

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1334

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From: Steve Leimberg's Estate Planning Newsletter

Subject: **Spousal Lifetime Access Trusts – The Good, The Bad, and The Ugly - Part I**

LISI Commentator Team Member **Mark Merric** is the principal in the **Merric Law Firm**, a boutique office emphasizing activity in the areas of estate planning, international tax, and asset protection planning. Mark is co-author of CCH's treatise on asset protection – first edition, *The Asset Protection Planning Guide* (first edition), and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*.

Mark's articles have been published in *Trusts & Estates*, *Estate Planning Magazine*, *Journal of Practical Estate Planning*, *Lawyers Weekly – Heckerling Edition*, *Journal of Taxation*, and the *Asset Protection Journal*. He has been quoted in *Forbes*, *Investor's News*, *On the Street*, the *Denver Business Journal*, *Oil and Gas Investor*, and the *Sioux Falls Business Journal*.

Mark speaks nationally on estate planning and asset protection and is giving an upcoming five day estate planning seminar sponsored by the University of Denver Graduate Tax Program <http://www.InternationalCounselor.com/HotoffthePress.htm>

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

Executive Summary

In the last ten years, there has been a great trend in drafting inter vivos trusts with spousal access. The benefit of a spousal lifetime access trust ("SLAT") is that in the event the family unit (i.e. husband and wife) need part of the property that has been gifted into trust, the trustee may make distributions to the spouse beneficiary.

However, all inter vivos SLATs are not created equally from a potential estate inclusion issue. For example, inter vivos SLATs where the trustee must make a distribution for the spouses support create an issue, because under state law spouses have an obligation to support each other. On the other hand, a mandatory distribution interest that is *not* combined with a standard of support does *not* create an estate inclusion issue.^[2] With a common law discretionary trust, a beneficiary has neither an enforceable right to a distribution nor a property interest, and therefore, the trustee is *not* required to make a distribution for the beneficiary's support. Therefore, these trusts do not have an estate inclusion issue.^[3] On the other hand, if a beneficiary has an *enforceable* right to a

distribution, a support trust, there *is* an estate inclusion issue.

Comment:

WHY THE RECENT TREND TOWARD SPOUSAL ACCESS TRUSTS?

ACTS OF INDEPENDENT SIGNIFICANCE:

The ability to use SLATs has been around ever since the estate tax was created. So why is there a sudden trend for the use of these types of trusts?

One reason is the clarification of "acts of independent significance." If a spouse is *named* in the trust document as a beneficiary and there is a divorce, the estranged spouse may now still request and possibly demand distributions as a beneficiary. With a fifty percent or greater chance for divorce, who would want to create a trust for the benefit of his or her family, and have his or her estranged spouse constantly suing a trustee for a distribution many years after the divorce? Naturally, most clients would be very reluctant to use a SLAT *if* there were not a method to draft around this issue. Fortunately, the Courts and the Service have clarified their position regarding divorce and "acts of independent significance." An act of independent significance is generally disregarded as to its tax effect. A divorce or a remarriage is an act of independent significance.^[4]

In Estate of Tully^[5], decedent had entered into an employment contract whereby the employer promised to pay death benefits to his widow. The Court of Claims held that the decedent did not have the power to revoke within the meaning of IRC § 2038, even though the decedent could have divorced the spouse, thereby eliminating the spouse's possible status as widow. The Court held,

"In reality, a man might divorce his wife, but to assume that he would go through an entire divorce process merely to alter employee death benefits approaches the absurd."

In PLR 8819001, the trust contained a provision that stated,

"In the event decedent and his wife become divorced, his wife shall have no further rights therein, and no further payments shall be paid to her."

The PLR went on to cite *Estate of Tully*,

"the act of divorcing one's spouse is an act of independent significance, the incidental and collateral consequences of which is to terminate the spouse's interest in the trust. Thus, we do not believe the decedent possessed an "incident of ownership" in the insurance policy as a result of the trust provision which would terminate the interest of the decedent's spouse in the event of divorce."

There are two steps to drafting around the divorce issue.

First, the drafter defines the term "Settlor's Spouse" with language something similar to the

following:

The words "Settlor's Spouse" shall refer to the person to whom the Settlor is married to from time. However, the term shall specifically exclude any former spouse who is no longer married to the settlor. Any former spouse by divorce shall be deemed to have predeceased the Settlor.

Second, when referring to the spouse as a beneficiary in the document, the *name* of the spouse is never mentioned. Rather, just the term "Settlor's Spouse" is used.

For example, the current beneficiaries may be listed as follows:

Beneficiaries:

Settlor has the following children. Their names are:

John Doe, and Mary Doe.

During the Settlor's lifetime, the beneficiaries of this trust are the Settlor's children, and the Settlor's Spouse.

