Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1610
Date: 25-Feb-10
From: Steve Leimberg's Estate Planning Newsletter
Subject: Who Can Be Sole Trustee – Part III

Do Savings Clauses or Statutes Mitigate Estate Inclusion Issues of Choosing the Wrong Trustee for a Discretionary Trust?

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This LISI is part of a continuing series known as the **Modular Approach to Estate Planning**.™[1]

Executive Summary:

Parts I and II of this LISI develops the following table regarding the estate inclusion issues when different persons serve as a sole trustee of a discretionary trust that is not limited by an ascertainable standard.

	IRC § 672(c)	Settlor	Trustee/ Beneficiary	Settlor's Spouse	Brother, Sister, Parents
Discretionary Distribution Standard	No estate Inclusion	Inclusion IRC §§ 2036(a)(2) & 2038	Inclusion IRC § 2041 Check for Support obligation Attribution analogy under Rev. Rul. 95-58 or SPA analogy	Check for Support obligation Attribution analogy – under Rev. Rul. 95-58 or SPA Analogy	Attribution analogy under Rev. Rul. 95-58 or SPA analogy

In the above discretionary trust table, if the settlor is serving as the sole trustee of a discretionary trust that is not limited by an ascertainable standard there are two estate inclusion issues:

(1) There is a definite estate inclusion issue under IRC § 2036(a)(2) and IRC § 2038. This is because the settlor can determine who will receive a distribution and when such person will receive a distribution.[2] Also the Settlor as trustee can alter the time and manner of enjoyment of the distributions.[3]

(2) In the event the settlor's spouse is a beneficiary or if the settlor's children are minors there is a support obligation estate inclusion issue. As noted in my prior installment, support obligation issues will be discussed in an upcoming installment under the ascertainable standard table.

A trustee/beneficiary also has the following two similar estate inclusion issues if he or she serves as a sole trustee.

(1) The trustee/beneficiary can make distributions to himself or herself without limitation; and

(2) If any of the other beneficiaries are minor children of the trustee at the time the trustee passes away, the trustee has an obligation to support such beneficiary. Again this will be discussed in detail in an upcoming installment.

Finally, there is the discussion of the conservative view of whether the trustee's powers will be attributed to the settlor if the settlor appoints his spouse, brother, sister, parents, child or other related persons under IRC § 672(c). If so, the settlor would now be considered to have a discretionary distribution power that is not limited by an ascertainable standard, resulting in an estate inclusion issue under IRC § 2036(a)(2) and IRC § 2038. This possible estate inclusion issue is based on an analogy to Rev. Rul. 95-58 regarding the safe harbor with unconditional removal/replacement powers. Conversely, another view takes the position that seldom, if ever, does a special power of appointment create an estate inclusion issue when granted to a spouse, child, parent, brother or sister, and unlike a trustee power, a special power of appointment is not subject to fiduciary duties. In this respect, if a special power of appointment that grants unbridled discretion[4] does not create an attribution issue, than neither should a discretionary distribution power that is subject to a fiduciary standard.

In the event the settlor appoints the wrong person to serve as a trustee of a discretionary trust that is not limited by an ascertainable standard, one does not automatically conclude that this results in an estate inclusion issue. Rather, one needs to analyze whether a savings clause can cure this issue. This LISI discusses the effectiveness of what some practitioners refer to as a support obligation savings clause and an ascertainable standard savings clause.[5]

Types of Trustee Savings Clauses and Statutes

Related to trustees, the purpose of a savings clause is to hopefully cure an estate inclusion issue if the settlor appoints the wrong person to serve as a trustee. A trustee savings clause[6] may be included in the trust document itself or it may be imposed as a limitation or change in the trustee's powers by a state statute. Regarding trustee estate inclusion issues, there are mainly the following three types of savings clauses:

1. A support obligation savings clause, which is a savings clause that prohibits a trustee/beneficiary from making any distributions that would be for a support obligation[7];

2. An ascertainable standard savings clause, which is a savings clause that changes the distribution standard from a discretionary interest not limited by an ascertainable standard to one that is based on an ascertainable standard depending on who is the trustee; and

3. Certain savings clauses for irrevocable life insurance trusts such as one preventing a trustee from exercising any power that might be considered an incident of ownership.

