Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1444
Date: 13-Apr-09
From: Steve Leimberg's Estate Planning Newsletter
Subject: Merric - Who Can Be Trustee - II

LISI readers are no doubt familiar with the informative and helpful commentary that **Mark Merric** has provided as part of his continuing series he refers to as the Modular Approach to Estate Planning.™ [[1]]

This **LISI** commentary is a continuation of Mark's Modular Approach to Estate Planning,™ It is a follow-up to Mark's "WHO CAN BE TRUSTEE" (**LISI Estate Planning Newsletter # 1414**) and focuses the following issue:

> Can a trustee/beneficiary, settlor's spouse, brother, sister, or parent serve as a sole trustee of a discretionary trust?

The Merric Law Firm, has a boutique practice 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. Mark speaks nationally on estate planning and asset protection and many of the topics he discusses in his publications are also available in his monthly webinar: http://www.InternationalCounselor.com/HotoffthePress.htm

EXECUTIVE SUMMARY:

The first installment of this series discussed the "Who Can Be a Trustee Matrix." The matrix had three dimensions with the first dimension dividing into two tables:

1) the *sole* trustee table; and

2) the *co-trustee* table.

The purpose behind this dimension is that there is the adverse co-trustee rule that turns off many estate inclusion rules, regardless of whether there is an

ascertainable standard.[[2]]

The *second* dimension notes that whether there is an estate inclusion issue also depends on whether the distributions standard is a common law discretionary distribution standard that is not limited by an ascertainable standard or whether the distribution standard is based on an ascertainable standard. The division of the second dimension is based on the ascertainable standard exception that prevents many estate inclusion issues.

The *third* dimension gives five different relationships to the settlor of persons who may serve as a trustee, noting that whether there is an estate inclusion issue also depends on these relationships.

The third dimension has been divided into five categories to discuss general power of appointment issues, support obligation issues as well as an analogy to Revenue Ruling 95-58 regarding persons that are not independent within the meaning of IRC § 672(c).

The five different categories of persons that may serve as trustee are:

1) Independent person within the meaning of IRC § 672(c);

2) Settlor;

3) Trustee/beneficiary, including a spouse who is a trustee and a beneficiary or a child who is a trustee and a beneficiary;

4) Settlor's spouse when he or she is not a beneficiary; and

5) Brothers, sisters, or parents.

For the sole trustee discretionary trust table, the first two relationships were analyzed in the first installment of this series. The last three are analyzed in this installment.

FACTS:

The following table summarizes the estate inclusion issues of the five relationships before any analysis of how a savings statute or savings clause

may mitigate an estate inclusion issue.

Sole Trustee Matrix					
	Independent Trustee	**Settlor**	**Trustee/ Beneficiary** (settlor's spouse)	**Settlor's Spouse** (not a beneficiary)	**Brother, Sister Parents**
Discretionary Distribution Standard	No estate Inclusion	Inclusion IRC § 2036(a)(2) § 2038	Inclusion IRC § 2041	Check for a support obligation	Uncertain Whether trustee powers will be attributed to the settlor
			Check for a support obligation	Uncertain Whether trustee powers will be attributed to the settlor	
			Uncertain Whether trustee powers will be attributed to the settlor		

TRUSTEE/BENEFICIARY AS SOLE TRUSTEE OF A DISCRETIONARY INTEREST

Assume H settles a trust and appoints his spouse W as a trustee. C1 and C2 are named beneficiaries. C1 and C2 are children of both H and W. W passes away while C2 is a minor and C1 is an adult.

If a trustee is also a beneficiary of a discretionary trust that is not limited by an ascertainable standard, the trustee may make distributions for the benefit of himself, his estate, or his creditor's without limitation. Therefore, the trustee/beneficiary holds a general power of appointment,[[3]] and upon the death of the trustee/beneficiary, the trust assets are included in the trustee/beneficiary's estate.

Since estate inclusion was found due to the GPA, the support obligation issue and possible attribution of trustee powers to the settlor under an analogy using Rev. Rul. 95-58 are not discussed in this section. The possible application of Rev. Rul. 95-58 by analogy when any person who is related to the settlor within the meaning of IRC § 672(c)[4] is discussed at the end of this article as well as a counter argument against attribution of a trustees powers.

From an income tax perspective, the distribution language is not limited to a reasonably definite standard under IRC § 674(b)(5) and § 674(d) and a related person is serving as a trustee. Therefore, the trust will be classified as a grantor trust under the general rule of IRC § 674(a).

SPOUSE AS SOLE TRUSTEE, NOT A BENEFICIARY-DISCRETIONARY TRUST

Assume H settles a trust and appoints his spouse W as a trustee. C1 and C2, who are children of both H and W, are named beneficiaries. W is not a beneficiary. C1 and C2 are children of both H and W. W passes away while C2 is a minor and C1 is an adult.

