

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1352

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From: Steve Leimberg's Estate Planning Newsletter

Subject: The Good, Bad, and Ugly of Spousal Access Trusts – II

The Good, Bad, and Ugly of Spousal Access Trusts – II

An inter vivos spousal access trust is designed so that, should the need ever arise, distributions can be made to the spouse for the benefit of the family unit through the spouse. But these trusts must carefully thread more than one needle.

"The Restatement Third has redefined "discretionary trusts" so that, a beneficiary will almost always have an enforceable right to a distribution. In this respect, the continuum is really a continuum of support trusts rather than discretionary trusts."

"In the event that a court decides to follow the Restatement Third position, in all but the most discretionary of trusts, a spousal access trust would create an estate inclusion issue." - unless, there is also a requirement to look to a beneficiary's resources, including the settlor's obligation of support.

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specializes in tax and estate planning research for attorneys and CPAs. Rod has written for Corporate Taxation, The Mergers and Acquisitions Report, CCH Journal of Practical Estate Planning, Taxation for Lawyers, Dunn and Bradstreet, Prentice Hall, contributed to a presentation at the Heckerling Institute on Asset Protection for Individual Retirement Accounts, Lawyer's Weekly and other professional publications and regularly speaks on tax and estate planning issues.

Mark and Rod have teamed up to create this **LISI** which covers the estate inclusion issues of a support trust and problems created by the Restatement (Third) of Trusts ("Restatement Third"). It's part of Mark's continuing series known as the **Modular Approach to Estate Planning**.TM[\[1\]](#)

Executive Summary:

The first installment of this **LISI**, [Estate Planning Newsletter # 1334](#), noted that spouses each have an obligation to support each other until death. If a settlor creates a spousal access trust that *must* satisfy a support obligation of the settlor, part or all of the trust property will be brought back into the settlor's estate as a retained interest under Code Section 2036.

Whether there *is* a support obligation depends on the classification of the distribution interest. Under common law, a beneficiary of a discretionary trust (i.e. discretionary interest) did *not* have an enforceable right to a distribution. Consequentially, a beneficiary did not have the ability to *force* the trustee to make a distribution for a support obligation of the settlor. Therefore, a spousal access trust where the spouse held a discretionary interest did *not* create an estate inclusion issue. Also, a mandatory interest that was *not* coupled with a standard did not create an estate inclusion issue, because there was no requirement that such distribution be used for the beneficiary's support.

This second installment discusses the estate inclusion issues of a support trust and problems created by the Restatement (Third) of Trusts ("Restatement Third"). Absent a savings clause or a requirement that the trustee look to a beneficiary's resources prior to making a distribution, anytime the spouse beneficiary has an enforceable right to a distribution, there most likely *is* an estate inclusion issue with a spousal lifetime access trust.

Unfortunately, the Restatement Third rewrites the definition of a discretionary interest so that *almost always* a beneficiary of a discretionary interest has an enforceable right to a distribution, thus turning a discretionary trust under prior

common law into a support trust with the resulting inclusion issues. Therefore, the estate inclusion issue may well be expanded by the courts to many common law discretionary trusts.

On the other hand, the Restatement Third also changes the common law so that if a trust instrument is silent, a trustee must look first to a beneficiary's resources before making a distribution. In this respect the Restatement Third may mitigate the estate inclusion issue.

FACTS AND COMMENTS:

Does the Restatement Third Make a Spousal Access Trust Prettier or Uglier?

