

Drafting and Administering Discretionary Trusts

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- 1) Introduction
 - a) Trustee's Discretionary Actions
 - i) Discretionary distributions – good faith (Wis. Stat. § 701.0814);
 - ii) Small Trust Termination – (Wis. Stat. § 701.0414);
 - iii) Unitrust Conversions – (Wis. Stat. § 701.1106);
 - iv) Power to adjust income and principal – (Wis. Stat. § 701.1104);
 - v) Power to change situs – (Wis. Stat. § 701.0108);
 - vi) Decanting – (Wis. Stat. § 701.0418);
 - vii) Mergers and Divisions – (Wis. Stat. § 701.0417);
 - viii) Trust Modification – (Wis. Stat. § 701.0410 - § 701.0416);
 - ix) Tax Elections;
 - x) Funding Decisions in Estate Settlement;
 - xi) Beneficiary Loans from Trusts (also an investment decision);
 - b) Trustee's Fiduciary Duties¹;
 - i) Duty of Impartiality – (Wis. Stat. § 701.0803);
 - ii) Duty of Loyalty – (Wis. Stat. § 701.0802);
 - iii) Duty of Care (Duty to Administer and Duty of Prudent Administration) – (Wis. Stat. § 701.0804);
 - iv) Abuse of Discretion – Note that a court may not determine that a trustee abused its discretion merely because the court would have exercised the discretion in a different manner or would not have exercised discretion. – (Wis. Stat. § 701.0814).
 - c) Health, Education, Maintenance, and Support (“HEMS”)
 - i) We all speak as though it is clear and understood.
 - ii) Goal of presentation is to look at HEMS from practical standpoint of drafter and of administrator.
- 2) Power of Appointment
 - a) A Power of appointment is any power that is in substance and effect a power of appointment, regardless of the term used in the document. The following are examples of powers of appointment.²

¹ Wis. Stat. §701.0801 – §701.0804

² 26 C.F.R. § 20.2041-1(b)(1)

- i) The power held by a trust beneficiary to appropriate or consume the principal of the trust.
 - ii) 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.
 - iii) The power, in certain cases, of a donor to remove or discharge a trustee and appoint the donee.
- b) General Power of Appointment
- i) A general power of appointment is a power exercisable in favor of the power holder, his or her estate, his or her creditors, or the creditors of his or her estate.³
- c) Consequences of Holding a General Power of Appointment
- i) Estate Tax. Property subject to a general power of appointment held by a power holder at his or her death is includable in his or her gross estate under I.R.C. § 2041.
 - ii) Gift Tax. An inter vivos exercise or release of a general power of appointment is a transfer of property that may be subject to gift tax under I.R.C. § 2514.
 - iii) Income tax. The possession by a trust beneficiary, or the exercise by a power holder creating a trust, of a general power of appointment can cause the trust to be a grantor trust under §§ 671-679, resulting in some or all of the income of the trust being attributable to that beneficiary, power holder, or some other party.
 - iv) Generation-Skipping. GST tax can be imposed on distributions made by a power holder as a result of the exercise of a power of appointment in favor of a skip person.
- 3) Ascertainable Standard Exclusion
- a) Introduction
- i) A power vested in a donor to consume, invade, or appropriate property, even though for his or her own benefit, is not deemed a general power of appointment if it is limited by an “ascertainable standard” relating to the health, education, support, or maintenance of the power holder.⁴
 - ii) The words “support” and “maintenance” are synonymous and their meaning is not limited to the bare necessities of life.⁵
 - iii) The regulations provide that the following limitations on exercise in favor of the power holder qualify as ascertainable standards.⁶
 - a) Support;
 - b) Support in reasonable comfort;
 - c) Maintenance in health and reasonable comfort;
 - d) Support in his or her accustomed manner of living;
 - e) Education, including college and professional education;
 - f) Health;
 - g) Medical, dental, hospital, and nursing expenses, and expenses of invalidism.
 - iv) When language strays from terms set forth in IRC and Regulations, state law is examined to determine whether the distribution standard is an ascertainable standard.

