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The Five Biggest Ways To Bungle a Trust

By LAUREN FOSTER

It's easy for trustees to botch their roles. Here's how to avoid the common pitfalls.

Trust and estate planning often comes down to three questions: Who gets what? How do you minimize taxes? And, once a trust has been set up, who is in control? Unfortunately, it's easy for a family to bungle any one of the three. That's especially so if you don't have a professional on board as a trustee. Here are the five most common mistakes of do-it-yourselfers, and tips on how to avoid them.

FAULTY RECORDS: Most states require trustees to provide regular accountings to the beneficiaries—not only the income beneficiaries, but also what are known as remaindermen, the family members down the line who will receive the principal once the trust has been dissolved. This means keeping comprehensive records of income, as- sets and distributions—and many trustees fall short of the mark. "This is probably the most mundane, and at the same time, the most troubling task for individual trustees," says David A. Baker, a partner in law firm McDermott Will & Emery. The price of failure could be a big lawsuit later on by a beneficiary or remainderman.

Tip: Assemble a reliable outside team with a money manager, a trust lawyer and a tax pro.

Brian Ajhar for Barron's

FAILURE TO DIVERSIFY: Trustees may be tempted to sit on a big chunk of a stock that has served the trust well over the years. That's especially true if the shares are company-owned or run by the dearly departed. Bad idea. As a trustee, you have a legal duty to thoroughly diversify investments. The kind of concentrated bet that you might make in your own portfolio simply won't fly for a trust.

Investment management is the area that probably leads to the most litigation against trustees, says Hugh Magill, Northern Trust's chief fiduciary officer. Though state laws vary, a good rule of thumb is that any position accounting for more than 10% of a portfolio is too big, Baker says. For some positions, you might want to stay even lower.

Tip: Read the Uniform Prudent Investor Act, which governs this area of trustees' work. If you aren't sufficiently diversified, tell the investment manager to get cracking.

BIASED DISTRIBUTIONS. Trustees owe a fiduciary duty to the current beneficiaries and the remaindermen. The problem is that many individual trustees don't realize there is a duty to both, and sometimes their interests conflict. "So when Trophy Wife Two needs more money, investing in higher-yielding securities may generate more income, but does it fairly and reasonably weigh the long-term needs of the kids from the first marriage who are the remaindermen?" asks Thomas O. Katz, a partner at law firm Katz Baskies in Boca Raton, Fla. "More often than not, there needs to be some consideration for current-income needs, but also for capital appreciation."

Knowingly or not, trustees also may favor distributions to certain beneficiaries. "If the trustee is a family member, it is hard not to bring personal bias into the relationship," says Anita Sarafa, a wealth advisor for JPMorgan Private Bank. "As a trustee, your job is to act impartially and put aside those biases."

Tip: Once you have made a distribution decision, set out in writing the reasons for making or denying it, and include supporting documentation so you can show you gave due consideration to all the facts and circumstances.

EXPECTING A PAYDAY. Individual trustees tend to assume that they are going to get paid a trustee fee—within a reasonable time frame and at a reasonable rate. "That is generally not a fair assumption," says Baker. In reality, it takes a lot of time and effort to get paid, largely because of laws that give beneficiaries the right to voice objections. Since the payments can reduce the money available to beneficiaries, they may even start litigation

Tip: Have the fee discussion early on and settle on appropriate payments. Fees for individual trustees, when paid, often run about 1% of assets for small trusts and as low as 0.15% for big ones.

FALSE SENSE OF SAFETY. You may feel honored when asked to be a trustee and readily accept. What you may not know is that you're taking on lots of legal risks.

"This is a role that potentially has unlimited liability," says Adam von Poblitz, head of Estate Planning at Citi Private Bank. Trustees could be held liable not just for investment losses, but also for profits that could have resulted from more prudent investing.

Daniel L. Kesten, a partner at Davis & Gilbert, a law firm in New York, says trustees often feel their personal relationship with the family will keep them from being sued. Think again. "In the long run," he says, "your exposure won't be to your friend who named you trustee but to his children or grandchildren." And face it, there's no telling what lurks in the heart of an angry child.