

ASCERTAINABLE STANDARDS

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I. Background

Trusts typically provide the trustee with guidance as to how they should exercise their discretion in making distribution to the trust beneficiaries. The guidance is often expressed as a variation of one of two models - - unlimited/absolute discretion, or discretion based on an ascertainable standard. A common example of unlimited discretion is, “My trustee may pay to or for the benefit of the beneficiary as much of the net income and principal of the trust as my trustee, in its sole and absolute discretion, may determine advisable for any purpose.” An example of discretion based on an ascertainable standard is, “My trustee may pay to or for the benefit of the beneficiary as much of the net income and principal of the trust as my Trustee determines is necessary or advisable for the beneficiary’s education, health, maintenance and support.”

The distinction between the two distribution models is significant for reasons that extend beyond the mere distribution itself. The purpose of this article is to outline and explain the consequences of the choice of distribution standards used in a trust document.

A. Statutory Guidance

Section 2041 of the Internal Revenue Code requires that a decedent’s gross estate include the value of property over which the decedent holds a general power of appointment. The phrase “general power of appointment” is defined in Section 2041(b)(1)(A):

(b) Definitions. For purposes of subsection (a) —

(1) General power of appointment. The term “general power of appointment” means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that—

(A) 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.

Section 2514 of the Internal Revenue Code treats the lifetime exercise of a general power of appointment as a transfer for gift tax purposes. The phrase “general power of appointment” is defined in Section 2514(c)(1):

(c) Definition of general power of appointment. For purposes of this section, the term “general power of appointment” means a power which is exercisable in favor of the individual possessing the power (hereafter in this subsection referred to as the “possessor”), his estate, his creditors, or the creditors of his estate; except that—

(1) A power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment.

In other words, if a power is limited by an ascertainable standard, the existence or use of the power will not subject the property, which is subject to the power, to gift or estate tax in the hands of the power holder.

The Maine Uniform Trust Code (Title 18-B) contains the following definition:

§ 103. Definitions

As used in this Code, unless the context otherwise indicates, the following terms have the following meanings.

1-A. Ascertainable standard. “Ascertainable standard” means an ascertainable standard relating to an individual’s health, education, support or maintenance within the meaning of Section 2041(b)(1)(A) or Section 2514(c)(1) of the federal Internal Revenue Code of 1986, as in effect on July 1, 2005.

B. Treasury Regulations Guidance

Internal Revenue Code §2041’s “ascertainable standard” is clarified in Treas. Reg. §20.2041-1(c)(2):

Powers limited by an ascertainable standard. A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. 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). As used in this subparagraph, the words “support” and “maintenance” are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which 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 in his accustomed manner of living,” “education, including college and professional education,” “health,” and “medical, dental, hospital and nursing expenses and expenses of invalidism.” In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

Internal Revenue Code §2514’s “ascertainable standard” is similarly clarified in Treas. Reg. §25.2514-1(c)(2):

Powers limited by an ascertainable standard. A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor is, by reason of section 2514(c)(1), not a general power of appointment. A power is limited by such a standard if the extent of the possessor’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). As used in this subparagraph, the words “support” and “maintenance” are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which 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 in his accustomed manner of living,” “education, including college and professional education,” “health,” and “medical, dental, hospital and nursing expenses and expenses of invalidism.” In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

C. Other Guidance

The wording of a standard of distribution in the trust document has differing significance to the trustee, the beneficiary and the IRS. The beneficiary and the trustee will look to the wording to discern the scope of distributions that may (or must) properly be made from the trust property.

There appears to be much leeway in the determination of what distributions properly fall within the scope of an ascertainable standard. According to the Restatement Third, Trusts §50, Comment d(2), a support standard:

. . . ordinarily entitles a beneficiary to distributions sufficient for accustomed living expenses, extending to such items as regular mortgage payments, property taxes, suitable health insurance or care, existing programs of life and property insurance, and continuation of accustomed patterns of vacation and of charitable and family giving. Reasonable additional comforts or ‘luxuries’ that 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. . . . A support standard normally covers not only the beneficiary’s own support but also that of persons for whom provision is customarily made as a part of the beneficiary’s accustomed manner of living. This generally includes the support of members of the beneficiary’s household and the costs of suitable education for the beneficiary’s children. . . . the terms ‘support’ and ‘maintenance’ do not . . . authorize distributions to enlarge the beneficiary’s personal estate or to enable the making of extraordinary gifts.

Some lawyers customarily use “may” in describing the trustee’s distribution discretion (e.g., “My trustee *may* pay to or for the benefit of the beneficiary . . .”). Others use “shall” (e.g., “My trustee *shall* pay to or for the benefit of the beneficiary . . .”). Is there a difference? The courts have been split. But, in 2005, with Maine’s adoption of the Uniform Trust Code (UTC), the issue was resolved by the adoption of §814(1):

“Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as “absolute,” “sole” or “uncontrolled,” the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust. *A trustee’s power to make distributions is discretionary notwithstanding terms of the trust providing that the trustee “shall” make distributions exercising a discretionary power, with or without standards.*” (Emphasis added)

Although a beneficiary’s creditor lacks the power to force a trustee to make a distribution from a trust, regardless of whether the trust contains a spendthrift provision, under the UTC the presence of an ascertainable standard gives the beneficiary a right to compel the trustee to make distributions consistent with the ascertainable standard.

