Trust Advisors Forum - 2018

Current Issues with Distribution Standards: Can They Come Back to Bite You?

Tuesday, February 27, 2018
8:00 a.m. – 9:30 a.m.

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The McGuireWoods Private Wealth Services Group

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about these seminar materials. Please feel free to contact any member of the Group.

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I. Introduction

A. The involvement of the trustee or trust officer, attorney, and advisor with distribution standards takes place on two levels.

1. The professional may have an opportunity to be involved at the planning stage, in educating the client about the standards to be used for determining what distributions are appropriate and the impact of various alternatives.

2. He or she also faces the practical application of those standards during the administration of a trust. The trust professional, often with the assistance and guidance of a discretionary distribution committee, will have to apply his or her judgment to the beneficiaries' situations, and determine if a distribution is appropriate.

B. Both levels require an understanding of the common meanings given to the distribution language used in trusts. These materials review the judicial interpretations of common distribution provisions, and suggest alternative provisions that can be used to provide more guidance. The materials also examine various ways in which lawyers are trying to provide greater flexibility in trusts, and to respond creatively to the demands of settlors, trustees, and beneficiaries.

C. The materials also discuss recent state law changes in the treatment of income and principal. These changes, such as Principal and Income Act provisions allowing trustees to provide current beneficiaries with a unitrust interest instead of an income interest, are a response to total return investment concepts. At its core, though, these developments are also responses to clients' demands for greater flexibility and for more flexible trusts.

D. The heart of the trust business is service. Good service requires an understanding of trust distribution standards and a willingness to work with unique versions of those standards.

II. Use of Trusts in Estate Planning and Property Management and Succession

A. Benefits of Placing Property in Trust

1. Individuals often believe that they need nothing more than a simple will if their estates are below the applicable exclusion amount and will escape federal estate tax at their death and their spouse's death. A simple will, that leaves all the assets to the spouse and, upon the spouse's death, divides the assets equally among the children, is often considered sufficient to protect the family adequately. A closer look points out the risks inherent in such a plan.

a. If an individual leaves even modest amounts of money to a spouse who has never had any experience with financial management and investment decisions, he or she may be placing an unfair burden upon the spouse. This type of burden translates into anxiety instead of security.

b. The surviving spouse may remarry, and all or a portion of the assets originally intended to go to children may end up in the hands of the new spouse, or children of the second marriage.

c. Even if the surviving spouse does not remarry, he or she may be put in the position of saying "no" to a child who wishes to use the inherited wealth for a risky new business venture or some speculative investment. Depending upon the relative strengths of the child and surviving spouse, imprudent decisions may be made which could rapidly dissipate the property left for the family.

d. A surviving spouse who has been insulated from financial matters may, upon receiving an inheritance, simply become overwhelmed by the immediate feeling of wealth and independence and live in a manner that could quickly exhaust the remaining estate.

2. By using trusts to transfer property, either during life or at death, the donor is able to maintain an element of control over the property. The donor can designate under what circumstances and for what purposes a beneficiary will receive that property or its income. Trusts also permit the donor to determine who will manage the property as trustee.

3. Other advantages of trusts include the following:

a. Retention of property in trust with a professional trustee preserves the benefits of the investment and management skills of the trustee.

b. A trust can protect assets from the claims of third-party creditors of the beneficiary, such as the plaintiff in a lawsuit or a spouse in a failed marriage. Generally, a creditor or litigant cannot gain access to assets set aside in a properly drafted trust by someone other than the beneficiary. The same is generally true with respect to a divorcing spouse, although state law varies on the degree to which courts can consider the existence of trust assets in determining the division of assets upon divorce.

c. Children who have not fully matured may rapidly dissipate an outright inheritance, whereas a trust can provide for incremental distribution of inheritances.

d. Large outright distributions, or trusts that do not contain thoughtful and deliberate distribution provisions, may interfere with a child's personal and professional development. Put simply, large gifts may spoil children and destroy their incentive to provide for self-support.

e. A well-drafted trust can also be flexible enough to allow a capable beneficiary to take advantage of entrepreneurial business opportunities.

B. Examples of Trust Provisions

1. The trust may be drawn narrowly so that during a child's minority, the trust's assets can be used only for the basic health, support, and education needs of the child. With this type of standard, the trustee cannot use the trust funds for expensive trips or cars, or other extravagances.

> **SAMPLE TRUST PROVISION:** Until the Termination Date (as later defined), the Trustee shall pay to or for the benefit of the Child as much of the net income and principal of the trust, even to the extent of exhausting principal, as the Trustee may deem necessary for the support, health, and education of the Child.

2. On the other hand, if the client prefers, the trust may be drawn very broadly so that the trust property would be available for virtually any purpose. Language making the trust property available for the "welfare and best interests" of the child leaves the trustee very great latitude to use the trust property for most any purpose believed appropriate.

> **SAMPLE TRUST PROVISION:** Until the Termination Date (as later defined), the Trustee shall pay to the Child from time to time such portion or portions of the net income and principal of the trust as the Trustee shall deem desirable for the benefit of such Child.

3. There are numerous alternatives to these trust provisions, as discussed in more detail below.

C. Trusts for Multiple Beneficiaries: the "One-Pot Trust" or Separate Trusts

1. When more than one child is a beneficiary of a trust, a choice must be made between two basic trust structures, the one-pot approach or separate-trust approach.

2. The several-trust structure divides the trust assets (usually equally) among the children at the death of both parents, and each child's share is held and administered exclusively for the benefit of that child and his or her family, with no child receiving assets from another child's share during the life of the other child.

a. In many cases, as each child reaches a designated age, he or she is then entitled to receive his or her share outright.

b. The income from the share may be required to be distributed to the child or may be distributable at the discretion of the trustee.

c. Similarly, the principal of the trust can be made available to be distributed for the benefit of the child in accordance with the standards provided in the trust.

d. In estates with adult children, division into separate pots immediately upon the death of both parents is common in order to allow separate children to act independently of each other on investment and distribution decisions.

3. The one-pot structure postpones the division of trust property, either for an indefinite period, or until all children have reached some stated age, such as 21 or 25, at which point the one-pot trust can be divided.

   a. During the one-pot period, the entire trust can be used according to the relative needs of the children without limiting each child to a particular share. In most cases, this structure more closely approximates the way a family normally conducts its affairs, and it is especially appropriate when priorities must be established because of concern that money will not be available for everything.

   b. For example, in the event of a major illness of one child, it may be appropriate to use all the trust's resources for the medical care of that child, even though this ultimately will reduce the inheritances of the other children.

   c. The one-pot trust also is perceived as a fairer approach before all the children have completed their educations. If separate trusts are created immediately, and one child has completed college while another has not started, the younger child's trust is burdened with a cost that the parents paid for the older child.

4. Whether a one-pot or several-pot approach is adopted, an age for trust division or direct distribution to beneficiaries must be selected, or the trust assets can remain in trust for the beneficiary's or beneficiaries' lifetimes. Some choose installment payments, such as one-half at age 25 and the remainder at age 30, which provides a reserve for a child who unwisely dissipates the first installment and learns from the experience to handle the second installment more prudently.

5. Another alternative to direct distribution to a child in a several-pot approach is to grant the child a power of withdrawal over the property in his or her trust when he or she reaches a certain age or ages.

> **SAMPLE TRUST PROVISION:** First Power of Withdrawal. When the Child reaches age twenty-five (25) (or, at the time the trust is created, if at that time the Child has reached age twenty-five (25) but has not reached age thirty (30)), the Child shall have the right at any time to withdraw one-third (1/3) of the principal and any undistributed income of the trust. Upon any addition to the trust after the Child reaches age twenty-five (25) but before the Child reaches age thirty (30), the Child shall have the right to withdraw one-third (1/3) of such addition.

a. This allows the child to leave the property in the trust and continue to take advantage of the benefits the corporate fiduciary can offer.

b. Once the child has withdrawal rights, the child is treated as the owner of any property in the trust subject to his withdrawal rights and will be directly taxed for any income or capital gain from such property.

c. If partial withdrawals are permitted at different ages, however, an unexpected tax trap is associated with this approach.

(1) Distributions to a grandchild from a trust established for his or her parent, when they are made after the date the parent can make his first withdrawal from the trust, will be considered gifts from the parent unless care is taken in the document to limit such distributions. This is because, for tax purposes, the parent will be considered the owner of any property subject to a power of withdrawal, just as if it had been distributed to him or her outright.

(2) To avoid this, the trust should direct that distributions to a grandchild be made from the portion of the trust not subject to a power of withdrawal.

D. Below, these materials discuss the numerous alternatives to these general types of provisions.

III. Particular Standards of Distribution: What Does the Trust Language Mean?

A. Distribution Standards

1. One of the key functions of a trustee is to make appropriate distributions to beneficiaries of the trust. The terms of the trust will provide guidance to the trustee of when and how to make such distributions, and what factors to consider when doing so.

2. Distribution provisions fall into two general categories: an "ascertainable standard" and a "non-ascertainable standard".

B. Ascertainable and Non-Ascertainable Standards.

1. Ascertainable Standard

a. An "ascertainable standard" provides specific guidance to the trustee, which a beneficiary can sue to enforce. Typically, these provisions allow distributions for a beneficiary or beneficiaries' "health, education, maintenance, and support."

b. The Uniform Trust Code defines an "ascertainable standard" as "a standard relating to an individual's health, education, support, or maintenance within the meaning of Section 2041(b)(1)(A) or 2514(c)(1) of the Internal Revenue Code of 1986." UTC § 103(2). This definition was added to the Uniform Trust Code in a 2004 amendment, in recognition of the appearance of this term in various places in the Uniform Trust Code. UTC § 103, comment.

c. Below is an example of a trust provision containing such a standard:

> **SAMPLE TRUST PROVISION:** During the Beneficiary's lifetime, the Trustee shall pay to or for the benefit of the Beneficiary and any descendant of the Beneficiary as much of the net income and principal of the trust, even to the extent of exhausting principal, as the Trustee may deem necessary for the support, health, and education of the Beneficiary and any such descendant of the Beneficiary.

d. The general principle of an ascertainable standard is that the standards such as "health" or "support" of a beneficiary could be reasonably determined by a third party, so a beneficiary could petition a court to resolve whether the trustee was properly administering the trust. For example, if a beneficiary argued that his needs for "support" were not being met, the beneficiary could request that the court order that the distributions be increased to meet the appropriate level of support. See generally Restatement (Third) of Trusts § 50, comments a, d.

2. Non-Ascertainable Standard

a. A "non-ascertainable standard" provides general guidance to the trustee, without giving specific terms which a beneficiary could enforce, such as allowing distributions for a beneficiary's "best interests," "happiness," or similar terms.

b. Below is an example of a trust provision containing such a standard:

> **SAMPLE TRUST PROVISION:** The Trustee shall pay to the Child from time to time such portion or portions of the net income and principal thereof as the Trustees shall deem desirable for the best interests and welfare of such Child.

c. For a non-ascertainable standard, judicial review is very limited. The judge would be unlikely to interfere and to determine whether distributions were sufficient to meet a beneficiary's "best interests" or "happiness." Instead, the court would only review to determine whether the trustee was generally acting in good faith. <u>See generally</u> Restatement (Third) of Trusts § 50, comment d.

3. Implications of Ascertainable Standard

a. As noted in more detail below, whether a standard qualifies as "ascertainable" or "non-ascertainable" can have important implications, particularly for tax purposes and purposes of creditor protection.

b. Creditor Protection

(1) Limiting distributions to an ascertainable standard can allow a beneficiary to serve as trustee or co-trustee, without making the trust assets subject to creditor claims.

(2) Under the Uniform Trust Code, a creditor may not reach the interest of a beneficiary who is also a trustee or a co-trustee, if the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard.

c. Transfer Taxes

(1) A beneficiary's service as trustee can also have important implications for purposes of estate and gift tax.

(2) A trustee who has the discretionary power to distribute trust property to himself as a trust beneficiary possesses a general power of appointment unless the discretionary power is limited by an ascertainable standard related to his

or her health, education, support or maintenance. IRC §§ 2041(b)(1)(A); 2514(c)(1).

(3) IRC § 2041(b)(1)(A) (regarding estate tax) and IRC § 2514(c)(1) (regarding gift tax) provide that property subject to a general power of appointment is included in a decedent's estate for estate tax purposes, but provides that the following is not a general power of appointment: "A power to consume, invade, or appropriate property for the benefit of [the individual] which is limited by an ascertainable standard relating to the health, education, support, or maintenance of [the individual]."

(4) The Regulations provide the following elaboration on this definition of "ascertainable standard":

> A power is limited by [an ascertainable] standard if the extent of the possessor's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

Treas. Reg. § 25.2514-1(c)(2); see also Treas. Reg. § 25-2041-1(c)(2).

d. Modification of Trusts with Ascertainable Standards: Decanting

(1) The presence or absence of an ascertainable standard can also affect the extent to which the distribution provisions of a trust can be modified.

(2) One method of modifying a trust is through a process called "decanting." Decanting can be authorized by the common law, statutory law, or the terms of the trust.

(3) Decanting is a process by which a trustee of one trust transfers the assets of a trust to a new trust, which is either already in existence or which was formed by the trustee of the first trust during the decanting process. This transfer is referred to as "decanting," after the example of pouring wine from one container to another.

(4) Currently, twenty-five states authorize decanting by statute; under those statutes, decanting must meet specific procedural and substantive requirements.

(5) If the original trust can make distributions only based on an ascertainable standard, then most states' decanting statutes would require the second trust to contain the same or a substantially similar ascertainable standard.

(6) This requirement also exists under the Uniform Trust Decanting Act, promulgated in 2016 and currently enacted in Colorado, New Mexico, North Carolina, Virginia, and Washington. See Uniform Law Commission, "Trust Decanting."

(7) Under the Uniform Trust Decanting Act, if a trust's distribution provisions are subject to "limited distributive discretion" (that is, a distribution power subject to "an ascertainable standard or a reasonably definite standard"), then a decanting to a second trust, "in the aggregate, must grant each beneficiary of the first trust beneficial interests which are substantially similar to the beneficial interests of the beneficiary in the first trust." UTDA § 12.

C. Structuring the Distribution Provisions

1. In light of the above, differences between ascertainable and non-ascertainable standards, and differences between specific terms without those trust provisions, can have important implications for creditor protection, taxes, and the distributions from the trust.

