The Evolution and Challenges of the Trust Industry

As trusts evolve, the need for a robust and experienced trustee is paramount

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Key Points

• Over the past half-century, the role of trustees has evolved rapidly along with the trust industry itself

• Increased complexity of trust investments and expansion of modern trust laws are just two elements of this evolution

• Modern trusts require the services of robust professional trustees adept at navigating complex legal, tax, investment, and regulatory issues
The trust industry: a brave new world

Over the past half-century, the role of trustees has evolved rapidly along with the trust industry itself. We have seen a transition in the investment standards guiding trustees from a “prudent man” using legal lists to a “prudent investor” employing modern portfolio theory. Jurisdictional considerations for a wealthy family have progressed from inter-state to multinational during this time as well; trustees are now required to understand concepts of foreign taxation and foreign property law regimes and remain compliant with strict federal Know Your Customer laws put in place to combat money laundering and terrorist financing.

There has also been an unbundling of the trustee’s role where co-fiduciaries take on the responsibility for directing certain aspects of a trust’s administration in a directed trust. Finally, today’s beneficiaries often request their inheritances in trust to obtain protection from creditors and to minimize transfer taxes by holding inherited assets in trust. These changes have spurred the evolution of the trust industry and presented new challenges to its continued growth and profitability.

Increased complexity of trust investments

Historically, trust laws evolved with the development of the common law as each new fiduciary issue was resolved by the courts. A trustee’s duties and obligations were often determined based upon standards of prudence and loyalty litigated after the fact. The result of judging fiduciary conduct using 20/20 hindsight was that a trustee’s default standards of care were very conservative. Statutes that attempted to modify the common law were strictly construed and, ultimately, may not be enforced by the court if there were appropriate grounds for the court to craft an exception. These circumstances required the trust industry to maintain a very conservative approach.

In the investment realm, the investment process was initially driven by “legal lists” of permissible investments including government bonds and first mortgages. By the 1940s, legal lists were replaced in most states by the prudent man rule which characterized investment in “speculative” stocks, discounted bonds, or buying any securities on margin as presumptively improper. Not until the late 1980s did states begin to repeal their prudent man rules in favor of a prudent investor rule that embraced modern portfolio theory. Until this time, it was generally not seen as prudent to invest in a diverse portfolio of securities.

Modern trust laws require a sophisticated trustee

Trust-friendly laws allowing for directed trustees and perpetual trusts are not new concepts, but their proliferation in recent years and broad acceptance in many states have expanded the scope of trustees who must administer these complex structures. Starting in the mid-1980s, states began to compete for trust business using favorable trust laws as a lure to bring trust assets into their states. Many states began to repeal their common law rules against perpetuities to allow for perpetual trusts and to codify laws allowing the role of the trustee to be unbundled so advisors could direct how the trustee exercised its fiduciary powers, the so-called directed trust. Beginning with Alaska and Delaware in 1997, certain states began to apply spendthrift protections to self-settled trusts allowing for the creation of domestic asset protection trusts. Until this time, wealthy individuals had to use offshore asset protection trusts if they wanted creditor protection while retaining access to their assets.

During this period of evolution in the trust laws, differences in state income tax laws created opportunities for residents of one state to explore the use of personal trusts administered in another trust-friendly state for the purpose of minimizing their overall state income tax burden. The situs of trust administration became a compelling reason to seek a trustee located in a favorable jurisdiction like Delaware, South Dakota, or Alaska. State income tax arbitrage lead to complex trust structures used to minimize taxes upon the recognition or receipt of income (a so-called “ING” trust) so the taxpayer remains a resident of his or her high-tax home state while exporting the assets to a trust in a low or no-tax jurisdiction to limit state income taxes.

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One challenge in the trust industry today is distinguishing between complicated trust structures that require a robust trustee who is fairly compensated for these services, versus trusts that may be serviced by a thinly-staffed trustee for the purpose of essentially renting administrative situs in a preferred jurisdiction. Describing and demonstrating the value proposition regarding the services being performed may be a challenge for a corporate trustee because many families face the decision of whom to select as their trustee only once and don’t appreciate the downside to picking the lowest-cost provider. Advisors who regularly counsel families on these decisions understand the value a sophisticated trustee brings and can help families find the right fit. Trustee services are not a commodity because each trust relationship is unique.

**Multinational families are utilizing more trusts**

A generation ago, inter-state planning was a complicating factor when structuring a family trust. Today, it is common to do trust planning for multinational families impacted by the laws and taxes of multiple countries. The variety of domestic and foreign tax laws involved when planning for the multinational family requires sophisticated tax counsel and a fiduciary partner able to meet the ongoing and evolving demands of these complex trust structures. Some multinational families seek efficient methods for importing their wealth to the United States after their children come to the U.S. for an education and then remain in the U.S. following marriage or to pursue professional opportunities in the states. Others seek a safe-haven for family wealth because their home country may be financially or politically unstable, with the United States seen as the “offshore” jurisdiction of choice. Finally, U.S. estate tax laws encourage the use of trusts to hold U.S.-based real estate by non-resident aliens to avoid U.S. estate taxes upon their death.

**Driving forces behind the expansion of the trust industry**

As trust and tax laws changed and investments became more complex, successful families sought the services of professional fiduciaries located in favorable jurisdictions who were adept at navigating these complex trust laws and able to take advantage of these modern investment options. The demand for fiduciary services made trust departments an attractive source of revenue to financial institutions and some states began to compete to attract trust assets into their states. Some innovations in trust laws that states used to bring assets into their state (such as perpetual trusts, directed trustees, and self-settled spendthrift trusts (asset protection trusts, or APTs)) made the role of a trustee so complex that only a professional fiduciary skilled at navigating these complex trust laws is able to carry out the basic duties of the fiduciary. However, as the sophistication in the role of the trustee evolved to this point, pricing demands created by fierce competition for this fiduciary business put a strain on operating margins.

While some people improperly view the role of the directed trustee as an easy and passive job, the workload (and sometimes the risk) of the directed trustee is often greater than when a trustee holds all of the duties and responsibilities of a traditional trustee. Each new directed transaction carries with it a unique set of facts. The trustee must ensure that the directed transaction is proper — i.e., the investment is permitted by the trust agreement, it is legal, and the trust qualifies to make the investment. For example, some unique circumstances can arise when a federally-regulated financial institution is directed to invest in a marijuana production business that may be legal under state, but not federal law. The directed trustee must also understand whether it is an accredited investor when directed to purchase securities that are not registered with financial authorities. While the role of the directed trustee may appear passive on paper and in concept, a trustee with a deep bench of fiduciary professionals is required to properly administer most directed trusts.
The industry today

The evolution of the trust industry has highlighted the fact that modern trusts require the services of robust professional trustees adept at navigating complex legal, tax, investment, and regulatory issues. Sophisticated wealth planners demand the use of sophisticated trustees in preferred jurisdictions who have in-house legal, tax, and administrative talent to deliver these complex fiduciary services. One challenge resulting from the proliferation of investment-directed trusts and thinly-staffed trust companies willing to serve as trustee in name only is to put pricing pressure on these services when they are viewed as a commodity in the market. However, trustees with the depth of talent required to administer trusts for multinational families, trusts holding unique investments, or trusts created in support of complex planning goals, may still be paid adequately for their services if they are able to detail and demonstrate the value of their robust fiduciary services. In the end, the trust industry continues to thrive and meet the needs of wealthy multinational families in this brave new world.

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