

Discretionary Trust Distributions of Principal and Income: Avoiding Beneficiary Challenges and Adverse Tax Consequences

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Discretionary Trust Distributions of Principal and Income: Avoiding Beneficiary Challenges and Adverse Tax Consequences

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Effectuating the Settlor's Intent and Providing Guidance to the Trustee

- Settlor needs to understand options to accurately convey his or her intent with respect to discretionary distributions.
- What does the language in the trust really mean?
- How are particular distribution provisions likely to be interpreted?
- What factors should the trustee consider in exercising discretion to make distributions of principal and income?
- How does the settlor want to prioritize between trust beneficiaries (e.g., spouse and children)?
- Does settlor want to provide additional protection to trustee (e.g., exculpatory provision)?

Ascertainable Standards/HEMS

An ascertainable standard is one that provides the trustee with parameters within which to make decisions regarding the scope of distributions appropriate for a particular beneficiary. The most commonly used ascertainable standard is the health, education, maintenance, and support (HEMS) standard, as defined in IRC section 2041(b)(1)(A) and in Treasury Regulation section 20.2041-1(c)(2).

Health and Medical Costs/ Potential Disputes

Disputes can arise about health and medical costs because they are not defined by law and some inherently gray areas exist. For example, does payment for health costs include:

- Cost of health and dental insurance
- Cost of life and disability insurance
- Fertility treatments
- Lasik surgery
- Counseling
- Naturopathic treatments
- Cosmetic dental work
- Gym membership
- Massage

Health/Sample Provision

- (a) Trustee may distribute principal to meet the health needs of any Beneficiary in full, regardless of financial need, provided that when requesting such principal the Beneficiary can show that he or she (i) obtained what the Trustee considers to be adequate health insurance and such distribution covers only the cost of uncovered health expenses, or (ii) attempted to obtain health insurance and was determined to be uninsurable.
- (b) Health needs shall not include elective cosmetic surgery unless such surgery is recommended as a result of an injury, accident, illness, disease or other medical reason (such as, reconstructive surgery after cancer treatment).
- (c) Health needs shall include the costs incurred as the result of infertility and the costs of adoption, but only to the extent of fifty thousand dollars (\$50,000) per Beneficiary during his or her lifetime.

Education Costs/Scope

- The “term ‘education,’ without elaboration, is ordinarily construed as extending to payment of living expenses as well as fees and other costs of attending an institution of higher education, or the beneficiary’s pursuit of a program of trade or technical training, and the like, as may be reasonably suitable to the individual and to the trust funds available for the purpose.” Restatement of Trusts (Third) ("Third Restatement"), §50, cmt. d(3).
- Treasury Regulation Section 20.2041-1 does not define the term “education” but does provide that the phrase “education, including college and professional education” is an ascertainable standard.

Education Costs/Illustrative Cases

- Trustee refused to pay for a beneficiary's room and board expenses between college semesters because the beneficiary was not actively in school at the time. The Court held that payments for education include support between college semesters. *In re Egan's Estate*, 39 N.Y.S.2d 96, 99 (Sur. 1942).
- Paying for the education of the beneficiary during his adult life was permitted when the testator was a scholarly man himself. *In the Matter of Estate of Wolfe*, 164 Misc. 504, 299 N.Y. Supp. 99 (Sur. Ct. 1937).
- Interpreting the term "education" to mean that any education up to and including a bachelor's degree, but not higher. The court found "nothing to indicate that the testator intended to provide funds for unlimited pursuit of education" and therefore would not deem the funds applicable to the post-graduate education. *Southern Bank & Trust Co. v. Brown*, 246 S.E.2d 598, 603 (S.C. 1978).

Education/Sample Provision

The term “education” shall include, but not be limited to, attendance at elementary, junior high, secondary, vocational, college, graduate and/or professional schools, whether public or private. The Trustees should do all things necessary to assure such beneficiary receives a reasonable education. Educational expenditures shall include, but not limited to, expenditures for tuition, books, lodging, food and a reasonable allowance. The failure of any such beneficiary to apply himself or herself to his or her studies, as evidenced by failure to attain passing grades, shall constitute sufficient cause for the refusal on the part of the Trustees to authorize further advancements from income or corpus on account of education. It is my intention that this trust pay for the expenses associated with studying abroad for one year provided it is part of an established curriculum of the college or university or graduate school the beneficiary is attending. This trust is not established to provide support for a beneficiary to attend school for his/her entire life. Eventually, the beneficiary should choose a career and begin employment.