2. But settlors, trustees, and beneficiaries often ask:

   a. What, for example, is the real difference between "support and maintenance" and "best interests and welfare" in terms of what access the beneficiaries will have to the trust assets?

   b. Or, what factors related to the beneficiary's other resources, lifestyle, etc. will the trustee take into account in making distributions?

3. Most attorneys have a standard procedure for addressing these issues and answering the client's questions. For instance, many clients have been told that "support and maintenance" allows the beneficiary to maintain his or her accustomed standard of living, whereas "best interests and welfare" could include distributions for luxury items—a Mercedes Benz or a trip to Europe.

   a. Attorneys typically answer these questions briefly, for very practical reasons—many clients cannot afford to have the attorney spend hours exploring the client's goals and drafting unique, specific provisions governing distributions. However, some can afford, or do expect, that type of tailoring. In these situations, trusts are likely to contain very customized distribution provisions.

   b. Any decision regarding the appropriate distribution standard for a trust must take into account the creditor protection and transfer tax consequences of using the distribution standard, which are discussed above.

   c. Most draftspersons include provisions in trust documents to limit the distribution powers of a beneficiary/trustee to purposes that fall within an ascertainable standard. This is done directly, by specifically giving broader distribution powers only to an independent trustee, or it is done indirectly, with a savings clause that provides that the powers of any trustee who also is a beneficiary are cut back to purposes that fall within the ascertainable standard.

   d. Many states also have statutes that prevent a beneficiary/trustee from exercising discretionary distribution powers or cut back the powers to ascertainable purposes. The Uniform Trust Code provides that, with certain exceptions (including express contrary direction in the trust), "a person other than the settlor who is a beneficiary and trustee of a trust that confers on the trustee a power to make discretionary distributions to or for the trustee's personal benefit may exercise the power only in accordance with an ascertainable standard." UTC § 814(b)(1). The provision also states that a trustee may not exercise a discretionary distribution power to satisfy a personal legal obligation to support another. UTC § 814(b)(2).

4. The interpretation of terms which set out a standard of distribution, such as "best interests," "support" and "comfort," is governed by state law. Therefore, the meaning of a particular term may be more or less restrictive, depending on the law of the state that governs the interpretation of the instrument.

5. In general, if the trustee's authority to make distributions is discretionary, and the trustee uses its judgment and makes a reasonable decision, a court will not disturb the trustee's decision to distribute or withhold trust assets unless there has been evidence of bad faith or an abuse of discretion. The Restatement (Third) of Trusts describes the trustee's powers and the court's oversight obligations as follows:

> § 50. Enforcement and Construction of Discretionary Interests
>
> (1) A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee.
>
> (2) The benefits to which a beneficiary of a discretionary interest is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor's purposes in granting the discretionary power and in creating the trust.

6. The commentary to the Restatement explains that a court will not interfere with a trustee's exercise of discretion merely because the court would have exercised the discretion differently. The court will act, however, to prevent an abuse of discretion. "What constitutes an abuse depends on the terms of the trust, as well as on basic fiduciary duties and principles…. Of particular importance are the purposes of the power and the standards…." Restatement Third § 50, cmt b.

7. The commentary states that intervention is appropriate to "rectify abuses resulting from bad faith or improper motive," to correct errors in interpretation, or to address a situation where the trustee failed to exercise his or her judgment or did so without inquiring into the relevant circumstances. Id.

8. One court recently confirmed that a court may review a trustee's actions as arbitrary or as an abuse of discretion:

> [S]tatutes and jurisprudence provide that, notwithstanding a broad grant of discretion or one specifically limited only by bad faith, fraud or dishonesty, a court is vested with the authority to evaluate whether the trustee's actions were consistent with the terms and purposes of the trust and in the best interests of the beneficiaries, and if they were not, to overrule the decision of the trustee as arbitrary and an abuse of discretion.

Rafalko v. Georgiadis, 777 S.E.2d 870 (Va. 2015).

D. Discretion of Trustee in Making Distributions

1. A trustee exercises discretion in determining whether to make distributions to beneficiaries.

2. A trustee may be vested with varying levels of discretion, such as "sole and absolute discretion" or "uncontrolled discretion." But case law and the Restatement indicates that using such adjectives does not indicate substantively greater discretion than another. As stated in the Third Restatement of Trusts, "the difference between extended and simple discretion is one of degree more than of kind." See Restatement (Third) of Trusts § 87, at 254 (2007).

3. In making distributions, the trustee must balance various factors, including, but not limited to, the following:

   a. The terms of the trust;

   b. The needs of current beneficiaries of the trust;

   c. The need to retain assets of the trust for future needs of current beneficiaries;

   d. The need to retain assets of the trust for future needs of future and remainder beneficiaries; and

   e. Other factors that may influence the retention of assets in the trust for the benefit of the beneficiaries, such as income tax implications of distributions to beneficiaries rather than retaining those assets in trust.

E. Consideration of the Beneficiary's Other Assets

1. Of particular concern, a trustee must determine whether it can, should, or must consider other resources of a beneficiary before making a distribution.

a. At common law, the general presumption was that, unless the instrument expressly provides that the trustee may consider the beneficiary's other assets and income, the trustee may not consider those assets in determining what distributions are required for the support of the beneficiary. The beneficiary has the right to look first to the trust assets for his support. See Restatement (Second) of Trusts, § 128, comment e; Nielsen v. Duyvejonck, 236 N.E.2d 743, 747 (Ill. App. 1968); Hart v. Connors, 228 N.E.2d 273 (Ill. App. 1967); Demitz' Estate, 208 A.2d 280 (Pa. 1965); Matter of Martin, 269 N.Y. 305 (1936); Godfrey v. Chandley, 811 P.2d 1248 (Kan. 1991); In re Bedell's Estate, 92 N.Y.S.2d 70 (1949).

b. In many cases, this rule would be disadvantageous from both a tax and a fairness standpoint, and the trend seems to be moving away from it. The Restatement Third of Trusts states that the general rule, absent specific direction to the contrary, is that the trustee has discretion to consider other resources. Restatement Third § 50, comment e.

c. In some states, if a gift to the beneficiary is conditioned on need—for example if the trustee is directed to make distributions "for a beneficiary's support as it deems necessary" or "as the beneficiary needs" or "if there is an insufficiency"—then the beneficiary's outside assets and income must be considered. See Boston Safe Deposit & Trust Company v. Boynton, 443 N.E.2d 1344 (Mass. App. 1983); Matter of Martin, 269 N.Y. 305 (1936); Matter of A. David Bernstein, NYLJ, December 7, 1988, p.26; Stempel v. Middletown Trust Co., 15 A.2d 305 (Conn. 1940); In re Tuthill's Will, 76 N.W.2d 499 (Minn. 1956); In re Martin's Will, 199 N.E. 491 (NY 1936); In re Seacrist's Estate, 66 A.2d 836 (Pa. 1949).

d. However, this is not a hard and fast rule, and in many cases the courts have not required the trustee to consider the beneficiary's other resources although the terms "as needed" or "necessary" were attached to the standard of distribution. See Cross v. Pharr, 221 S.W.2d 24 (Ark. 1949); Hamilton National Bank of Chattanooga, Tennessee v. Childers, 211 S.E.2d 723 (Ga. 1975); McClintock v. Smith, 29 N.W.2d 248 (Iowa 1947); Sibson v. First National Bank & Trust Co. of Paulsboro, 160 A.2d 76 (N.J. Super. 1960); In re Stern's Will, 228 N.Y.S.2d 90 (1962).

e. Some courts have found that where the trustee was directed to pay income and principal as needed for the support of the beneficiary, the beneficiary's other income, but not his other assets, should be considered. Peoples Bank & Trust Co. v. Shearin, 219 S.E.2d 299 (N.C. App. 1975); Sibson v. First National Bank & Trust Co. of Paulsboro, 165 A.2d 800 (N.J. Super. 1960).

f. Still other courts have concluded that even if a trustee is given extended discretion by a settlor, the trustee's judgment in making distributions "should be evaluated in light of the availability of other resources." In re Trusts of McDonald, 100 A.D.3d 1349 (N.Y. App. Div. 2012) (finding no abuse of discretion when trustee declined to make distribution for education, when beneficiary had access to additional resources, including a Section 529 plan for educational expenses and potential public assistance.

g. Some courts have held that if the trustee is granted broad discretion in making distributions, the trustee is permitted to consider the beneficiary's other assets.

(1) In one case, a standard which authorized the trustee to make distributions of principal which she "in her sole discretion, determines necessary for the support and maintenance" of the beneficiary allowed the trustee to consider the beneficiary's other assets. The Pennsylvania Superior Court held that such a broad grant of discretion indicated that the trustee had the authority to withhold trust principal from a beneficiary with independent resources. In re Estate of Tahjian, 544 A.2d 67 (Pa. Super. 1988).

(2) However, in a New York case involving similar language, the court held that the trustees should not require the beneficiary to use his personal assets for support before looking to the trust assets. In that case, the trustees were authorized to distribute as much of the trust income to the beneficiary as they in their sole discretion deemed advisable to supplement an annuity that the settlor gave to the beneficiary. Matter of Estate of McNab, 558 N.Y.S.2d 751 (1990).

h. If the settlor directs the trustee to consider the beneficiary's "other resources," there is still a question of which resources it may or must consider. In some circumstances, the settlor may want to specify whether the trustee is to consider only the beneficiary's liquid assets, or the beneficiary's entire estate, including non-liquid assets such as the beneficiary's home. Tax considerations also may be relevant.

i. The settlor may wish trust property which is not needed for the beneficiary's support to remain in trust for other beneficiaries, especially if the trust property will not be taxable in the beneficiary's estate.

j. For example, it may be desirable for the trustee of a credit shelter trust to consider the surviving spouse's marital trust and non-trust assets before making a distribution from the credit shelter trust, because those other assets will be included in the surviving spouse's gross estate, whereas the credit shelter trust assets will not.

F. Particular Standards of Distribution

1. The following terms or scenarios are discussed below, in this order:

a. "Support" and "maintenance"

b. "Standard of living"

c. "Comfort"

d. "Education"

e. "Health"

f. "Emergency" and similar "extraordinary" standards

g. "Best interests" or "best interests and welfare"

h. "Happiness"

i. To enable the beneficiary to make gifts

j. Distributions to save income taxes

k. "Sole and absolute" discretion

l. Special needs trusts

m. Additional language or circumstances

2. "Support" and "maintenance"

a. The terms "support" and "maintenance" normally are construed as synonyms. See Restatement Third § 50, comment d(2). They encompass more than bare subsistence. Hartford-Connecticut Trust Co. v. Eaton, 36 F.2d 710 (2d Cir. 1929). These terms include the beneficiary's normal living expenses, such as housing, clothing, food, and medical care, depending on the standard of living enjoyed by the beneficiary during the settlor's or testator's life. In re Levinson's Will, 5 Misc. 2d 979, 162 N.Y.S.2d 287 (1957); Hill v. Comm'r, 88 F.2d 941 (8th Cir. 1937); Equitable Trust Co. v. Montgomery, 44 A.2d 420 (Del. Ch. 1945).

b. The commentary to the Restatement adds that living expenses normally would include things such as mortgage payments, property taxes, suitable health insurance or care, casualty insurance, and also items such as vacation expenses in accordance with past vacations. The Restatement suggests that a beneficiary should be able to continue past patterns of charitable and family giving; not that the trustee would cover these with distributions, but that the beneficiary should be able to make these expenditures without reduction of the support coming from the trust. Restatement Third § 50, comment d(2)

c. The extent to which the standard of living or lifestyle of the beneficiary should be taken into account also depends on the size of the trust fund, and whether it needs to be preserved for probably future needs of the beneficiary. See Restatement Third § 50, comment d(2). In other words, the beneficiary may need to accept a less extravagant lifestyle if he or she is dependent on a trust of more limited size as his or her primary source of support.

d. In many states, if a trustee may distribute principal for a beneficiary's support, the trustee also may distribute principal for the support of the beneficiary's spouse and children. The beneficiary's legal obligations of support are a part of his living expenses. See In re Sullivan, 12 N.W.2d 148 (Neb. 1943); Robinson v. Robinson, 173 Misc. 985, 19 N.Y.S.2d 44 (Surr. Ct. 1940); Seattle-First National Bank v. Crosby, 254 P.2d 732 (1953); Akers v. Fidelity & Columbian Trust Co., 234 S.W. 72 (1921). But see Cavett v. Buck, 397 P.2d 901 (Okla. 1964) (Court limited the permissible distributions to those for the support of the beneficiary alone, and not for the support of his wife and dependent children).

e. If the settlor wishes to allow the trustee to make distributions to spouses of the settlor's descendants, he or she should include a specific provision in the trust instrument:

> **SAMPLE TRUST PROVISION:** In the trustee's sole and uncontrolled discretion, the trustee also may distribute income or principal to any individual who at any time was married to a descendant of mine in such amounts as the trustee, other than the distributee, deems necessary for the distributee's health and support in reasonable comfort in light of the distributee's role within the family of that descendant of mine.

3. “Standard of living”

a. A distribution standard, and in particular a distribution standard regarding “support,” often refers to the beneficiary’s standard of living. In most cases, it is not necessary to elaborate on this reference. However, if there is a concern about changing standards of living, the time to which the standard of living refers should be made clear.

(1) For example, it could refer to the standard of living when the instrument was drafted, when the instrument became effective (i.e., at the decedent’s death in the case of the will), or when the beneficiary’s interest vested.

(2) It may be especially important to provide guidance on standard of living in a very wealthy family. The standard of living may be quite opulent for the creator of the trust, but he or she recognizes that future generations cannot or should not be able to live that lifestyle, in particular at a younger age. This may be simply because the amounts available to descendants will be far less after reduction by estate taxes and division among multiple family members.

b. If the beneficiary’s standard of living substantially improves or is reduced between the time the instrument is drafted and the decedent’s death, a standard of distribution tied to the beneficiary’s standard of living may not carry out the settlor’s intent.

> **SAMPLE TRUST PROVISION:** The trustee shall distribute to my wife so much of the income and principal as it determines to be desirable for her comfortable support and reasonable health, considering our standard of living at my death and all other income currently available for such purposes.

