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Money Matters

Bank & Trust Company

April 2025

Who will be your successor trustee?

What qualities should you seek?

Revocable living trusts have grown in popularity for implementing an estate plan. In many cases, the trustee will be a bank or trust company, but it is not unusual for an individual to act as his or her own trustee of a living trust. The eventual problem with this approach is that at some point, likely a point well before the death of the person creating the trust, a successor trustee will be required.

Who should be trusted with that responsibility?

An unfortunate example

This story is true, as we know from court records. John Garner executed a revocable trust and a durable power of attorney in 2001. Evidently, John had no close relatives because he named his nephew, Patrick Garner, as successor trustee in the event of John's incapacity, as attorney-in-fact, and also empowered Patrick to make healthcare decisions. The durable power of attorney was very broad and purported to absolve the power holder from claims of breach of fiduciary duty. Oddly, John never told Patrick about any of this, perhaps because Patrick was still in college in 2001. The two were not close, only exchanging occasional notes or Christmas cards.

John fell in the summer of 2020 and was taken to the hospital. As his health deteriorated, and he was found to be incapacitated, the hospital petitioned for appointment of a healthcare guardian. The trial court denied the request because Patrick had already been granted that power. Patrick was contacted about taking responsibility for his uncle, and he said that it was "surprising" that he had been given this job.

In December 2020, John suffered a stroke and was again admitted to the hospital. On December 23, 2020, Patrick executed an amendment of John's trust. John's trust provided that, at his death, the remaining trust assets were to be divided among three named charities. Patrick substituted himself as the sole remainder beneficiary of the trust, then worth $3 million. He did not discuss this with John beforehand. John died soon after.

One of the charities brought a lawsuit challenging the amendment to the trust, which is how the story came to light. Making himself the sole

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beneficiary of the trust violated Patrick's fiduciary duty to John, the court reasoned. It was not in accordance with John's expectations or his best interest. This duty was not waivable, regardless of the language in the durable power of attorney. It is very likely that Patrick also had violated a fiduciary duty that he owed to the charities. However, given this decision, the court did not need to answer that question. The remainder went to the charities, as John had intended.

Lessons

Several lessons come to mind from this story. First, choose the successor trustee with care. Banks and trust companies receive fees for their services and would never consider making themselves beneficiaries of the trusts in their care. Second, being a trustee is a job, not an honor. It's very important that the successor trustee knows well in advance about the appointment, and knows what is expected—the full scope of the duties of a trustee.

Finally, although this story had a happy ending, in that the legal system protected John's estate from the bad decisions of his successor trustee so that John's philanthropic goals were fulfilled, it must be remembered that this came at the cost of litigation and delay.

What are the duties of the successor trustee?

Being a trustee is not a simple job. There are investment and money management tasks, to be sure, but there are also an array of legal responsibilities that have developed, falling under the heading of "fiduciary responsibility." A sampling:

