PRENEED FIDUCIARY LIABILITY

By a memorandum dated April 11, 2000, the Office of the Comptroller of the Currency provides national banks an overview of the risks of administering the preneed funeral trust. The purpose of this PRC White Paper is to expand upon that OCC preneed memorandum by addressing two forms of liability exposure inherent to the preneed trust account: regulatory negligence or fiduciary breach.

Regulatory Negligence

As a preneed fiduciary, a bank is subject to four distinct regulators:

> Office of the Comptroller of the Currency – Fiduciary administration may be evaluated for consistency with written policies, trust instruments terms, applicable state laws, and Reg 9 investment oversight responsibilities.
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> Internal Revenue Service - The diversity of state trusting requirements has precipitated Federal income reporting requirements unique to death care trusts.
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> Securities Exchange Commission - Death care trusts are pooled for administrative efficiency, implicating securities regulation.
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> State Death Care Regulator - The potential for fraud and abuse to an elderly consumer has resulted in an extensive state regulatory system with multiple agencies that may have overlapping jurisdiction of the funeral/cemetery transaction.

Fiduciary Breach

As a general rule, state death care laws require a trust or fiduciary relationship between the bank, the death care company and the consumer. However, the fiduciary relationship does not 'vest' until funds are actually received by the trust. Liability is generally an issue only when the bank fails to act reasonably with regard to the fundamental duties imposed by applicable law. Fraud and regulatory negligence are generally contributing factors to fiduciary breaches that result in liability. The fundamental fiduciary duties include the following:

> Investment - While some state laws allow the delegation of the trust's investment authorities, these laws generally impose on the trustee the duty to provide investment oversight, and to reject imprudent investments or unauthorized investments.
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> Distribution Supervision - Most state laws require documentation supporting death care trust distributions.
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> Income Reporting - There are two permissible methods for reporting income on preneed trusts established since 1988, and both are dependent upon contract information maintained by the death care company. A special complex trust return is also required of perpetual care trusts.

Discussion – The Future of Death Care Compliance

The United States General Accounting Office issued Congressional Reports on the death care industry in 1999[1] and 2003[2]. The 2003 Report describes the various approaches taken by states to regulate the death care industry, particularly the preneed transaction. As detailed by the GOA, the laws are intended to impose primary responsibility for compliance on the death care company. As both GOA reports explain, enforcement of death care laws varies substantially from state to state, with some states having very comprehensive oversight (Florida and Texas). Most states, though, do not have proactive enforcement programs for their death care laws. The GAO reports acknowledge a growing interest in Congress for Federal regulation of the death care industry.

Consumer dissatisfaction with the states' oversight of the death care industry has prompted some Federal agencies to assume a more active role in death care regulation.[3] In 1988, the Internal Revenue Service issued Revenue Ruling 87-127 to impose a single method of income reporting on preneed trusts. In the late 1980's and early 1990's the FDLIC issued a number of advisory interpretations regarding the application of insurance requirements to death care trusts. As referenced at the beginning of the document, the OCC issued a Memorandum dated April 11, 2000, to describe to national banks the risks associated with death care accounts, and to advise examiners that review the accounts.

Office of the Comptroller of the Currency

The OCC Memorandum is slightly dated with regard to its description of the death care industry, and includes certain over-generalizations or misstatements. However the OCC's ending disclosures are worth noting:

> Poor management of preneed funeral trusts, including weak internal controls over account acceptance and disbursements, noncompliance with trust agreements and applicable law, and inadequate due diligence on funeral homes and directors, can negatively affect a bank's reputation. Banks that align themselves, or are affiliated, with funeral companies that have or subsequently develop reputation problems may themselves be tarnished, even if their internal practices are appropriate.
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> Preneed funeral trusts require the same level of supervisory oversight and risk management systems as other fiduciary activities in national banks. We expect banks that are active in this line of business to have appropriate strategic plans, policies and procedures, internal controls, MIS, and monitoring systems for this product. The administration of these accounts must comply with 12 CFR 9, Fiduciary Activities of National Banks, particularly the pre-acceptance, post-acceptance and annual review processes. It may be appropriate to have policies and

[1] GOA/GGD-99-156 Funeral-Related Industries.
[2] GOA-03-757 Death Care Industry.
[3] The Federal Trade Commission has been the most active Federal agency. The FTC promulgated The Funeral Rule in 1982 to require universal disclosures to be made by funeral homes. However, the FTC proceedings have not impacted the trusting requirements imposed by state law.

> procedures specific to this business line, and, if the business is significant for a bank, a separate administrative and investment review committee should be established.
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> It is imperative that national banks perform due diligence reviews on a funeral company before they enter a business arrangement with it. Bankers should also perform annual reviews of companies with which a bank has established a business relationship. Bankers should administer the use of third party service providers, such as investment advisors or managers, with appropriate controls and monitoring systems. National banks should also include preneed funeral trusts in internal compliance and audit programs.