4. “Comfort”

a. In some states, the term “comfort” is limited to an ascertainable standard related to the beneficiary’s health and support. <u>Estate of Vissering</u>, 990 F.2d 578 (10th Cir. 1993).

b. In other states, the standard is broader than “support or maintenance,” and encompasses a beneficiary’s enjoyment, pleasure, happiness, satisfaction, or peace of mind.

c. The Restatement Third takes the position that the term “comfort”, whether used separately (“support and comfort”) or as a modifier ("comfortable support") adds nothing to the usual meaning of support for a beneficiary whose lifestyle already is comfortable. It may be meaningful if the beneficiary's lifestyle has been more modest. <u>See</u> Restatement Third § 50, comment d(2).

d. In applying this standard, one court allowed distributions to purchase an automobile to enable the beneficiary's daughter to visit the beneficiary because her visits "did much to ease the mind" of the beneficiary. <u>In re Mirfield's Estate</u>, 126 N.Y.S. 465 (Sur. Ct. 1953).

e. "Comfort" has also been construed as relating to the grantor's, rather than the beneficiary's, accustomed standard of living. The Mississippi Supreme Court ruled that the term "comfort" should be construed according to the grantor's understanding of the word, which could be discovered by looking at the grantor's standard of living. <u>Gulf National Bank v. Sturtevant</u>, 511 So. 2d 936 (Miss. 1987).

5. "Education"

a. In general, the term "education" includes college education, but does not include graduate level or professional education, unless specifically provided by the trust instrument. Bogert § 182; <u>Murphy v. Morris</u>, 141 S.W.2d 518 (Ark. 1940); <u>Epstein v. Kuvin</u>, 95 A.2d 753 (N.J. Super. 1953).

b. The term "college education" has been held to include the expenses of a high school education, since a high school education is normally required to prepare the beneficiary for college. <u>Security Trust Co. v. Smith</u>, 145 S.W.2d 512 (Ky. 1940).

> **SAMPLE TRUST PROVISION:** The term "education" includes, but is not limited to, the expenses of private schooling at the elementary and secondary school level, college, graduate and professional schools, and specialized or vocational training.

> **SAMPLE TRUST PROVISION:** The term "education" includes all expenses of public and private education at any level, such as tuition, room and board, books, fees, all desirable study materials, dues, reasonable allowance and travel to and from home, as well as graduate and professional education, and specialized or vocational training.

6. “Health”

a. The term “health” includes all routine medical care, medication, surgery and hospitalization, as well as expenditures for extended nursing care and mental health. It arguably is duplicative of support, because most states would find that reasonable health care expenses would be included within support.

b. Some commentators have suggested that the term “medical care” may be more limited than health, because it may not cover treatment for psychological or mental health problems or addictions, which have not been universally accepted as “medical” problems. See Q. Heisler, Jr. & W. Butler, “Discretionary Distributions,” Illinois Trust Administration, p. 5-13 (Illinois Institute for Continuing Legal Education 1992).

> **SAMPLE TRUST PROVISION:** The term “health” shall be construed liberally to include all forms of mental or physical health care, including, but not limited to, nursing or other extended care.

> **SAMPLE TRUST PROVISION:** The term “health” includes all expenses of health care providers net of insurance benefits paid to or for the beneficiary, such as hospital charges, physician service fees, lab charges, ambulance, nursing care at any location, physical and psychological therapy, drugs and the like, health insurance premiums for a beneficiary, as well as all costs of an extended health care facility, including an entrance fee or endowment fee (whether refundable or not), interest free loan and other forms of capital charge, as well as monthly assessments and other periodic charges.

c. In some cases, the settlor may wish to express a preference for home health care over nursing home care, and specifically to authorize distributions for that purpose.

> **SAMPLE TRUST PROVISION:** In making discretionary distributions for me or my spouse under this instrument, the trustee shall consider my strong desire that medical care, nursing care, and other types of care and assistance that are necessary for me or my spouse be provided to me or my spouse in the familiar environment of our home to the greatest extent practicable, without regard to the additional cost of such home care and assistance.

7. “Emergency” and Similar “Extraordinary” Standards

a. The Restatement Third categorizes “emergency” as restrictive terminology, along with terms like “severe hardship” or “special need.” Restatement Third § 50, comment d(4). Likewise, many courts interpret the term “emergency” as a very narrow and restrictive standard, which authorizes distributions only for the beneficiary’s unusual and unforeseen expenses, and not for the beneficiary’s routine or ordinary support and maintenance. See, e.g., Nardi v. United States, 385 F.2d 343 (7th Cir. 1967); Budd v. Commissioner, 49 T.C. 468 (1968).

b. Nevertheless, the IRS has taken the position on a number of occasions that the term, by itself, does not create an ascertainable standard for federal estate and gift tax purposes.

c. The IRS has privately ruled that a standard of “great emergencies which may arise in the lives and affairs of [the beneficiary], such as extra needed medical services or hospitalization” did not restrict distributions to emergencies relating to medical needs. The language “such as extra needed medical services or hospitalization” merely illustrated some of the types of expenditures that would qualify as emergencies, but were not intended to be an exclusive list. The IRS noted that distributions could also be made for any “sudden or unexpected happenings,” such as being stranded in a foreign country without funds to return home. Letter Ruling 8304009 (Oct. 25, 1982).

d. The IRS has also ruled that the phrase “any other emergency condition of any exigencies” did not constitute an ascertainable standard. Letter Ruling 9044081 (July 31, 1990).

e. However, in Letter Ruling 200028008 (July 14, 2000), the IRS gave a more favorable interpretation to the standard “proper care, support and maintenance, or in the event of any other accident, illness or other emergency.” The IRS concluded that “emergency” must be limited to the types of emergencies itemized before the word “other” and therefore constituted an ascertainable standard.

f. Several courts have rejected the IRS position and held that a standard of distribution related to “emergency” is an ascertainable standard for tax purposes. Estate of Sowell v. Commissioner, 708 F.2d 1564 (10th Cir. 1983), rev’g 74 T.C. 1001 (1980); Wahlfeld v. United States, 47 A.F.T.R.2d (P-H) ¶ 148,432, at 81-1565 (C.D. Ill. 1980); Hunter v. United States, 597 F. Supp. 1293 (W.D. Pa. 1984). In Hunter, the court stated that it could not envision an emergency that was not measurable in terms of the beneficiary's health or support.

g. In another case, the Second Circuit has held that a trust provides an ascertainable standard when it allows distributions in the event of "prolonged illness or financial misfortune which the trustee deems extraordinary." Jennings v. Smith, 161 F.2d 74, 76 n.3 (2d Cir. 1947). In that case, the Court held that this language created an ascertainable and enforceable standard, and it put the right to distributions "beyond [the trustee's] control or retention by imposing conditions upon the exercise of it" which was subject to judicial oversight. Id. at 78.

h. The Tax Court has also held to be ascertainable the apparently less strict standard of "sickness or other emergency." See Estate of Budlong v. Commissioner, 7 T.C. 758 (1946). In Budlong, the trust allowed the grantor/trustee to make distributions "in case of sickness or other emergency." Id. at 757. The Court held that this standard was ascertainable and enforceable. Id. at 761. The Court reasoned, "It is obvious that the power in question gave the trustee no absolute and arbitrary control over the corpus. On the contrary, it was conditional and limited. A definite standard—the sickness or other emergency of the respective beneficiaries—was provided to govern its exercise…. We have little doubt that … if [the] decedent had chosen to apply principal for an income beneficiary when no sickness or emergency existed, a remainderman would have had just cause for complaint in equity." Id.

i. To forestall the IRS's argument that the term emergency is not an ascertainable standard, the draftsperson may wish to specify the types of emergencies for which distributions are authorized: such as financial emergencies or only those related to health or maintenance.

> **SAMPLE TRUST PROVISION:** The trustee shall distribute as much of the principal of the trust, even to the extent of exhausting principal, as the trustee from time to time determines to be required to meet the expenses of an illness or other emergency relating to the health, support and education of the Child and the Child's descendants.

> **SAMPLE TRUST PROVISION:** In the event that the Child should suffer prolonged illness or financial misfortune which the trustee deems extraordinary, the trustee may pay to the Child so much of the net income and principal of the trust as

the trustee may deem appropriate to meet such conditions.

8. "Best interests" or "best interests and welfare"

a. Under these standards, the trustee may make distributions to allow the beneficiary to enjoy a higher standard of living, or to have certain selected luxuries, such as extensive travel or the purchase of luxury automobiles and jewelry.

b. The term "best interests" has been interpreted to allow distributions for more than the beneficiary's pecuniary interests. Best interests include peace of mind, as well as financial gain. Wiedenmanyer v. Johnson, 254 A.2d 534, aff'd, 259 A.2d 465 (1969). In light of the broad meaning of the term and the liberal attitude towards distributions that it encompasses, it may be appropriate to add some limitations to the standard, such as the italicized language below.

> **SAMPLE TRUST PROVISION:** The term "best interests" with respect to distributions to any beneficiary shall be construed to provide the beneficiary with the means to enjoy a comfortable lifestyle, including recreation, cultural pursuits, and travel, but, in the case of a descendant of mine, shall not be construed so generously as to discourage the descendant from assuming the responsibilities of self-support.

> **SAMPLE TRUST PROVISION:** The term "best interests" refers to all aspects of a beneficiary's happiness and well-being within the context of reasonable personal and social conduct, as determined in the absolute discretion of the trustee.

c. Although distributions are permissible for a wider variety of purposes under a best interests standard than under a standard of support, the beneficiary may be less able to compel the trustee to distribute trust assets since the beneficiary's best interests are less easily defined. In other words, the standard is less enforceable from a beneficiary's perspective and therefore grants the trustee greater latitude.

d. Some courts have held that if the trustee is authorized to distribute principal under a best interests or similar standard, then the trustee has the authority to distribute the entire trust principal to the beneficiary in a lump sum, provided that such a distribution is not an abuse of the trustee's discretion. See, e.g., Lees v. Howarth, 131 A.2d 229 (R.I. 1957). Therefore, if a best interests standard is used, but the settlor wants to preserve trust principal for the remaindermen, the trust instrument should contain language which expresses that intention.

> **SAMPLE TRUST PROVISION:** My primary concerns during the life of the Child are to preserve trust principal for ultimate distribution to the Child's descendants while at the same time reasonably providing for the health, support, education and best interests of the Child.

e. If the settlor does want the trustee to have the power to distribute the entire trust principal to the beneficiary, the settlor could use the following provision:

> **SAMPLE TRUST PROVISION:** If at any time the trustee believes that it would be in my child's best interests and determines that it is otherwise appropriate under the circumstances, it may in its absolute discretion distribute to him the entire principal of his trust and terminate his trust, without regard to the interests of remaindermen. My child shall have no right to require that the trustee make any distribution that is not subject to an ascertainable standard, and the trustee is expressly exonerated from all liability to my child and all other interested parties by reason of the exercise or non-exercise of its discretionary authority in such matters.

9. "Happiness"

a. In contrast to "emergency", the use of the term "happiness" is considered expansive of the distribution power.

b. The Restatement Third states that the term suggests an intention that the trustee act generously and "without relatively objective limitation." Restatement Third § 50, comment d(3). It adds that the primary effect of the term is to immunize decisions from the challenge of remainder beneficiaries. At the same time, it does not create minimum entitlements for the current beneficiary, so the trustee still can legitimately decline requests. Id.

10. Distributions to Allow a Beneficiary to Make Gifts

a. It is often uncertain whether a particular standard of distribution, such as a best interests standard, will allow the trustee to make distributions to a beneficiary for the purpose of allowing the beneficiary to make gifts. Often distributions for this purpose are desired in order to allow a surviving spouse to make annual exclusion gifts from property held in the marital trust.

b. In one case, the trustees were given the power to invade principal under the following standard: "As in the absolute discretion of my Trustee shall be appropriate and to the best interest of my wife. . . . In determining whether or not to make these encroachments, my Trustee shall be liberal if it considers that an actual need or reasonable request of my said wife is involved." The South Carolina Supreme Court refused to allow the trustee to distribute principal to the wife in order to permit her to make gifts to her children. The court found that principal could be invaded only if it were to be used for the wife's own welfare. <u>In re Estate of Howard</u>, 235 S.E.2d 423 (S.C. 1977).

c. Similarly, the trustee was prohibited from distributing principal to the beneficiary of a marital trust where the will authorized distributions "for the spouse or for her use." <u>Matter of Mandel</u>, 46 Misc. 2d 850, 261 N.Y.2d 110 (1965).

d. In yet another case, a trustee did not have the authority to distribute principal to a beneficiary to allow her to make gifts to relatives where the trust instrument gave the trustee power to distribute principal to the beneficiary for her needs. <u>Flowers v. Collins</u>, 357 S.W.2d 179 (Tex. Civ. App. 1962) (dismissed for error).

e. A Connecticut trustee was authorized to invade principal "for any reason in its discretion for the benefit of" the beneficiary. At the request of the beneficiary, the trustee distributed the entire trust principal to the beneficiary, to be used by the beneficiary to support his stepchildren. The court construed the term "benefit" broadly, to include anything that worked to the "advantage, gain or happiness" of the beneficiary, and concluded that the distribution of principal to allow the beneficiary to support his stepchildren was for the benefit of that beneficiary. <u>Ewing v. Ruml</u>, 892 F.2d 168 (2d Cir. 1989).

f. The Illinois Supreme Court has construed the terms "comfort and satisfaction" to allow the trustee to distribute principal to the testator's wife to allow her to continue a program of charitable contributions. Rock Island Bank & Trust Co. v. Rhoads, 353 Ill. 131, 187 N.E. 139 (1933).

g. The IRS also has a stake in the issue of distributions for the purpose of making gifts. In Estate of Hartzell v. Comm'r., 68 T.C. Memo 1243 (1994), the IRS attempted to have distributions made from a marital trust and the gifts made by the spouse with those distributions declared invalid. The standard for principal distributions under the trust was "comfort, maintenance, support and general well being." The court rejected the IRS position. The same issue was before the court in Estate of Halpern v. Comm'r., 70 T.C. Memo 229 (1995). The standard in the trust in this case was much more limited, but the court nevertheless approved gifts the spouse had made with distributions before her incompetency. It brought back into the estate gifts made on behalf of the spouse with trust distributions after she was declared incompetent.

h. Trust language which defines the best interests of a beneficiary as including distributions for benefit of the beneficiary's descendants would allow the beneficiary to make gifts of trust property.