Section 501 of the UTC addresses creditors’ rights in a trust that does not have a spendthrift provision. Section 501 says, “To the extent a beneficiary’s interest is not protected by a spendthrift provision, the court may authorize a creditor or assignee of the beneficiary to reach the beneficiary’s interest by attachment of present or

future distributions to the beneficiary.” In other words, if the trust does not contain a spendthrift provision, a creditor may obtain an attachment of the trust property after the property leaves the trust but before it reaches the beneficiary. The creditor has no right to reach the assets of the trust, but does have the right to attach distributions actually made to the beneficiary. The creditor may obtain a court order directing the trustee to pay to the creditor any distributions that the trustee is required to make or chooses to make to the beneficiary, although once such an attachment order is issued, it is unlikely that a trustee will make a discretionary distribution knowing that the distribution will end up in the hands of the creditor. Under Maine’s §501, if the trust does not contain a spendthrift provision, a creditor may attach distributions to the beneficiary, but not “for the benefit of” the beneficiary. Maine deleted the “for the benefit of” language from the Uniform version of the UTC as originally distributed by the Uniform Law Commissioners, strengthening the creditor protection available to a trust that does not contain a spendthrift provision.

Under §502 of the Maine UTC, if a trust has a valid spendthrift provision (one that restrains both voluntary and involuntary transfer of a beneficiary’s interest), a creditor may not reach the beneficiary’s interest or a distribution by the trustee before the beneficiary actually receives the distribution. A valid spendthrift provision exists if the trust says “the interest of a beneficiary is held subject to a ‘spendthrift trust,’ or words of similar import.” The creditor will therefore not be able to attach trust distributions even if the distributions to the beneficiary are required by the terms of the trust. Instead, the beneficiary’s creditor may only attempt to collect directly from the beneficiary after payment is made from the trust to the beneficiary.

Section 504 of the Maine UTC makes it clear that whether or not the trust has a spendthrift provision, a creditor cannot compel a distribution from the trust that is subject to the trustee’s discretion, even if the trustee has abused its discretion.

§504. Discretionary trusts; effect of standard

- 1. Creditor may not compel distribution.** Whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee’s discretion, even if:
 - A. The discretion is expressed in the form of a standard of distribution; or
 - B. The trustee has abused the discretion.
- 2. Right of beneficiary not limited.** This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for failure to exercise a discretionary power in accordance with the terms and purposes of the trust or for failure to comply with a standard for distribution.

- 3. Creditor limited.** If a trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee.

In other words, Section 504(2) permits a beneficiary to bring an action against the trustee to enforce the beneficiary's right to a distribution if the trustee has failed to properly exercise its discretion for the beneficiary's education, health, maintenance or support under an ascertainable standard.

From the standpoint of the IRS, the wording of the standard of distribution will influence the IRS's position on whether the standard of distribution creates gift or estate tax inclusion. For example, the following terms or phrases have been determined to constitute an ascertainable standard: "maintenance and medical care" Rev Rul 78-398, 1978-2 CB 237; "maintenance, support and comfort, in order to defray expenses incurred by reason of sickness" PLR 9203047; "proper care, maintenance and support." PLR 9713008; "reasonable care, comfort and support" *Tucker, Mary, tr v. U.S.*, (1974, DC CA) 34 AFTR 2d 74-6301; "care and comfort, considering his standard of living as of the date of [the donor's] death and considering his income, right to income and other property he may have. . . ." *Strauss, Victor J. Est*, (1995) TC Memo 1995-248; "necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures needed by [the beneficiaries] taking into consideration the standard of living to which they are accustomed and any income available to them from other sources" *Chancellor, Ann R., Est*, (2011) TC Memo 2011-172; "required for the continued comfort, support, maintenance, or education" *Vissering, Norman H. Est v. Com.*, (1993, CA10) 71 AFTR 2d 93-2190, 990 F2d 578; "to encroach if she desires" *Finlay, Phyllis v. U.S.*, (1985, CA6) 55 AFTR 2d 85-1546, 752 F2d 246; as the donee "may from time to time request, he to be the sole judge of his needs" *Pittsfield National Bank, exr (Samuel Colt Est) v. U.S.*, (1960, DC MA) 5 AFTR 2d 1878, 181 F Supp 851; "needed for [the donee's] reasonable health, education, support and maintenance needs consistent with a high standard and quality of living" PLR 7836008.

However, note with caution that the cases determining that words like "comfort" or "welfare" fall within the ambit of an ascertainable standard hinged on the nuances of state law and the context of other language in the trust that justified a finding that the settlor's intent was to maintain the beneficiary's standard of living . . . an ascertainable standard. When drafting an ascertainable standard, the safe harbor is to stay strictly within the confines of the Treasury Regulations (see above).

