DISCRETIONARY DISTRIBUTIONS: A PRACTICAL GUIDE TO PLANNING, DRAFTING AND ADMINISTERING
First Run Broadcast: November 27, 2012
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One of the difficult decisions in a trust is when to make a discretionary distribution. It is difficult for the settlor of the trust to confer that (often broad) discretion on a fiduciary. It’s difficult for a trustee because the standards established by law or by trust documents are often vague and that vagueness leads to substantial tension with beneficiaries who want more. It’s difficult for the planner and draftsman because the client often has an uncertain sense of what the standards for distributions should be in the first instance and client’s decision may shift over time over time.
All of these difficulties combine to make discretionary distributions a source of contention and potentially litigation and liability. This program will provide you with a real-world guide to establishing and drafting distribution standards, and provide you tips on administration and how to avoid disputes with and among beneficiaries.

- Practical guide to discretionary distributions in trusts – establishing standards and making judgments for planners, draftsmen and fiduciaries
- Interpreting trust documents to discern objective, measurable standards for discretionary distributions
- Statutory and common law framework for discretionary distributions
- Understanding “HEM” – health, education and maintenance – standards and how they operate in practice
- How discretionary distributions are treated by corporate v. individual trustees
- Balancing the tension between income beneficiaries and beneficiaries with remainder interests

Speaker:

Jeremiah W. Doyle, IV is senior vice president in the Boston office of BNY Mellon Wealth Management, where he provides integrated wealth management advice to high net worth individuals on holding, managing and transferring wealth in a tax-efficient manner. He is the editor and co-author of “Preparing Fiduciary Income Tax Returns,” a contributing author of Preparing Estate Tax Returns, and a contributing author of “Understanding and Using Trusts,” all published by Massachusetts Continuing Legal Education. Mr. Doyle received his B.S. from Providence College, his J.D. form Hamline University Law School, and his LL.M. in banking from Boston University Law School.
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Teleseminar
November 27, 2012

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Speaker Contact Information

Discretionary Distributions:
A Practical Guide to Planning, Drafting & Administering

Jeremiah "Jere" W. Doyle, IV
BNY Mellon Wealth Management
(o) (617) 722-7420
jere.doyle@bnymellon.com

David T. Leibell
Wiggin & Dana, LLP - Greenwich, Connecticut
(o) (203) 363-7623
dleibell@wiggin.com
Discretionary Trust Distributions from Trusts

Jeremiah "Jere" W. Doyle, IV
BNY Mellon Wealth Management
(o) (617) 722-7420
jere.doyle@bnymellon.com
Discretionary Distributions

• Planning stage
  – Educating the client about the various standards and the tax and non-tax implications

• Administration stage
  – Determining if a distribution is appropriate
Discretionary Distributions

• References:
  – The trust instrument, any amendments and settlement agreements
  – The Internal Revenue Code and applicable regulations
  – Bogert, Law of Trusts
  – Scott on Trusts
  – Restatement (Second) of Trusts
  – Restatement (Third) of Trusts
  – Uniform Trust Code
  – Loring, A Trustee’s handbook
  – Case law
Discretionary Distributions

- Distribution standards
  - What is the settlor’s intent?
  - What does the trust language mean?
  - What factors must be taken into account before making a distribution?
    - Beneficiary’s lifestyle, other resources?
  - Why is the distribution standard not expressed in detail?
    - Too expensive to have attorney spend hours drafting customized distribution provisions.
  - What are the tax considerations in adopting distribution standards?
    - 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 health, education, maintenance or support. §2041(b)(1)(A); §2514(c)(1).
  - Interpretation of distribution standards are governed by state law.
    - The meaning of a particular term may be more or less restrictive, depending on the law of the state that governs the language of the trust.
    - As a general rule, if the trustee uses its judgment and makes a reasonable decision to make a discretionary distribution, a court will not reverse the trustee’s decision unless the distribution was made in bad faith or is deemed to be an abuse of discretion.
    - If the trustee’s discretion is “absolute” or “uncontrolled,” a court will give the trustee’s decision more deference.

