The Princess Bride’s Guide to Discretionary Distribution Powers

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Discretionary Distribution Provisions Have Consequences

- Trustees are routinely given discretionary distribution powers over a trust’s income and/or principal.
- The phrasing and scope of discretionary distribution powers, and related provisions, can have important tax and non-tax consequences to the beneficiaries and to the trustee.
Beneficiary Trustee

- Always remember that if a beneficiary can remove trustees, and appoint successor trustees who are related or subordinate to that beneficiary, the beneficiary is treated as holding all of the powers of the trustee. See Estate of Wall v. Commissioner, 101 T.C. 300 (1993); Estate of Vak v. Commissioner, 973 F.2d 1409 (8th Cir. 1992), rev'g T.C. Memo 1991-503; and Rev. Rul. 95-58.

- The same concept should apply if a beneficiary can remove and appoint successor trust protectors, investment advisors, and the like under the trust instrument.

- References in this outline to an “independent trustee” mean a trustee who will be treated as not being related or subordinate to the relevant beneficiary and/or whose powers as trustee are not attributed to the beneficiary due to any removal and appointment powers granted to the beneficiary.
Ascertainable and Non Ascertainable Distribution Standards

- We often think of discretionary distribution powers from a tax perspective –
  - Ascertainable Standards: Those powers that a beneficiary can hold without adverse estate/gift/GST/income tax consequences.
  - Non Ascertainable Standards: Those powers that the beneficiary cannot hold without potentially adverse tax consequences.

- Understanding the distinctions between those two standards is important to avoid adverse tax (and perhaps creditor) consequences if a beneficiary will be a trustee or have the power to remove trustees and appoint related or subordinate successor trustees.
Pros/Cons of Ascertainable Standards

- Ascertainable standards
  - Benefits
    - Avoids estate/gift tax inclusion for a beneficiary trustee
    - May help avoid creditor exposure for a beneficiary trustee
    - Clearer guidance for the trustee and the beneficiary (maybe?)
    - Less exposure for drafting mistakes
  - Drawbacks
    - May be less flexible than a non ascertainable standard
    - May provide greater creditor rights
Pros/Cons of Non Ascertainable Standards

- Non ascertainable standards
  - Benefits
    - Usually greater flexibility than ascertainable standards
  - Drawbacks
    - Requires third party trustee
    - Easier to create tax or other pitfalls (requires more careful drafting)
    - May be harder for the beneficiary to challenge the trustee’s decision. This may be considered an advantage or disadvantage depending on the situation and whose perspective
Pros/Cons of Including Both Ascertainable & Non Ascertainable Standards

- Using, or allowing the use of, both standards in the same trust
  - Benefits – Creates more flexibility
  - Drawbacks – Creates more potential drafting traps
Ascertainable Standards – General Concepts for Federal Tax Purposes

- Code §2041(b)(1)(A): “A [beneficiary’s] power to consume, invade, or appropriate property limited by an ascertainable standard related to the health, education, support, or maintenance [of that beneficiary] shall not be deemed to be a general power of appointment.”

- Regulation §20.2041-1(c)(2): Ascertainable means that the Trustee’s duty to exercise or not to exercise the power is limited by an ascertainable standard (that can be reasonably measured) relating to the beneficiary’s health, education or support, or any combination thereof.

- Code §2514 and Regulation §25.2514-1(c)(2) incorporate provisions similar to Code §2041(b)(1)(A) and Regulation §20.2041-1(c)(2) in determining what constitutes an ascertainable standard for gift tax purposes.

- If a distribution standard has been determined under state law to be ascertainable, then it should be respected for Federal estate and gift tax purposes; but beware of Commissioner v. Estate of Bosch, 387 U.S. 456 (1967).

- The Regulations provide that any requirement that the beneficiary trustee must exhaust his or her income before exercising a discretionary distribution power is ignored in determining whether that beneficiary has a non ascertainable discretionary distribution power.
Ascertainable Standards - Specific Samples Under the Code and Regulations

- Health, education, maintenance and support - Code §2041(b)(1)(A).

