WHAT IS AN EFFECTIVE DIRECTED TRUST?

An effective directed trust is a trust that looks like a traditional trust where the corporate trustee has full powers on paper but operates much like a directed trust.

WHAT IS THE DIFFERENCE?

The difference is in the structure of the assets. In an effective directed trust, the trust owns an LLC membership interest where the corporate trustee is NOT the Manager or Managing Member. Since the trust assets are wrapped in the LLC, which is controlled by the Manager or Managing Member, you have effectively taken the investment discretion away from the corporate trustee.

WHAT IS THE BENEFIT OF A TRUST OWNING AN LLC?

While there are many benefits of a trust owning an LLC for asset protection, having a trust own an LLC also allows greater flexibility from an investment standpoint. It allows the Manager or Managing Member to buy and sell investments, or oversee a business owned by the LLC, without requiring the corporate trustee to review, sign, and approve such actions. This is especially important when time is of the essence and decisions need to be made quickly.

An effective directed trust is the closest to a client being able to manage their investments as if the trust did not exist. You can make an argument that an effective directed trust is even more seamless than a directed trust. Financial institutions may require the trustee's involvement for a directed trust because of a lack of understanding of how they operate. However, financial institutions understand LLCs and typically require little to no involvement from the corporate trustee.

TRUSTEE FEES

Trustees will typically charge based on their liability for the underlying investments in the trust. A directed trust removes the corporate trustee from investment responsibility and liability. Therefore, a trustee's fee for a directed trust is typically much less. In an effective directed trust, even though the trustee has investment responsibility on paper, you have effectively taken it away by wrapping the assets in an LLC. This is the reason why trustees should charge the same for an effective directed trust as they do for a truly directed trust.

A CLASSIC PITFALL

One issue that may preclude an effective directed trust is if the client has a non-grantor trust and the Manager is in a state with a state income tax. If the Manager lives in a state such as California, there is the potential that California will try and tax the income. In this scenario, it might be best to simply name an investment trustee that resides outside of California and have a truly directed trust. We always recommend consulting with a CPA to determine if an effective directed trust makes sense in your estate planning.