For purposes of this article we are not yet discussing issues that are unique to irrevocable life insurance trusts. Therefore, except for an analogous example below, the trustee savings clauses unique to life insurance trusts will be discussed in an upcoming installment of this series.

A Support Obligation Savings Clause Does Not Cure a IRC § 2036(a)(2) or § 2038 Inclusion Issue

In *Estate of Arthur J. O'Connor*[8], the settlor was the sole trustee of a discretionary trust not limited by an ascertainable standard. Absent a particular type of savings clause, this would result in estate inclusion under IRC § 2036(a)(2) and § 2038. The specific distribution language provided in the trust stated:

> "The trustee shall hold, manage, invest and reinvest nineteen seventy-ninths (19/79) of the total trust funds in the manner hereafter provided, collect and receive the income therefrom, pay therefrom all proper expenses, taxes, and charges, *in his* ***discretion expend for the benefit*** *of said* Arthur J. O'Connor, Jr. any balance of income or any principal, and accumulate and add to principal any income remaining . . . "

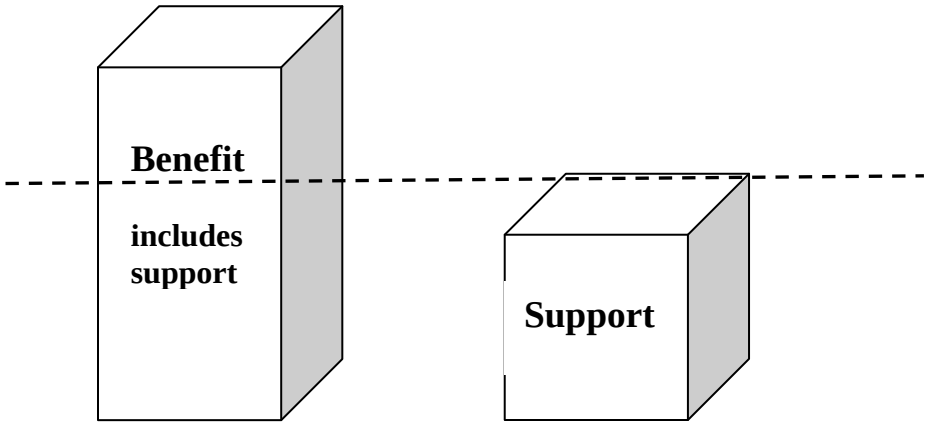
There were two limitations on the trustee's discretionary authority. The first limitation was that as to any principal as well as 60/79 of the income, the discretionary distribution needed to be for the benefit of Arthur J. O'Connor, Jr., the settlor's son. The second limitation was a form of a support obligation savings clause known as *Upjohn clause*.[9] This support obligation savings clause provided that:

> "Under no circumstances shall any part of the principal or income there from . . . be used or applied directly or indirectly for the benefit of the Grantors or be used or applied to meet or relieve the Grantor's legal obligations to support their dependents."

Regarding the first limitation, the estate argued that the word "benefit" was equivalent to support, and the second limitation, the support obligation savings clause (i.e. the Upjohn Clause), prevented any distributions from being made from the trust for support if the Settlor was the trustee of the trust. Therefore, the estate argued that the trust should not be included in the settlor's estate, because the settlor as trustee could not and did not make any discretionary distributions to the beneficiary.

Since the discretionary distribution standard was not limited by an ascertainable standard, the Tax Court was forced to determine the meaning of the word "benefit." Citing New York law, the Tax Court noted that the word "benefit" was far more extensive than the word "support," meaning "anything that will work to the advantage of the recipient."[10]

A diagram of this point appears below.



The Tax Court further noted that IRC § 2036(a)(2) results in estate inclusion if a settlor may control who receives distributions and such distributions are not limited by an external standard[11]. In the above diagram, distributions for the beneficiary's benefit are not limited by an external standard. Also, IRC § 2038 includes trust assets in the settlor's estate if the settlor controls the timing or enjoyment of such assets by being able to accumulate the trust income and such power is also not limited by an external standard. Therefore, the trust assets were included in the settlor's estate under both IRC § 2036(a)(2) and IRC §2038.