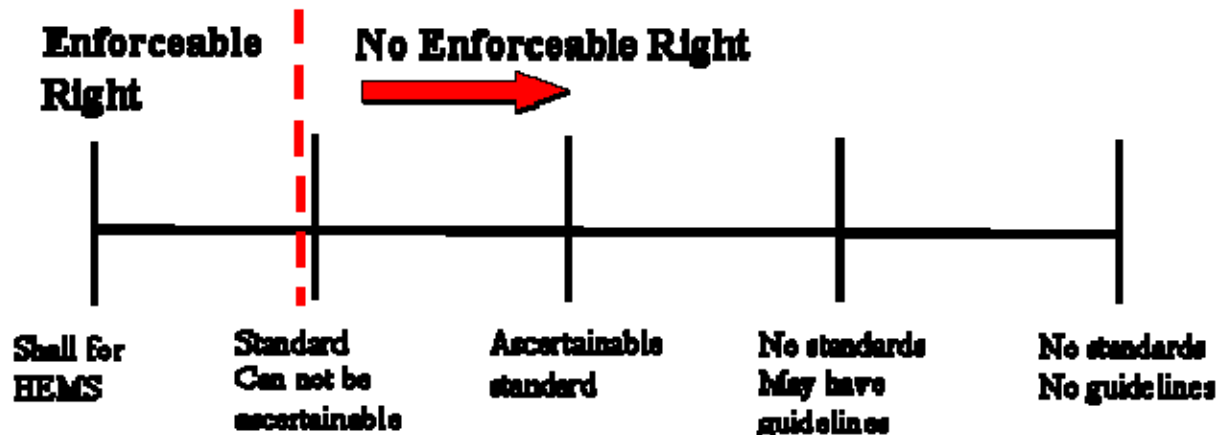
In all but the three or four hybrid trust states^[2], it was relatively easy to create a common law discretionary trust where a beneficiary did *not* hold an enforceable right or a property interest. As noted in the previous installment to this series, the following language would accomplish this classification in all but the three or four hybrid states:

My Trustee may pay to or apply for the benefit of any one or more of the beneficiaries listed in Section 1.07 as much of the net income and principal as the trustee determines in his sole and absolute discretion for a beneficiary's health, education, maintenance, support, comfort, general welfare, an emergency, or happiness. The Trustees, in their sole and absolute discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them.

Under the Restatement (Second) of Trusts ("Restatement Second"), the primary key to classification of a discretionary trust was the words of uncontrolled discretion. Therefore, under the Restatement Second and most case law, a settlor could create a common law discretionary trust with an ascertainable standard.

A diagram showing the strong propensity under the Restatement Second to classify trusts as a common law discretionary trust appears immediately below:

Restatement Second Graph



Continuum of Discretionary Trusts

Ignoring almost all case law on point (hundreds of cases), the Restatement Third arbitrarily abolishes the common law discretionary-support distinction.^[3] In place of the discretionary-support distinction, the Restatement Third creates a *continuum* of discretionary trusts.

Unfortunately, the term "discretionary" as used by the Restatement Third is a misnomer. Based on the following statements, the Restatement Third has redefined "discretionary trusts" so that, a beneficiary will almost always have an enforceable right to a distribution. In this respect, the continuum is really a continuum of support trusts rather than discretionary trusts.

- "A transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so."^[4] At first glance it appears that the Restatement Third is following common law. Yet, the sentence immediately following the above sentence, for almost all purposes negates the above sentence. It states, "It is rare, however, that the beneficiary's circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless."^[5]
- "Reasonably definite or objective standards serve to assure a beneficiary some minimum level of benefits, even when other standards are included to grant broad latitude with respect to additional benefits."^[6] In other words, similar to the hybrid line of discretionary-support trust cases in Ohio, Connecticut and to a lesser extent Pennsylvania, the Restatement Third adopts this distinct minority

position where each element of an ascertainable standard creates an enforceable right to a distribution.