The result, in the event that there is a divorce, is that the spouse's interest is terminated. Yet, because divorce is an act of independent significance, the use of such a provision has no tax effect. The estranged spouse has no interest in the trust after the divorce. In the event that the settlor remarries, his new spouse now has an interest in the trust.

What Were the Concerns Where Some Estate Planners Felt Uneasy Regarding Inter Vivos Spousal Access Trusts?

While the issue of divorce has been clarified with its classification as an act of independent significance, there remains another major issue regarding spousal access trusts. This is whether a settlor created a trust that was required to be used for a spouse's support.^[6] If so, the purpose of the trust requires the trustee to satisfy a legal obligation of the settlor. Treas. Reg. § 20-2036.1(b):

"(2) The "use, possession, right to the income, or other enjoyment of the transferred property" is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the **discharge of a legal obligation of the decedent**, or otherwise for his pecuniary benefit. **The term "legal obligation" includes a legal obligation to support a dependent during the decedent's lifetime.**" {Emphasis Added}

Therefore, if a settlor creates an *inter vivos* trust that *must* satisfy a legal obligation of the

settlor, the trust will be included in the settlor's estate.

At this point, inter vivos trusts should be distinguished from testamentary trusts. All planners have been creating QTIP and credit shelter trusts for some time, and these trusts are spousal access trusts. Why isn't there a support obligation issue with *these* trusts?

The answer is simple: When the QTIP or credit shelter trust is created at the settlor's death, a settlor's obligation to support his spouse terminates. Therefore, there is no support obligation. The support obligation issue *only* occurs when a settlor creates an *inter vivos* spousal access trust and the trustee *must* use the trust property for the support of a spouse.

Classification of Trusts:

Under common law, whether or not a trust requires the trustee to use trust property for the support of a spouse depends on the classification of the distribution interest. Generally, whether a beneficiary had an enforceable right to a distribution depended on whether the trust was classified as a (1) mandatory interest^[7]; (2) support interest; and (3) a discretionary interest.^[8] On the other hand, many times whether there is an estate inclusion issue under the Internal Revenue Code is dependent on an ascertainable standard. The typical ascertainable standard is HEMS (health, education, maintenance and support). For purposes of this article, the analysis will begin with the following classifications:

1. Mandatory interest, which generally does not include an ascertainable standard;
2. Support interest, by definition this would include an ascertainable standard; and
3. Common law discretionary interest^[9] – one where a beneficiary has neither an enforceable right to a distribution nor a property interest, and no creditor, not even an exception creditor may attach the beneficiary's interest.

Mandatory Interest

Generally, a mandatory distribution standard requires that a fixed amount, percentage, or definition of income be paid out annually. For tax purposes, a QTIP, which requires all income to be paid to the surviving spouse, is a mandatory distribution. The same for the annuity or uni-trust interest in a GRAT or CRUT. Similarly, a \$100,000 distribution to a certain beneficiary that is required to be made each year is a mandatory distribution.

Almost all mandatory distribution interests do not contain a standard. However, for purposes of analysis of this article, we do need to look at a few cases where a mandatory distribution was coupled with a support or maintenance standard. For example, the distribution language stated the trustee was to pay "40% of the income to the decedent's wife for support and maintenance."^[10]

Support Interest

Under common law, the term support trust means that the distribution creates an enforceable

right in a beneficiary based on a standard. Generally, a support trust is created with mandatory words such as "shall" or "must" combined with a standard that is capable of judicial interpretation. For example, Courts have determined the following language to create a support trust.

"[T]he trustee shall pay...[to the settlor's] daughters such reasonable sums as shall be needed for their care, support, maintenance, and education" [emphasis added].^[11]

"[T]he Trustee shall use a sufficient amount of the income to provide for the grandchild's support, maintenance and education" [emphasis added].^[12]

"[T]he trustee shall administer the trust estate for the benefit of my wife and my said daughter, or the survivor of either, and the trustee shall apply the income in such proportion together with such amounts of principal as the trustee, in its discretion, deems advisable for the maintenance, care, support and education of both my wife and my said daughter" [emphasis added].^[13]

Discretionary Interest

For purposes of this article, the term common law discretionary trust refers to a trust where a beneficiary has neither an enforceable right to compel a distribution nor a property interest. At this point I need to clarify an area of confusion among some practitioners. The term "purely discretionary trust" or "wholly discretionary trust" under common law did not require that the distribution interest not have any standards. Rather, in the hundreds of cases on point, almost all common law discretionary trusts contained a standard for making distributions. Furthermore, in many, if not most states following the Restatement (First) and (Second), the standard could be ascertainable.

In determining the classification of a trust as a discretionary or support trust (i.e. interest), common law used a combination of usually two or more of the following four factors in order of importance to find that the settlor intended to create a discretionary interest.