When reviewing the types of trustee savings clauses, the Estate of Arthur J. O'Connor (senior[12]) properly stands for the proposition that a support obligation savings clause will not cure the discretionary distribution standard estate tax inclusion issue for a settlor/trustee. The same would be true for a trustee/beneficiary. This is because the trustee/beneficiary could still make

distributions to himself or herself for reasons in excess of the trustee/beneficiary's support, and therefore, the trustee/beneficiary would still hold a general power of appointment. However, there is another type of savings clause that may address the estate inclusion issue for a trustee/beneficiary as discussed below.

Savings Statute That Changes the Distribution Standard

Many states have passed statutes that attempt to correct the problem created when a beneficiary becomes the trustee of a discretionary trust that is not limited by an ascertainable standard. For example, the District of Columbia's statute § 21-1722 (b) prohibits a trustee/beneficiary from making distributions to himself or herself if they are not limited by an ascertainable standard. It also converts the discretionary distribution standard into an ascertainable standard should the trustee/beneficiary wish to make distributions to himself or herself. Section 814(b)(1) of the Uniform Trust Code Section also has an ascertainable savings clause for a trustee/beneficiary.

An ascertainable standard savings statute changes the distribution standard from a discretionary standard that was not limited by an ascertainable standard to a distribution standard based on an ascertainable standard.

In Rev. Proc. 94-44, the Service upheld the validity of Florida Statute § 737.402(4) that provided by statute that any fiduciary power conferred upon a trustee to make discretionary distributions of either principal or income to or for the trustee's own benefit cannot be exercised by the trustee, except to provide for the trustee's health, education, maintenance, or support as described in §§ 2041 and 2514 of the Internal Revenue Code. The Service, referring to Rev. Proc. 94-44, also ruled likewise in three PLRs regarding other state laws on the same issue.[13]

A state savings statute that restricts a trustee/beneficiary's distributions to himself or herself should solve the general power appointment issue regarding distributions to himself or herself. However, there are other estate inclusion issues in the "Who Can Be a Trustee Matrix"™[14] such as support obligation issues. The ascertainable standard savings clause does not address the second support obligation issue that is discussed in an upcoming LISI installment. Further, the author is not aware of a state ascertainable standard savings statute that addresses the estate inclusion issue if the settlor is appointed as a trustee.

Trust Savings Clause That Changes the Distribution Standard if a Beneficiary is a Trustee

While the Uniform Trust Code and many states have statutes that by state law change a discretionary distribution standard for a trustee/beneficiary to one based on an ascertainable standard, some states have not yet statutorily adopted an ascertainable standard savings clause. Many estate planners' documents address this issue by including an ascertainable standard savings clause in the trust document. In this respect, the trust document seeks to avoid an estate

inclusion issue if the wrong person is appointed as trustee by the same method that a state savings statute does.

State ascertainable standard savings statutes have been respected by the Service in a Rev. Proc. and at least three PLRs. Conversely, it does not appear that we have any direct authority on the Service's position regarding whether the Service will respect an ascertainable standard savings clause created by the drafter of the trust document. While the author thinks the result should be the same, the analysis of savings clauses that are created within the trust document is actually a bit more complicated. One needs to review Sebastin Grassi's immortal treatise *A Practical Guide to Drafting Marital Deduction Trusts*[15] where he notes that savings clauses in trust documents are not always respected. Mr. Grassi points out the maxim that "the specific always governs over the general" when one is interpreting the provisions of a trust. Therefore, when discussing marital deduction savings clauses, Mr. Grassi cites PLR 7905088 stating that a general savings clause such as "nothing in this trust shall be construed to prevent the marital deductions" will have no effect if the trust contains any specific provisions that result in the failure of the trust to qualify for the marital deduction.

As noted above, the author is not aware of any direct authority where the Service as ruled on an ascertainable standard savings clause that was created by the drafting attorney. However, the author is aware of an analogous specific v. general analogy case dealing with an incident of ownership savings clause. In *Terriberry v. U.S.,*[16] the decedent's wife created a revocable trust and appointed her husband as trustee. Pursuant to Article III (3). the trust specifically provided that upon the settlor's death, the husband/trustee could select a settlement option with regarding the life insurance owned by the trust. Selecting a settlement option is an incident of ownership. Conversely, both Article III (1) provided that the transfer of ownership by the settlor to the settlor's husband was in a fiduciary capacity, and Article III (2) stated that the settlor's husband as trustee "is expressly prohibited from exercising any of the incidents of ownership thereof in his individual capacity and further prohibited from making any use, disposition, retention or other control thereof, either individually or as a Trustee or Co-Trustee, except as herein directed." The husband/trustee then predeceased his settlor/wife, and the Service took the position that the husband held an incident of ownership over the life insurance policies at the time of his death.

