



**FIFTH THIRD
PRIVATE BANK**

Profound and Problematic: The Opportunities and Challenges Presented by Irrevocable Trust Distributions

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TRUSTEE DISCRETIONARY DISTRIBUTIONS

General definitions, case law and examples

Discretionary Actions- at beneficiary request



- Ascertain settlor intent:
 - What do the trust terms provide?
- Identify appropriate beneficiaries:
 - Current versus remainder
 - Members of settlor's family?
- Review and understand distribution standard:
 - What does the standard mean?
 - Does request fit within the standard?
- Understand trustee discretion:
 - Must the trustee consider all requests?
 - Must the trustee distribute if certain criteria are met?

Review of the Trust Document

Scope of and Standards Set Forth in the Discretionary Provisions

- Scope. Do the discretionary provisions apply to income, principal, or both?
- Standards. *How broad* is the trustee's discretion under the document? Some frequently seen standards:
 - “Health, education, maintenance and support” (HEMS).
 - “Comfort.”
 - “Well being.”
 - “Best interests.”
 - “Medical emergency.”
 - “To pursue a career or professional opportunity.”
 - “To purchase a residence.”
 - “Any purpose which, in the Trustee's discretion, is a proper use of principal.”
- Judicial limitations on the standard. A Court will only reverse a trustee's discretionary decision for abuse of the standard. *Woodward v. Mordecai*, 234 N.C. 463 (Supreme Court of North Carolina, 1951)

Support standard

- Ordinarily allows consideration of:
 - Regular mortgage payments.
 - Property taxes.
 - Suitable health insurance or care.
 - Existing programs of life or property insurance.
 - Continuation of accustomed vacations.
 - Might also allow special vacations within the means of others in like station of life
 - Continuation of accustomed charitable and family gifting.

Health and Education

- Health
 - Routine medical needs, including mental health.
 - Even without a specific reference to health, health and medical benefits are normally implied by a support standard
 - What about elective surgery? Generally not covered unless needed for beneficiary's health. May be covered if the standard is "Best interests".
 - Generally, not construed to include expensive home care.

- Education
 - Tuition expenses for primary and secondary education including fees and costs
 - Generally extends to payment of living expenses
 - Generally includes pursuit of a program of trade or technical training

The support standard

Example 1

- John's trust provides that the trustee is authorized to "distribute income and or principal to any of his descendants as the trustee in its sole discretion deems appropriate for the health, education, maintenance and support of such descendants".
- John has two children: Mary and Tom who each have two children of their own.
- Mary asks the trustee to help pay for medical expenses incurred by her husband.

Consideration of a standard of living

Example 2

- Fred's trust provides for mandatory net income to his surviving spouse, Jane and "such amounts of principal as the trustee may deem necessary to maintain her in her customary manner of life."
- Jane's adult son, Ethan moves in with Jane after Fred's death because Ethan is recently divorced, unemployed and a recovering alcoholic.
- Jane asks the trustee to increase monthly distributions to her so that she can maintain her customary manner of life with the additional expenses associated with her new live-in son.

Support and maintenance

- The terms are normally construed as synonyms
- May be accompanied by a reference to the beneficiary's accustomed standard of living (when?)
 - Standard of living is usually that at the time of settlor's death or at time the trust is created
 - May be adjusted for increased needs or higher lifestyle
 - May also be decreased if trust is small or of long duration
- Ithaca Trust Co. V. U.S. 279 U.S. 151 (1929)
 - The customary standard of support is a question of fact. It is not a question of what the trustee thinks the standard should be, nor is it one of what the beneficiary thinks it should be.
- May include legal obligations of the beneficiary, i.e. support of minor dependent children or support of a former spouse

Standard of living case law

- Standard generally does not include:
 - Distributions for a beneficiary's contentment or happiness.
 - Distributions to enlarge the beneficiary's personal estate.
 - Distributions to enable the beneficiary to make extraordinary gifts.
- Estate of Ward, 342 Mich. 172 (1955)
 - Support does not authorize payments to enlarge a beneficiary's estate
- Robison v. Elston Bank & Trust, 113 Ind. App. 633 (1943)
 - The needs of a married man include the needs of his family living with him and entitled to his support. It would not be consistent with his welfare for his family to be in want and it is hardly probable that the testatrix intended to provide for his needs and let his wife and children go without.