1. Granting the trustee uncontrolled discretion with words such as "sole," "absolute," or "unfettered" discretion. This is the single most important factor and is the only factor required under the Restatement (Second) of trusts.
2. The use of the permissive word "may" rather than the mandatory word "shall or must." For examples, "The trustee may, in the trustee's sole and absolute discretion, make distributions to the beneficiaries"
3. Allowing the trustee to make unequal distributions between the beneficiaries.
4. The addition of words that were not ascertainable of judicial interpretation, such as "an emergency" or "happiness."

In almost all states, except for three to four hybrid states^[14], a common law discretionary trust would contain a standard, and under the Restatement (Second) this standard as well as most case law, this standard could even be ascertainable. For example, the following language would result in discretionary trust 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 his or her 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.

For purposes of this article, the term "common law discretionary trust" is distinguished from the Restatement Third's new definition of a discretionary trust. Unfortunately, ignoring almost all common law on the subject (hundreds of cases), the Restatement Third arbitrarily abolished the discretionary-support distinction. Presently, it does not appear that the courts have adopted the Restatement Third's newly created view of trust law. However, due to its possible future impact on spousal access trusts, it will be discussed in detail in part II of this series.

The Good

Using the above classification, there are primarily two types of trusts that do *not* create any estate inclusion issue: (1) A mandatory interest, without any standard; and (2) a common law discretionary interest.

A mandatory interest without any standard such as a QTIP, CRUT, or GRAT does not command the trustee to make a distribution for the beneficiary's support or maintenance.^[15] Therefore, there is not an estate inclusion issue by virtue of the mandatory distribution interest.

With a common law discretionary interest, a beneficiary has no enforceable right to a distribution, he or she does not hold a property interest, and no creditor, not even an exception creditor, may attach such interest. Therefore, a common law discretionary trust does not mandate the trustee to fulfill a support obligation of the settlor of a spousal access trust, and there is no estate inclusion issue by virtue of the discretionary distribution interest.^[16]

The Bad

A mandatory distribution interest that requires a distribution only for support or maintenance is fatal.^[17] For example in *Estate of Lee*^[18], husband created a trust for the benefit of his wife and then to his son. As to the wife, the distribution language state the

trustee "shall pay" the income "for her maintenance and support." The court in Lee noted that the settlor/husband had an obligation to support his wife, and that the decedent reserved an enforceable right^[19] to have the income applied toward his spouse's support.

In First Nat. Bank of Montgomery v. U.S., the District Court of Alabama noted that the trust instrument places an "obligation upon the trustee to pay the income to the wife for her support."^[20] The key to determine whether a spousal access trust creates a support obligation issue is whether the beneficiary has an *enforceable* right to demand a distribution for support. If so, the settlor also has an enforceable right to force the trustee to make a distribution for his or her support obligation.

The Ugly (the Grey Area)

In general, a support trust that states the "trustee shall make distributions to the beneficiaries for health, education, maintenance and support," has estate inclusion issues. *In Estate of Richards*, the Tax Court classified the following distribution language as support trust, by focusing on the words "shall" and the standard of support and maintenance.^[21]

"My Trustees *shall* pay to my wife Irene Merrill Richards for her maintenance and support the net income from my trust estate as such times as they in their sole discretion shall determine."

The Tax Court noted that the only discretion that was given was the times payments were to be made, and the settlor "*retained an enforceable right* to have the trust income used to discharge his legal obligation to support his wife."

In Estate of Gokey^[22], the taxpayer attempted to argue the words "care" and "welfare" allowed the trustee to distribute for something *other* than support.

"The Trustee *shall* use such part or all of the net income of his or her trust for the *support*, care, welfare, and education of the beneficiary thereof, payments from such net income to be made to such beneficiary or in such other manner as the Trustee deems to be in the best interest of the beneficiary, and any unused income shall be accumulated and added to principal of such beneficiary's trust."

The Tax Court stated that the above language which relates to "*shall* use such part or all of the income . . . for support, care, welfare, and education of the beneficiary clearly manifests decedent's intent to *require* the trustees to apply the income for a stated purpose." Once the Tax Court had concluded that the trust was a support interest, rather than a discretionary interest, the Tax Court went on to include that "care and welfare" were ascertainable under Illinois law, and referred to a beneficiary's accustomed standard of life. Therefore, the trustee did not have discretion to make payments for non-support purposes; rather such payments were mandatory and the trust was included in the settlor's estate.

Any spousal access trust that creates an enforceable right in a beneficiary to demand a distribution for support, also creates the same enforceable right in the settlor to force the

trustee to make a distribution for a support obligation. Hence, the common law support trust (i.e. interest) creates the greatest degree of complexity when drafting spousal access trusts, and these trusts will be discussed in detail in my next installment in this **LISI** series.