The Fifth Circuit[17] refused to recognize a incident of ownership savings clause that provided the settlor/trustee could not exercise any <u>incidents of ownership</u> over policies owned by the irrevocable life insurance trust. It stated, "We cannot accept appellee's ingenious nullification of the express provisions of Article III(3) by this preferred reliance on Article III(2)'s all-purpose incantation or on its sister phrases in Article III(1) or III(3)." At first, the author was puzzled by the Fifth Circuit's holding. It seemed to imply that an incident of ownership savings clause was too broad or general to work. However, it appears that even though the Fifth Circuit Court did not specifically state it was relying on a "specific v. general" analysis, this is what it meant. The express provisions of Article III allowing the trustee/husband to select settlement options should govern over the general "all purpose incantation" that the trustee could not exercise any incidents of ownership.

For this reason, the author finds that the facts of *Terriberry* are distinguishable from an ascertainable standard savings clause. An ascertainable standard savings clause is an "if then" type of savings clause. If a trustee/beneficiary is appointed as a trustee, then the savings clause changes from a discretionary distribution standard not limited by an ascertainable standard to one that is based on an ascertainable standard. The terms of the trust are not in conflict when the distribution standard is changed. Conversely, an incident of ownership savings clause is a blanket savings clause that can result in conflicts with other provisions of the trust document. For example, in *Terriberry*, paragraph 3 specifically allowed the trustee/husband to exercise an incident of ownership and paragraph 2 stated he could not exercise any incident of ownership.

While the author finds the facts of *Terriberry* to be distinguishable, the analysis in *Terriberry* is very brief, and different practitioners may come to different conclusions. Conservative drafters will generally point out that due to the uncertainty of savings clauses, particularly when the clause is not blessed by a state statute and there is no authority directly on point, one should not rely on savings clauses to cure an estate inclusion issue. Rather, one should learn the "Who Can Be a Trustee" rules, follow the rule of thumb and should not appoint the settlor as a trustee over a discretionary trust that is not limited by an ascertainable standard.

Trust Savings Clause That Changes the Distribution Standard if the Settlor is the Trustee

What if the settlor is appointed as a trustee of a discretionary trust not limited by an ascertainable standard, similar to the fact patter in the *Estate of Arthur J. O'Connor*? The author is not aware of a state statute where the distribution standard is changed to an ascertainable standard for all beneficiaries[18] when the settlor is appointed as a trustee. Further, it is a bit unusual to find a second isolated ascertainable savings clause addressing the settlor in most trust documents. Conversely, in the last ten years, a new drafting concept has developed in some of the national drafting systems that is referred to as "an interested trustee."

In general, the definition section of the document defines an interested trustee to be the settlor as well as anyone who is related or subordinate to the settlor within the meaning of IRC § 672(c). Therefore, in general the settlor, the settlor's spouse, a child, grandchild, parent, brother, sister, and anyone receiving a W-2 from the settlor would be classified as an interested trustee. Somewhere else in the document, many times under trustee powers, the trust document provides that if an interested person is appointed as a trustee, the distribution standard changes for all beneficiaries so that distributions are based on an ascertainable standard.

While, the author is not aware of any direct authority on point, the analysis should be the same. The distribution standard has been changed to an ascertainable standard. Both IRC § 2036(a)(2) and § 2038 should not apply, and the trust should be analyzed under the ascertainable standard table of the Who Can Be a Trustee Matrix™.

Trust Savings Clause That Changes the Distribution Standard if a Related Person Under IRC § 672(c) is Appointed

The conservative view applying an analogy to Revenue Ruling 95-58, is that the Service may argue that the trustee's powers are attributed to the settlor if a spouse, trustee/beneficiary (e.g. child), parent, brother, or sister are appointed. If the trustee powers are attributed to the settlor, then the settlor holds a discretionary distribution power that is not limited by an ascertainable standard, and absent a trustee savings clause, there is an estate inclusion issue under IRC § 2036(a)(2) and § 2038. While the author would generally favor the view that there is no attribution of trustee powers, based on the special power of appointment analogy discussed in the second installment of this series, for purposes of discussion in the next paragraph this analysis will assume that the Service was successful in attributing the trustee powers to the settlor .