Maintenance, Support, and Accustomed Standard of Living

- “Maintenance” and “support” are generally considered to be synonymous
- Generally provide for ordinary expenses; see examples in explanatory material in Third Restatement § 50, cmt. d(2)
- Often to be measured by the beneficiaries “accustomed standard of living”
- Accustomed standard of living generally refers to time of settlor’s death or time irrevocable trust was created. *See* Third Restatement § 50, Comment (d)(2)(2003)

Unascertainable Standards

- Comfort
- Best interest, welfare, and/or happiness
- Necessities, need, and/or emergency
- Complete discretion (e.g., “Trustee shall pay to or apply for the benefit of the beneficiary as much of the net income or principal, or both, of the trust as the Trustee deems appropriate for any reasonable purpose”)

WHAT COULD POSSIBLY GO WRONG?

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Additional Considerations in Evaluating Discretionary Distribution Requests

- “Clues” in trust language and overall structure
- Hierarchy for distributions
- Magnitude of trust assets
- Anticipated duration of trust
- Competing beneficiary interests
- Factual and family circumstances
- Alternatives/compromises to satisfy distribution requests

Documenting Decisions/ Seeking Court Approval

- Courts will be deferential to a trustee's thoughtful and prudent exercise of discretion
- Trustee should ensure that the evaluation and decision-making process is well documented
- If a discretionary decision is likely to be challenged by a beneficiary, seek court approval through a petition for instructions or similar proceeding, providing all beneficiaries with notice and the opportunity to object

What are the Estate Tax Risks for Discretionary Distribution Provisions?

- If the decedent has a general power of appointment, then the decedent's estate includes the value of property in which the decedent possessed, exercised or released that general power of appointment. §2041
- Discretionary distribution provisions can “unintentionally” create a general power of appointment and cause the trust to be included in the power holder's estate for estate tax purposes.

What is a Power of Appointment?

- The power held by a trust beneficiary to “appropriate or consume the principal of the trust”;
- The power to “affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust”;
- The power, conferred upon a spouse under the community property laws of a state, of “testamentary disposition over property in which [the spouse] does not have a vested interest”; or
- The power, in certain cases, of a person to “remove or discharge a trustee and appoint” herself as trustee. Treas Reg. §20.2041-1(b)(1).
- Power must be “granted” not retained – 2036, 2038.

What is Not a Power of Appointment?

- The power held by the decedent to appoint a successor trustee, including himself or herself, under limited conditions that did not exist at the time of his or her death without an accompanying unrestricted power of removal;
- The power to amend only the administrative provisions of a trust instrument, that cannot substantially affect the beneficial enjoyment of trust property or income;
- The mere power of asset management, investment, custody, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, if the power holder has no power to enlarge or shift any beneficial interests except incidentally; or
- The right of a trust beneficiary to assent to periodic accounting, relieving the trustee from further accountability, if the right of assent does not allow the power holder to shift or enlarge any beneficial trust interest. Treas Reg. §20.2041-1(b)(1)

General vs. Limited Power of Appointment

- **General** – a power which is exercisable in favor of the decedent, her estate, her creditors, or the creditors of her estate. §2041(b)(1)
 - May include power to revoke or amend a trust, or power to withdraw income or principal from a trust (Uniform Act)
 - May include ability to discharge a legal obligation – include provision that cannot exercise in way to discharge legal obligation.
 - Assets subject to power are included in power-holder’s estate for estate tax purposes.
 - Creditors = If donor creates for self as donee, then same as being owned by donor
 - If grant to person other than donor, creditors may only get the appointive property during the donee’s lifetime, to extent power is presently exercisable and powerholder/donee’s other assets are insufficient.
 - If donee holds at time of death, then to extent estate is insufficient, creditors can reach assets subject to GPOA (NY does not require it be “insufficient”); may trump a spendthrift provision.
- **Limited (Non-General)** – a power that is (1) not expressly exercisable in favor of the decedent, her estate, her creditors or the creditors of her estate; or (2) exercisable only in favor of one or more designated persons or classes other than the decedent, her creditors, or the decedent’s estate or the creditors of her estate. Treas. Reg. 20.2014-1(c)(1).
 - Creditors) – exempt from the powerholder/donee’s creditors (unless done as fraudulent transfer to evade creditors.)

How does the Ascertainable Standard Impact a Power of Appointment?

- “A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.” §2041(b)(1)(A).
- “A power is limited by such a standard if the extent of the holder'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).” Treasury Regulation § 20.2041-1(c)(2).
 - It is irrelevant if the trustee may or must consider the beneficiary’s other assets before making a principal distribution.
 - Trustee’s sole and absolute discretion - may impact ascertainable standard if no judicial oversight

Un-Ascertainable Standards – Who has power and who benefits?

- Non-ascertainable standard: “may distribute income or principal as trustee deems advisable or necessary” without reference to HEMS or other limits (Rev. Rule. 76-368)
 - Independent Trustee – not a general power of appointment because cannot benefit self.
 - Beneficiary as Trustee – will be imputed to the income beneficiary
 - Surviving spouse serving as trustee of credit shelter or bypass trust.