- ***Duty to administer a trust by its terms.*** Patrick Garner failed at this particular duty. Every trust agreement should make plain the purposes of the trust, as they provide the critical benchmark for evaluating the trustee's actions.
- ***Duty of skill and care.*** A high standard of performance is required, even if an amateur is named who has no prior experience as a trustee.
- ***Duty to give notices.*** Notices may concern legal rights of the trust beneficiaries, such as a power to make withdrawals, or they may cover such ministerial matters as designating a successor trustee or an agent to assist in trust administration.
- ***Duty to furnish information and to communicate.*** The trustee must respond to requests from beneficiaries concerning the trust and its administration.
- ***Duty to account.*** A written accounting of the assets, liabilities, receipts and disbursements of the trust must be provided to the beneficiaries regularly.
- ***Duty not to delegate.*** Although a trustee may employ professionals to assist in trust administration, the trustee may not accept blindly the advice of such persons. The trustee retains supervisory responsibility. Matters concerning the exercise of judgment and discretion generally cannot be delegated.
- ***Duty of loyalty.*** Trusts must be administered solely for the benefit of the trust beneficiaries.
- ***Duty to avoid conflict of interest.*** This is closely related to the duty of loyalty and may come up when a beneficiary is named as successor trustee. Generally, the trustee should not engage in transactions with the trust unless such activities are authorized by the trust.
- ***Duty to segregate trust property.*** Trust assets must not be commingled with personal funds or other nontrust assets.
- ***Duty of impartiality.*** The trustee must not favor one beneficiary over another, unless the trust document directs that providing for a particular beneficiary is a principal purpose of the trust.
- ***Duty to invest.*** Trust assets must not be left idle. In addition to making the trust investments, the trustee has a duty to diversify the investments and develop an asset allocation plan. This is a job for professional investors or corporate fiduciaries.
- ***Duty to enforce and defend claims.*** Reasonable steps must be taken to protect the trust from adverse claims and enforce the rights of the trust and its beneficiaries.
- ***Duty of confidentiality.*** Normally, the terms of a trust, the identity of its beneficiaries and their respective interests, and the nature of the trust assets cannot be disclosed to anyone except the beneficiaries and those who need such information in order to be able to administer the trust.

Who will you choose?

Given this list of intricate responsibilities, one can quickly see the value of corporate fiduciaries, organizations such as ours who are dedicated to trust administration as a business. We are staffed for this; we have trained for it. We do it every day.

To learn more about how seriously we take our trusteeship responsibilities, we invite you to arrange a meeting with one of our officers at your earliest convenience. Talk over your family's financial objectives. See how we can help. ☐

If you've decided against a corporate fiduciary

If you've decided to name an individual as your successor trustee, reflect upon these questions:

- Will the person also be your beneficiary?
- Do you owe this person money?
- Does this person owe you money?
- Does the person have an unusual need for money?
- Can your beneficiaries trust the person?
- Will the person work well with others?
- Will the person have enough free time to handle the job?

As you can see, there is a potential for conflict of interest and other difficulties when one turns to a family member or friend, even one with excellent credentials.

Accidental estate planning

Beneficiary designations operate independently of wills or trusts

Probate is the process of winding up an individual's financial affairs. Retirement plans and life insurance policies usually operate outside the probate process because they have named beneficiaries. This is generally considered advantageous because it avoids delays for beneficiaries. However, just as the terms of a will should be reviewed from time to time for fidelity to the wishes of the owner, so should one's beneficiary designations. Overlooking outdated beneficiary designations creates "accidental" estate planning, and in many cases, leads to litigation. Here's a true recent example.

The old girlfriend

Jeffrey Rolison was living with Margaret when he joined P&G in 1987 and began saving in the company's 401(k) plan. He named Margaret as his plan beneficiary in the enrollment papers. Two years later the couple broke up, reportedly because she wanted children and he didn't.

Jeffrey remained unmarried and childless throughout his life. He lived with a different girlfriend, Mary Lou, for several years, until 2014. During that time, he designated his mother and Mary Lou as beneficiaries of his life insurance. After his mother died, Mary Lou was the sole beneficiary.

P&G had moved the 401(k) plan online, but it did not transfer the beneficiary designations from the paper files. Instead, the company repeatedly asked participants to complete an online form to confirm or change beneficiaries. Jeffrey never completed the form. When he died in 2015, a few months before his planned retirement, his 401(k) account was worth $754,006.56.

A contest ensued for that money. Margaret's claim was based on the original paper beneficiary designation. Mary claimed she had become Jeffrey's common-law wife and should inherit as a spouse, even though the relationship had ended before Jeffrey's death. The executors of Jeffrey's estate argued that because he had no relationship with either woman when he died, the money should go to his estate.

Last year, some nine years after Jeffrey died, a court ruled that Margaret was entitled to the money as the named beneficiary. Jeffrey had many opportunities to change that outcome, but for whatever reason, he never did.