³ 26 I.R.C. § 2041

⁴ 26 I.R.C. § 2041(b)(1)(A)

⁵ 26 C.F.R. 20.2041-1(c)(2)

⁶ 26 C.F.R. 20.2041-1(c)(2)

- b) What does not qualify as ascertainable standard?
 - i) A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard;⁷
 - ii) Best Interests;
 - iii) Trustee's Sole and Absolute Discretion;
 - iv) However, "comfort" may qualify if paired with other standards that qualify as ascertainable standards.⁸
- c) Health
 - i) Emergency medical treatment;
 - ii) Psychiatric treatment;
 - iii) Psychological treatment;
 - iv) Routine health care examinations;
 - v) Dental;
 - vi) Eye care;
 - vii) Cosmetic Surgery (if medically necessary or recommended; not if elective);
 - viii) Lasik surgery;
 - ix) Unconventional medical treatment;
 - x) Home health care;⁹
- d) Education
 - i) Grammar, secondary and high school tuition;
 - ii) Undergraduate school;
 - iii) Graduate school;
 - iv) Post-graduate school;
 - v) Medical school, law school, or other professional school;
 - vi) Support of the beneficiary while in school;
 - vii) Studies for the student that makes a career out of learning;
 - viii) Technical school training;
 - ix) Career training and certification programs;
 - x) College in Europe as part of a study abroad program; and
 - xi) Related expenses such as supporting the beneficiary not only during the semester, but, also between semesters.¹⁰
- e) Maintenance/Support
 - i) Intro
 - a) Commonly references the beneficiary's accustomed standard of living or station in life.¹¹
 - b) Typically references the customary manner of living enjoyed by the beneficiary at the time of the settlor's death or at the time an irrevocable trust is created.¹²
 - c) Can increase due to inflation.¹³
 - d) Can increase due to beneficiary's circumstances, for example from deteriorating health or from added burdens appropriately assumed for the needs of another.¹⁴

⁷ 26 C.F.R. 20.2041-1(c)(2)

⁸ See e.g., *Pyle v. U.S.*, 766 F.2d 1141 (7th Cir. 1985)

⁹ Restatement (Third) of Trusts, § 50(2003) cmt d(3)

¹⁰ *Id.*

¹¹ *Id.* at cmt. d(2)

¹² *Id.*

¹³ *Id.*

- ii) Typically includes:
 - a) Regular mortgage payments and Rent;
 - b) Property taxes;
 - c) Suitable health insurance or care;
 - d) Existing programs of life and property insurance;
 - e) Support and maintenance for those that the beneficiary is supporting.¹⁵
- iii) Might include:
 - a) Continuation of accustomed patterns of vacation and of charitable and family giving;
 - b) 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, may be borderline as entitlements but would normally be within the permissible range of the trustee’s judgment, even without benefit of a grant of extended discretion.¹⁶
- iv) Without additional language typically does not cover:
 - a) Payments that are unrelated to support but merely contribute in other ways to a beneficiary’s contentment or happiness;
 - b) Distributions to enlarge the beneficiary’s personal estate;
 - c) To enable the making of extraordinary gifts;¹⁷
 - d) Credit card debt payoffs (unless the expenses incurred qualify under a distribution under another standard).
- 4) Other factors impacting discretionary standard
 - a) Consideration of other resources
 - i) Must it be considered even if document does not say so?
 - ii) Goes to duty of impartiality;
 - iii) WTC is silent as to this issue;
 - iv) But the general rule (with qualifications) under the Restatement (Third) of Trusts is to consider other resources.¹⁸
 - v) Whether the holder is required first to exhaust his other sources of revenue is of no significance in determining whether a power is limited by an ascertainable standard.¹⁹
 - b) Statement of intent
 - i) See Attachments
 - c) Examples of HEMS in definitions section
 - d) Multiple beneficiaries
 - i) Primary beneficiary
 - e) Additional Considerations to be Eligible to Receive Distributions

¹⁴ Id.