Words and phrases straying from the language of the Treasury Regulations have been determined not be limited by an ascertainable standard: "health, support and reasonable comfort, best interest and welfare" PLR 9125002; "the use and benefit

of” *Lanigan, Josephine R. Est (a/k/a Josephine Ranck Lanigan)*, (1965) 45 TC 247, and *de Oliveira, Jose Jr. v. U.S.*, (1985, CA9) 56 AFTR 2d 85-6541, 767 F2d 1344; “benefit or comfort” *Strite, Albert exr v. Edgar A. McGinnis*, (1963, DC PA) 11 AFTR 2d 1859, 215 F Supp 513, affd (1964, CA3) 13 AFTR 2d 1863, 330 F2d 234; “comfort and well-being” *Miller, Horace S. Jr. v. U.S.*, (1968, CA3) 21 AFTR 2d 1592, 387 F2d 866; “proper comfort and welfare” Rev Rul 77-194, 1977-1 CB 283; as may be “necessary for the comfort, maintenance and support of the donee, or in the event of illness or emergency as the result of which there may be a need” *Doyle, Leo, admr v. U.S.*, (1973, DC PA) 32 AFTR 2d 73-6252, 358 F Supp 300; “reasonable support, care and comfort.” *Whelan, Francis v. U.S.*, (1982, CA9) 688 F2d 850 (unpublished), affg (1980, DC CA) 46 AFTR 2d 80-6227; “support, maintenance, comfort and welfare” *Lehman, Herbert H. v. U.S.*, (1971, CA5) 28 AFTR 2d 71-6257, 448 F2d 1318; “care, maintenance and welfare” *Franz, Riley v. U.S.*, (1977, DC KY) 39 AFTR 2d 77-1658.

II. Why it matters whether the distribution discretion is governed by an ascertainable standard

A. Choice of Trustee

Under Internal Revenue Code Section 2041 the value of the trust’s assets will be included in the beneficiary’s gross estate if the beneficiary has a general power of appointment - - “a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate”, unless the power in favor of the beneficiary is limited by an ascertainable standard. Therefore, a beneficiary who, as trustee of the trust, has the power to appoint property to himself for reasons other than his health, education, support or maintenance, has a general power of appointment over the trust’s assets and the value of the trust’s assets will be included in the beneficiary’s estate at the time of his death. Conversely, if a beneficiary’s invasion power is a limited power of appointment, *i.e.*, an ascertainable standard, the value of the trust assets will not be included in the beneficiary’s gross estate at death.

In addition to estate tax inclusion resulting from the beneficiary having an invasion power that constitutes a general power of appointment, estate tax inclusion will result by attribution to the beneficiary of the trustee’s powers if the beneficiary has the power to remove and replace the trustee and (i) the trustee’s distribution authority is not limited to an ascertainable standard, and (ii) the beneficiary has the power to replace the trustee with a trustee who is related or subordinate to the beneficiary as defined by Internal Revenue Code §672(c):

(c) Related or subordinate party.

For purposes of this subpart, the term “related or subordinate party” means any nonadverse party who is—

- (1) the grantor’s spouse if living with the grantor;
- (2) any one of the following: The grantor’s father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

As a result, if the grantor’s estate planning objectives include ensuring that the trust assets are not included in the beneficiary’s taxable estate, and giving the trustee broad distribution discretion (not limited to an ascertainable standard), the trust must be carefully drafted to avoid the risk of having the trustee’s distribution powers attributed to the beneficiary. Attribution to the beneficiary of the trustee’s broad discretionary distribution authority will result in the beneficiary being deemed to hold a general power of appointment over the trust property and will result in the trust property being included in the beneficiary’s estate at death. See *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993); *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992); Rev. Rul. 95-58. Although a trustee’s powers will be attributed to a beneficiary who has the power to remove and replace the trustee with a trustee who is related or subordinate to the beneficiary as defined by Internal Revenue Code §672(c), if the trustee’s discretionary distribution authority is limited to ascertainable standards, attribution of the trustee’s authority to the beneficiary does not result in estate tax inclusion.

There will be times when trustee removal and replacement powers are limited for reasons that have nothing to do with estate tax inclusion concerns. It may be quite important to the grantor that the beneficiary not be given the power to remove the grantor’s chosen trustee. Or, if the grantor’s chosen trustee is or becomes unable or unwilling to serve, the grantor may be willing to give the beneficiary the power to appoint a successor trustee, but may insist that the successor trustee be selected from within a narrow universe defined by the grantor, e.g., a corporate trustee, one of grantor’s siblings, an attorney, a CPA, etc.

The likely size of the beneficiary’s estate, or the size of the trust may be such that estate tax inclusion is not a concern in the planning process. As a result, the beneficiary may intentionally be given a testamentary general power of appointment. In that case, short of the grantor desiring to restrict the beneficiary’s power to remove or replace the trustee for non-tax related purposes, there is no estate tax benefit to placing limitations on the beneficiary’s power to remove and replace the trustee. Similarly, the trust may grant the beneficiary a general power of appointment for the

purpose of avoiding the possibility of the generation-skipping transfer (GST) tax, in which case trustee removal and replacement do not need to be limited as a result of attribution concerns.