> **SAMPLE TRUST PROVISION:** The term "best interests" shall be construed to provide the beneficiary with means to enjoy a comfortable lifestyle and to assist the beneficiary's descendants as the beneficiary may wish, including distributions to allow the beneficiary to make gifts to the beneficiary's descendants.

11. Distributions to Save Income Taxes for the Trust and Beneficiaries

a. Recent developments in tax law have made more attractive the distribution of ordinary income or capital gains to a beneficiary.

b. Generally, ordinary income or capital gains tax that is earned by a trust is paid by the trust itself. But if that income is distributed to a beneficiary, then that income tax liability can shift to the beneficiary, and the trust is allowed a deduction for that income.

c. Ordinary Income Tax

(1) Shifting the income tax liability from the trust to the beneficiary can result in overall income tax savings for the trust and the beneficiary.

(2) For ordinary income, the trust reaches the highest marginal tax bracket of 39.6% upon reaching $12,500 in income for 2017. But individuals reach the highest marginal tax

bracket of 39.6% upon reaching $415,050 for single filers, and $466,950 for joint filers.

d. Capital Gains Tax

(1) Capital gains are also taxed to trusts and individuals at different rates. Under current law, a trust must pay capital gains at the top marginal rate of 20% upon reaching $12,500 in income for 2017.

(2) A beneficiary who has not reached the highest marginal tax bracket would pay capital gains at 15% for 2017.

e. Net Investment Income Tax

(1) The trust typically would also be subject to the 3.8% net investment income tax for taxpayers in the highest tax bracket, such that a trust's total marginal capital gains rate might be expected to be 23.8%, and a trust's total ordinary income rate might be 43.4%.

(2) An individual is subject to the net investment income tax at $200,000 for single filers and $250,000 for married individuals filing jointly.

f. Capital Gains and DNI

(1) Generally, capital gains are not included in distributable net income ("DNI") of a trust, and thus the capital gains tax is borne by the trust, not by any beneficiary.

(2) However, if capital gains are properly allocated to income under certain circumstances, including as a result of a proper exercise of the trustee's power to adjust under the Uniform Principal and Income Act (discussed below), then capital gains can be included in DNI, the capital gains can be distributed to the beneficiary, and the tax burden of such gains can be shifted to a beneficiary. Notably, the Treasury Regulations require that such an adjustment must be made properly under local law. <u>See</u> Treas. Reg. § 1.643(a)-3(b)(1).

g. Step-Up in Basis

(1) Given the increase of the estate tax exemption (which is currently $5,490,000 per individual for 2017), a distribution of property to a beneficiary could also allow that property to pass through the taxable estate of the beneficiary without

incurring estate tax, but allowing for a step-up in basis upon that individual's death.

h. Specific Language

(1) Generally speaking, a trustee may consider the tax consequences of a distribution. See Restatement (Third) of Trusts § 58 & comments. However, without express language in the trust authorizing distributions to save on overall income taxes, distributions for the sole purpose of saving taxes may subject the trustee to later liability to a beneficiary.

(2) The settlor can include specific language authorizing these distributions in the trust document. However, this type of language should be included after careful consideration; these distributions might lead the trustee to exhaust the corpus of the trust prematurely, with the intent of saving taxes; that is, this type of power might lead the trustee to allow the tax "tail" to wag the trust "dog":

> **SAMPLE TRUST PROVISION:** In addition, my Trustee may distribute income of the trust to any descendant of mine to reduce overall income taxes when considering the taxes that would be payable by such descendant if such income were distributed, as compared to the taxes that would be payable by the trust if such distributions were not made.

(3) The settlor may also want the trustee to consider the income tax consequences to the beneficiary if the beneficiary must liquidate his own assets to meet expenses and incur capital gains tax.

> **SAMPLE TRUST PROVISION:** In determining whether to make discretionary distributions of net income or principal to a beneficiary, the trustee may consider such circumstances and factors as the trustee believes are relevant, including the other income and assets known to the trustee to be available to that beneficiary, including funds which might be made available by enforcement of the legal obligation of any person to furnish support or education, and

the advisability of supplementing such income or assets, the tax consequences to the beneficiary of requiring the beneficiary to rely first on his or her own assets, and the tax consequences of any such distribution.

(4) For very wealthy families, this is another area where customized guidance often is helpful. For example, there may be certain dynasty trusts in the family that pay mandatory income. The creator of a new trust may want to explicitly provide that the trustee should take that income into account before making additional distributions.

12. "Sole and absolute discretion" of the Trustee

a. As discussed in more detail above, the trustee exercises his or her discretion in making distributions under the standards articulated in the instrument.

b. The instrument can also expand or contract the trustee's discretion, although, as also noted above, such differences are often considered as matters of degree, rather than of kind. For example, in one case, a court found that the discretion granted to trustees was similar in trusts that granted the trustee "sole and absolute" discretion, "absolute and uncontrolled discretion," on the one hand, and trusts that only granted a trustee "discretion," on the other. Citing the Restatement, the court concluded, "The adjectives that described the trustee's discretion [in prior cases] … do not indicate substantively greater discretion than that afforded to the plaintiff…." Morse v. Kraft, 992 N.E.2d 1021, 1026 n.9 (Mass. 2013) (quoting Restatement (Third) of Trusts § 87, at 254 (2007) ("difference between extended and simple discretion is one of degree more than of kind").

c. Nevertheless, when a trustee is granted "sole and absolute" discretion, or discretion described by similar adjectives, the trustee has wider latitude in making distributions than if the trustee's discretion is not described by such adjectives.

d. Under the older common law interpretation of this standard, the trustee may make distributions for any purpose or withhold funds from the beneficiary, as long as the trustee does not act in bad faith or arbitrarily. See In re Ledyard's Estate, 21 N.Y.S.2d 860 (1939); Estate of Zuckerman, NYLJ, January 29, 1990, p. 30. Where the trustee's discretion is "absolute" or "uncontrolled," a court will grant the trustee's decision even more deference. Bogert § 811.

e. More recent guidance suggests that the courts exercise more oversight, in light of the fundamental duty to act in a beneficiary's interests. The UTC provision, UTC § 814(a), is as follows:

> (a) Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

f. As noted above, the Supreme Court of Virginia has recently confirmed that a trustee's actions are subject to court review for being arbitrary or an abuse of discretion: "[N]otwithstanding a broad grant of discretion or one specifically limited only by bad faith, fraud or dishonesty, a court is vested with the authority to evaluate whether the trustee's actions were consistent with the terms and purposes of the trust and in the best interests of the beneficiaries, and if they were not, to overrule the decision of the trustee as arbitrary and an abuse of discretion." Rafalko v. Georgiadis, 777 S.E.2d 870 (Va. 2015).

g. The commentary to UTC § 814 states that no grant of discretion to a trustee should be absolute.

h. Indeed, courts often impose a standard of reasonableness, even where the trustees are given "absolute and uncontrolled discretion" to invade principal.

(1) In one case, the beneficiaries of two $8 million trusts requested distributions of $145,000 and $150,000 in principal. The trustees refused the request because the money was not needed and the beneficiaries' planned use for the money was unlikely to be productive. Although the court found that the trustees had acted in good faith in refusing the request, the court found that the trustees should not have applied such considerations in determining whether or not to make the requested distribution, and directed the trustees to make the distribution. Matter of Stillman, 433 N.Y.S.2d 701 (1980).

(2) In another case in which the trustees had the power to invade principal "as the trustees in their discretion shall deem proper," the court held that "even where the payment of principal rests in the uncontrolled discretion of the trustee, he must not in exercising his authority act

dishonestly, or with an improper motive or fail to use his judgment or act beyond the bounds of reasonable judgment." Estate of Joseph P. Sanders, NYLJ, April 19, 1991, p. 25.

(3) In a Connecticut case, a trustee was given authority to distribute as much of the income as it thought advisable in its absolute discretion. The court found that the trustee could withhold income from the beneficiaries as long as it acted in good faith and without abuse of discretion. Auchincloss v. City Bank Farmers Trust Co., 70 A.2d 105 (Conn. 1949).

(4) And in another Virginia case, the Supreme Court of Virginia held that a trustee did not abuse its discretion by refusing to invade the trust principal on behalf of a beneficiary, when the beneficiary had "substantial personal assets" that were available for satisfaction of her debts. In that case, the trustee was authorized to make distributions of principal in its "uncontrolled judgment and discretion." NationsBank of Virginia, N.A. v. Estate of Grandy, 450 S.E. 140 (Va. 1994).

(5) The case law indicates that the use of the words "sole and absolute discretion" will not necessarily free the trustee completely from enforceable requests for distributions. If the settlor wants the trustee to have complete latitude and the beneficiaries to have no enforceable rights against the trustee, it may be necessary to be more explicit.

> **SAMPLE TRUST PROVISION:** My child shall have no right to require that the trustee make any distribution, and the trustee is expressly exonerated from all liability to my child by reason of the exercise or non-exercise of its discretionary power.

(6) It is possible that a state court might declare this broad a grant of discretion void as against public policy.

i. A trustee's power to make distributions in its sole discretion must be distinguished from a trustee's power, in its sole discretion, to make distributions pursuant to a particular standard, such as for the beneficiary's support. In one case, the trustee argued that his authority to make payments for "the comfortable maintenance, support and education [of the beneficiary] as he or it shall, in his or its sole discretion, deem advisable" authorized the trustee to withhold any payments to the beneficiary. The court disagreed, and found that the trustee's power was limited by the standard of "comfortable maintenance, support and education," and that the trustee had the duty to make distributions in accordance with that standard. Kolodney v. Kolodney, 503 A.2d 625 (Conn. App. 1986).

j. The Third Restatement provides the following illustration regarding the grant of uncontrolled discretion in the context of a defined standard, see Restatement Third § 50, comment c:

> 3. Following S's death his previously revocable trust has been administered for nearly a decade by T Bank, which is directed to pay income to S's widow, W, and also empowered to pay her "such additional amounts from the principal of the trust as the Trustee, in its sole and uncontrolled discretion, believes appropriate for W's comfortable support and care," with the remainder upon W's death to pass to S's then living issue. In response to requests by W, T Bank has begun to pay substantially increased amounts to her to enable her to accumulate funds from which she may aid C (her child by a prior marriage) in his plans to obtain control and expand the activities of X Co., of which C has been an officer and shareholder for a number of years. S's children petition the court to instruct T Bank that principal distributions for that purpose are improper and that it must recover amounts previously paid to W for that purpose. Nothing in relevant circumstances or in other terms of the trust indicates a broader purpose for the invasion power than the support-related (see Comment *d)* language quoted above. The court will issue the order requested by the remainder beneficiaries. Despite S's grant of extensive discretion, and without a finding of bad faith, T's judgment was not exercised in an appropriate state of mind, that is, for a purpose falling within the quoted standard.

13. Special Needs Trusts

a. Distribution standards must be carefully drafted in order to allow a beneficiary to qualify for Medicaid or other needs-tested government benefits. Many states have passed laws that permit agencies to seek reimbursement and that define the assets which are available to the government agency. Put differently, depending on the distribution standard of the governing document, the assets of a trust for the benefit of an individual may be treated by government agencies as an available resource to the individual, thereby preventing the individual from qualifying for governing benefits until those assets are exhausted.

b. A "special needs trust" is a trust that is specifically drafted to allow the beneficiary to still qualify for those government benefits. The nuances of special needs trusts are beyond the scope of this presentation. However, some key principles are summarized below.

c. State case law is not consistent in defining the standard of distribution that will cause trust assets to be chargeable for a disabled beneficiary's care. In many states, a trust that allows the trustee to make distributions for the "support and maintenance" of a beneficiary will be treated as an asset of the beneficiary for the purpose of determining eligibility for public aid. However, in other cases, a state has been unable to obtain reimbursement for public aid where the trust instrument allowed the trustee to use principal for the beneficiary's support and maintenance (especially in cases in which the trust instrument evidenced the testator's intent that trust assets merely supplement support from other sources).

14. Relevance of Additional Language or Circumstances

a. Other, more subtle differences in language referring to the distribution standards, or even facts and circumstances surrounding the settlor and beneficiary, can also be relevant in reviewing a trustee's conduct or in determining a beneficiary's right to receive distributions. But in most cases, the "the most revealing and reliable guides for resolving these types of questions are the underlying or general purposes of the trust or provision in question." Restatement (Third) of Trusts § 50, comment g.

b. The Restatement generally provides the following summary of additional language or circumstances that might be relevant to a distribution standard:

> Many factors may be influential in a process of interpretation [of a settlor's intent regarding a beneficiary's interest in the trust]…. Factors often cited in opinions as influential range from the particular language used in the grant of discretion (e.g., details of wording such as whether "may" or "shall" was used, whether discretion was about amounts "necessary" rather than "appropriate" to a

> beneficiary's support, and whether remainder beneficiaries were to take "the principal" or "whatever principal remains") to the relationships between the settlor and one or more of the beneficiaries…. Specific language, facts, and circumstances in a situation are properly to be considered in the process of interpretation, and may overcome, alter, or reinforce a particular presumption.

Restatement (Third) of Trusts § 50, comment g.

c. But the Restatement continues that these factors or language often "reveal little of a settlor's actual intent." The Restatement provides that these additional factors may be unreliable for a number of reasons:

> The settlor may have formed no intention on the matter at issue, or whatever intention may have existed might not have been ascertained by counsel or preserved in the drafting. In any event, the significance of particular facts and circumstances is often highly speculative, or they may cut both or several ways even if judicial opinions sometimes mention but one side. Furthermore, to be influenced by and draw meaning from subtle details of wording may well ignore the realities of how drafting is done, not to mention that the words were those of one whose work product suggests inattention to the particular issue or circumstances for which it has become necessary to discover, or attribute, an intention.

Restatement (Third) of Trusts § 50, comment g.

d. IRS Tax Levies

(1) In particular, courts have found the specific nuances of the language used, even beyond words such as "support," to be key in determining whether the IRS may seize assets held in a trust for the benefit of an individual who is subject to an IRS tax levy.