- Even if a trust does not include a standard, under the Restatement Third neither the beneficiary nor the settlor are safe.^[7] *"It is not necessary, however, that the terms of the trust provide specific standards in order for the trustee's good-faith decision to be found unreasonable and thus constitute an abuse of discretion."*^[8] The Restatement Third goes further to the most likely imputation of a distribution standard if there is no standard or guideline when it states, *"Sometimes trust terms express no standards or other clear guidance concerning the purpose of a discretionary power, or about the relative priority intended among the various beneficiaries. Even then a general standard of reasonableness or at least good-faith judgment will apply to the trustee (Comment b), based on the extent of the trustee's discretion, the various beneficial interests created, the beneficiaries' circumstances and relationships to the settlor, and the general purposes of the trust."*^[9]
- Reporter Comment under Section 60(a) states: "The fact of the matter is that there is a continuum of discretionary trusts, with the terms of the distributive powers ranging from the most objective (or "ascertainable," IRC § 2041 of standards (pure "support") to the most open ended (e.g. "happiness") or vague ("benefit") of standards, or even with no standards manifested (*for which a court will probably apply "a general standard of reasonableness."*{Emphasis added}. In other words, it is the Third Restatement view that a "reasonableness standard" of review should be applied to *most* discretionary trusts, regardless of whether or not the trustee is granted "sole," "absolute," or "unfettered" discretion.

After reviewing the above statements as well as reading Sections 50 and 60 (including comments and reporter comments), it becomes quite apparent that *"It is rare, however, that the beneficiary's circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless"* that such beneficiary cannot force a minimal distribution, and that such minimal distribution may cause the trust at issue to be considered a support trust.

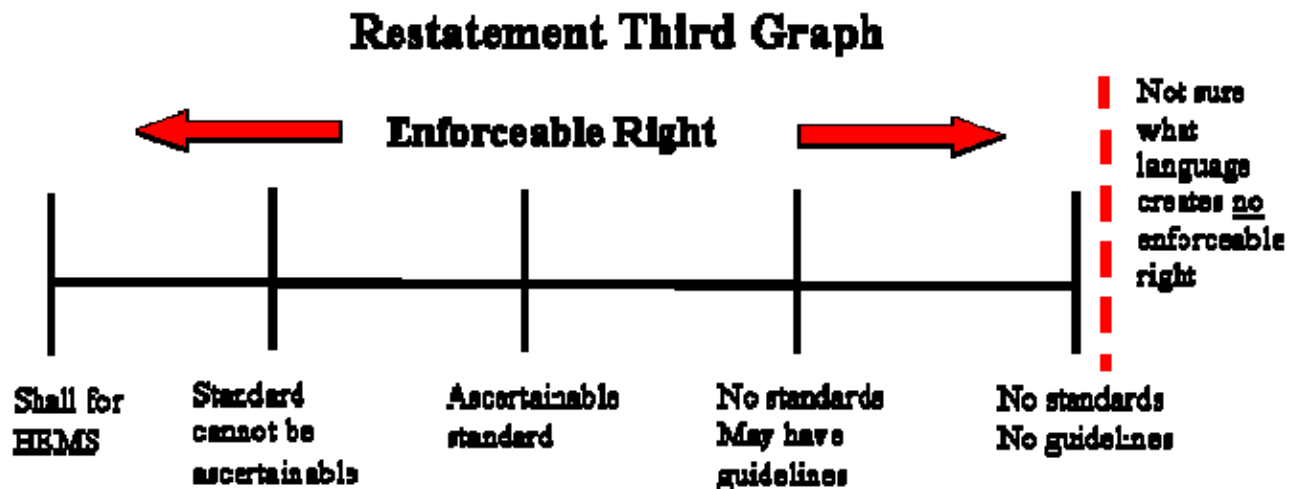
In other words, the Restatement Third at minimum^[10] adopts the hybrid state law regarding the creation of an enforceable right and a property interest in

almost *all* discretionary trusts that contain a reasonably definite or objective standard.

Worse yet, even if there is no standard, the Restatement Third suggests that one should be *imputed* based on a standard of reasonableness or possibly good faith.

The Restatement Third provides no guidance for how an estate planner should draft a discretionary interest so that a beneficiary has neither an enforceable right to a distribution nor a property interest.