Similarly, if a qualified terminable interest property (QTIP) election is made over a marital trust, the result of the QTIP election will be to have the trust property included in the estate of the surviving spouse. See Internal Revenue Code §2044. Unless there are non-tax reasons to limit the surviving spouse's control over the trust property, either during her lifetime or upon death (and there are often compelling non-estate tax reasons for doing so), there is no estate tax benefit to imposing limits on her trustee removal and replacement powers or her testamentary power of appointment over the trust assets. On the other hand, in Maine, where it may be desirable to make separate state and federal QTIP elections and have a divisible QTIP based on those separate elections, it is important to design the marital trust so that the spouse does not have a general power of appointment. That will mean giving the spouse a limited, and not a general testamentary power of appointment, and ensuring that the trustee distribution powers and trustee removal and replacement powers are crafted to avoid having the spouse be treated as holding a general power of appointment. If the trustee distribution powers are limited to an ascertainable standard, the spouse can have unrestricted trustee removal and replacement powers and the spouse may serve as the sole trustee without causing estate tax inclusion. However, if the trustee distribution powers are not limited to an ascertainable standard, then the spouse cannot serve as sole trustee without triggering estate tax inclusion, and the spouse's power to remove and replace the trustee must be limited to appointing a successor trustee who is not related or subordinate to the spouse, per Internal Revenue Code §672(c).

B. The Beneficiary as Sole Trustee

UTC §504(3) presents creative planning and drafting options that were not available pre-UTC:

3. Creditor limited. If a trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee.

Under §504(3), if a beneficiary is the sole trustee of the beneficiary's trust and the trustee's distribution discretion is limited by an ascertainable standard, the beneficiary's creditors cannot reach the beneficiary's interest in the trust and cannot compel the beneficiary-trustee to make a distribution from the trust, even if the beneficiary-trustee has abused its distribution discretion. See §504(1) above. Under §504(1), if someone other than the beneficiary is serving as trustee, the beneficiary's creditor may not compel a distribution whether or not (i) the trust

contains a spendthrift provision, (ii) the distribution standard is unlimited/absolute or an ascertainable standard, or (iii) the trustee has abused its distribution discretion. Under §504(3), if the beneficiary is serving as sole trustee or co-trustee and the trustee's distribution discretion is limited to an ascertainable standard, then the trust assets remain out of the creditor's reach as long as the assets do not actually come into the beneficiary's hands. If the trust has a valid spendthrift provision, then §502 will prevent the creditor from reaching the beneficiary's interest or a distribution by the trustee before the beneficiary actually receives the distribution.

§ 502. Spendthrift provision

- 1. Restrains voluntary and involuntary transfers.** A spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest.
- 2. Terminology.** A term of a trust providing that the interest of a beneficiary is held subject to a "spendthrift trust," or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.
- 3. No transfer by beneficiary; creditors and assignees.** A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, *except as otherwise provided in this chapter, a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.*

(Emphasis added)

In other words, §502 permits the beneficiary-trustee to make a distribution for the beneficiary's own benefit, without the money coming into the beneficiary's hands, and the beneficiary's creditor will be powerless to intercede.

The Uniform Comments to §504(3) provide good insight into its purpose:

Trusts are frequently drafted in which a trustee is also a beneficiary. A common example is what is often referred to as a bypass trust, under which the settlor's spouse will frequently be named as both trustee and beneficiary. An amount equal to the exemption from federal estate tax will be placed in the bypass trust, and the trustee, who will often be the settlor's spouse, will be given discretion to make distributions to the beneficiaries, a class which will usually include the spouse/trustee. To prevent the inclusion of the trust in the spouse-trustee's gross estate, the spouse's discretion to make distributions for the spouse's own benefit will be limited by an ascertainable standard relating to health, education, maintenance, or support.

The UTC, as previously drafted, did not specifically address the issue of whether a creditor of a beneficiary may reach the beneficial interest of a beneficiary who is also a trustee. However, Restatement (Third) of Trusts §60, comment g, which was approved by the American Law Institute in 1999, provides that the beneficial interest of a beneficiary/trustee may be reached by the beneficiary/trustee's creditors. Because the UTC is supplemented by the common law (see UTC Section 106), this Restatement rule might also apply in states enacting the UTC. The drafting committee has concluded that adoption of the Restatement rule would unduly disrupt standard estate planning and should be limited. Consequently, *Section 504 is amended to provide that the provisions of this section, which generally prohibit a creditor of a beneficiary from reaching a beneficiary's discretionary interest, apply even if the beneficiary is also a trustee or cotrustee. The beneficiary-trustee is protected from creditor claims to the extent the beneficiary-trustee's discretion is protected by an ascertainable standard as defined in the relevant Internal Revenue Code sections. The result is that the beneficiary's trustee's interest is protected to the extent it is also exempt from federal estate tax. The amendment thereby achieves its main purpose, which is to protect the trustee-beneficiary of a bypass trust from creditor claims.*

The protection conferred by this subsection, however, is no greater than if the beneficiary had not been named trustee. If an exception creditor can reach the beneficiary's interest under some other provision, the interest is not insulated from creditor claims by the fact the beneficiary is or becomes a trustee.

In addition, the definition of "power of withdrawal" in Section 103 is amended to clarify that a power of withdrawal does not include a power exercisable by the trustee that is limited by an ascertainable standard. The purpose of this amendment is to preclude a claim that the power of a trustee-beneficiary to make discretionary distributions for the trustee-beneficiary's own benefit results in an enforceable claim of the trustee-beneficiary's creditors to reach the trustee-beneficiary's interest as provided in Section 505(b). Similar to the amendment to Section 504, the amendment to "power of withdrawal" is being made because of concerns that Restatement (Third) of Trusts Section 60, comment g, otherwise might allow a beneficiary-trustee's creditors to reach the trustee's beneficial interest.