The OCC's assessment of the trend for death care trust administration is on target:

> Historically, most of the competition for the preneed funeral trust business has been among small financial institutions in a local marketplace. In recent years, however, the industry has begun to consolidate with larger financial institutions forging alliances or merging with regional and national funeral companies. The preneed funeral planning business is volume driven and economies of scale are important. Increasing product demand, technological improvements, and the ability to provide trust services nationally are creating potentially profitable opportunities for larger financial institutions and may be driving the industry alliances and consolidation trends.

The economies of scale described by the OCC are important factors to the death care consolidators seeking national banks for their trust accounts, and domiciliary requirements imposed by state death care laws force these companies to seek out the national banks with a large "footprint".

Internal Revenue Service

The Service recognizes two types of death care trusts: preneed versus perpetual (endowed) care.

There is little controversy about the taxation of perpetual care trusts. A hybrid complex trust return is required pursuant to IRC § 642. The Service appreciates that the state laws vary about requirements and restrictions, and facilitate the trustee's protection by allowing for a statement:

> A trustee of a cemetery perpetual care fund shall not be held personally liable for civil or criminal penalties resulting from false statements on the trust's tax return to the extent that such false statements resulted from the trustee's reliance on a certified statement made by the cemetery <u>specifying the number of interments sold by the cemetery</u> **or** <u>the amount of the cemetery's expenditures for care and maintenance</u>. The statement must indicate the basis upon which the cemetery determined what portion of its expenditures was made for the care and maintenance of gravesites.

In contrast to perpetual care trusts, controversy over the taxation of preneed trusts dates back more than thirty years. The various state requirements regarding trusting and income accrual led to many different tax methods. With Revenue Ruling 87-127, the Service established a universal grantor reporting approach for most trusts established after 1987.[4] However, the revenue ruling proved problematic, and compliance has been poor. [5]

Preneed trustees may elect out of the grantor trust method pursuant to Section 685. Section 685 was enacted with the Taxpayer Relief Act of 1997 to allow a preneed trustee to avoid the Treas. Reg. §1.671-4 reporting problems by electing to have each purchaser trust account become a taxable entity. While the election is taken on a preneed contract by preneed contract basis, Section 685 allows for a composite Form 1041 QFT return. However, the industry's switch from grantor reporting to Section 685 has been impeded by a contribution limitation and the law's administrative requirements.

As enacted, Section 685 imposed a contribution limitation ($7,000) on the preneed trust. Despite the inclusion of an "inflator", the contribution limitation proved too low to fund both a funeral and a burial. The contribution limitation was eliminated with the passage of the Hubbard Act (H.R. 6580) on August 29, 2008.

For purposes of Section 685, each purchaser trust account is taxed separately. Section 685 provides for a composite Form 1041QFT, allowing all preneed contracts administered under the same trust instrument to be reported on a single return. The composite return requires a schedule that reports by line item: each purchaser's name; the purchaser's proportionate share of income (by type); deductions (by type and deductibility); credits; the purchaser's taxable income and income tax liability; and the account termination date (if applicable).

From a practical approach, many of the Section 685 requirements are burdensome and inapplicable. It will be difficult for a single QFT trust to produce income that would trigger a tax rate higher than 15%. Cooperation between the trustee and the funeral home is necessary to avoid investment advisor fees being characterized as allowable miscellaneous itemized deductions subject to the 2% floor.

Securities Exchange Commission

State death care laws require a trust for each individual preneed contract, but allow the trusts' assets to be commingled for investment. The SEC began to address the securities implications of pooled investments in the early 1970's through no action letters. The initial no action letters involved single funeral home locations. Subsequent requests became more complex, involving trade association trusts representing multiple funeral homes.

As the OCC memorandum advises, the national death care companies have sought the national bank for the opportunity to pool accounts from multiple states.

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[4] Rev. Rul. 87-127 has retroactive application to many preneed trusts established prior to 1988. Prospective application is permitted in limited circumstances in certain states.

[5] An article published by the American Bankers Association that addresses the problems of Rev. Rul. 87-127 in detail. Preneed Funeral Trusts: A Tax Primer, American Bankers Association's "Bank Compliance" periodical, July/August 2001.

The SEC's willingness to grant no action letters for death care trusts has been attributed in part to the oversight afforded by state regulation. New preneed products are beginning to emerge with insurance companies introducing programs that eliminate the funeral home's role in the sale of the product. It is a matter of time before a financial based product is introduced into the market as well. Financial based preneed already exists in England, Canada, Australia and New Zealand. To the extent such a program would fall outside the jurisdiction of state death care laws, an SEC review would be prudent.

State Death Care Regulation

Several trends are forcing states to expand their regulation of the preneed transaction. Preneed sales continue to grow, and the vast majority of funeral homes now have preneed programs. The national death care companies have transformed preneed from a local consumer transaction with a single funeral home to an interstate transaction that can be performed in a number of states. Consumers have responded with demands for portability and increased funding requirements. Contracts remain active for 15 years or more, and this forces funeral homes to seek greater investment performance to offset increases in the cost to service the preneed contract.

Death care laws can vary substantially from state to state. Historically, the death care client has borne the burden of monitoring these laws. While non-compliance presents a greater exposure to the death care company, the OCC warns that the national bank must also comply with state death care law requirements. Consequently, compliance requires a cooperative effort between the death care company and the fiduciary.