The graph below depicts how the Restatement Third has rewritten the definition of a discretionary trust so that almost always a beneficiary will have an enforceable right to a distribution.



In the event that a court decides to follow the Restatement Third position, in all but the most discretionary of trusts, a spousal access trust would create an estate inclusion issue. The hallmark discretionary trust cases cited in the first installment of *Jack F. Chrysler, Commr. v. Douglas's Estate, and Lettice v. U.S.* would now give the beneficiary an enforceable right to a distribution, creating an estate inclusion issue.

Trustee Must Look to a Beneficiary's Resources

At first glance, one might conclude that the Restatement (Third) has created immense problems with many spousal lifetime access trusts by creating an enforceable right in many discretionary interests. However, there is another

area of the common law that the Restatement Third *reversed* – whether a trustee must look to a beneficiary's resources before making a distribution.

Under common law, if a trust instrument did *not* state that the trustee must look to a beneficiary's resources, the trustee had no obligation to ask the beneficiary for personal financial information and then determine whether a beneficiary should receive a distribution for support.

Conversely, noting that it departed from the Restatement (First) of Trusts and Restatement (Second) of Trusts, the Restatement Third takes the *opposite* position. If a trust instrument does not address the issue of whether to look to a beneficiary's resources (i.e. the trust instrument is silent on the issue), then the Restatement Third takes a position that the Trustee *must* look to a beneficiary's resources.

In PLR (TAM)^{[111](#)} 8504011, the distribution language stated:

"The independent Trustees, acting together, are further authorized from time to time in their sole discretion to pay to a beneficiary of any separate trust such sums, first from the accumulated income, and then from principal that the independent Trustees considered necessary for the support, maintenance in the health and reasonable comfort, and education, including college and professional education, of such beneficiary and his or her descendants, taking into consideration all other cash resources available to such beneficiary for such purposes from all sources known to such trustee."

The author of the PLR made an excellent analysis regarding a discretionary trust under common law as compared to a support trust. He quotes *Scott of Trusts*, Vol. 2., § 187, p. 197:

"If he (the trustee) is directed to pay so much of the net income and principal as is necessary for the support of a beneficiary he can be compelled to pay at least the minimum amount which in the opinion of a reasonable man would be necessary. If, on the other hand, he is to pay a part of the principal to the beneficiary entitled to the income, if in his discretion he deems it wise, the trustee's decision would normally be final, although, as it will be seen, the court will control his discretion when he acts in bad faith."

Therefore, the first part of the PLR conclusion reinforced what we already know: a beneficiary holding a common law discretionary interest does *not* have an enforceable right to a distribution, and does *not* have a spousal access trust estate inclusion issue.^[12]

Yet, one should analyze the PLR's *entire* conclusion to determine whether including a requirement to look to a beneficiary's resources will solve the settlor's estate inclusion issue in a support trust.

The entire conclusion states,

"In this case, after considering the limitations of 1) "sole trustee," 2) "such sums," 3) 'as the independent trustees consider necessary," and 4) taking into consideration all other cash resources available to such beneficiary for such purposes', as used in the trust instrument, we conclude that all payments for the support of the minor beneficiaries were within the independent trustee's discretion. Under any circumstances, the independent trustees had to consider the minors' other sources of support,^[13] including a decedent's parental duty of support, before making any distributions. Therefore, the provisions authorizing payments for a minor's support are not mandatory and neither the decedent nor the minor beneficiaries had any enforceable right to compel a distribution absent showing that the independent trustee's abused its discretion."

Due to the "Under any circumstances" language, one interpretation of the above language is that even if the trust *were* a support trust, the provision requiring the trustees to look to a beneficiary's resources would solve the estate inclusion issue. This appears to be the position of the Restatement (Third) of Trusts Section 50(e)(3).