The Code does not specifically address the extent to which a creditor of a trustee/beneficiary may reach a beneficial interest of a beneficiary/trustee that is not limited by an ascertainable standard. (Emphasis added)

The Maine legislature updated §504(3) in 2011 to conform with the amended Uniform Trust Code provision. The 2011 Maine Comments state:

The change to section 504, subsection 3 does not represent a change in Maine law. Since the effective date of the Maine Uniform Trust Code, Maine law has prohibited a creditor from reaching or compelling distribution of the interest of a beneficiary who also serves as trustee as long as the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard.

The restrictions on a creditor's ability to reach or compel distribution of the beneficial interest as provided in subsection 3 are not limited to a bypass trust. Although a bypass trust is a common example of a trust in which a cotrustee or the sole trustee is also a beneficiary, with the settlor's spouse frequently named as both trustee and beneficiary, the provisions of subsection 3 are not limited to a bypass trust. The provisions of subsection 3 apply to any trust in which a beneficiary serves as a cotrustee or the sole trustee of the trust as long as the trustee's or cotrustee's discretion to make distributions for the trustee-beneficiary's own benefit is limited by an ascertainable standard, regardless of whether the beneficiary has a testamentary power of appointment that will result in the trust property being included in the beneficiary's taxable estate upon the beneficiary's death. Therefore, although the main purpose of subsection 3 may be to protect the trustee-beneficiary of a bypass trust from creditor claims, the same protection from creditor claims is available to the trustee-beneficiary of any trust that limits the trustee's discretion to make distributions for the trustee-beneficiary's own benefit by an ascertainable standard.

C. Drafting Opportunities

Although the primary purpose of the beneficiary-trustee creditor protection presented by §504(3) was to provide creditor protection to a credit shelter trust with the surviving spouse as sole trustee, as indicated in the Maine Comments to §504(3) the drafting opportunities extend beyond the credit shelter trust. By creating a trust for a beneficiary, and limiting the trustee's distribution authority to an ascertainable standard, the beneficiary as sole trustee of the trust will enjoy the benefit of having the trust assets protected from claims by the beneficiary's creditors and enjoy freedom to make distributions for the beneficiary's health and support without having to consult with a third-party trustee. The resulting trust is sometimes referred to as a "beneficiary controlled trust."

1. Testamentary Power of Appointment

In order to minimize, or avoid entirely, any potential interference by remainder beneficiaries who might be inclined to exercise intrusive oversight of the current beneficiary's distribution discretion, if the goal is to give the beneficiary-

trustee authority that is as close as possible to the degree of authority that the beneficiary would have over the trust property if the beneficiary had inherited the property outright as opposed to in trust, the beneficiary should be given either a testamentary general power of appointment (if estate tax inclusion in the beneficiary's estate is not a concern) or a testamentary "broad limited" power of appointment if the goal is to keep the property out of the beneficiary's taxable estate. Broad testamentary appointment authority, whether it is a general power or a "broad-limited" power, either of which includes the authority to effectively disinherit a meddlesome remainder beneficiary, will assure the current beneficiary of substantial freedom to control the trust without interference from a remainder beneficiary. A meddlesome remainder beneficiary need only be reminded that a power of appointment is also a power of disappointment.

Following is an example of a testamentary general power of appointment:

The beneficiary shall have the testamentary unlimited and unrestricted general power to appoint, by a valid last will and testament or by a valid living trust agreement, the entire principal and any accrued and undistributed net income of the beneficiary's trust as it exists at the beneficiary's death. In exercising this general power of appointment, the beneficiary shall specifically refer to this power.

The beneficiary shall have the sole and exclusive right to exercise the general power of appointment.

This general power of appointment specifically grants to the beneficiary the right to appoint property to the beneficiary's own estate. It also specifically grants to the beneficiary the right to appoint the property among persons or entities in equal or unequal proportions, and on such terms and conditions, whether outright or in trust, as the beneficiary may elect. This power of appointment is intended to be a general power of appointment as defined in Section 2041 of the Internal Revenue Code.

To the extent that any part of the beneficiary's trust shall not be effectively appointed, my Trustee shall distribute the remaining unappointed balance to the beneficiary's then living descendants, *per stirpes*.

If the beneficiary has no then living descendants, my Trustee shall distribute the balance of the trust property to my then living descendants, *per stirpes*.

If there is a desire to avoid having the trust assets included in the beneficiary's estate, and assuming the trust is exempt from generation skipping transfer tax, the beneficiary should be given to a "broad limited" power of appointment - - the power to appoint the property to anyone other than the beneficiary, the beneficiary's estate, the beneficiary's creditor's, or the creditors of the beneficiary's estate. See Internal Revenue Code §2041(b)(1). For example:

The beneficiary shall have the testamentary limited power to appoint, by a valid last will and testament or by a valid living trust agreement, the entire principal and any accrued and undistributed net income of the beneficiary's trust as it exists at the beneficiary's death. In exercising this limited power of appointment, the beneficiary shall specifically refer to this power.

The beneficiary shall have the sole and exclusive right to exercise the limited power of appointment.

The beneficiary shall not exercise this power in favor of the beneficiary, the beneficiary's creditors, the beneficiary's estate, or the creditors of the beneficiary's estate.