In the event of attribution of the trustee powers to the settlor, an interested trustee type of savings clause should still change the distribution standard to one based on an ascertainable standard. Subject to the specific v. general discussion above as well as no direct authority from the Service, it is the author's view that the interested trustee savings clause has prevented one of the estate planning issues. In the event the drafter did not use the interested trustee type of savings clause, but instead included a second trustee ascertainable savings clause that applied only if the settlor was the trustee, the result should be the same. Conversely, if the drafter only included a trustee/beneficiary ascertainable standard savings clause and if the Service is successful in attributing the powers of a related or subordinate trustee to the settlor, then this would result in an estate inclusion issue under IRC § 672(c). In this respect, the conservative view takes the position that one should not rely on savings clauses when drafting. Rather, he or she should know the "Who Can Be Trustee" rules, and simply follow the general rule of thumb and only appoint a person who is independent within the meaning of IRC § 672(c) to serve as trustee of a discretionary trust not limited by an ascertainable standard.

Conclusion

There are generally three types of trustee savings clauses: (1) support obligation savings clauses; (2) ascertainable standard savings clauses; and (3) incidents of ownership savings clauses. With a discretionary trust not limited by an ascertainable standard, a support obligation savings clause will not cure the estate inclusion issue for either a settlor/trustee or a trustee/beneficiary. However, there are other estate inclusion issues that a support obligation savings clause should help remedy that are discussed in a subsequent installment of this series.

As noted in Rev. Proc. 94-44, an ascertainable standard savings statute should solve one[19] of the estate inclusion issues if a trustee/beneficiary is appointed as the trustee of a discretionary trust that is not limited by an ascertainable standard. If a state has not passed an ascertainable standard savings statute and the drafter relies on an ascertainable standard savings clause within the trust, it appears there is no direct authority on point blessing the approach. It is the author's view that the analogous case of *Terriberry* is distinguishable, and that such a clause should work just like a state ascertainable standard savings statute. The same should be true if a second

ascertainable savings clause is added in the case of a settlor/trustee as long as the distribution standard is changed to an ascertainable standard for all beneficiaries. A few of the national drafting systems use the concept of an "interested trustee" to create a savings clause for a trustee/beneficiary, the settlor, as well as anyone related or subordinate within the meaning of IRC § 672(c).

In the event that a spouse who is not a beneficiary, parent, brother or sister is appointed as a trustee, some conservative planners worry that for a discretionary trust not limited by an ascertainable standard, the Service may attribute the trustee powers to the settlor based on analogy to Rev. Rul. 95-58. The interested trustee method addresses this issue. However, few trusts that do not use the interested trustee method provide a second ascertainable standard savings clause as related to the settlor serving as a trustee, and the author is unaware of a state statute that applies to the settlor.

With all of the twists and turns as well as unaddressed issues in the discretionary trust table, a conservative planner may well point out that one should not rely on savings clauses when drafting. Further, they may either disagree with the author's analysis of *Terriberry* or find the analysis inconclusive. Therefore, many conservative estate planners follow the rule of thumb that in addition to not relying on savings clauses, one should only appoint an independent trustee within the meaning of IRC § 672(c) for a discretionary trust that is not limited by an ascertainable standard.

If the settlor, a trustee/beneficiary, or someone related within the meaning of IRC § 672(c) has been appointed as trustee and if either an ascertainable savings statute or a savings clause has successfully changed the distribution standard to one based on an ascertainable standard, this does not automatically mean that all estate inclusion issues have been solved. Rather, it means that the analysis has now moved from the discretionary standard table to the ascertainable standard table of the Who Can Be Trustee Matrix™. The fourth installment of this series begins the ascertainable standard table analysis.

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1 The Modular Approach to Estate Planning is trademarked by Mark Merric.

2 IRC § 2036(a)(2).

3 IRC § 2038.

4 For a special power of appointment, "unbridled discretion" means within the class of persons that the power holder may exercise the power, generally there are not any limits (i.e. an ascertainable standard or a fiduciary duty) to the power holder's discretion. Naturally by definition, a special power of appointment prevents the power holder from appointing the property to himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate.