(2) Spendthrift provisions and other asset protection features of a trust generally are not enforceable against the government.

(3) Instead, courts have allowed the IRS to actually seize property held in a trust for the benefit of a delinquent taxpayer. The threshold issue is whether the beneficiary's interest constitutes "property" or a "right to property" under applicable law. This inquiry is dependent on the particular language of the trust. But if the beneficiary's interest is a determined to be a property interest under applicable law, then the IRS may foreclose upon the interest in the trust. See, e.g., United States v. Delano, 182 F. Supp. 2d 1020, 1022–25 (D. Colo. 2011); see also CCA 200614006 (November 30, 2005); Rev. Rul. 55-210, 1955-1 C.B. 544 (regarding the right of the IRS to seize a beneficiary's income or principal interest).

(4) In considering whether the beneficiary has an actual "property" interest in the trust, which would be subject to the levy, versus a mere "expectancy," courts have closely reviewed the language of the trust. In one case, a court found it relevant whether the trust provided that the trustee "shall make" distributions subject to a standard, as opposed to providing that the trustee "may make" distributions subject to that same standard. See Duckett v. Enomoto, No. CV-14-01771 (D. Ariz. 2016); Delano, 182 F. Supp. 2d at 1022.

e. Thus, there are certain situations in which a court might look beyond the general substance of the standard, and consider other language, circumstances, or indicators of the settlor's intent.

IV. Providing Additional Guidance to the Fiduciary

A. It often is not sufficient to simply define for a trustee or other fiduciary the purposes for which distributions can be made. For example, if the client's goal is to make the trust fund available in a manner that will not interfere with a beneficiary's development as a productive member of society, the trustee should be given authority to consider factors related to the beneficiary's personal development in determining whether to make distributions for the purposes set forth in the trust agreement.

B. At a minimum it is good practice to give the trustee discretion to consider the beneficiary's personal characteristics. A trustee generally cannot do this unless specifically authorized in the trust agreement.

SAMPLE TRUST PROVISION: In determining whether to make discretionary distributions of net income or principal to a beneficiary, the trustee may consider such circumstances and factors as the trustee believes are relevant, including the following:

1) other income and assets known to the trustee to be available to the beneficiary and the advisability of supplementing such income or assets;

2) the tax consequences of any such distribution; and

3) in the case of any descendant of mine, the character and habits of the beneficiary, the diligence, progress and aptitude of the beneficiary in acquiring an education and the ability of the beneficiary to handle money usefully and prudently and to assume the responsibilities of adult life and self-support.

C. Some practitioners advocate including more of this type of guidance in the trust agreement rather than less, focusing on guidance that describes the settlor's values and principles. In Handler and Loathes, "The Case for Principle Trusts and Against Incentive Trusts," Trusts & Estates (Oct. 2008), the authors suggest guidance that encourages the trustee to consider and reward certain desirable behaviors, such as:

1. Pursue an education at least through college;

2. Pursue gainful employment with a goal of becoming financially self-sufficient;

3. Be a law-abiding citizen;

4. Become a productive member of society, as exhibited by meaningful contributions to family, community and society;

5. Engage in entrepreneurial and/or creative activities;

6. Handle money intelligently and avoid wasteful spending;

7. Act with empathy, thoughtfulness, kindness and consideration toward others;

8. Develop healthy and meaningful relationships;

9. Make contributions of time and talent to charities; and

10. Maintain a healthy lifestyle, avoiding drugs and other harmful substances.

D. The authors advocate giving the trustee discretion to reward such behaviors rather than setting objective benchmarks that result in mandated distributions, as in some types of incentive trusts (see the discussion below). Id. The guidance of course would be personalized to reflect the particular values and beliefs of the settlor.

E. The trust agreement also can direct the trustee to obtain certain information from a beneficiary regarding finances, spending habits, or personal activities before authorizing a distribution to that beneficiary. In many cases this information is needed to apply the guidance that the trustee is directed to consider.

> **SAMPLE TRUST PROVISION:** In determining whether to make discretionary distributions of net income or principal to a beneficiary, the trustee shall consider the other income and assets known to be available to the beneficiary [same provisions as above] . . . adult life and self-support, it being my intent that the failure of a beneficiary in any of these areas may, in the discretion of the trustee, constitute a reason for denying a distribution. In order to make these determinations, the trustee shall request any information it deems relevant from a beneficiary (and withhold a distribution if the beneficiary refuses to provide such information), including without limitation, the following:
>
> 1. A statement of the beneficiary's assets and liabilities, and the assets and liabilities of his or her spouse;
>
> 2. Copies of bank statements, cancelled checks, credit card statements or any related material that evidences the beneficiary's spending habits;
>
> 3. Evidence that the beneficiary is enrolled in school or employed and, for a beneficiary in school, copies of transcripts;
>
> 4. A beneficiary's employment history and authorization to contact and request employment information from the beneficiary's current employer;
>
> 5. A list of the beneficiary's place of residence for whatever period of time the trustee determines to be relevant;
>
> 6. Access to medical records, blood tests, or related medical information; and
>
> 7. Information concerning travel by the beneficiary and a copy of the beneficiary's passport.

F. One method of limiting the funds in the trust so that they do not interfere with the beneficiary's own motivation is to direct that the trustee should use the trust property for the purposes designated only as a last resort, if no other assets are available.

> **SAMPLE TRUST PROVISION:** The primary purpose of the trust is to maintain a reserve fund to provide for the health, support and education of my descendants in situations in which all other

assets and sources of income available to a descendant of mine are insufficient for those purposes.

G. A more common provision is one directing the trustee to make trust distributions sparingly so as to encourage self-sufficiency and avoid the development of unmotivated children or grandchildren who are content to live off their inheritance.

> **SAMPLE TRUST PROVISION:** The primary purposes of the trust are (i) to provide for the health, support and education of the child for whom the trust is named, and (ii) to avoid use of the trust property in a manner that might impair the desire of the child or a descendant of the child to be self-sufficient. I intend for the trustee to distribute trust income and principal to the child or his or her descendants on a selective and considered basis, my concern being that the child or the child's descendants may receive too much rather than too little.

H. Letter of Wishes

1. Some practitioners are advocating that the grantor provide guidance to the trustee outside the trust agreement, through a separate written set of instructions or general statement of the grantor's views and beliefs—a "Letter of Wishes."

2. The advice is meant in particular for trusts in which the trustee is granted broad discretion to make distributions, such as under as undefined standard like "as the trustee determines" or "best interests."

   a. The advantage of such a standard is that it gives the trustee the greatest latitude to do what is appropriate in any given situation. In addition, because it is an undefined standard, the trustee should be less subject to claims by a beneficiary who does not agree with the trustee's distribution decisions.

   b. Such broad standards, however, leave the trustee with little guidance about what the settlor wants or believes. The initial trustee may know the settlor personally, but future trustees may not, and therefore may have little or no knowledge about the settlor's intent. See Bove, "Letter of Wishes," Trusts & Estates (Jan. 2006). As Bove points out, quoting Scott on Trusts, "The real question is whether it appears that the trustee is acting in that state of mind in which it was contemplated by the settlor that he would act." Id. (quoting Scott and Fratcher, The Law of Trusts, Section 187).

c. A Letter of Wishes can help to clarify what the settlor intended, while still granting the trustee wide latitude to address unforeseen circumstances.

3. As suggested above, such guidance can be included in the trust agreement. The challenge is that, in many cases, the settlor is not prepared to provide such guidance at the time the trust is drafted, or the settlor may develop particular viewpoints after the trust has been in place for a period of time, for example because his or her children are older and the settlor now sees certain habits that he wishes to encourage or discourage.

4. Some settlors also like the idea of providing private guidance to a trustee, that the trustee does not have to share with the beneficiaries or others. Unfortunately, this idea, that the trustee has guidance that is not part of the trust agreement, yet the trustee is relying on it, creates a host of potential legal issues if a dispute later arises.

a. Mandatory Disclosure

(1) The first issue is whether the trustee has an affirmative duty to disclose the letter to beneficiaries, either under the trustee's general duty to provide complete and accurate information about the trust to beneficiaries, or as part of a request for information from a beneficiary.

(2) The answer might depend on whether a court would categorize the letter as part of the trust agreement, or part of the books and records of the trust.

(3) Even if the settlor wishes the Letter of Wishes be kept secret, a beneficiary might have the right to see it, if the trustee will consider the letter in determining whether to make distributions. That is, if the Letter of Wishes provides binding guidance to the trustee in how it will evaluate a beneficiary's requests, then the beneficiary might have a right to view it.

(4) The Third Restatement of Trusts explains that this duty might override a provision in the trust that keeps the trust secret:

> By the terms of the trust … the settlor can limit the trustee's duty to disclose trust provisions or information on a reasonable basis, in order, for example, to lessen the risk of unnecessary or unwarranted loss of privacy…. Even limitations of these types, however, cannot properly prevent

beneficiaries, even underage beneficiaries (or their duly appointed representatives), from requesting and receiving information to the extent currently necessary for the protection of their interests.

Restatement (Third) of Trusts § 82, comment e.; see also Restatement (Second) of Trusts § 173; George G. Bogert & George T. Bogert, The Laws of Trusts and Trustees § 961, at 2–4 (2d ed. 1983).

(5) Furthermore, the Restatement also suggests that a trustee should "advise discretionary distributees of information the trustee may need (or desire) regarding the beneficiaries' circumstances, needs, resources, concerns, or wishes, as may be relevant to fiduciary judgments with respect to discretionary distributions, along with disclosure by the trustee of the bases upon which discretion will be exercised." Restatement (Third) of Trusts § 82, cmt. d.

b. Voluntary Disclosure

(1) The next issue is whether the trustee can disclose the letter at an appropriate time, in particular as a defense for the actions taken by the trustee.

(2) If the letter is not binding on the trustee, and the issue relates to the actions of the trustee under unambiguous trust terms, then the letter would be extrinsic evidence that would not be relevant.

(3) If, on the other hand, there is an ambiguity and outside evidence of the settlor's intent is relevant, the letter would have evidentiary value.

5. Thus, whether the Letter of Wishes must be disclosure, or can be disclosed, to a beneficiary might depend on the facts and circumstances. If a settlor is concerned about this issue, then his or her advisor should consider how best to achieve the settlor's wishes. At the very least, it seems appropriate to recommend that the settlor address these questions of use and availability to the beneficiaries in the letter.

I. Ethical Will

1. A somewhat different way to approach the question of providing guidance is the concept of an "ethical will."

2. An ethical will is a written document designed to "transfer" a person's values, advice, life lessons and hopes and wishes for his or her family and loved ones. It is not a legal document of course, and it can be in almost any form. It is meant primarily for the person's family, not as guidance to trustees, although it certainly can serve that purpose too.

V. Incentive Trusts

A. One particular means of combining distribution standards and additional guidance to the trustee is through an "incentive trust."

B. If the settlor's goal is to assist children or grandchildren without spoiling them, then it may not be adequate simply to select a responsible trustee and describe the purposes for which trust property can be used (such as "health, support, and education"). The trust agreement should give the trustee additional guidance, for example whether to treat all beneficiaries within a certain set equally or to give preferential treatment to beneficiaries based on personal characteristics and abilities. But even that guidance may not go far enough in achieving the settlor's intent.

C. In particular, a settlor may wish to structure the distribution provisions so that the trust provides incentives for beneficiaries to be productive or to follow a course of action the settlor would approve of, and to avoid disincentives from such a course of action.

D. Incentive provisions can take various forms. But at the core of the concept is the use of trust property to encourage certain behavior or achievement by the trust beneficiaries or to reward beneficiaries for reaching certain benchmark goals.

1. Incentive provisions can add specificity to the general guidance given to trustees, and can provide clearer evidence of the grantor's intent with respect to use of the trust property.

2. This can be particularly important for a long-term dynasty trust which the trustees will be administering many years after the deaths of the grantor and contemporaries who were familiar with the grantor's intent.

E. Drafting Guidance and Examples of Incentive Trust Provisions

1. If the grantor is interested in using the trust to incentivize certain behavior, at a minimum it is good practice to give the trustee discretion to consider the beneficiary's personal characteristics. A trustee generally cannot condition distributions upon such behavior unless specifically authorized in the trust agreement.

2. A simple trust provision may simply authorize the trustee to take into consideration the character and habits of the beneficiary, and would

authorize the trustee to condition distributions on certain behavior of the beneficiary.

> **SAMPLE TRUST PROVISION:** In determining whether to make discretionary distributions of net income or principal to a descendant of mine, the trustee may consider such circumstances and factors as the trustee believes are relevant, including the character and habits of the beneficiary; the diligence, progress, and aptitude of the beneficiary in acquiring an education; and the potential effect, if any, that such distribution may have on the beneficiary's motivation to pursue such goals. As the Trustee deems advisable, the Trustee may condition all or any part of a distribution under this paragraph upon such descendant pursuing an education or upon such descendant engaging in conduct that I would find laudable.

3. The guidance that a trust can provide can go much farther, to try to motivate or incentivize specific behavior. In many circumstances, it is quite appropriate to weave into the terms and conditions of trusts the provisions that will guide the next generation or generations along the lines and in accordance with the value system of the persons who have made the wealth.

4. Types of Incentive Provisions

 a. "Matching" Distributions

  (1) One example of such a philosophy is a trust provision directing the trustee to pay to a child of the grantor of the trust only so much of the trust income and principal as matches what the child earns from independent employment, or which is otherwise tied to the child's own contribution.

> **SAMPLE TRUST PROVISION:** The trustee shall distribute to the Child as much of the net income and principal of the trust named for the Child as the trustee determines to be required for the health, support, education and best interests of the Child; provided, however, that after the Child for whom the trust is named reaches the age of twenty-five (25) years and until he or she reaches the age of sixty (60) years, the trustee may only make distributions of income and principal pursuant to this

paragraph to the Child in a given year not exceeding in value an amount equal to the amount of income earned by that Child in the year from gainful employment. The decision of the trustee as to what constitutes gainful employment and the amount of income earned by the Child for whom the trust is named in a given year shall be conclusive, absent bad faith.

SAMPLE TRUST PROVISION: In making a distribution to the Child to assist the Child in the purchase of a personal residence, no such distribution may exceed the amount of the down payment contributed by the Child from his or her funds, or, if applicable, by the Child and his or her spouse from their own funds.

