC §402(a) and §408(d)(1). (Roth accounts are an important exception. IRC §408A(d).) This is true even after the death of the participant who owns the account. IRC §691. Therefore, it is desirable to be able to defer taxable withdrawals from an IRA or qualified plan, if not needed. IRC §401(a)(9) requires payments normally to begin by April 1 following the year in which the participant reaches age 70-1/2 (the "required beginning date", or "*RBD*"), and requires that the amount distributed each year, starting that year, be at least equal to the minimum required distribution" ("*MRD*").

After the death of a participant, the *normal rule* is that the benefit must be paid out over no more than five years if the participant dies *before* his RBD, and no later than over the life expectancy that the participant had in the year of his death, if death occurs *after* the participant's RBD. However, if there is a "*designated beneficiary*", the payments can be made over the life expectancy of the designated beneficiary, regardless of whether death occurs before or after the RBD.

If a trust is the beneficiary, the "designated beneficiary" to determine the MRDs is the beneficiary of the trust who is the oldest individual (*i.e.*, the individual with the shortest life expectancy). Reg. §1.401(a)(9)-5, A-7.

If the trust has one or more beneficiaries who are not individuals, then the trust is deemed to have no "designated beneficiary", and therefore the normal rules apply, meaning benefits must be paid out - and taxed - more rapidly.

Trusts in other states often have contingent beneficiaries who might very well not be individuals; they might be charities for example, or they might be determined under procedures that make it impossible to determine who is the oldest possible beneficiary. In Louisiana this would not normally be a problem.

The regulations state that an individual will be recognized as the "designated beneficiary", even if other beneficiaries may be substituted later, if the trust is designated as a "*conduit trust*" under which all the payments from the account have to be paid out to the individual during the individual's life, and nothing from the account is accumulated in the trust. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 2.

Because the usual non-Louisiana trust is likely to have contingent remainders that make it difficult otherwise to have a "designated beneficiary" that allows longer taxable payouts of benefits, many draftsman in other states routinely design the trust so that it qualifies as a conduit trust. Passing through all payments to a beneficiary may be desirable to avoid the high income-tax rates that apply to trusts. Nevertheless, it is not necessary to have a conduit trust to have a "designated beneficiary" for RMD purposes, if the principal beneficiary has a vested interest that passes to his heirs or legatees.

This position is supported by the following wording in the regulations:

> "A person will not be considered a beneficiary for purposes of determining who is the beneficiary [of the trust] with the shortest life expectancy under Paragraph (a) of this A-7, or whether a person who is not an individual is the beneficiary, merely because the person could become the successor to the interest of the one of the employee's beneficiaries after that beneficiary's death." Reg. §1.401(a)(9)-5, A-7(c)(1).

Unfortunately, there are no IRS rulings that support this proposition, but on the other hand, none have denied it either. See, e.g., PLR 200537049 and 200620025.

Furthermore, shouldn't the MRD rules be the same whether an individual is the outright beneficiary or is the sole beneficiary of a trust?

5. Using the Power to Adjust in a Down Market

Section 2127 requires the trustee to “invest and manage trust property as a prudent investor.” This is generally understood to require the trustee to invest for total return. A total return strategy may result in very little ordinary income. As a result Sections 2158 through 2163 were added to the Trust Code in 2001 in order to permit a trustee to “make an adjustment between principal and income when the interest of one or more beneficiaries is defined by reference to the ‘income’ of a trust, and the trustee determines, after taking into account the allocations for the year under subpart D [‘Allocations to Income and Principal’], that the adjustment is necessary in order for the trustee to satisfy his duty to be fair and reasonable to all the beneficiaries, taking into account the purposes of the trust.”

This is sometimes understood to mean that when the trust has substantial capital gains, those should be shared with the income beneficiary. If, however, the trust has substantial capital losses, is it appropriate for the trustee to continue to make adjustments from principal to income?

The answer should be, yes. It is not the total realized return of the trust that determines a distribution policy, but rather the amount that is sufficient to treat the income and principal beneficiaries fairly. For example, if inflation is expected to be 3% per annum, and the investments are expected to have a total return of 8% per annum, is not a distribution policy of up to 5% fair to both the income beneficiary and the principal beneficiary? The investment strategy of a prudent investor looks to total return, and is therefore likely to produce only a small amount of trust accounting income. The investment results for a year – gains or losses – are not really relevant.

In fact, a trustee can develop a strategy of distributing some percentage of the assets of a trust, such as 4% or 5% of the value of the trust at the start of the year, on a regular basis during the year.

Under this theory, a decline in the value of the trust during the year would not necessarily affect the amount distributed that year, but the percentage available for distribution in the following year would be based on a smaller asset base. Note that under Section 2162 a court order is required if the adjustment from principal to income causes the total income distribution to exceed 5% of the fair market value of the assets of the trust at the beginning of the year.

6. Foreign Trusts in Louisiana

By the term “foreign trust” we mean a trust created under the law of a state other than Louisiana. It is well known that trusts created under the laws of other states are often riddled with provisions that are invalid in Louisiana. As a result, on occasions such trusts have been declared completely invalid. See e.g. *Succession of Guillory*, 94 So.2d 38 (1957); *Succession of Meadors*, 135 So.2d 679 (1961). If the trust is invalid, then it cannot hold title to Louisiana immovable property.