In this scenario, there are two issues that need to be analyzed:

1) Whether a spouse has a support obligation for a beneficiary; and

2) Whether the trustee's powers will be attributed to the settlor.

Since the possible trustee attribution issue applies to anytime a related person serves as a trustee of a discretionary trust, it is discussed in detail under the Rev. Rul. 95-58 issues at the end of this article.

If a spouse has a support obligation for a beneficiary, then there is an estate inclusion issue.[[5]] Until a child reaches the state age of majority, a parent has a support obligation for any child. Even after a child reaches the age of majority, if the child is disabled, in most states a parent continues to have a support obligation.

In the example, C2 is age 16. If the settlor's spouse dies when C2 is a minor, there is an estate inclusion issue[[6]] in the sense that W could have made

distributions to the minor to fulfill a support obligation. If C2 attains the age of majority before W passes away, the estate inclusion issue disappears. [[7]]

While there is no foolproof method to completely eliminate this possible estate inclusion issue, the potential of estate inclusion may be greatly reduced with a savings statute and possibly a savings clause.

For example, a trustee support obligation savings clause reads something similar to:

> "The Trustee may not make any distributions that constitute a support obligation."

The analysis of savings clauses or savings statutes is actually quite a complex process and will be discussed in the *next* installment of this series. Further, regardless of savings statutes or savings clauses, there is no substitute for knowing who can be a trustee rules and avoiding the issue completely.

In the example above, the conservative solution would be not to appoint W as a trustee.

From an income tax perspective, since the distribution standard is not limited to a reasonably definite standard under IRC § 674(b)(5) and IRC § 674(d) and a related person is serving as a trustee, the general rule of IRC § 674(a) applies and the trust is classified as a grantor trust as to income under IRC § 674(a).

BROTHER, SISTER OR PARENT AS TRUSTEE

Assume H creates a discretionary trust with C1 and C2 as beneficiaries. H appoints his mom as the sole trustee. In almost all cases[[8]], a parent, brother, or sister does not have a support obligation for one of the settlor's children.[[9]]

On the other hand, whether the trustee's powers will be attributed to the settlor when a brother, sister, or parent serves as a trustee of a discretionary trust not limited by an ascertainable standard is unknown. The possible application of Revenue Ruling 95-58 by analogy is discussed below.

On another note, from an income tax perspective, since the distribution

standard is not limited to a reasonably definite standard under IRC § 674(b)(5) and IRC § 674(d) and a related person is serving as a trustee, the trust is classified as a grantor trust under IRC § 674.

ANALOGY TO REVENUE RULING 95-58

Even if all of the child beneficiaries are adults and the spouse is not a beneficiary, it is unclear whether a spouse may serve as the trustee of a discretionary trust that is not limited by an ascertainable standard. It is also unclear whether a brother, sister, or parent may serve as a trustee.

Many conservative estate planners worry that the Service may assert an estate inclusion issue by attributing the trustee's powers to the settlor if the trustee is related or subordinate within the meaning of IRC § 672(c). This estate inclusion concern is not based on direct authority, rather it is based on an analogy to Rev. Rul. 95-58.

Rev. Rul. 95-58 deals with removal/replacement powers held by the settlor of a discretionary trust that was not limited by an ascertainable standard. The removal/replacement issue will be discussed in detail in an upcoming installment of this series.

In summary, this revenue ruling provides a safe harbor where the Service will not attribute the trustee's powers to the settlor if the settlor of a discretionary trust that is not limited by an ascertainable standard holds an unrestricted removal power over a trustee for so long as the settlor may only simultaneously replace the trustee with someone who is independent under IRC § 672(c). Spouses, brothers, sisters, and parents are all related, and therefore, not independent under IRC § 672(c).

If the trustee's powers are attributed to the settlor, because the settlor's spouse, brother, sister, or parent is serving as trustee, then the trust would be included in the settlor's estate under both IRC §§ 2036(a)(2) and 2038. This is because the settlor by attribution of the trustee's powers would have the ability to determine who and when distributions were received by beneficiaries.

To date, it does not appear that the Service has pursued the possible attribution issue.

AN ANOLOGY TO SPECIAL OR LIMITED POWERS OF APPOINTMENT

Many times a settlor will give a beneficiary or his spouse a special (i.e. limited) power of appointment where the power holder has the ability to appoint trust property among certain beneficiaries.

A special power of appointment is personal, and can be exercised in the complete discretion of the power holder. Seldom does a special power of appointment create an estate inclusion issue.