(2) In appropriate cases, there can be exception to the general restriction, such as for a disabled child or a child who is staying at home and raising his or her own children. Another approach is to take into account income earned by both the child and the child's spouse.

b. Distributions to Enable Certain Behavior

(1) As suggested above, an incentive trust might be thought of negatively, as a means of discouraging non-productive behavior.

(2) But an incentive trust may also be narrowly tailored to encourage or enable certain behavior that the grantor finds beneficial, but which the descendant may not be able to pursue on his or her own.

SAMPLE TRUST PROVISION: In addition, if the Grandchild is engaged in a profession which, in the trustee's sole discretion, the trustee deems to be a profession that I would consider as honorable and as resulting in some financial sacrifice to the grandchild, such as teaching, counseling, or a religious vocation, the trustee may distribute to the Grandchild as much or all of the net income and principal of the trust as the trustee deems to be necessary to provide the Grandchild with sufficient financial security to permit the Grandchild to remain in that profession, notwithstanding the more limited monetary compensation therefrom.

c. Distributions at Benchmarks

(1) Other common incentive provisions in trusts include providing a specific dollar amount to be paid to a beneficiary after the completion of college (even a particular college, such as where the grandparent attended), or upon completing graduate school, or upon entering into a particular profession, such as medicine, law, nursing, accounting, or teaching.

(2) These types of benchmarks can be easy to envision and to apply; however, the provisions might fail to apply to an otherwise deserving beneficiary, because the beneficiary did not meet a certain benchmark.

d. Restrictions to Avoid Dependence

(1) Some grantors wish to use the trust only as a guarantee that their descendants will be able to have food on the table and a roof over their heads.

(2) In such a case, the grantor can direct that the trustee should use the trust property for the purposes designated only as a last resort, if no other assets are available.

SAMPLE TRUST PROVISION: The primary purpose of the trust is to maintain a reserve fund to provide for the health, support and education of my descendants in situations in which all other assets and sources of income available to a descendant of mine are insufficient for those purposes.

(3) A concern with this approach is it may be too successful: if the beneficiaries enjoy even a modest success in life, such a policy may leave large amounts of assets in the trust, out of reach of the beneficiaries.

e. Using Trustee Discretion to Encourage Self-Sufficiency

(1) A more common provision is one directing the trustee to make trust distributions sparingly so as to encourage self-

sufficiency and avoid the development of unmotivated children or grandchildren who are content to live off their inheritance.

> **SAMPLE TRUST PROVISION:** The primary purposes of the trust are (i) to provide for the health, support and education of the Child, and (ii) to avoid use of the trust property in a manner that might impair the desire of the Child or a descendant of the Child to be self-sufficient. I intend for the trustee to distribute trust income and principal to the Child or his or her descendants on a selective and considered basis, my concern being that the child or the Child's descendants may receive too much rather than too little.

5. Incentive Clauses and Corporate Trustees

   a. The grantor of a trust should be made aware that many corporate fiduciaries may be reluctant to make personal judgments about beneficiaries with whom they have little contact.

   b. In these cases, it may be advisable to have a family member acting as co-trustee, so that the family member can provide personal information on the beneficiaries that will impact whether distributions should be made and in what amounts.

   c. Another option is to create a special "distribution committee" consisting of one or more family members and trusted family advisers. The committee could control all distribution decisions, with the corporate trustee focusing its attention on the investment and management of the trust funds.

VI. Treatment of Multiple Beneficiaries and the Duty of Impartiality

A. Duty of Impartiality Among Trust Beneficiaries

1. The duty of impartiality requires the trustee to balance the competing interests of differently situated beneficiaries in a fair and reasonable manner.

2. In practice, the trustee's decisions regarding investments and regarding distributions must both take into consideration the interests of the current or income beneficiaries, and the interests of the remainder beneficiaries.

3. The distribution standard contained in a trust instrument has important consequences for what the trustee's duty of impartiality will entail. The Third Restatement observes that when the trustee is given authority to invade principal for the income beneficiary's needs, rather than being limited solely to payment of income, conflict with the remaindermen over investment policy is diminished.

a. If the income beneficiary is entitled only to income in a trust accounting sense, the trustee, in fulfilling its duty of impartiality, must produce a reasonable cash flow income.

> **EXAMPLE:** T is trustee of a trust requiring net income to be paid to the grantor's surviving spouse for life, remainder to grantor's children. During the grantor's life, the grantor, as trustee, invested the assets for growth, with a very low income yield. T's duty of impartiality requires that T make the trust reasonably productive of income in the trust accounting sense. Restatement (Third) of Trusts, § 227, illustration 16).

b. If the current beneficiary is not limited to net income, the trustee can pay less attention to whether the return to the trust is in the form of traditional income or in the form of capital appreciation. Restatement (Third) of Trusts, § 227, comment i. The trustee with discretion to distribute principal is able to pursue total return with greater flexibility and with less concern about the balance between traditional allocations to income and to principal.

> **EXAMPLE:** Same facts as above, except the trust authorizes T to invade principal to maintain the surviving spouse's standard of living. Ordinarily, this distribution provision relaxes the standard of reasonable income productivity of the property. Restatement (Third) of Trusts, § 227, illustration 17.

c. Trustees have the greatest flexibility and freedom to pursue a total return philosophy in trusts under which the trustee has complete discretion to pay out income and principal, or in which the income beneficiary's interest is an annuity (fixed dollar amount) or a unitrust (fixed percentage payout). These types of trusts allow the trustee to be impartial while pursuing total return. Restatement (Third) of Trusts, § 227, comment i.

> **EXAMPLE:** Same facts as above, except the trust authorizes T to distribute "such amounts of income or principal or both as T shall deem appropriate" for

the support and care of the surviving spouse. Because the trust makes no distinction between income and principal, T's duty of impartiality entails no duty to make the trust property currently productive of income. T may adopt an investment strategy focusing on total return without regard to the amount of trust accounting income included in total return. Restatement (Third) of Trusts, § 227, illustration 18.

d. In drafting trusts, consideration should be given to the impact of income and principal distribution standards on the trustee's ability to pursue a total return strategy.

(1) If a trust provides the spouse with all the income and makes principal available under an ascertainable standard, the trustee will need to pay greater attention to income return than if principal is available under a non-ascertainable standard.

(2) Likewise, the trustee will have greater ability to pursue a total return strategy if the trust states that the trustee is to focus first on the spouse's needs in making principal distributions.

4. Priority Among Beneficiaries

a. In light of the trustee's general duty to treat beneficiaries equally and impartially, a grantor may structure a trust to give priority to certain beneficiaries. This structure may avoid conflict by specifying in the instrument that certain individuals or interests should take priority over others.

b. The commentary to the Third Restatement of Trusts states that "structure and terms of the interests may suggest a priority to be accorded various individuals or classes." The commentary adds that certain inferences can be identified even where the trust agreement does not specifically set priorities. For example, in a spray trust for spouse and descendants, a common inference to draw is that the spouse's needs should be accorded first priority. Similarly, it is reasonable to conclude that a child of the grantor has priority in a trust for the child and his or her descendants. See Restatement Third § 50, comment f.

c. It is best to specifically establish priorities among the beneficiaries in a trust benefiting multiple generations.

SAMPLE TRUST PROVISION: My primary concern during the life of the Child is for the Child's health, support and education and the trustee need not consider the interest of any other beneficiary in making distributions to the child for those purposes under this paragraph.

SAMPLE TRUST PROVISION: My spouse shall be accorded clear first priority, and my children second priority (particularly those under age 25).

SAMPLE TRUST PROVISION: My primary concern during the period described in this paragraph is for the health, support and education of my children and the descendants of a deceased child of mine, rather than for the preservation of principal for ultimate distribution to my children or their descendants.

d. Priorities may also be made explicit in the structure of the trust itself. As an example, the needs of one beneficiary can be given priority by providing that all income is to be paid to one beneficiary except for the amount not required for the beneficiary's support, and that only the excess may be used for other beneficiaries.

SAMPLE TRUST PROVISION: Commencing with the death of the last to die of me and my spouse, the trustee shall pay all of the net income of the trust to my child during his or her life. Notwithstanding the foregoing, whenever the trustee may determine that the income of the trust is partially or wholly in excess of that required for my child's support and health needs, considering his or her standard of living at my death and all other income available from time to time for such purposes, then the trustee may in its discretion withhold part or all of such excess income. Income not paid to my child may be paid in whole or in part to any one or more of his or her children, living from time to time, in such equal or unequal proportions as the trustee determines to be desirable for the support, education, health needs and best interests of each of them. Income not paid out may in the discretion of the trustee be added to principal from time to time

5. Treating Beneficiaries Differently

a. This duty of impartiality is strong, and it can often lead to confusion. Absent authority in the trust, a trustee generally cannot treat children unequally or take into account their other financial resources, or their ability to manage assets themselves, when making distributions.

b. However, similar to the general language above specifying which beneficiaries should be given priority, a settlor might expressly intend that the trustee should treat beneficiaries differently.

c. Even if the grantor does not have a specific preference or order of priority, it is wise for the grantor to give the trustee specific direction whether the trustee is able to treat beneficiaries differently, and what additional factors, if any, the trustee may consider when determining whether to make a distribution to a beneficiary.

d. Unequal Distributions

(1) If the client wishes to give the trustee the power to distribute unequal amounts to beneficiaries or to favor one group of beneficiaries over another, the trust agreement should specify that unequal distributions are permitted.

(2) While it may seem at first that the desirable course is to treat beneficiaries equally, the trustee should be authorized to make unequal distributions to take into account the children's different circumstances; for example, a child with an expensive medical problem or physical disability, or the fact that one child becomes a wealthy corporate executive and the other is a school teacher. Therefore, it is common to provide that a trustee may make unequal distributions to children.

> **SAMPLE TRUST PROVISION:** The trustee may make unequal distributions to the beneficiaries or may at any time make a distribution to fewer than all of them, and shall have no duty to equalize those distributions.

(3) As an alternative, the trust instrument may authorize unequal distributions, but provide that distributions for certain purposes, such as to start a business or for graduate education, will be treated as advancements.

> **SAMPLE TRUST PROVISION:** Any distribution (i) to a child for graduate or professional education, (ii) to permit a child to enter into or engage in a business or profession, (iii) to permit a child to make a down payment on a personal residence, or (iv) to defray wedding expenses of a child, shall be charged as an interest-free advancement against the share, if any, distributable to that child or descendant of that child under [later provisions of the trust agreement].

6. Personal Characteristics and Financial Resources of Beneficiaries

    a. The fact that the beneficiaries are in different financial circumstances also may justify unequal distributions, even absent specific authority. That is, a distribution for "support" may be warranted if the beneficiary is unemployed and needs money to pay rent, whereas such a distribution may not be warranted if the beneficiary has a steady income from employment.

    b. Nevertheless, it is also often desirable to permit the trustee to consider the financial characteristics of the beneficiaries. This will remove any ambiguity of a trustee's ability to consider those additional resources.

    > **SAMPLE TRUST PROVISION:** In making any distribution to a descendant of mine, the Trustee shall take into consideration all other sources of income and assets that the Trustee is aware are reasonably available to such descendant or for such descendant's benefit.

    > **SAMPLE TRUST PROVISION:** In determining whether to make discretionary distributions of net income or principal to a descendant of mine, the trustee may consider such circumstances and factors as the trustee believes are relevant, including the other income and assets known to the trustee to be available to that beneficiary and the advisability of supplementing such income or assets.

    c. As noted several times above, if the trust contains such a provision, the trust should also specifically authorize the trustee to require the beneficiaries to produce documentation of their financial resources—and should allow the trustee to condition a distribution on the beneficiary's compliance.

> **SAMPLE TRUST PROVISION:** The Trustee may require any such descendant to produce, or to cooperate in good faith in producing, to the Trustee reasonable documentation regarding such sources of income and assets; and as the Trustee deems advisable, my Trustee may condition all or any part of a distribution under this paragraph upon such descendant producing, or cooperating in good faith in producing, such documentation to my Trustee.

d. In addition, it may be desirable for the grantor to allow the trustee to consider the maturity and responsibility of a beneficiary in making distributions. With such a provision, the trustee can take into account the fact that some of their children simply may be more deserving of, or better able to handle, trust assets, because they are able to manage the money more responsibly, will able to put it to more productive use, or simply have better moral characters.

> **SAMPLE TRUST PROVISION:** In determining whether to make discretionary distributions of net income or principal to a descendant of mine, the trustee may consider such circumstances and factors as the trustee believes are relevant, including the ability of the beneficiary to handle money usefully and prudently and to assume the responsibilities of adult life and self-support.

B. Addressing Impartiality: Adjustment of Income and Principal, and Unitrusts

1. For many years, the "prudent man" standard governed a trustee's investment actions. This standard fell out of favor as the financial world began to adopt the modern portfolio theory, which calls for an investor to look at the portfolio as a whole and balance overall risks instead of the risks of each individual investment.

2. As a result, most states have now adopted a "prudent investor" standard for investments that embraces modern portfolio theory.

   a. In practice, this often means that a larger percentage of a trust's assets are invested in equities to improve the "total return" of the trust's investments, with a corresponding decrease in the income of the trust.

b. If a trust instrument allows the trustee to make distributions of either income or principal to a beneficiary, this should not be a problem. However, if a beneficiary may only receive income, or if the standards for distribution of income and principal are different, this may raise significant issues for the trustee. The preferred investment policy for the trustee creates tension with the trustee's obligation to treat income and principal beneficiaries fairly.

3. State legislatures have dealt with this potential problem in at least two different ways:

   a. Power to adjust: Statutes granting a trustee the discretion to make equitable adjustments between income and principal, in order to allocate capital gains or principal appreciation to accounting income; and

   b. Unitrusts or total return trusts: Statutes granting a trustee the right to convert an income interest into a unitrust interest, that pays a set percentage of the trust value, determined annually, to the income beneficiary.

   c. These are discussed in more detail, below.