Besides these potential substantive invalidities, a trust instrument executed under the laws of another state may not be in a form that is recognized in Louisiana. If the trust is created under a will, the Uniform Wills Act will validate the form of the trust but not its substance. R.S. 9:2401.

Act 890 of 2001, which added R.S. 9:2262.1, *et seq*., is designed to expedite holding of title to Louisiana immovable property by a foreign trust.

R.S. 9:2262.4 specifies that a trust instrument executed outside Louisiana "in conformity with the law of the place of its execution, or the law of the settlor's domicile at the time of its execution shall be deemed to be legally executed", in other words, in good form.

The sentence goes on to say that the trust instrument "shall have the same force and effect in this state as if executed in the manner prescribed by the laws of this state." This might be read as validating not only the form but the substance; however, the title to this section is "form". Furthermore, by saying that the trust would have the same force and effect as if executed in a form permitted under Louisiana law does not address the question of the validity of the substance. A trust document may be perfectly valid in form when executed in Louisiana but could have invalid substance.

Section 2092 of the Trust Code requires the trustee to record the trust instrument or an extract thereof in each parish in which immovable property held in the trust is located. R.S. 9:2262.2 likewise permits an extract of a foreign trust to be recorded instead of the trust instrument itself. An extract should include "the name or the description of the beneficiary or beneficiaries." It would seem that the extract may be prepared in a way that would not disclose to third parties the existence of provisions of the trust that would invalidate it under Louisiana law.

Nevertheless, there is nothing in this law that would validate a foreign trust and third parties must still be suspicious when a foreign trust holds Louisiana immovables.

R.S. 9:2262.3 purports to give the trustee of a foreign trust authority to sell immovable property situated in Louisiana provided that the authority of the trustee is evidenced in any manner that is lawful under the law which the parties have expressly chosen to govern the trust." This provision would again not cure the problem of a foreign trust which, because of its invalid substance, cannot be the owner of Louisiana property.

7. What Does the *Yokum* Case Mean for Trusts?

In the case of *Yokum vs. Van Calsem*, 935 S.2d 736 (La 4th Cir. 2006), the Court of Appeal held that a usufructary did not have the power unilaterally to sell property that he was usufructary of, even though the Will expressly granted him that power. The reason that he was found not to have the power is that the Judgment of Possession failed to mention it, and the default rules in the law do not give him the power.

It is quite possible that the case was wrongly decided, and some bad facts in the case may have contributed to the court reaching its decision.

If the court is correct, however, the decision could affect trusts, particularly testamentary trusts. It is not common for a Judgment of Possession to spell out every provision of the Will regarding the trustee's powers. Suppose, for example, that the Will names two trustees and authorizes either to act alone in selling property, but the Judgment of Possession says nothing about that. Since Section 2113 says that if there are two or more trustees the powers must be exercised by both unless the trust instrument provides otherwise, a sale by just one trustee might be attacked as unauthorized,

Taking *Yokum* into account, it would be wise to set forth in the Judgment of Possession (or in the transfer of property by an independent executor) all the powers of the trustee that deviate from the default rules in the Trust Code.

8. <u>Liability of Trustees versus Liability of Beneficiaries.</u>

The Trustee owns the assets of the trust and incurs personal liability when he incurs a trust obligation. However, the assets of the trust are there to satisfy the obligation. If it should happen that the assets of the trust insufficient to satisfy its liabilities, the trust may have to make up the difference.

What happens if the trust terminates and the assets are distributed but the liabilities are not paid? In the case of *Federal Deposit Insurance Corporation vs. Lewis*, 21 F.3d 89 (5th Cir. 1994), the court held that there was nothing in the Trust Code that authorized collection of claims by a trust creditor from the beneficiaries after the termination of the trust. Nor did the court allow a claim for undue enrichment because one of the elements of such a claim was not satisfied, namely that there would be no other remedy. The court held that there was a remedy against the trustee and therefore the FDIC could not collect from the beneficiaries.

It may be that the Trust Code should be amended to make it clear that when the assets of a trust are distributed its obligations go with the assets. At the least, a trustee should make sure that the liabilities are transferred, so that the trustee does not get stuck holding the liabilities with no assets to pay them from.

A provision of some relevance to this is Section 2069 of the Trust Code, added in 1995, which provides that after a trust terminates the trustee has the power to continue to manage the assets to the extent necessary in order to arrange for their delivery to the beneficiaries as soon as possible.

D. Changes in Charitable Trust Law

Louisiana has had a *charitable* trust law since 1882. It was amended from time to time but was not restated until Act 637 of 2008. The following are the principal changes made by the restatement, which applies to R.S. 9:2271-2275, and 2290-91:

1. The term "charitable trust" is broadly defined with reference to the trust's purpose, and includes a catchall of "other purposes the achievement of which is beneficial to society".

2. The law now recognizes that a charitable trust may be for the benefit of one or more specified "institutional beneficiaries", such as a hospital or university.

3. A method is provided to fill gaps in the office of trustee if the trust document does not provide a method.

4. Individuals and banks or trust companies may serve as trustee.

5. Gaps in the law of charitable trusts can now be filled by reference to the Trust Code's law on private trusts.

6. A charitable trust can be enforced by any of a settlor (or his universal successor), a trustee, an institutional beneficiary, a person appointed in the instrument with authority to enforce the trust, or the attorney general.

7. A charitable trust has perpetual duration unless the instrument provides otherwise, but a trust of under $100,000 can be terminated by the trustee.