Considering a beneficiary's other resources

- Does the document require us to consider “other resources” of the beneficiary (personal income, income from other trusts, personal assets, etc.)?
- Does the document mention an “other resources” inquiry at all? Does it explicitly make it optional, as trustee sees fit?
- In exercising our duty of loyalty to the Settlor and other beneficiaries, should we make such an inquiry, even if it's not required by -- or even mentioned in – the document?

Considering a beneficiary's other resources

- If trust terms require consideration of other resources, necessary documentation or other information must be obtained to support a request for funds and justify trustee's decision.
- If trust terms do not require consideration of other resources (and also do not prohibit the trustee from considering other resources) and the discretionary standard is for "support" or "maintenance", necessary documentation or other information should be obtained.
 - Nature of the documentation will generally be other sources of income and expenses of the beneficiary- use of a budget form is encouraged.

Considering a beneficiary's other resources

- In the case of non-objective standards such as “benefit” or “happiness” other resources have less direct relevance than with regard to additional amounts necessary to support the beneficiary or maintain an accustomed lifestyle. The resources can have a bearing on the overall reasonableness of an exercise of the discretionary authority.
- The general rule of construction does not apply when the settlor expresses a different intent or if the presumption is contrary to the purposes or terms of the trust.
- The settlor may provide that resources are not to be taken into account or that they must be considered.

Consideration of other resources

Example 3



- Flo established a trust for the benefit of her son, Mark which provided for mandatory income and principal at the trustee's discretion "as is necessary for the care, maintenance, support and medical attention of Mark."
- Flo's trust does not mention trustee consideration of other resources.
- Eventually, Mark requested principal to cover his nursing home expenses and the trustee asked for information pertaining to his other resources.

Considering other resources

- Barnett Bank Trust Co. v. Herr, 546 So. 2d 755 (Fla. App 1989)
 - While trustee was required to take account of other income, the beneficiary was not required to liquidate non-income producing assets
- NCNB National Bank v. Shanaberger, 616 So. 2d 96 (Fla. App 1993)
 - There was no abuse of discretion when trustee required information about beneficiary's other resources

Additional supplemental terms

- “Generous support”
 - Permits the trustee to allow reasonable enhancement of the beneficiary’s lifestyle
 - Distributions must still be support related
- “Happiness”
 - Allows the trustee to exercise judgment generously and make any reasonably affordable distributions
 - Immunizes the trustee from challenges by remainder beneficiaries

Additional supplemental terms

- Benefit”; “Best Interests”; “Welfare”
 - Terms that authorize distributions beyond the usual scope of a purely support-related standard.
 - Might allow a substantial distribution to enable a beneficiary to start a business.
 - These terms also diminish the relevance of the beneficiary’s other resources.

Supplemental standards- Example 4

- Karl's trust terms provide for authority to distribute principal to Lila, his surviving spouse for her "comfortable support and happiness."
- Lila asks for funds for an extended overseas vacation, something she never did while her husband was alive, and to provide funds so that her sister can accompany her.

Supplemental standards case law

- Comfort:
 - Not construed to enhance an already comfortable lifestyle, but could enhance a modest lifestyle
 - Is not construed to enhance a beneficiary's lifestyle that is already reasonably comfortable
- Rock Island Bank & Trust v. Rhoads, 353 Ill. 131 (1933)
 - Comfort should be interpreted as equivalent to the “station of life” to which the beneficiary is accustomed.

Restrictive Standards

- “Emergency”; “Severe Hardship”; “Disability”
 - Restrictive terminology
 - Authorizes distributions only when described conditions or circumstances arise.
 - Distributions should be made only to the extent appropriate to alleviate emergency, hardship or special need.

Restrictive standards- case law

- Estate of Seacrist, 362 Pa. 190 (1949)
 - Trustee did not abuse discretion when discontinuing support payments to beneficiary who refused to substantiate his need for them
- Griffin v. Griffin, 463 So. 2d 569(Fla. App. 1985)
 - Trustee challenged by beneficiaries regarding payments made that did not fall within the “emergency or hardship” requirement of the distribution standard

Ascertaining Needs and Resources

- Generally, a trustee has a duty to ascertain a beneficiary's needs.
- A trustee should consider other resources that may be reasonably available.
- A trustee may rely upon a beneficiary's representations and on readily available, minimally intrusive information from a beneficiary.