- The fiduciary duty of impartiality overlays every distribution decision
- Alternate provisions to provide guidance
- Creditor protection issues
Discretionary Distributions

• How is the distribution to be made?
  – To beneficiary directly
  – To beneficiary’s guardian
  – To be applied for the benefit of the beneficiary
  – To third person for the benefit of the beneficiary
  – To custodian for minor beneficiary
Ascertainable Standard

- Not a general power of appointment – no estate tax inclusion
- Health, education, maintenance and support
  - Constitutes an ascertainable standard if the power is reasonably measurable in terms of the beneficiary’s needs for health, education or support.
  - A power to use property for the comfort, welfare or happiness of the holder of the power is not limited by the requisite standard.
  - Regulations under Section 2041 provide that a power is limited by an ascertainable standard if the words “health, education, support and maintenance” appear in connection with the granted discretionary power.
  - Examples of powers that 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 is accustomed manner of living
    - Education including college and professional education
    - Health
    - Medical, dental, hospital and nursing expenses and expenses of invalidism
“Support” and “Maintenance”

• Means more than bare subsistence
• Includes 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 lifetime
  – Includes regular mortgage payments, property taxes, suitable health insurance or care, life and property insurance, vacations, family and charitable gifting
• In many states, if a trustee may distribute principal for a beneficiary’s support, the trustee may also distribute principal for the support of the beneficiary’s spouse and children
  – If the settlor wants 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 document
• Drafting attorney: Help out the trustee - Define what you mean by the term
“Comfort”

- Generally, “comfort” is broader than “support or maintenance” and includes the beneficiary’s enjoyment, pleasure, happiness, satisfaction or peace of mind.
- Drafting attorney: Help out the trustee - Define what you mean by the term
“Best Interest” or “Best Interest and Welfare”

- Allows the trustee to make distributions to allow the beneficiary to enjoy a high standard of living, including extensive travel or the purchase of expensive cars and jewelry.
- “Best interests” standard allows distributions for broader purposes than a “support” standard but the “best interest” standard is less easy to define.
- This could be interpreted to allow the trustee to distribute the entire principal of the trust.
- Drafting attorney: Help out the trustee - Define what you mean by the term
“Education”

- Includes college, but generally does not include graduate or professional education unless specifically provided by the trust instrument.
- Includes living expenses as well as fees and other costs of attending an institution of higher educations.
- Drafting attorney: Help out the trustee - Define what you mean by the term.
“Health”

• Includes routine medical care, medication, surgery and hospitalization, extended nursing care and mental health
• Settlor may want to expressly allow home health care over nursing home care
• Does it cover emergency medical treatment, psychiatric treatment, psychological treatment, routine health exams, dental care, eye care, eye glasses/contact lenses, elective cosmetic surgery, cosmetic dental work, lasik surgery, health insurance, dental insurance, unconventional medical treatment, home health care (round the clock nurses), gym memberships, day at the spa, golf club memberships, vacations to relieve tensions and stress, an expensive car with more comfortable seats to relieve back pain?
• Drafting attorney: Help out the trustee - Define what you mean by the term
“Emergency”

- Courts interpret this term narrowly
- Authorizes distributions only for the beneficiary’s unusual and unforeseen expenses
- IRS takes the position that the term “emergency” does not create an ascertainable standard for federal estate and gift tax purposes.
  - However, some courts take the opposite view i.e. that the term “emergency” is an ascertainable standard for tax purposes.
- Drafting attorney: Help out the trustee - Define what you mean by the term
“Sole and Absolute Discretion”

• Trustee may make distributions for any purpose or withhold distributions as long as the trustee does not act in bad faith or arbitrarily.

• Restatement 2d of Trust states that the trustee’s decision to distribute or withhold distributions does not need to be reasonable.
  – However, most courts will impose a standard of reasonableness even where the standard for principal distributions is the “absolute and uncontrolled discretion” of the trustee.

• If the settlor wants the trustee to have complete latitude and the beneficiaries to have no enforceable rights against the trustee, the language of the standard should be explicit that that is the settlor’s desire.

• Drafting attorney: Help out the trustee - Define what you mean by the term.
“Standard of Living”

• If there is a concern about changing standards of living, the time to which the standard refers should be made clear.
  – Example: Beneficiary’s standard of living at the time of the settlor’s death v. beneficiary’s standard of living at the time of the distribution.
  – The beneficiary’s standard of living may change between the time the trust is drafted and the date of the testator’s death or the beneficiary’s standard of living at the time the distribution is made
  – Specify at what time the standard of living should be measured.