This is also the position of the BNA portfolio when it cites the PLR and states, "A provision that the trustee is to consider the beneficiary's other resources would take the trust out of IRC § 2036 if the other resources included the ongoing support obligation of the settlor apart from the trust."^[14] This is also the opinion of several other esteemed colleagues.^[15]

In addition to the PLR, which may not be relied on as legal authority,^[16] the Fourth Circuit case of *Colonial-American Nat'l Bank v. U.S.*^[17], provides some authority that a provision to look to a beneficiary's resources will solve the

estate inclusion issue. *In Colonial*, husband created a spousal lifetime access trust for his wife and provided that all income would be distributed to her. Principal would be distributed if the income proved insufficient to her needs. As noted in the prior installment of this series, the mandatory income interest presents no issue from an estate inclusion standpoint. However, distributing principal for her needs, may well be construed a support obligation. Fortunately, the trust included a provision that the spouse/beneficiary was to deplete her assets first before there were any distributions of principal. This by itself would normally not be sufficient. However, the court interpreted "her assets" to include the husband's obligation to support his spouse under state law. Therefore, a distribution could not be made from the trust that would satisfy a husband's support obligation for his wife.^[18]

While the interpretation of PLR 8504011 that looking to a beneficiary's resources, including the settlor's support obligation, will resolve the estate inclusion issue is most likely the correct interpretation of the above language, I would like to explore some other possible interpretations.

Another interpretation of the language quoted from PLR 8504011 may be that all of the provisions together result in a beneficiary *not* having an enforceable right. If this is the case, it is the discretionary trust language that prevents the estate inclusion issue,^[19] not the provision requiring a trustee to look to the beneficiary's resources before making a distribution.

In addition to the possible difference of opinion regarding the holding of the above PLR, there is a pragmatic issue. The purpose of an inter vivos spousal access trust is so that, should the need ever arise, distributions can be made to the spouse for the benefit of the family unit through the spouse. Yet, if a trustee must first look to the husband/settlor to fulfill his support obligations to the spouse before making a distribution, under what circumstances, if any, may the trustee make a distribution to the spouse for support? This actually becomes a much more complicated issue that will be discussed in detail in Part III.

Summary of Restatement Third Issues

- Regarding the Restatement Third, if a court follows the newly created continuum of discretionary trusts that creates an enforceable right in almost all beneficiaries, any common law discretionary trust that contains a standard that is the equivalent of support or maintenance now

gives the beneficiary an enforceable right to a distribution, aside from the potential effect of the need to consider the beneficiary's assets. If a beneficiary has an enforceable right to demand a distribution for support, the settlor also has the ability to force a distribution to satisfy a support obligation.

- On the other hand, if a state also adopts the Restatement position that a trustee is to look to the beneficiary's resources *first* before making a distribution, and if beneficiary's resources would include any support obligation of the settlor to a spouse, then the Restatement Third appears to have mitigated the estate inclusion issue it created.

It remains to be seen which aspect of the Restatement Third will ultimately prevail.

Unfortunately, there are still some answered questions. A state may adopt the new continuum of discretionary trusts.

Conversely, one must remember that the Restatement Third reversed both the Restatement First and Restatement Second on the issue of whether a trustee has an obligation to look to a beneficiary's resources when the trust instrument is silent. The state is under no obligation to adopt the reversal of law regarding looking to a beneficiary's resources when the trust instrument is silent.

Furthermore, if a state *does* follow the Restatement Third's position on looking to a beneficiary's resources, it *still* does not have to hold that looking to a beneficiary's resources also includes the settlor's obligations to support his spouse.

Careful drafting has become critical as the estate inclusion issue seems to be coming more to the fore with the creation of so many spousal access trusts in recent years.

PLANNING TIPS:

The most conservative method to draft a spousal access trust is to always use a common law discretionary trust where the beneficiary does not have an enforceable right to a distribution.