Ascertaining needs and resources- case law

- Estate of Winograd, 65 Ohio App. 3d 76 (1989)
 - The terms of the trust authorized, during the lifetime of the daughter, distributions “to or for any one or more members of a class composed of the daughter and her lineal descendants”
 - According to the court while the settlor intended to provide primarily for the daughter, distributions were also to reflect consideration of the individual needs of all the discretionary beneficiaries.

LOANS TO BENEFICIARIES OF IRREVOCABLE TRUSTS

Loans to Beneficiaries

Hypothetical Loan Scenario: The John Smith Trust

Some Basics on Loans to Beneficiaries

- We are focused here on loans to beneficiaries from a trustee of an irrevocable trust where the trustee is not being directed to make the loan by a trust director.
- Trustee power to loan is typically considered included within the power to make discretionary distributions.
- Express power to make loans in the trust terms is preferred.
- In the absence of express terms, state law often provides the authority.

Justifications for Loans to Beneficiaries

- Justification No. 1: A loan as a distribution alternative -- i.e., getting cash to a beneficiary other than through an outright distribution.
- Justification No. 2: A loan as an estate planning tool.
- Justification No. 3: A loan as an alternative form of investment.

Every trustee loan is a “hybrid” creature, primarily being a form of discretionary distribution or an estate-planning vehicle but also, by its nature, being an investment in the form of a note receivable.

Some Important Threshold Issues Under the UTC Loan Provisions

- What are the purposes of the trust?
- Who are the current beneficiaries and what is the discretionary standard, if any, that applies to distributions of principal to them?
- Who are the "second-tier" beneficiaries -- the "presumptive remainder" beneficiaries?
- What's the purpose of the loan? How will the loan proceeds be used?

Some Other Issues to Consider Regarding a Loan to a Beneficiary

- Interest rate
- Payments
- Collateral
- Should you consider securing consents from other beneficiaries? NJSA?
- For a corporate trustee, stay away from loans to a beneficiary who is an employee, board member or insider of the corporate trustee.
- Rationale for the proposed loan from all of the beneficiaries' perspectives. *Why is the making of this loan in the best interest of the beneficiaries of the trust as a whole?*

The Inherent Conflict for the Trustee When Making a Loan to a Beneficiary

Any loan to a trust beneficiary inherently places the trustee in a conflicted posture with respect to the borrower:

- (1) As a fiduciary with duties to the borrower as a beneficiary; but also
- (2) As a creditor with a duty to collect from the beneficiary as a borrower.

Loans to Beneficiaries: A Closing Thought

Key take-away from this portion of our presentation: *Because of the inherent conflict of interest and the administrative burden of monitoring compliance with the loan terms, the trustee should generally thoroughly explore other possibilities before considering a loan to a beneficiary.*

But when an outright distribution is not appropriate, the trustee should be sure to thoughtfully consider all of the issues and ramifications that a loan to a beneficiary can involve.

“Be careful out there!”

POWERS OF APPOINTMENT

Looks Can Be Deceiving

Robert Smith has a very short and simple trust document. It says in part:

“All income of the trust shall be paid to my son, Steven Smith, for life. ***He can dispose of the trust assets at his death by will but the persons to whom he can direct the assets are limited to his issue or his estate.***”

How would you describe the highlighted sentence above?

Some Key Things to Determine When Analyzing a Power of Appointment

- What assets are subject to the power?
- When may the power be exercised?
- How must it be exercised?
- To whom may the subject property be appointed?
- Is the power a "general" power for tax purposes? *
- Did the power holder in fact effectively exercise it?
- To the extent that the power is not effectively exercised, who receives the subject property?

* This is the key factor concerning basis adjustment at the holder's death..

Classifications of Powers of Appointment

- When exercisable: *Inter vivos* (lifetime) power or testamentary power?
- Scope of the power:
 - Classification for purposes of general trust administration
 - Classification for tax purposes

A trust that appears to be limited for purposes of trust administration may in fact be a general power for tax purposes – or vice versa.