- Regulation §20.2041-1(c)(2) provides some additional ascertainable standards:
  - Support in reasonable comfort;
  - Maintenance in health and reasonable comfort;
  - Support in [the beneficiary’s] accustomed manner of living;
  - Educating, including college and professional education; and
  - Medical, dental, hospital and nursing expenses and expenses of invalidism.
Non Ascertainable Standards

- Specific examples from the Regulation
  - Comfort
  - Welfare
  - Happiness

- Other Examples
  - Best Interests
  - Absolute/Sole/Uncontrolled Discretion
  - Happiness
  - To enable a beneficiary to make gifts (include in a marital deduction trust?)
  - Needs
  - For any purpose
  - Emergency. However, the use of the word “emergency” to modify an ascertainable standard (e.g. “emergency health needs of the beneficiary”), does not cause that standard to become non ascertainable. See PLR 200028008.
When Using An Ascertainable Standard -- Watch Out for Being Too Creative, or Sloppy

- Example: “Support in [the beneficiary’s] accustomed manner of living” is listed as an ascertainable standard in the Regulations. However, in Rev. Rul. 77-60 the IRS held that “to continue the [beneficiary’s] accustomed standard of living” was **not** an ascertainable standard. Then, in TAM 7914036, the IRS held that “to maintain the standard of living to which … [the beneficiary] was accustomed” was an ascertainable standard because it included the word “maintain”, and therefore the standard relates back to one of the Code §2041(b)(1) statutory standards (maintenance).

- Example: The term “reasonable comfort” is ascertainable, but “comfort” alone is not an ascertainable standard (unless the governing state law has held that such term has a defined/ascertainable meaning).
Observations on Some of the Available Standards
Accustomed Manner of Living

- May be a good standard for established beneficiaries - such as the settlor's spouse.
- Define the period of time to which the standard of living is to be matched (e.g., “as of my death”). If the trust is silent, likely means as of the settlor's death or date the trust became irrevocable.
- Exercise caution in using the accustomed manner of living standard for individuals who lifestyle is expected to change by reason of the trust, or due to their career or life stages. For those persons --at what stage is accustomed manner of living appropriately determined?
  - Real World Example: Grandchild requests private flights because he flew that way when traveling with grandma (who created the trust for his benefit).
- Consider whether the anticipated trust assets can support an accustomed manner of living standard.
- Barnett Banks Trust Company N.A. v. Herr, 546 So.2d 755 (Fla. 3rd DCA 1989). Interesting case about how much discretion the trustee had in a trust that contained an accustomed manner of living distribution standard. Held: “if the beneficiary's standard of living at the time of the encroachment request is less than the beneficiary's standard of living at the time of the testator's death, the trustee must invade the corpus of the trust for the benefit of the beneficiary.”
Support & Maintenance

According to the Regulations, the terms “support” and “maintenance” are synonymous, and are not limited to the bare necessities of life.

The Restatement of the Law (Third) Trusts, §50, comment (d)(2), provides that “support” distribution standard (without any modifiers), ordinarily:

- **Covers** distributions sufficient for accustomed living expenses, such as: (i) regular mortgage payments, (ii) property taxes, (iii) suitable health insurance or care, (iv) existing life and property insurance, and (v) continuation of accustomed patterns of vacation and charitable and family giving.

- **May cover** reasonable additional comforts or “luxuries” that are within the means of many individuals of like station in life, such as a special vacation of a type the beneficiary had never before taken.

- **Would not allow for:** (i) distributions that are unrelated to support but merely contribute in other ways to a beneficiary’s contentment or happiness; and (ii) distributions to enlarge the beneficiary’s personal estate or to enable the making of extraordinary gifts.

- **Covers (would allow for)** distributions: (i) to members of the beneficiary’s household, (ii) costs of suitable education … for the beneficiary’s children, (iii) reasonable amounts for the support of a current spouse, (iv) distributions for minor children who reside elsewhere but for whom the beneficiary either chooses or is required to provide support; and (v) the beneficiary’s support obligation to a former spouse. [Just because the trustee may be able to make a distribution to the beneficiary with respect to the beneficiary’s obligations to a former spouse or child support does not necessarily mean that the trustee has to do so, or that the trustee can be forced to do so. See discussion below.]
**Best Interests**

- Whose best interest?
- Consider limiting this standard to one beneficiary at a time.
- If the best interest standard covers more than one beneficiary simultaneously, then in most cases will a distribution that is in one beneficiary’s “best interest” also not be in the “best interest” of at least one or more other beneficiaries?
  - Real word example: Large trust allowing trustee to make distributions on best interest standard to a current class of 20+ beneficiaries.
  - An exception may be a distribution to achieve a basis step up, which could benefit multiple beneficiaries.
- Consider using “best interest” as a standard when a substantial age based distribution or withdrawal right is anticipated so as to provide some flexibility to the trustee. “I anticipate that the trustee shall distribute one-third of the trust to my son when he attains 35 years of age, unless the trustee determines that it would not be in my son’s best interest to do so.”
- Case law/treatises indicate that the best interest standard is more liberal than support & maintenance, but less liberal than comfort, pleasure/happiness or sole discretion in the trustee.
Absolute/Sole Discretion