• Drafting attorney: Help out the trustee - Define what you mean by the term
“Making Gifts”

• Does a standard of distribution (e.g. distribution in the “best interests” of the beneficiary) allow a trustee to make distributions to a beneficiary so the beneficiary can make gifts?
  – Annual exclusion gifts
  – Charitable gifts
  – Use of lifetime gift tax exemption (e.g. $5,120,000 for 2012)

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

• Best to have language in the trust document that specifies that the trustee may make distributions to the beneficiary for the purpose of making gifts and the type and amount of such gifts.
Priorities Among Beneficiaries

• Unequal distributions
  – If trust has multiple beneficiaries and the trustee is not given discretion to make unequal distributions, the presumption is that the beneficiaries should receive equal distributions
    • Presumption is based on the trustee’s duty to treat beneficiaries impartially.
  – If the settlor wants to give the trustee the power to make unequal distributions or to favor one beneficiary over another, the trust instrument should state specifically that unequal distributions are allowed.
  – An alternative is that trust may permit unequal distributions but have them be treated as an advancement
  – Settlor may wish to establish priorities among beneficiaries
    • Example: primary concern is for child and trustee need not consider the interest of any other beneficiary in making distributions to the child.
    • Example: spouse should be given first priority and children second priority
Taking Beneficiary’s Other Assets into Consideration

• Unless the trust instrument states otherwise, the general rule is that the trustee need not consider the beneficiary’s other assets in determining what assets are required for support of the beneficiary. The beneficiary has the right to look to the trust assets first for his or her support.

• Consider the tax consequences – it may be better from a tax point of view to take other sources of income into account before making distributions from a trust
  – Example: take spouse’s rights to distributions from a marital trust into consideration before making distributions from a credit shelter trust
  – Example: take non-skip person’s other sources of income, especially those from a non-exempt generation skipping trust, before making distribution from a generation skipping exempt trust.
Taking Beneficiary’s Other Assets into Consideration

• Distributions conditioned on “need”
  – In some states, if a distribution from a trust is conditioned on “need,” the beneficiary’s outside assets and income must be considered. Boston Safe Deposit and Trust Company v. Boynton, 443 N.E. 2d 1344 (Mass. App. 1983).

• Even if the trust directs the trustee to consider the beneficiary’s “other assets,” there is a question as to which assets the trustee must consider.
  – Income, liquid assets, beneficiary’s entire estate including illiquid assets?
  – What about taking into consideration the income tax consequences to the beneficiary if the beneficiary must liquidate his own assets.
Fiduciary Guidance

• Advisable to give the trustee discretion to consider the beneficiary’s personal characteristics e.g. does the beneficiary have a job, is he or she a spendthrift or a substance abuser, can he or she handle money?
• The general rule is that the trustee cannot take the beneficiary’s personal characteristics into account unless specifically authorized by the trust instrument.
Professional Trustee

- Decisions made by trust committee
- Trust officer presents facts of case to trust committee who, in turn, decides if a discretionary distribution should be made.
- Trust committee usually has a form that the trust officer must complete about the trust to aid the trust committee in making a decision.
Creditor Claims

• Generally, purely discretionary trusts are not subject to creditor’s claims
  – Creditor may not attach a beneficiary’s discretionary distribution interest until it is distributed to the beneficiary

• A beneficiary of a purely discretionary trust cannot compel the trustee to make distributions.
  – Right in a discretionary trust is not a property interest – it is a mere expectancy

• To the contrary: Restatement (Third) of Trust and Uniform Trust Code
  – Restatement (Third) give trust beneficiaries a right to force a distribution pursuant to ambiguous terms
  – Restatement (Third) position is that a “reasonableness standard” of review should be applied to most discretionary trusts, regardless of whether or not the trustee is grantor “sole,” “absolute,” or “unfettered” discretion.
  – Restatement (Third) creates an enforceable right and a property interest in almost all discretionary trusts that contain a standard.
  – Some states have enacted statute codifying the Restatement (Second) approach that creditors may not attach a beneficiary’s interest in a discretionary trust.
Creditor’s Claims

• Some states have not adopted the Uniform Trust Code’s authority allowing a creditor to attach a discretionary interest.

• Solution for estate planners seeking to prevent creditors from attaching an interest in a discretionary trust:
  – Forum shop – choose a state that has codified the discretionary trust law under the Restatement (Second)
Conclusion

• Discretionary trusts have administration issues, tax issues and creditor claims issues
• There are a number of issues the trustee must consider in making discretionary distributions.
• The role of a trustee, whether an individual or corporate, of a discretionary trust is not an easy task.