Why is Tax Classification of a Power of Appointment Important?

Consequences if a power of appointment is a general power for tax purposes:

1. Estate tax includibility. The assets subject to the power are includible in the gross estate of the power holder for federal estate tax purposes. * (Int. Rev. Code § 2041)

and

2. Adjustment of basis. The basis of all assets subject to the power at the death of the power holder must be adjusted to reflect their values at the date of the power holder's death. (Int. Rev. Code § 1014)

* Assets subject to the power may also be includible for purposes of some state death taxes.

Classifying Powers of Appointment for Tax Purposes: *“The Fab Four”* (?)



Classifying Powers of Appointment for Tax Purposes: *“The Fab Four”*

- The power holder
- The power holder’s estate
- The power holder’s creditors
- The creditors of the power holder’s estate

Classifying a Power of Appointment for Tax Purposes: The Test

Regardless of who else the property may permissibly be appointed to, does the document -- either explicitly or implicitly -- allow it to be appointed to any one or more of the following:

- The power holder?
- His estate?
- His creditors?
- The creditors of his estate?

If the power allows any of “the Fab Four” to be a permissible appointee – either explicitly or implicitly -- it’s a general power of appointment (“GPOA”) for tax purposes.

(Int. Rev. Code § 2041(b)(1))

Limited . . and Yet General? Broad . . and Yet Not a GPOA?

The settlor may well intend to achieve GPOA status for tax purposes even if he wishes to limit the pool of permissible appointees.

On the other hand, a different settlor may wish to give the power holder very broad discretion in terms of appointees – but may specifically want to avoid having the power classified as a GPOA for tax purposes.

TIP: Watch for (1) general language that's broad enough to include any of the four GPOA elements, (2) specific language including any of the four elements, and (3) specific language exclusions (carve-outs) of the four.

The Importance of General Powers of Appointment under the Tax Cuts and Jobs Act

- With the passage of the 2017 Tax Cuts and Jobs Act (“the Tax Act”), many clients no longer need trusts for federal estate tax purposes, due to the substantial increases in the federal estate and GST exemption amounts.
- But: all of our clients and their beneficiaries will remain subject to income tax – including the tax on capital gains.
- The decision on whether to fashion a power of appointment as limited or general involves a two-sided coin:
 - The bad side. Making it general causes it to be included in the holder’s gross estate, which could result in estate tax at the holder’s death.
 - The good side. Making it general allows for a basis step-up .

The New Paradigm

- With the greatly increased federal estate tax exemption amount, the “power of appointment coin” for many clients now effectively has only “upside” potential, favorable for a general POA.
- Even after the Tax Act, upon the death of the holder of a general POA, the assets subject to the power will be deemed to be part of her gross estate for federal estate tax purposes.
- But: with the greatly increased exemption amounts, this may be a merely academic matter.

Applying the principles: Steven’s GPOA

Was the Power Effectively Exercised?

- Effective exercise is irrelevant to the tax analysis.
- But it's critical for purposes of proper distribution of the assets subject to the power.
- *TIP:* A professional trustee should develop a protocol that addresses what it will accept as evidence of exercise or non-exercise of a testamentary power. For example:
 - Do you insist on a probated will, whether or not it's required by the trust terms? If not, what evidence will you accept as proof that a particular document that you have been provided was the power holder's "last" and governing will?
 - Should your protocol establish a deadline for the production of a document that meets your organization's requirements?
- If you determine that the power has not been properly exercised, be sure to carefully review the trust terms regarding the "default" takers of the property subject to the power.

Some Key Practical Takeaways as to Powers of Appointment

- Be on the lookout for powers of appointment. Watch for powers of appointment. They can be powerful tools – and, in the aftermath of the Tax Cuts and Jobs Act , they may be more commonly used in the years to come.
- Know how to identify a power of appointment when you see it and how to analyze it – including how to determine whether it's a general power for tax purposes.
- Adjust your file and records to reflect the power and, if it's a testamentary power, take steps to assure that appropriate actions are taken upon death of the power holder.

CONCLUSION

Thanks for participating in today's presentation!

We hope you found it interesting and beneficial.



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