4. The Power to Adjust

   a. The most recent version of the Uniform Principal and Income Act (1997) specifically grants a trustee the right to make adjustments between income and principal to provide for equitable treatment of all beneficiaries.

   b. Under this power to adjust, if, for example, a trustee invests for total return and the portfolio increases in value by 10%, but only has 2% of dividends and interest, the trustee could allocate a portion of the appreciation (either capital gains or the principal itself) to income in order to treat the income beneficiary fairly. Over 40 states have adopted UPAIA's power to adjust under § 104.

   c. Sections 103 and 104 of the UPAIA provide that a trustee may adjust between principal and income (by allocating income to principal or principal to income) in an income trust if, after administering the trust in accordance with the governing instrument and the applicable Principal and Income Act, the trustee is unable to administer the trust impartially between the current beneficiary and the remainder beneficiary, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the governing instrument manifests an intention that the trustee favor one or more beneficiaries.

d. Section 104(b) of the UPAIA lists the factors that the trustee must consider in determining whether and to what extent to exercise the power to adjust, including:

(1) The nature, purpose, and expected duration of the trust;

(2) The settlor's or testator's intent;

(3) The identity and circumstances of the beneficiary;

(4) The needs for liquidity, regularity of income, and preservation and appreciation of capital;

(5) The type of assets held in the trust;

(6) The income as calculated before making an adjustment;

(7) Whether the trustee has a power to invade principal;

(8) The actual and anticipated effects of economic conditions, including the effects of inflation/deflation; and

(9) The anticipated tax consequences of an adjustment.

e. Adjustments may not be made if they would have the following effects:

(1) Reduce the income of a trust that qualified for the transfer tax marital deduction;

(2) Reduce the actuarial value of the income interest in a trust for which for a federal gift tax exclusion was taken;

(3) Change an amount payable to a beneficiary as a fixed annuity or fixed fraction of the assets of a trust; or

(4) Reduce any amount permanently set aside for charity.

f. A trustee cannot exercise the power to adjust if doing so would cause the trust to be a grantor trust or it would cause the trust included in his or her estate for federal estate tax purposes. In addition, a trustee who is a beneficiary cannot exercise the power. These limitations may make the power unavailable in many trusts. However, if the trust permits the appointment of a co-trustee, it may be possible to name an independent co-trustee who can exercise the power.

g. Sections 103(b) and 105 of the UPAIA provide significant protection for the trustees.

(1) Section 103(b) of the UPAIA states that "a determination in accordance with the Act is presumably fair and reasonable to all of the beneficiaries."

(2) The primary remedy if the trustee abuses its discretion is to restore the income and remainder beneficiaries to the positions they would have occupied if the trustee had not abused its discretion by distributing an additional amount to the income beneficiary or withholding future distributions from the income beneficiary. The court may surcharge the trustee if restoring the income and remainder beneficiaries to their original positions is not possible.

h. Shortcomings of the Power to Adjust

(1) Although the power to adjust under the UPAIA seems to provide an optimum solution for a trustee to invest assets prudently and then to address different beneficiaries' interests, the power to adjust suffers from some shortcomings that limit its application and use.

(2) Difficult to administer

(i) Commentators have noted that trustees may not want to exercise the discretion required on an ongoing basis to make or not make an equitable adjustment.

(ii) These trustees would prefer a rule that does not subject them to the hindsight of beneficiaries or the court. R. Nenno, "Where the Rubber Meets the Road: Implementing Total Return Trust Statutes," <u>36th Annual Phillip E. Heckerling Institute on Estate Planning</u>, p. 13-12 (2002).

(a) For example, in <u>Matter of Orpheus</u>, a trustee made an adjustment of several million dollars from principal to income, to compensate an income beneficiary for investments that greatly increased the principal. The Supreme Court of Nevada noted that the trustee's notes revealed that the trustee "briefly stated that it had analyzed each of the factors listed [in the statute], but it not provide a detailed analysis of each factor." The Court remanded the matter to the trial court to conduct a hearing on whether the trustee had sufficiently considered these factors. In re Orpheus Trust, 179 P.3d 562, 569–70 (Nev. 2008).

(3) Income tax treatment

(i) When the state statutes first started appearing, the income tax treatment of adjustments was unclear.

(ii) The IRS has now issued regulations, discussed later, that help resolve many issues such as whether capital gains can be included in distributable net income. However, the regulations still leave it up to state law, or the trustee, to determine if an allocation of principal to income consists of capital gains or of nontaxable principal.

(4) Timing

(i) Some issues and questions arise regarding the timing of an adjustment, or the timing of an adjustment based on market fluctuations.

(ii) When does the trustee exercise the adjustment power? If the beneficiaries are used to quarterly distributions (or they are mandated), the trustee might look at adjustments each quarter.

(iii) But what if the trustee allocates principal to income in one quarter, and the trust suffers a large drop in the market value in the next quarter?

(iv) These types of fluctuations can make a trustee adverse to making specific adjustments between income and principal.

5. Unitrusts

a. The alternative unitrust approach bypasses the granting of discretion to the trustee in favor of requiring a fixed percentage of the trust assets to be distributed each year as "income."

b. The potential conflict between income beneficiaries, on the one hand, and remainder beneficiaries, on the other hand, may ultimately injure both. That is, in a desire to generate income, the trustee will feel compelled to invest the trust in assets that generate some predictable income, such as bonds or stock that generates dividends. But if the assets are invested in such a way, then the underlying principal of the assets may not appreciate in a way that a total return portfolio would.

c. The preferred investment policy for the trustee creates tension with the trustee's obligation to treat income and principal beneficiaries fairly.

d. Under most statutes, state law fixes a default unitrust percentage, but grant discretion to the parties or the court to select a different percentage. The percentage is rest annually, but applied against a rolling average (three years or 12 quarters are common) of the value of the trust assets. This is done to avoid significant fluctuation of distributions from year to year

e. At least 30 states have adopted statutes that permit unitrust conversions. Many state statutes permit both equitable adjustments and unitrust conversions. Some states, including Illinois and Iowa, have adopted just a unitrust conversion statute.

f. There was a significant concern initially that total return unitrusts would not necessarily qualify for the federal estate tax marital deduction. The problem could be avoided by providing in a marital trust that the spouse has the right to receive the greater of the unitrust amount or net income, as well as the right to compel the trustee to make the property productive. The IRS regulations issued in response to the state total return statutes eliminated this concern by stating that unitrusts (as well as powers to adjust) which are authorized by and in conformance with state law will qualify for the marital deduction. Treas. Reg. § 20.2056(b)-5(f)(1), § 20.2056(b)-7(d)(1).

g. Anticipating this concern, a grantor may wish to avoid simply giving one beneficiary the right to income. Instead, the grantor may give one beneficiary the right to receive a certain percentage of the trust assets each year, also known as a "unitrust" amount. This unitrust amount would represent the amount of reasonable income that the grantor would hope to provide the beneficiary, and it would free the trustee to invest in assets that would produce a return that benefitted all beneficiaries.

SAMPLE TRUST PROVISION:

Distribution of Unitrust Amount.

During the Child's lifetime, the Child shall have the right to require that an amount up to or equal to the Distribution Amount (as defined in the following subparagraphs of this paragraph) be annually distributed to the Child, and the Child shall have the right to require that such distributions be made quarter-annually or at intervals that are not less frequent than quarter-annually.

The term "Distribution Amount" as used in this Article for any tax year of the Child's Separate Trust shall mean an amount equal to Four Percent (4%) of the average of the net fair market value of the Child's Separate Trust assets for the preceding three (3) years of the Child's Separate Trust (or, for each of the first three (3) years of the trust's existence, such lesser number of tax years that the trust has been in existence) valued as of the first day of each taxable year.

The taxable year of the Child's Separate Trust shall be the calendar year. The trustee shall use the same valuation methods for each taxable year. The trustee shall pay THE Distribution Amount to the child in equal quarterly installments. The Distribution Amount shall be paid first from income, and, to the extent income is not sufficient, from principal. The quarterly installments shall be paid on the last day of March, June, September, and December.

6. Preference of Adjustment Power or Unitrust

a. An informal 2008 poll of corporate trustees by the Fiduciary Responsibilities Subcommittee of the ACTEC Fiduciary Litigation Committee indicated that corporate trustees preferred to use the power to adjust if it was available rather than the power to convert to the unitrust. Sager, "Litigation and the Total Return Trust," 35 ACTEC Journal No. 3, at 207 (Winter 2009).

b. The author, Margaret Sager, hypothesized that corporate trustees preferred the flexibility of the power to adjust, even though it arguably requires more ongoing oversight and discretionary decision-making than a unitrust conversion.

c. It does not appear that the choice is being made based on perceived litigation risk.

7. Tax Treatment of Adjustments and Unitrusts

a. Final Regulations on Section 643 (January 2, 2004)

(1) On December 30, 2003, the IRS issued final regulations that revise the definition of trust income found in Code Section 643. These regulations were issued to take account of changes in the definition of trust income under state law and to clarify when capital gains would be includable in the distributable net income of an estate or trust.

(2) The new final regulations provide that “an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between income and remainder beneficiaries of the total return of the trust for the year.” Treas. Reg. § 1.643(b)-1. Capital gains may be allocated to income under either an equitable adjustment or unitrust approach if permitted by the terms of the governing instrument and applicable local law or if it is pursuant to a reasonable and impartial exercise in discretion by the fiduciary and is not prohibited by applicable local law. Treas. Reg. § 1.643(a)-3. If the unitrust approach is taken, a discretionary power to allocate gains to income for tax reporting purposes must be exercised consistently and the amount cannot exceed the excess of the unitrust amount over the amount of distributable net income that would otherwise have been determined.

(3) Interestingly, the regulations specifically provided in Treas. Sec. 1.643(b)-1 that the IRS will only recognize equitable adjustments or a switch to a unitrust approach if permitted by state statute

(4) A switch to a method not specifically authorized by state statute but valid under state law, such as a switch by a judicial decision or a binding nonjudicial settlement, may result in the imposition of capital gains tax to the trust or its beneficiaries or may result in taxable gifts, depending upon the circumstances.

(5) An income interest subject to equitable adjustments or unitrust conversion will also be recognized for purposes of a marital deduction provided that state law permits an equitable adjustment or unitrust conversion. Absent state law specifically permitting such actions, trust provisions alone cannot qualify such a trust for the marital deduction.

Moreover, the proposed regulations make it clear that the conversion of a pre-1986 trust to a total return trust will not cause the trust to lose its grandfathered status for generation-skipping purposes.

b. Generation-Skipping Tax Regulations

(1) There also was concern initially that the exercise of a power to adjust or conversion to a total return unitrust could cause a grandfathered GST trust to lose its grandfathered status.

(2) The regulations now make it clear that administration of a pre-1986 trust under state law provisions regarding income will not cause a trust to lose its grandfathered status for generation-skipping tax purposes. Treas. Reg. §26.2601-1(b)(4)(i)(D)(2) and (E), examples 11 and 12.

VII. Selection of Trustees and Division of Fiduciary Responsibility Among Trustees

A. Once the decision is made to use a trust, the donor must designate a trustee.

B. Provisions defining the powers of the trustees, and governing their selection and removal are very important. The trustee of a trust will make investment decisions and provide for the management of trust assets. The trustee normally also is responsible for exercising discretionary distribution powers. The trustee must interpret the trust agreement to determine whether a beneficiary's need or request is within the scope of the standard for invasion defined by the grantor, applying the guidance set forth in the instrument. It is therefore a critical role, and one that may last several decades or even generations.

C. The "Individual" or "Family" Trustee and the "Professional" or "Corporate" Trustee.

1. There are numerous potential options for who might serve as trustee: a spouse; one or more of the beneficiaries; a family friend; a trusted advisor, such as an attorney or financial advisor; or a bank, trust company, or other entity. In fact, one of the only limits on the potential menu of naming and replacing trustees relates to tax considerations, discussed below.

2. Many commentators find it helpful to distinguished between an "individual" trustee, who is a single person and who may already be involved with and knows the settlor, the beneficiaries, and related parties; and a "corporate" trustee, who is a bank, trust company, or other institution or entity.

3. Individual Trustee

a. Many settlors find it appealing to name as trustee an individual, such as a member of the family, a family friend, or a trusted family advisor. This has advantages and disadvantages.

b. Advantages of Naming an Individual Trustee

(1) The individual may already know the settlor and the settlor's intent, the family, its history and dynamics, and the various situations and needs of the beneficiaries.

(2) The individual may be willing to serve for a smaller fee or free, However, because acting as a trustee requires a fair amount of financial and tax sophistication and a substantial commitment of time, it usually is not fair or appropriate to ask a friend or relative to act as trustee without compensation. Meanwhile, if the trustee is to be paid a fee for services rendered, it is not fair to the ultimate beneficiaries of the trust to use a friend or relative in this capacity unless such individual is capable, experienced, and trustworthy.

(3) The individual may give more time and attention (or be perceived as giving more time and attention) to matters related to the trust.

c. Disadvantages to Naming an Individual Trustee

(1) If the trustee is familiar with the family and the beneficiaries, such familiarity may not necessarily be an advantage.

(a) The trustee may be perceived as being biased towards one family member (most often the settlor) or one beneficiary.

(b) Generally, it may be problematic to name the spouse or a single beneficiary as trustee of a trust with multiple beneficiaries.

(c) It may be preferable not to name the spouse as trustee if that is likely to subject the spouse to pressures from children who wish greater access to trust funds.

(d) Likewise, if the individual has several children and names only one as trustee, the potential for problems arising between the child/trustee and his or her siblings is obviously considerable. If all of the children are named as co-trustees, it may be difficult, administratively, to reach decisions affecting trust property.

(2) Managing a trust requires various filings, including the preparation of regular tax returns, and an individual who is a family member or friend may be inexperienced with these duties; however, such a trustee can usually retain attorneys and accountants to assist with these duties.

(3) Many trusts are structured to last for the lifetime of beneficiaries, or perhaps for several generations; an individual trustee will almost surely retire or die before the expiration of such a trust.

4. Corporate Trustee

a. For these reasons noted above, in the case of a large or complex trust it is preferable in many cases to name a corporate fiduciary. A corporate fiduciary adds permanence to the choice and introduces persons who are skilled in money management, taxes, and the conservation of trust principal. The corporate fiduciary can take advantage of investment options not available to individual fiduciaries, such as proprietary funds or investment managers available through special contractual arrangements. Most corporate fiduciaries also provide custodial services for trust assets, accounting services and tax preparation as part of their services as trustee.

b. A corporate fiduciary will not become emotionally involved in family disputes and will not be subject to the pressures that trust beneficiaries could bring to bear on a relative or family friend. Of course, a corporate fiduciary charges a fee for its services, usually determined as a percentage of the trust assets.