The Restatement Third of Trusts redefines the term discretionary trust so that almost all inter vivos spousal lifetime access discretionary trusts that were protected under common law now give the beneficiary an enforceable right to a

minimum distribution. In the event the distribution language in these support interests provide for support or maintenance, the beneficiary now has an *enforceable* right to force the trustee to make a distribution for beneficiary's support and thus the estate inclusion issue is present.

Drafters should not rely on the hope that a court will also adopt the Restatement Third's position regarding looking to a beneficiary's resources when a trust instrument is silent as a solution to the estate inclusion issue. Rather, drafters should either draft a discretionary interest that should not be an enforceable right under the Restatement Third or applicable state law or they should consider including a savings provision and/or distribution language looking to the beneficiary's resources including a spouses obligation of support.

Drafting around Restatement Third issues as well as savings clauses are discussed in the upcoming third installment of this series.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mark Merric

Rod Goodwin

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CITES:

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- ^[1] The modular approach to estate planning is trademarked by Mark Merric.
- ^[2] Ohio, Pennsylvania, Connecticut, and until the Iowa trust corrected this issue, Iowa, were known as hybrid trust states. With a hybrid trust state, any element within an ascertainable standard would create an enforceable right to a distribution.
- ^[3] *Restatement (Third) of Trusts*, Reporter Notes Sections 50 and 60 comment a.
- ^[4] *Restatement (Third) of Trusts*, Section 60, comment e.
- ^[5] *Id.*
- ^[6] *Restatement (Third) of Trusts*, Section 50, comment on Subsection (2): d. first paragraph.
- ^[7] The beneficiary does not receive the superior asset protection feature of a discretionary interest, and the settlor of a spousal access trust may have an estate inclusion issue.
- ^[8] *Restatement (Third) of Trusts*, Section 50, comment on Subsection (1): b., third paragraph last line.
- ^[9] *Restatement (Third) of Trusts*, Section 50, comment on Subsection 2: d., Second Paragraph.
- ^[10] Please note that *Restatement Third* takes the position that an enforceable right should many, if not most of the time, be imputed even if a trust does not have any standard or any guidelines.
- ^[11] The author notes that some publishing services refer to this pronouncement as a PLR and others as a TAM.
- ^[12] Please note that PLR 8504011 was issued based on the *Restatement (Second) of Trusts*, not the *Restatement Third's* newly created definition of a discretionary interest where a beneficiary will have enforceable rights in most discretionary trusts. *See Endnote 9.*
- ^[13] The above case dealt with a discretionary trust of a decedent's minor children. Since the settlor also has an obligation to support his or her spouse, the support obligation issue is the same as that for a spousal access trust.
- ^[14] BNA Tax Management Portfolios, Estate Tax; 50-5th: Transfers With Retained Interests and Powers pg. 30.
- ^[15] Steve Akers and Mark Parthemer, in their incredible outline *Structuring Powers to Avoid a Catastrophe*, Financial and Estate Planning Council of Metropolitan Detroit, May 6, 2008; p. 16
- ^[16] IRC § 6110(k)(3).
- ^[17] *Colonial-American Nat'l Bank v. U.S.*, 243 F.2d 3112 (4th Cir. 1957).
- ^[18] There is further tangential authority supporting the position that looking to the beneficiary's resources solves the estate inclusion issue under PLR 8113079.
- ^[19] Esteemed colleagues, Susan Porter, Susan Brachtl, and Fredrick Keydel do not comment on whether looking to a beneficiary's resources is a viable option. Rather, these noted scholars rely on the conservative approach of using a common law discretionary trust. Susan Porter, *Exercising Discretion in Discretionary Trusts Great Expectations*, pg. 4, Practising Law Institute, March 21-22, 2005; PLI Order Number 6194; Susan P. Brachtl, *Discretionary Trusts*, pg. 3, Practising Law Institute, March 1, 1988, PLI Order Number D4-5201; and Fredrick Keydel, *Trusts For Minors*, pg. 62-63, Practising Law Institute, March 1, 1988, PLI Order Number D4-5201.