To the extent that any part of the beneficiary's trust shall not be effectively appointed, my Trustee shall distribute the remaining unappointed balance to the beneficiary's then living descendants, *per stirpes*.

If the beneficiary has no then living descendants, my Trustee shall distribute the balance of the trust property to my then living descendants, *per stirpes*.

A limited power of appointment can be crafted to be as limited as desired; for example, it could permit the beneficiary to appoint the trust assets only to the beneficiary's or the grantor's descendants. The critical limiting design element, to avoid the power from being a general power of appointment and to avoid the trust assets from being included in the beneficiary's estate, is that the beneficiary must not have the power to appoint the trust property to the beneficiary, the beneficiary's estate, the beneficiary's creditor's, or the creditors of the beneficiary's estate. A "limited limited" power of appointment, in contrast to a "broad limited" power of appointment, however, is somewhat inconsistent with the underlying premise of a beneficiary controlled trust, which is to give the beneficiary the broadest possible control over the trust property while still providing the benefit of creditor protection and, if desired, estate tax exclusion. Therefore, a beneficiary controlled trust is likely to provide the beneficiary with either an unlimited general power of appointment or a "broad limited" power of appointment.

2. Trustee Reports

As a result of 2011 amendments to the Maine UTC, under §105(2)(H) and (I) a grantor has the ability to limit trust reports and information to the current beneficiary only. As of 2011, §103 was amended by the addition of a new definition in sub-paragraph (4-A): ““Current beneficiary” means a beneficiary that, on the date the beneficiary’s qualification is determined, is a distributee or permissible distributee of trust income or principal.” In drafting a beneficiary controlled trust, if the goal is to give the current beneficiary as much control over the trust property as possible, then the trust should be written to keep the remainder beneficiaries “in the dark” about the existence of the trust. The 2011 amendments to §105(2)(H) and (I) are explained in the 2011 Maine Comment to §105:

As a result of the changes to subsection 2, paragraph H and Subsection 3, paragraph B, the original Maine Comment is revised to read:

Subsection 2, paragraph H has been changed by adding the word “current” before “beneficiary”. “Current” beneficiary is a defined term under section 103, subsection 4-A. The term identifies a sub-class of “qualified” beneficiaries, as defined in section 103, subsection 12, paragraph A. Section 813, subsection 1, as adopted in Maine, requires that a trustee respond to a “qualified beneficiary’s” request for trustee’s reports and other information reasonably related to the administration of a trust. Notwithstanding the trustee’s default duty under section 813, subsection 2, paragraphs B and C to provide qualified beneficiaries with notice of certain information about the trust, under subsection 105, subsection 2, paragraph H a settlor may, by the terms of the trust, prohibit the trustee from notifying a current beneficiary who has not yet attained 25 years of age, of the existence of the trust, of the identity of the trustee and of the current beneficiary’s right to request trustee reports. However, once a current beneficiary attains 25 years of age, the only way the current beneficiary may be “kept in the dark” as to the existence of the trust is for the settlor to name a person or persons to receive trustee reports on behalf of the current beneficiary as provided in subsection 3. The “protector” named in subsection 3 must act in good faith to protect the interests of the current beneficiary on whose behalf the protector is receiving trust information. Subsection 3 is not a uniform provision of the Uniform Trust Code. Maine added subsection 3 as a means to provide settlors with an option to prevent disclosure of the existence of the trust and details of the trust administration to current beneficiaries. A settlor has the power to prohibit the disclosure of the existence of the trust and details of the trust administration to all non-qualified beneficiaries and to all qualified beneficiaries that are not current beneficiaries (i.e., remainder

beneficiaries) without the need to name a third person to receive such information on behalf of the non-qualified beneficiaries and remainder beneficiaries.

For example, in a trust for the lifetime benefit of settlor's child, with distribution to the child's descendants upon the death of the child, the child is the only current beneficiary of the trust. The settlor may direct that until the child attains 25 years of age, no notices, information or reports need be given to the child or to anyone on the child's behalf. After the child attains 25 years of age, the settlor may direct that child still be "kept in the dark" about the trust, but in order to do so, the settlor must identify another person to receive trust notices, information and reports on behalf of the 25+ year old child. The child's descendants are not current beneficiaries and therefore settlor may direct that the trustee withhold all notices, information and reports from the child's descendants, regardless of their age. By permitting a settlor to direct the Trustee to withhold notice, information and reports from remainder beneficiaries, the settlor avoids the need to provide notice, information and reports to a class of beneficiaries who may never benefit from the trust, particularly when the current beneficiary has a testamentary power of appointment that may be exercised to eliminate the interest of one or more of the remainder beneficiaries.

Note that a settlor may not name a protector to receive notice, information or reports in lieu of providing the notice, information or reports directly to the settlor's surviving spouse.

The UTC has built into its default provisions a hierarchy of rights relating to providing various beneficiaries with information about a trust. The default provisions will govern unless the settlor chooses to modify them by the terms of the trust document:

- i. . Some classes of beneficiaries have a right to information whether they request it or not (e.g., under section 813, subsection 3 distributees or permissible distributees of trust income or principal have a right to receive annual reports without request).
- ii. Other beneficiaries have a right to be affirmatively told of their right to request information (e.g., under section 813, subsection 2, paragraph C qualified beneficiaries have to be informed of their right to request a copy of the trust instrument and of trustee's reports).
- iii. Nonqualified beneficiaries have a right to obtain a copy of the trust instrument only if they request a copy, but a trustee is under no affirmative obligation to inform them of the existence of the trust or

of their right to request a copy; the non-qualified beneficiaries are on their own to learn of the existence of the trust (see section 813, subsection 2, paragraph A).