¹⁵ Id.

¹⁶ Id.

¹⁷ Id.

¹⁸ Id. at cmt. e. (subject to qualifications, the presumption is that the trustee is to take the beneficiary's other resources into account in determining whether and in what amounts distributions are to be made, except insofar as, in the trustee's discretionary judgment, the settlor's intended treatment of the beneficiary or the purposes of the trust will in some respect be better accomplished by not doing so).

¹⁹ 26 C.F.R. § 20.2041-1(c)(2)

- i) Provisions that require or advise the trustee to take additional considerations into account can add complexity and liability.
 - a) Beneficiary's moral character;
 - b) Physical and/or mental health;
 - c) Addiction issues (drug, alcohol, gambling, etc...) including regular testing;
 - d) Marital Status;
 - e) Maintaining membership of a specific church or religion; and
 - f) Political stability of the beneficiary's place or residence or nationality.
 - ii) May be deemed intrusive by the beneficiaries.
 - iii) Corporate trustees are often unable to confirm or deny these considerations due to their very personal nature and use of a trust protector or family committee that the trustee can fully rely upon may provide a more reasonable solution.
- 5) A Trustee's Process for Requests
- a) Written request letter
 - b) Supporting documentation
 - i) Budget
 - ii) Financial Statement
 - iii) Tax Return
 - iv) Offer to Purchase
 - c) Written co-trustee approval, if appropriate
 - d) Reviewed and re-approved annually
 - e) Authority Levels for Approvals
 - i) Trust Administrator Only approvals
 - ii) Discretionary Review Group
 - iii) Discretionary Oversight Committee
- 7) Creditor Protection – Making a third party trust wholly discretionary is as good or even better than a spend-thrift clause. – (Wis. Stats. § 701.0504 states “a beneficiary’s interest in a trust that is subject to the trustee’s discretion does not constitute an interest in property or an enforceable right even if the discretion is expressed in the form of a standard of distribution or the beneficiary is then serving as sole trustee or cotrustee”). If there are creditor concerns consider using “may distribute” rather than “shall distribute.”

Attachment A

Example of Short Statement of Intent

The net income and principal of the trust may be distributed to the child or on the child's behalf, in the trustee's discretion, for his or her care, comfort, education, welfare, purchase of a home, starting a business or professional venture or any other worthwhile purpose. In making discretionary distributions of principal, the Trustee shall keep in mind the Settlor's desire that the existence of the trust shall not discourage the individual effort and initiative of a beneficiary who has completed his or her education.

Attachment B

Example of Long Statement of Intent

1. Distributions. The trustee may pay from the trust for my child as much of the net income or principal or both as it considers advisable for my child's general welfare. The trustee shall use its discretion in making distributions and shall consider my intention that the trust be used for the following purposes:

- a. Health Expenses. Health care expenses, including uninsured medical expenses, dental care, vision care, psychological and counseling expenses.
- b. Education. Educational expenses for pre-school, kindergarten, elementary, middle school, high school, technical school, college, and graduate school, including professional school. Allowable expenses include, but are not limited to, tuition, books, fees, room and board, a computer and other necessary technological expenses, meals, and travel expenses.
- c. Maintenance. Maintenance expenses, including but not limited to, the down payment on a home and the purchase of a business, so that a beneficiary may live in a manner that the beneficiary is accustomed to.
- d. Support. A beneficiary may also receive income and/or principal distributions so that he or she has sufficient funds to live in a manner that he or she is accustomed to.

2. Discretion of Trustee. The trustee shall have discretion to make decisions and establish policies and procedures consistent with my intentions, which are (1) for my child to obtain a good education and to meaningfully participate in the labor force, and (2) to instill certain qualities in my children, including to act with integrity, (3) to have a sense of family unity, and (4) to have a sense of equality.

3. Consideration of Other Resources. The trustee shall consider the resources and income of the beneficiary. The trustee may require the beneficiaries to periodically furnish a financial statement on a form the trustee shall provide to the beneficiary.