- Maximum flexibility. But does it offer enough guidance about the settlor’s intent?
- Some corporate trustees like this language; others like it less.
- Consider adding “primary beneficiary” language or other settlor intent to provide additional guidance (but don’t jumble/mix standards-see below).
- What is the purpose of absolute discretion in the specific trust? In some cases consider using very liberal standards (“comfort, pleasure, happiness, and otherwise as the independent trustee determines in absolute discretion”).
Health, Education, Maintenance and Support (HEMS)

- HEMS still is a good safe standard to use.
- Keep in mind that case law and treatises on each of the concepts ("health", "education", "maintenance/support") can provide guidance/depth in the meaning of those concepts.
- Generally going to be viewed as a pretty conservative distribution standard by corporate trustees.
Other Drafting Considerations
Primary Beneficiary Language & Substantial Invasion or Depletion of Principal & Purpose of Trust Language

- If the settlor intends for the trust to primarily benefit a beneficiary, be sure the trust includes language to that effect.

- If the settlor anticipates that a substantial portion of the principal of the trust likely will be distributed to or for the benefit of a beneficiary over that beneficiary’s lifetime, consider including language to that effect.

- If the settlor originally planned on giving the beneficiary his or her inheritance outright, but, based on the advice from the settlor’s attorney or other advisors, provided for the beneficiary’s inheritance to be held in trust to provide some measure of asset protection or tax planning, consider providing that information in the trust or a side letter to the trustee(s) as further evidence of the settlor’s intent to substantially benefit the primary beneficiary as opposed to preserve assets for future beneficiaries.
“Purpose of Trust” Language – Caution on “Tax Consequences”/ “Benefit Multiple Generations” Language

- Sometimes drafters include language directing the trustee to take into account estate/GST tax considerations, or state that the settlor’s intent is to minimize estate/GST taxes and/or to benefit multiple generations.
- Consider whether this language may push the trustee too far against making discretionary distributions.
Beneficiary’s Resources

- Address in the trust whether the trustee is to consider the beneficiary’s other resources.
- If the trust provides anything other than “shall not”, then address whether the trustee is to consider only the beneficiary’s income or whether the beneficiary’s other resources (capital assets) are also to be considered.
- Consider what the anticipated trustee’s likely reaction will be to a “may” or “may but is not required to” clause and discuss this with the client.
- Beneficiaries invariably view having to produce a budget, their income tax return, and information about their income and assets as invasive. Did the settlor understand that this information likely will have to be provided on an annual basis?
- Sample: “In the exercise of discretion with respect to any distributions of income and/or principal to any beneficiary under this instrument, the Trustee [shall, may, may but is not required to, shall not] consider all income [and resources; and readily marketable resources] available to such beneficiary from all sources known to the Trustee.”
Beneficiary’s Resources - Continued

What if the document is silent as to the beneficiary’s resources?

- Restatement of the Law (Second) Trusts stated that common law was that the trustee was not to look at the beneficiary’s resources if trust did not address the issue. The Restatement (Third) states the opposite.

- Florida law:
  - NCB National Bank of Florida v. Shanaberger, 616 So.2d 96 (Fla. 2nd DCA 1993) held that a trustee may ask for a beneficiary’s other sources of income when evaluating a discretionary distribution request if the trust is silent on the beneficiary’s other resources. The court was not asked and did not decide whether the trustee may ask about capital assets in making discretionary distribution.

  - Barnett Banks Trust Company N.A. v. Herr, 546 So.2d 755 (Fla. 3rd DCA 1989). The governing instrument provided that in making discretionary principal distributions the trustee was to take “into consideration … all other income available to her from all sources known to the Trustee....” Held: The trustee “can look only to income [presently] available from all sources to the beneficiary, but not to the beneficiary’s current non-income producing assets.”
Don’t Mix/Jumble Standards

- It is ok to use both ascertainable and non ascertainable standards. However, don’t mix them. If a discretionary power is not ascertainable, be sure that it can only be exercised by an independent trustee.