Points to remember about beneficiary designations

Whenever there is a major life change, such as a death or divorce, it is appropriate to review beneficiary designations, changing them as needed. Keep in mind:

Backup beneficiaries. Generally, one should name a contingent beneficiary (or beneficiaries) if the primary beneficiary dies prematurely, or if a beneficiary declines to accept the property for some reason.

Takers in default. In the absence of a valid beneficiary, the plan or other instrument may provide a default beneficiary, which may not prove appropriate in some circumstances.

Estate taxes. Assets such as retirement plan benefits are subject to federal estate tax even though they don't pass through the probate estate. If your estate will be large enough to owe federal estate taxes, it is important to consider how those taxes will be paid on non-probate property.

Income taxes. Making one's estate the beneficiary may have adverse income tax consequences. For example, when an individual inherits retirement assets, the income tax deferral ends ten years after the owner's death. If an estate inherits that same asset, the tax deferral ends after five years.

Coordination with wills and trusts. Each element of an estate plan must be evaluated in the context of the full inventory of assets.

Jeffrey died without making a will. A will provision generally will not override a valid beneficiary designation anyway, but if Jeffrey had consulted an estate planning attorney, the lawyer likely would have advised him to take steps to remove all ambiguity about his wishes. Perhaps he really did want Margaret to have this money; perhaps he thought his original paperwork should be sufficient. There was evidence that Jeffrey checked his 401(k) account several times in the months before his death, which persuaded the court that this was his intended outcome.

What about *your* beneficiary designations? How long has it been since you last reviewed them? Are they still optimal? Will your executor be able to quickly identify and notify those beneficiaries after your death? Checking up on beneficiary designations is a critical element of routine will review. □

Taxes on benefits

Until 1984, Social Security benefits were entirely tax-free. That year, up to 50% of benefits became taxable for higher income retirees as part of a major reform to restore the system's solvency. The justification was that while retirees had already paid income tax on their Social Security contributions, no one had been taxed on the employer's share of FICA taxes. Thus, taxing the benefits did not amount to "double taxation." The same legislation also gradually increased the normal retirement age.

In 1993, the taxable portion was lifted further to 85%. This time, an analogy was drawn to the taxation of annuity contracts. The additional tax exposure was on the theoretical earnings of the savings in the Social Security trust fund, while the tax-free 15% represented the return of the investment in the benefits.

When partial taxation of benefits was adopted, it did not affect very many retirees because there was a threshold below which benefits were not taxable—$25,000 for single retirees and $32,000 for married filing jointly. The 85% inclusion begins at $34,000 of income for singles and $44,000 for married filing jointly. Those thresholds were not inflation adjusted and have never been changed. Now nearly half of retirees must include Social Security benefits in their taxable income, according to The Senior Citizens League. Two new bills in Congress would change that.

The Reducing Excessive Taxation and Inefficiencies by Reforming Elder Exemptions to Support Fairness, Inflation Relief, and Simple Taxes (RETIREES FIRST) Act would increase the exemption levels to $34,000 for single and $68,000 for married. What's more, it would add annual inflation adjustments to the thresholds to prevent bracket creep.

Alternatively, more radically, the Senior Citizens Tax Elimination Act would repeal the taxes on benefits entirely, as well as on tier 1 railroad retirement benefits.

The good news for retirees is that repeal would save the average retiree household about $3,000 per year in federal income tax. The bad news is that repealing taxes on benefits would reduce the Social Security trust funds by $1.6 trillion to $1.8 trillion over the next ten years, increasing the risk of insolvency. According to the Social Security Administration, the trust fund reserves will be depleted by 2033 *without* making the benefits tax-free. That moment could come a year earlier with the revenue reduction. When the reserves are gone, benefits are projected to be reduced by about 21%—an average of $4,000.

Prospects for either of these bills are uncertain at this time. With the expiration at the end of this year of many of the 2017 tax changes, the tax-writing committees in Congress have some serious work ahead. It will be a delicate balancing act. ☐