The Simple Solution to Solving the Estate Inclusion Issue

The simplest solution is to always create inter vivos *discretionary* spousal access trust. Under common law, the beneficiary does not have an enforceable right to a distribution, and therefore, the trustee is not required to use the trust property for the beneficiary's support. Since the beneficiary does not have an enforceable right to a distribution, then neither does the settlor have an ability to force the trustee to use the trust property for a support obligation. Also, a mandatory distribution that does not refer to any standard is a safe alternative when creating inter vivos spousal access trusts.

Conclusion:

Since the doctrine of independent significance has addressed the divorce issue, the popularity of spousal access trusts has greatly expanded. Those drafting common law discretionary trusts that by definition do not create an enforceable right in a beneficiary nor are a property interest, do not have an estate inclusion issue by virtue of the distribution interest.

The same is true for those who draft mandatory distribution interests that do not have any standard. For those who wish to draft spousal access trust with an ascertainable standard, further distinctions under common law as well as the possible impact of the Restatement (Third) of Trusts newly created continuum of discretionary trusts must be analyzed. The next installment of this two part series will discuss methods suggested to mitigate an estate tax inclusion of a support trust as well as drafting issues created by the Restatement Third of Trusts.

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

Mark Merric

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- [1] The modular approach to estate planning is trademarked by Mark Merric.
- [2] However, as explained in the third installment of this series, if there is a prearranged plan that distributions shall be used for the support of the spouse, there is a potential estate inclusion issue..
- [3] *Id.*
- [4] PLR 8819001; PLR 9141027; Rev. Rul. 80-255; *Estate of Tully*, 528 F.2d 1401 (Ct. Cl. 1976). Also see GCM 36681 where remarriage is also an "act of independent significance."
- [5] *Id.*
- [6] All state laws require a husband to support his wife, the reverse is also true in almost all states.
- [7] For creditor purposes, the Restatement Second provided spendthrift protection to both mandatory and support trusts, and therefore does not make a distinction between these two types of trust. The Restatement Third and the Uniform Trust Code do not provide protection for a mandatory distribution that has become overdue, thereby reducing the asset protection under common law and creating a third classification for creditor purposes.
- [8] The term "interest" is used rather than mandatory "trust," support "trust," or discretionary "trust" to provide a more precise term referring to the distribution interest, rather than the entire trust.
- [9] The Restatement (Third) of trusts arbitrarily eliminates the discretionary-support distinction. Restatement (Third) Section 50 Reporters Notes comment a.
- [10] *Commr. of Internal Revenue v. Dwight's Estate*, 205 F.2d. 298 (2nd Cir. 1953).
- [11] *In re Carlson's Trust*, 152 N.W.2d 434 (SD 1967).
- [12] *McElrath v. Citizens and Southern Nat. Bank*, 189 S.E.2d 49 (GA. 1972).
- [13] *McNiff v. Olmsted County Welfare Dept.*, 176 N.W. 2d 888 (Minn. 1970).
- [14] 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.
- [15] *Estate of Sullivan v. C.I.R.*, TC Memo 1993-531.
- [16] *Estate of Jack F. Chrysler*, 44 T.C. 55 (1965); *Commr. v. Douglass' Estate*, 143 F.2d 961 (3rd Cir. 1944); *Also see Lettice v. U.S.*, 237 F. Supp. 123 (S.D. Calif. 1964) as applied to minor dependent children.
- [17] *First Nat. Bank of Montgomery v. U.S.*, 211 F. Supp. 403 (D.C. Ala. 1962). *Estate of Lee v. C.I.R.*, 33 T.C. 1064 (1960); *Commr. of Internal Revenue v. Dwight's Estate*, 205 F.2d. 298 (2nd Cir. 1953).
- [18] *See Endnote 16.*
- [19] If a trust has either a mandatory distribution interest or a support distribution interest, the beneficiary has the ability to force a distribution pursuant the mandatory distribution or the ascertainable standard, as the case may be. The settlor may also enforce the terms of the trust, including the trustee's requirements to make distributions under a standard. Seldom is there an occasion where the settlor brings such an action. However, the Service's argument for estate inclusion is based on the ability of the settlor to do so.
- [20] *Supra* at 16.
- [21] Unfortunately, the drafting attorney of the trust conflicted the distribution language. He or she used discretionary language such as "sole and absolute" in combination with support language such as "shall" and an ascertainable standard of "maintenance and support."
- [22] *Estate of Gokey*, 72 T.C. 721 (1980). *Gokey* is not a spousal access trust case. However, a settlor also

has an estate inclusion issue if he or she creates a trust that satisfies an obligation to support minor children. The case is used in this article as an analogy of the same exact issue to illustrate the distribution language of a support trust.