- Florida has a surprising number of court decisions where the trust instrument appears to have two inconsistent standards intertwined with each other and sometimes granted to a beneficiary trustee. Example:
  
  - Minassian v. Rachins, 152 So.3d 719 (Fla 4th DCA 2014): Discretionary distributions may be made “as my Trustee, in its sole and absolute discretion, shall consider advisable for my spouse’s health, education, and maintenance.”

- In situations like the above, is the trustee’s discretionary power “absolute” or is it limited by the subsequently stated standard?
  
  - The Restatement (Third) takes the position that if trust has a broad grant of discretion (e.g., absolute) followed by a more limited standard, then the trustee’s power is limited by that narrower standard and the broad grant of authority (absolute/sole discretion) is to be given little weight. See Restatement Third § 50, comment c.

  - What is the IRS position? The answer is not totally clear, and the answer could depend on whether the governing state law follows the Restatement Third.

  - Regulation §25.2511-1(g)(2) provide that an ascertainable standard is rendered unascertainable for a beneficiary trustee “if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or non-exercise of a power....”
Other Beneficiary-Trustee Issues

- **Savings clause language**: The trust should prohibit any trustee from making discretionary distributions to satisfy the trustee’s legal obligations of support. Absent such a prohibition the trustee may be required to report the income of the trust on the trustee’s personal return. The trust also should prohibit any trustee from exercising any power that can cause estate tax inclusion.
  - §736.0814, Florida Statutes, generally provides statutory protections (savings clause) with respect to these items and other potential “hot” powers. It is based on the Uniform Trust Code (UTC). Most states that have adopted some form of the UTC have a similar provision.
  - Don’t just rely on state savings clause statute: It likely is best to have a savings clause in the trust in case it is administered in a different state in the future.

- **Allocation of receipts and disbursements; allocation of capital gains to income**: The IRS generally provides that a beneficiary-trustee’s power under state law to allocate receipts and disbursements does not rise to a general power of appointment (non ascertainable discretionary distribution power). However, some caution may be warranted if the trust instrument gives absolute discretion or some other very broad discretion in making such decisions, and any such decision can impact the beneficiary interest of that beneficiary trustee. State savings clause statutes based on the UTC also limit beneficiary discretion on these matters.
Other Beneficiary-Trustee Issues … Continued

Creditors Rights: Can a creditor force a beneficiary who is also trustee to exercise a discretionary distribution power to make distributions to the beneficiary?

- Common Law: See Restatement (Third) of Trusts §60, comment g, which states that absent a state statute or contrary case law, the common law is that a beneficiary trustee can be forced to make a distribution from a trust to his or her creditors even if the trust contains ascertainable standards.

- Uniform Trust Code: After the Restatement (Third) came out, NCUSSL added language to the model Uniform Trust Code as a direct response to “comment g”, and provided in the UTC that a creditor cannot force a beneficiary trustee to make a distribution if the beneficiary trustee is subject to an ascertainable standard. [The creditor still can force a distribution to the extent that the creditor could force an independent trustee to make a distribution.]

- Some version of the Uniform Trust Code has been adopted in 32 states, of which 24 states have language similar to the Uniform Trust Code.

- Florida adopted this UTC provision. See §736.0504, Florida Statutes. Many, but not all, other states have similar provisions.

- We don’t know where a beneficiary trustee will be administering the trust in the future. Does the law of the state where the trust was created control on this issue, or does the law of the state where the beneficiary/trustee is residing/administering the trust at the relevant time govern this issue?
Key Suggestions

- Consider whether your “go to” ascertainable or non ascertainable standards are likely to accomplish the settlor’s intent.
- Revisit “beneficiary’s other resources” language.
- Revisit “primary beneficiary” and other settlor “intent” language.
- Consider the anticipated trustee’s likely reaction to the discretionary distribution standards.
- Talk with the client regarding how discretionary distribution decisions are typically made, noting the standards for distribution and the “primary beneficiary”, “intent” and “other resources” provisions (if any) contained in the trust.
- Recommend that the client meet with the anticipated trustee to discuss how that anticipated trustee typically handles discretionary distribution requests and also how the anticipated trustee interprets the proposed standards for distributions contained in the draft trust.
- Verify distribution standards that are intended to be ascertainable clearly fit within the examples of the Code and Regulations, or relevant (binding) IRS pronouncements or case law.
- Ensure that non ascertainable distribution powers & other “hot” powers are granted only to independent trustees.
- Verify that non ascertainable and ascertainable standards are not mixed/jumbled together.
- Include savings clause language (Section 736.0814, Florida Statutes type provisions).