5 Okay, it is probably only me. However, if Professor Samuel Donaldson can use this approach to nicknaming a "swap power" in his legendary grantor trust outline that was presented at Lonnie McGee's Southern California Tax and Estate Planning Forum in October of 2008, so can I.

6 This article distinguishes "trustee savings clauses" that hopefully cure a "who can be a trustee estate inclusion issue" from other types of saving clauses such as a marital deduction savings clause.

[7] Sometimes this is drafted broader than just prohibiting distributions that are a support/obligation for a trustee/beneficiary, but it is drafted to also prohibit making any distribution that would be a support obligation of the settlor. This broader support obligation savings clause is referred to as an "Upjohn clause," named after the case *Upjohn v. U.S.*, (not reported in F. Supp.) 1972 WL 3200 (W.D. Mich. 1972), 30 A.F.T.R. 2d 72-5918, 72-2 USTC P12,888.

[8] *Estate of Arthur J. O'Connor*, 54 TC 969 (1970).

[9] For a discussion regarding Upjohn clauses and limitations placed on spousal lifetime access trusts see Estate Planning LISI # 1379.

[10] *Citing In re Rachlin's Will*, 133 N.Y.S.2d 151 (Surrogate Ct. Queen Cnty, 1954).

[11] For Settlor estate inclusion issues under IRC § 2036(a)(2) and IRC § 2038, the term "external standard" is used, rather than ascertainable standard. The term "external standard" was created by case law. *Jennings v. Smith*, 161 F.2d 74 (2nd Cir. 1947); *Hurd v. Comm'r*, 160 F.2d 610 (1st Cir. 1947).

[12] Sometimes practitioners are a bit confused about the case because of the "junior" and "senior" references. In the *Estate of Arthur J. O'Connor*, dad (Arthur J. O'Connor senior) created an irrevocable trust for the benefit of his son, Arthur J. O'Connor, Jr. Dad then appointed himself as trustee.

[13] PLR 200530020 and PLR 200637021. *See* PLR 9323028 where the Service ruled likewise prior to Rev. Proc. 94-44. *Also see*, Roy Adams and Ann Burns, *The Important Tax Issues Which Affect Trustee Selection*, teleconference outline, August 26, 2008. As analogous authority *see* PLR 200014002 and Rev. Rul. 54-153 where a state statute provided that if there were co-trustees of a discretionary trust, distribution powers could only be exercised by a trustee who was not a beneficiary.

[14] The "Who Can Be a Trustee Matrix" is trademarked by Mark Merric.

[15] Sebastin Grassi, *A Practical Guide to Drafting Marital Trusts*, p. 155, published by the American Law Institute and the American Bar Association, Phil. PA. Similar to Natalie Choate's, *The QPRT Manual* as well as many of Steven Akers outlines, both of Sebastin Grassi's treaties, *A Practical Guide to Drafting Marital Trusts* and *A Practical Guide to Drafting Irrevocable Life Insurance Trusts*, are a "must have in my library" for most estate planning practitioners.

[16] *Terribery v. U.S.*, 517 F2d 286 (5th Cir. 1975)

[17] The Fifth Circuit reversed the Florida District Court holding that stated because the trust was a revocable trust, the settlor-wife could revoke it at anytime, and therefore, the trustee-husband had no incident of ownership. The Florida District Court case may be found at *Terriberry v. U.S.*, 1974 WL 716 (M.D. Fla.) or at 74-2 USTC P 13,002.

[18] State ascertainable standard statutes usually only address a trustee/beneficiary and limit the distributions by the trustee/beneficiary to himself or herself. The trustee/beneficiary may still make discretionary distributions not limited by an ascertainable standard to the other beneficiaries. Rev. Rul. 94-44 and the related PLRs only address the trustee/beneficiary estate inclusion issue, not a second settlor ascertainable standard savings clause. To address the settlor estate inclusion issue, if the settlor is appointed as a trustee (also assuming the settlor is not a beneficiary of the irrevocable trust), then the distribution standard must be changed to an ascertainable standard for all of the beneficiaries to cure one of the estate inclusion issues.

[19] As noted above, the support obligation estate inclusion issue will be discussed in a subsequent installment of this series.