Examples

- Power to invade to “maintain standard of living”. PLR 7914036
- Power to use income and principal for “reasonable health, education, support and maintenance of needs consistent with high standard of living”. PLR 7836008
- If power is jointly exercisable with a person having a substantial interest in the property subject to power that is adverse to the donee, then it is limited power. 2041(b)(1)(c)(ii). (If not adverse, then may have issue because of estate tax liability without control over asset).
- Power to appoint assets of testamentary trust limited by requirement that it be for her benefit was GPOA. *De Oliveira v. United States*, [767 F.2d 1344](#) (9th Cir. 1985).
- Power to request such amounts out of corpus as Donee from time to time might “require” and Donee was the sole judge as to the amount and frequency of such corpus amounts. Donee had a general power. State law did not limit the word “require” to mean needs or necessities, or maintenance. *Peoples Trust Co. Bergen Cnty v. United States*, 412 F.2d 1156 (3d Cir. 1969).
- A beneficiary’s power to remove or replace a trustee who has the power to make discretionary distributions to that beneficiary so long as replacement trustee cannot be related or subordinate to the beneficiary within §672(c).
- If a donee has power to distribute income to herself, but accumulates it, then she has a general power of appointment over the income which is then a taxable gift each year the power if not exercised. *Treas. Reg. 20.2041-3(f)*, Ex. 2.

State Law Issues

- State law determines nature of donee's interest in property and scope of interest – may determine if donee has authority to appoint, to whom, and if limited by a standard.
- Savings provisions
 - Prevents donee from exercising discretionary power in donee's favor (how is the power exercised if donee is trustee)
 - Some states have laws that restrict ability of trustee to make distributions to themselves absent provisions in the trust agreement.
 - Converts a discretionary power to an ascertainable standard.
 - Specifically requires trustee/beneficiary to make distributions to self pursuant to ascertainable standard

What are the Income Tax risks for Discretionary Distribution Provisions?

- Grantor is Taxed – The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. §674(a)
 - Exceptions – does not matter who holds the power:
 - Power to distribute corpus to beneficiary if limited by a reasonably definite standard which is set forth in the trust instrument or to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust. 674(b)(5).
 - Exception: Power to distribute or apply income or accumulate income, however accumulated income must be paid to beneficiary so long as beneficiary has a general power of appointment or on termination of the trust the income is distributed to the current income beneficiaries who are irrevocably specified in the trust instrument. 674(b)(6).
 - Exception: Power to distribute or apply income or accumulate income for a beneficiary during her legal disability or if beneficiary is under 21. 674(b)(7).
 - Exceptions depend on who holds the power:
 - If power is exercisable by an independent trustee to distribute, apportion, or accumulate income or distribute corpus 674(c)
 - If power is exercisable by a trustee who is not the grantor or spouse living with grantor to distribute, apportion, or accumulate income if the power is limited by a reasonably definite external standard in trust. 674(d)

Income Tax Continued

- Exceptions depend on who holds the power:
 - If power is exercisable by an independent trustee to distribute, apportion, or accumulate income or distribute corpus 674(c)
 - If power is exercisable by a trustee who is not the grantor or spouse living with grantor to distribute, apportion, or accumulate income if the power is limited by a reasonably definite external standard in trust. 674(d)
- Power Holder is Taxed on Income - A holder of a power, other than the grantor, is treated as the owner of any portion of a trust with respect to which such holder has a power exercisable solely by herself to vest trust corpus or income in herself. §678(a)(2).
- Income Tax Consequences if taxable to holder or grantor
 - If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner. Treas. Reg. § 1.671-3(a)(1)
 - If it relates to specific trust property, or a fractional interest, then only those properties or portions will be included. Treas. Reg. § 1.671-3(a)(2) & (3)

S Corporations and Discretionary Distributions

- Irrevocable Trust as Shareholder of S Corporation
 - Qualified Subchapter S Corporation §1361(d)(3)(A), §1361(d)(4)(A).
 - Only one beneficiary may receive income and principal distributions
 - Trustee must distribute or be required to distribute to beneficiary who is a US citizen or resident
 - Beneficiary's interest in trust terminates on death or termination of trust
 - If terminates during beneficiary's life, trust assets distributed to the beneficiary.
 - Drafting – if concerned about S corporation stock, do not including “sprinkling” powers; create separate trusts
 - Beneficiary is treated as shareholder for income tax purposes – not trust.
 - Electing Small Business Trust §1361(e)(1)(A).
 - A trust is eligible to become an ESBT if no interest in trust was acquired by purchase and all beneficiaries are individuals or estates.
 - Treated as two separate trusts for tax purposes – S portion and non-S portion. S portion is S corp stock and non-grantor – taxed at highest rates.
 - Tax Consequences

Misc. Discretionary Distribution Issues

- Requirements that beneficiary have prenuptial agreement or cohabitation agreement
- Priority of Distributions
 - Among class of beneficiaries (sprinkling powers)
 - Multiple Trust - Marital Trust vs. Bypass, GSTT exempt vs. GSTT Non-exempt