D. Using Co-Trustees

1. The various strengths that different trustees can bring to the administration of a trust suggest that it can be beneficial to use co-trustees. For example, an individual can name a family member and a corporate trustee as co-trustees in order to have the corporate trustee's professional management skills and the family member's involvement in an official capacity in the administration of the trust and distribution decisions. The family member and the corporate trustee working together can have the ideal combination

of personal knowledge of family needs and detached analysis for making distribution decisions. The corporate trustee can act as a shield for the family member who is being pressured by a child to make an ill-advised distribution by refusing to consent to the distribution.

2. One approach that can be very effective for trusts for children is to name the child as a co-trustee when they obtain a certain age. For example, if the trust will terminate when the child turns age 35, the trust agreement could permit the child to become a co-trustee at age 30. This gives the child an opportunity to learn more directly about managing the property with the corporate trustee's assistance, and prepares the child for becoming the direct owner.

3. The corporate trustee can be given sole discretion to make distributions for purposes not subject to an ascertainable standard, such as the welfare of the spouse or to assist a child with a business venture. This permits the entire family to benefit from the trust under a broad distribution standard without adverse tax consequences.

> **SAMPLE TRUST PROVISION:** Commencing as of my death and until the division date (defined later in this Article), the trustee shall distribute to any one or more of my spouse and my descendants living at the time of the distribution as much of the net income and principal, even to the extent of exhausting principal, as the trustee determines from time to time to be required for such descendants' respective health, support and education, and as the trustee, other than my spouse, in the sole discretion of that trustee, determines from time to time to be required (i) for the best interests of my spouse, and (ii) to permit a child of mine to make a reasonable down payment on a personal residence.

4. Another common approach is to name a corporate trustee or other independent person as trustee of a child's trust and provide that the child will become a co-trustee upon obtaining a certain age. This provides many of the benefits noted above and can give a child an opportunity to learn how to manage his or her inheritance before the child's trust terminates and is distributed outright.

E. Dividing the Trustee's Authority among Co-Trustees or Advisory Committees

1. An important consideration often overlooked in the planning process is the division of the trustee's duties and powers among different fiduciaries. This can be especially useful in complex, multi-generation trusts, in trusts that will hold a family business or other closely held assets, or in trusts of considerable size.

2. For example, a trust holding closely held business interests could name individual family members active in the business and a corporate trustee as co-trustees and vest all decision-making authority related to the business in the family members. The corporate trustee would be in charge of all administrative functions as well as the management of other trust assets.

> **SAMPLE TRUST PROVISION:** The corporate trustee shall not participate in any decision with respect to the purchase, sale or encumbrance of any interests in or indebtedness of a family enterprise that are part of the trust principal, or in the voting of securities in any family enterprise, and the corporate trustee shall not be responsible for the decision of the individual trustees to purchase, sell or encumber such interests in or indebtedness of a family enterprise, or for the manner in which securities in any family enterprise are voted, for any direct or indirect result of that voting, or for any failure to vote those securities. The corporate trustee shall not be accountable for any loss or depreciation in value sustained by reason of an act or failure to act of the individual trustees pursuant to the preceding provisions of this paragraph. Notwithstanding the foregoing, if at any time the individual trustees are evenly divided upon any question related to the disposition of any interests in or indebtedness of a family enterprise or the voting of securities in any family enterprise, the decision of the corporate trustee shall control.

3. The trust could name multiple co-trustees and require the trustees to designate one of their number as a "managing" trustee.

4. Many clients who wish to divide the fiduciary's duties in this manner prefer to create a separate "committee" rather than naming multiple trustees. The most frequent use of an advisory committee is in managing closely held business assets. In some cases, the client wishes to delegate all investment authority to the advisory committee and reduce the trustee's role to that of acting as the committee's agent.

> **SAMPLE TRUST PROVISION:** Despite the general powers of the trustee, the following provisions shall apply, when the context admits, to each trust from time to time held hereunder:
>
> 1. The trustee shall follow the written directions of the Advisory Committee with respect to the purchase, sale, or encumbrance of any interests in or indebtedness of a family enterprise that are part of the trust principal, and the trustee

shall not be responsible for the decision to purchase, sell or encumber such interests in or indebtedness of a family enterprise. The Advisory Committee shall have full authority to direct the trustee to take any action with respect to interests in or indebtedness of a family enterprise which the trustee is authorized to take [the articles related to financial and management powers], without limitation;

2. The trustee shall issue proxies to vote all securities in any family enterprise held by the trustee to or on the written order of the Advisory Committee, and the trustee shall not thereafter be liable for the manner in which those securities are voted, for any direct or indirect result of that voting, or for any failure to vote those securities;

3. No trustee shall be accountable for any loss or depreciation in value sustained by reason of an act or failure to act of the Advisory Committee pursuant to the preceding provisions of this paragraph and no person dealing with the trustee shall be required or privileged to inquire whether there has been compliance with those provisions. The trustee shall not be required to participate in the conduct of the business of any family enterprise or to keep itself informed about its day to day affairs;

4. For all purposes of this trust agreement and of any trust established under this trust agreement, the term "family enterprise" means any business entity, whether in existence on the date of this trust agreement or established hereafter, whether in the form of a business corporation, partnership, joint venture, or other organization, in which one-third or more of the outstanding equity interests are held, in the aggregate, directly or indirectly, by me, my spouse, my descendants, any trust for the benefit of me, my spouse or any of my descendants, or another family enterprise. For all purposes of this trust agreement and of any trust established under this trust agreement, the term "interest" in a family enterprise means (i) stocks, partnership interests (whether general, special or limited) or other evidences of equity ownership in a family enterprise, and (ii) notes, bonds or other evidences of a debt owed by such family enterprise.

5. Another role for a committee may be to take charge of discretionary distribution decisions. The use of a committee reduces the pressure on any one individual serving as a fiduciary—both the pressure involved in making proper decisions and the pressure that can be brought by

dissatisfied beneficiaries. Both these types of pressure can be significant when the trust assets are substantial.

> **SAMPLE TRUST PROVISION:** The trustee shall follow the written directions of the Advisory Committee with respect to discretionary distributions of income and principal to the beneficiaries of the trust, and the Advisory Committee shall determine whether to make distributions in accordance with the distribution standards for the trust set forth in this instrument.

6. There are an unlimited number of ways to structure an advisory committee in a trust. It can consist solely of family members or a combination of family members and non-family members. The number of members can be fixed, or the committee can be given authority to expand or contract. The trust agreement can set forth minimum qualifications necessary for committee membership, such as minimum and maximum ages, business or professional experience, and minimum net worth or annual income.

7. The trust agreement also should contain provisions regarding appointment of successor committee members similar to those that address appointment of successor trustees. A common method for appointment of successors is to have the committee appoint successor non-family members, and have adult trust beneficiaries select successor family members to serve on the committee. Another option is to have the committee nominate successors and require a confirmation vote by adult trust beneficiaries.

> **SAMPLE TRUST PROVISION:** The Advisory Committee shall consist initially of such of my children who are willing and able to act, and ________________ and ______________, who shall be the initial "independent" members (as defined below). If one of my children fails to become or ceases to be an Advisory Committee member, no successor need be appointed as long as there are at least three "family" members (as defined below) of the Advisory Committee then acting. At all times there shall be two independent members of the Advisory Committee, and at least three, but no more than five, family members of the Advisory Committee.
>
> Any member of an Advisory Committee may resign by giving written notice to the other members of that Advisory Committee and to the trustee. A successor Advisory Committee member shall be appointed by a majority in number of my children who are not disabled. If none of my children are able to act, then a successor family member of the Advisory Committee and the successor to one

independent member position of the Advisory Committee shall be appointed by a majority in number of my adult descendants who are not disabled, otherwise by a majority in number of the beneficiaries of the trust to whom the current trust income may or must then be distributed; and the successor to the second independent member position of the Advisory Committee shall be appointed by the remaining members of the Advisory Committee.

A "family" member of the Advisory Committee must be a descendant of my parents.

An "independent" member of the Advisory Committee must be an individual who does not qualify as a "family" member, has attained the age of thirty-five years, and has at least ten years' experience as either (i) an officer, director or principal partner of a business or professional organization, (ii) an elected or appointed official in a governmental, philanthropic or community organization, or (iii) an educator at the secondary school, college or graduate school level.

8. Many states' laws also allow a settlor to give various trustees specific duties; one trustee may have the power to control investments; another trustee may have the power to direct distributions from the trust; and another trustee has the responsibility to administer the trust and perform tax and recordkeeping functions.

F. Removal of Trustee

1. It is also possible to give the settlor, other beneficiaries or family members, a Trust Protector, or another individual or entity the power to remove and replace a trustee.

2. For both trustees and advisory committee members, the client should consider giving designated individuals the power to remove the fiduciary. The removal power can be unlimited or for specified causes.

3. These options can often be used to address potential conflicts between the settlor, beneficiaries, and trustees.

4. However, there are transfer tax considerations that the practitioner must consider if trust beneficiaries will possess removal powers. A beneficiary who can remove a trustee and appoint himself or herself as trustee will be treated as possessing the powers of the trustee for purposes of Section 2041 of the Code. If the trustee has the power to distribute property pursuant to a non-ascertainable standard, the beneficiary will be treated as having a general power of appointment. <u>See</u> Treas. Reg. § 20.2041-1(b).

a. The IRS in the past took the position that a beneficiary's power to remove a trustee and appoint a new trustee (other than the beneficiary) saddles the beneficiary with the potential Section 2041 problem. See Rev. Rul. 79-353, 1979-2 C.B. 325. Practitioners have generally agreed that the IRS's basis for this position was weak. It was decisively rejected by the Tax Court in Estate of Wall v. Comm'r, 101 T.C. 300 (1993). Subsequently, the IRS issued Revenue Ruling 95-58, 1995-2 C.B. 191, in which it revoked Revenue Ruling 79-353.

b. However, the IRS limited its ruling to situations in which the beneficiary can only appoint an independent trustee. The Ruling suggests that a beneficiary's trustee removal power could have adverse tax consequences if the holder of that power can appoint a related or subordinate party (as defined in Code Section 672) as successor trustee. Under Section 672, a "related or subordinate party" is any nonadverse party who is the person's spouse, parent, descendant, sibling or employee.

c. It is clear that a beneficiary can have the power to remove a trustee for cause and appoint a new trustee without fear of Section 2041. See Ltr. Rul. 9303018 (October 23, 1992).

d. The causes that justify removal can be numerous and broad. In Letter Ruling 9303018, the trust instrument stated that a trustee could be removed for the following reasons: (1) legal incapacity; (2) willful or negligent mismanagement; (3) abuse, abandonment of, or inattention to the trust; (4) being charged with a crime; (5) a criminal act or an act of moral turpitude or moral degeneration; (6) substance abuse; (7) poor physical, emotional or mental health; (8) failing to comply with written agreements with the trust; (9) failing to appoint a senior officer with at least five years' experience to administer the trust; (10) changing the account office responsible for the trust more frequently than every five years; (11) relocating away from where the trust was located; (12) demanding unreasonable compensation; and (13) any other reason for which a [state] court of competent jurisdiction would remove a trustee.

e. It also is possible to vest the removal and appointment powers in different individuals. Finally, if the trust distribution standards all are ascertainable, a beneficiary can hold trustee removal and appointment powers without concern about possessing a general power of appointment.

f. If the settlor has in mind a time period when a given trustee should no longer serve, or when a beneficiary should become trustee or co-trustee, then an attractive alternative to removal provisions is to create term limits for the fiduciaries serving under the trust agreement. This is especially useful in an advisory committee because it gives trust beneficiaries an opportunity to evaluate a committee member's performance and, if necessary, replace the member in a manner that may be easier, and less stigmatized, than removal.

G. Additional Tax Considerations for Naming a Trustee

1. If a spouse or family member who also will be a beneficiary of the trust will be designated as trustee, it is usually necessary to limit the trustee's control of the property so it will not be included in his or her gross estate.

    a. For example, if the spouse is the trustee of a nonmarital trust, the invasion standard must be ascertainable and must relate to health, support, maintenance, and education (IRC § 2041(b)(1)(A)).

    b. Broad invasion provisions, such as for "best interests and welfare," would result in the entire nonmarital trust being taxed in the spouse's estate, which generally would defeat the goal of the decedent's estate plan.

    c. One common nonmarital trust provision is to permit the trust income to be "sprayed" among the spouse and descendants (or retained in trust) at the trustee's discretion. If the trustee has minor children who are trust beneficiaries, however, and the spouse as trustee can "spray" trust income or principal to them, the distribution power must be limited so distributions cannot be used to satisfy the trustee's legal obligation to provide support or education for the minor children. Otherwise, the trustee may be deemed to possess a general power of appointment over the trust to the extent of those legal obligations, causing the trust principal to be includable in his or her estate at death. Treas. Reg. § 20.2041-1(c).

2. For these and many other reasons, it may be preferable for a corporation or independent individual to act as sole trustee or as co-trustee with the beneficiary. If this is done, the independent co-trustee is given the power to make discretionary distributions of principal and income among the spouse and the descendants, or to make those distributions that a family member trustee cannot make. This permits the entire family to benefit from the trust without adverse estate tax consequences.

3. There are generally no estate tax dangers in making the spouse the sole trustee of a general power of appointment marital trust, since that property will be includable in her estate anyway. However, if a QTIP marital trust is used, it may be necessary to limit the standard for distributing trust

principal, if it is possible that a partial QTIP election will be made (so that not all the trust will be treated as marital deduction property).

VIII. Conclusion

A. A trustee's tasks of custody, investment, and distribution decisions all work together to achieve a settlor's goals.

B. But distribution decisions in particular can have a key impact on whether a trust achieves a settlor's goals.

C. In establishing the distribution provisions of the trust, the settlor should be mindful of the appropriate language and distribution standards to use to ensure that the distributions of the trust meet the settlor's intended goals.

D. In drafting and administering the trust, settlors and trustees can structure the relevant provisions related to distributions to ensure, to the extent possible, that the trust will meet the settlor's intended vision over the lifetime of the trust.

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