Section 105 permits the settlor, by the terms of the trust, to alter the beneficiaries' rights and trustee's duties under section 813, except as specified in section 105, subsection 2, paragraphs H and I.

3. The Ideal Beneficiary-Trustee

The ideal beneficiary to be the sole trustee of his or her own trust is the beneficiary who, but for the option of a UTC beneficiary controlled trust, would likely have received his or her inheritance outright; *i.e.*, a beneficiary who is mature enough and responsible enough that there is minimal or no concern about the beneficiary's ability to responsibly manage his or her own financial affairs and inheritance. For that beneficiary, if given the choice of receiving his or her inheritance outright and receiving the inheritance in a trust where he or she has virtually full control of the trust and where the trust assets are protected from claims of creditors and are excluded from his or her taxable estate at death, the answer for many beneficiaries would seem obvious, at least where the inheritance is likely to be sizable - - opt for the beneficiary controlled trust.

On the other hand, a beneficiary controlled trust will not be appropriate if the grantor views the beneficiary as lacking good judgment or if the grantor wants assurance that the trust assets will be used for the current beneficiary's lifetime and then pass to designated remainder beneficiaries. The beneficiary controlled trust, designed with ascertainable standards, either a general (unlimited) power of appointment or a "broad limited" power of appointment, and a directive for the trustee to provide trust reports and information only to the current beneficiary, is only appropriate when the grantor would have been inclined to leave the inheritance outright, rather than in trust, but sees an added benefit to providing the beneficiary with the statutory creditor protection that comes with a beneficiary controlled trust. The added benefit of estate tax exclusion may or may not be viewed as important to the grantor or the beneficiary.

Because the creditor protection provided by §504(3) only applies when the trustee's discretion is limited by an ascertainable standard, the beneficiary-trustee who wants to preserve the creditor protection should be cautioned to honor the ascertainable standard distribution discretion. Otherwise, a creditor that is intent on piercing the protection provided by §504(3) may argue that because the beneficiary-trustee ignored the ascertainable standard limits of the trust, the beneficiary should not benefit from the creditor protection afforded by §504(3). Whether a creditor will prevail on that argument is unknown. However, even if the beneficiary fails to honor the ascertainable standard

limitations on discretionary distributions, the existence of the trust and

the financial burdens and risks of litigating the issue are likely to enable the beneficiary to settle any creditor's claim on terms far more favorable than the beneficiary would have been able to do without the existence of the trust.

If creditor protection is an immediate and known concern (for example, the beneficiary is the defendant in a pending lawsuit or a judgment has already been entered against the beneficiary at the time trust is being drafted) the beneficiary controlled trust is probably not the optimum design choice. Stronger creditor protection will be available with an independent trustee, either as a co-trustee with the beneficiary, or as sole trustee. The effectiveness of creditor protection is a design continuum and the degree of creditor protection desired will affect the design of the trust. As a general pragmatic rule of design, the more "bullet proof" the degree of creditor protection desired, the less control the beneficiary should be given over the trust.

A beneficiary-trustee of a beneficiary controlled trust who finds himself or herself facing a creditor's attempt to reach the trust assets will not need to forego the benefits of the trust. Under that circumstance, the beneficiary-trustee has two options available: purchase assets in the name of the trust to make available for the beneficiary's benefit (for example, the trustee could purchase a home or vacation property in the name of the trust and pay the ongoing expenses of ownership with trust property); or, make distributions of trust property "for the benefit of" the beneficiary, rather than directly to the beneficiary.

Just as a beneficiary-trustee who wants to preserve the creditor protection afforded by the trust design should be cautioned to honor the ascertainable standard distribution discretion, a beneficiary-trustee who wants to preserve the estate tax exclusion, if estate tax exclusion is a design element of the trust – as in a credit shelter trust or a trust exempt from generation skipping transfer tax, should be similarly cautioned. Although there are many cases where the IRS has litigated whether the distribution standard under the terms of the governing trust constituted an ascertainable standard, and whether the beneficiary had a general power of appointment that required inclusion of the trust assets in the beneficiary's estate at death (see section I.C. above of this article), there don't seem to be any cases where the IRS has argued that a beneficiary held a general power of appointment as the result of the beneficiary-trustee's failure to strictly adhere to the confines of a standard that was undeniably ascertainable. However, in *Atkinson v. Commissioner*, (2002, CA11) 309 F2d 1290, the Court denied a charitable deduction to a charitable remainder annuity trust where, although the trust was properly drafted, the trustees failed to make annuity

payments to the grantor during her lifetime as required by the terms of the CRAT. The Court held:

“The documents that establish the Atkinson annuity trust track the CRAT requirements to the letter. However, the Atkinson annuity trust failed to comply with the CRAT rules throughout its existence. Yearly annuity payments to Atkinson were not made during her lifetime. Accordingly, since the CRAT regulations were not scrupulously followed through the life of the trust, a charitable deduction is not appropriate. . . . It is not sufficient to establish a trust under the CRAT rules, then completely ignore the rules during the trust’s administration, thereby defeating the policy interests advanced by Congress in enacting the rules.”

In *Hurford v. Commissioner*, TC Memo 2008-278, the decedent was the sole trustee of a credit shelter trust created at her husband’s death. The credit shelter trust was crafted with ascertainable standards, permitting distribution for decedent’s education, health maintenance and support. Decedent withdrew all the assets of the credit shelter trust. At her death, her personal representative argued that the assets distributed to decedent should still receive the benefit of estate tax exemption that the credit shelter trust was designed to provide. The Court rejected the personal representative’s argument:

“The Family Trust was an entirely legitimate part of Gary’s estate plan, intended to use his unified credit of \$650,000. Bisignano [the drafting lawyer] had carefully ensured that the terms of the Family Trust imposed an ascertainable standard on withdrawals – Thelma was limited to taking distributions for her “health, education, support, or maintenance.” But the Hurfords cannot qualify for the exception merely by stating it in the will and avoiding it in practice. Thelma exercised a general power by “distributing” all of the Family Trust to herself Since Thelma used all of the Family Trust assets as her own . . . we disregard the fact that they at one time could have been sheltered from any estate tax under the plan designed by Bisignano.”

The facts of the case show more than a mere distribution beyond the scope of an ascertainable standard. The estate was trying to put the assets back in trust after they had been distributed.

4. The Best of Both Worlds

Rather than restrict the trust distributions to an ascertainable standard, the trust may be drafted to permit the beneficiary, as sole trustee, to make distributions for education, health, support and maintenance, and permit an independent

trustee (a trustee not related or subordinate to the beneficiary within Internal Revenue Code §672(c)) to make distributions beyond the scope of an ascertainable standard. For example,

My Independent Trustee may pay to or for the benefit of the beneficiary as much of the income and principal of the beneficiary's trust as my Independent Trustee, in its sole and absolute discretion, may determine advisable for any purpose. If my Trustee is not Independent, my Trustee may pay to or for the benefit of the beneficiary, as much of the income and principal of the beneficiary's trust as my Trustee determines is necessary or advisable for the health, education, maintenance or support of the beneficiary.

Such language will require adding including a definition in the trust document to define an "Independent" trustee and will require language permitting the beneficiary-trustee to appoint (and remove and replace) an independent trustee as co-trustee for the purpose of exercising discretion to make distributions beyond the scope of an ascertainable standard. The following is sample language authorizing the appointment of an independent trustee for that purpose, and others:

If for any reason the Trustee of any trust created under this agreement is unwilling or unable to act as to any trust property of that trust, or with respect to any provision of this agreement, the Trustee shall appoint, in writing, a corporate fiduciary or an individual who is Independent to act as a special Independent Trustee as to such property or with respect to such provision, and may revoke any such appointment at will.

A special Independent Trustee who has been appointed with the authority to exercise a discretionary power to distribute income or principal that is not limited by an ascertainable standard as defined by Internal Revenue Code Section 2041(b)(1)(A), and whose appointment is revoked, may be replaced only by the appointment of another corporate fiduciary or an individual who is Independent.

Each special Independent Trustee so acting shall exercise all fiduciary powers granted by this agreement unless expressly limited elsewhere in this agreement or by the delegating Trustee in the instrument appointing such special Independent Trustee. Any special Independent Trustee may

resign at any time by delivering written notice to the Trustee to that effect.

5. Statutory Safeguard

If there is concern that the scope of the beneficiary-trustee's discretion is broader than an ascertainable standard, §814(2)(A) of the Maine UTC has a savings clause that prevents the trustee from exercising any discretionary power in excess of an ascertainable standard:

“A person other than a settlor who is a beneficiary and trustee of a trust that confers on the trustee a power to make discretionary distributions to or for the trustee's personal benefit may exercise the power only in accordance with an ascertainable standard”.

See PLR 200530020, where a beneficiary served as trustee and had the power to distribute income to herself in such amounts “as the trustees in their sole and absolute discretion deem advisable”. The IRS ruled that a state savings clause similar to §814(2)(A) of the Maine UTC converted what would otherwise be a general power of appointment to an ascertainable standard and that therefore, no portion of the trust income would be included in the beneficiary-trustee's estate. Similarly, in PLR 200637021 the IRS determined that a state savings clause identical to Maine's §814(2)(A) would prevent the beneficiary-trustee from being treated as holding a general power of appointment when the beneficiary-trustee had the power to distribute trust principal to herself for her “care, maintenance, and support.

III. Conclusion

Drafting with ascertainable standards, when appropriate, can provide tremendous flexibility to the operation and management of a trust, the choice of trustee and the power of a beneficiary to remove and replace a trustee. However, there will be many times, especially with the use of an independent trustee, when restricting a trustee's distribution discretion to ascertainable standards may be unnecessarily restrictive. As with most trust drafting, the goal is to have a full understanding of the grantor's goals for the trust. Only then can appropriate design decisions be made regarding the scope of distribution discretion, choice of trustee, trustee removal and replacement, lifetime or testamentary powers of appointment, and the issuance of trustee reports and information to the trust beneficiaries.