Conversely, how different is a *trustee*'s discretionary power to distribute property in a common law discretionary trust.[[10]] With a common law discretionary trust, a beneficiary does not have an enforceable right to a distribution or hold a property interest.[[11]] A trustee's discretion generally can only be reviewed if the trustee:

1) Fails to use its judgment;

2) Acts dishonestly; or

3) Acts with an improper motive.[[12]]

There is no reasonableness standard of review with a common law discretionary trust.[[13]] While a trustee of a common law discretionary trust is a fiduciary, its duties and ability to distribute the property among certain named beneficiaries it its discretion is fairly close to the power holder of a special power of appointment.

If a related person's absolute uncontrolled discretion by virtue of a special power of appointment does not result in attribution to the settlor, why would a slightly lesser degree of uncontrolled discretion by serving as trustee result in attribution of the trustee's powers to the settlor?

Based on this analogy of a holder of a special power of appointment to the trustee of a common law discretionary trust, many estate planners take the view that there should be no attribution of a trustee's powers to the settlor when a spouse, brother, sister, or parent serves as a trustee of a discretionary trust.

COMMENT:

Camp 1: *Independent* Trustee Only Way To Go:

From the summary table in the Executive Summary above, one camp of drafters concludes that the conservative approach is to only have an *independent* trustee serve as the trustee of a discretionary trust that is not limited by an ascertainable standard. In this case, the trust does not fulfill any support obligation of the settlor, because it is discretionary.

Under this theory, the drafting attorney does not need to worry about whether a spouse has a support obligation to a minor beneficiary, when a savings clause will be effective, or whether the Service may someday assert an analogy based on Rev. Rul. 95-58.

Camp 2: No Problem Using Sibling or Parent as Sole Trustee:

A second camp of drafters finds that an analogy under Rev. Rul. 95-58 is not appropriate based on the fact that a special power of appointment almost never creates an estate inclusion issue. This camp sees no issue with a brother, sister, or parent serving as the sole trustee of a discretionary trust that is not limited by an ascertainable standard.

If a spouse is not a beneficiary and the children are not minors or disabled, this camp also does not see a problem with a spouse serving as the sole trustee of a discretionary trust not limited by an ascertainable standard. If a spouse, brother, sister, or parent is serving as the sole trustee, this camp acknowledges that the trust will be classified as a grantor trust.

Camp 3: Savings for Rainy Day

Finally, in the third camp, some drafters discuss how savings statutes and savings clauses may alleviate many of the estate tax inclusion issues, which will be the subject of the next commentary in this series.

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] IRC § 2041(b)(1)(C)(ii).

[3] IRC § 2041. The ascertainable standard exception does not apply by definition of the common law discretionary trust distribution standard. Also, since the trustee/beneficiary is the sole trustee, the adverse co-trustee exception cannot apply.

[4] Spouses, brothers, sisters, and parents are all related to the settlor within the meaning of IRC § 672(c).

[5] Treas. Reg. §20.2041-1(c).

[6] Rev. Rul. 79-154; *Townsend v. Thompson*, 50-2 USTC P 10,8780 (Ark. W.D. 1950), 1950 WL 6770 where the settlor held such power in his capacity as trustee, but upon age of a child attaining age of majority there is no longer an estate inclusion issue.

[7] Rev. Rul. 79-154.

[8] Naturally, if the parent, brother, or sister legally adopts the settlor's child, then by adoption they would have a support obligation under state law to support the trust.

[9] Further, even if W, the settlor's spouse is a beneficiary, and it is one of W's parents who is the trustee, W will almost always be over age 18, and one of W's parents will not have a support obligation to W – unless W is disabled.

[[10]] The term "common law discretionary trust" is used to distinguish the common law definition from the virtually unsupported view of discretionary trusts where a beneficiary almost always has an enforceable right to a distribution espoused by the Restatement (Third) of Trusts. The term "common law discretionary trust" also means that the distribution standard the extended discretion by using words similar to "sole, absolute, or uncontrolled" discretion.

[[11]] Colorado	*In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991); *Ramey v. Rizzuto,* 72 F. Supp. 2d. 1202 (D.Colo. 1999); *U.S. v. Delano*, 182 F.Supp.2d 10, (D. Colo. 1991).
Connecticut	*Dryfoos v. Dryfoos*, 2000 WL 1196339 (Conn. Super. 2000) not reported; *In re Britton*, 300 B.R. 155 (Bankr. D. Conn. 2003).
Florida	Florida UTC § 736.0504, recognizing that a beneficiciary's interest may not be a property interest with the words "if any' and "might have" added by the 2007 amendment.
Illinois	*In re Pritzker*, 2004 WL 414313 (Ill. Cir. 2004) – not reported.
Indiana	*U.S. v. Grim*, 865 F. Supp. 1303 (N.D.Ind. 1994).
Kansas	*In re Pechanec*, 59 B.R. 899 (Bkrtcy D.Kan. 1986).
Massachusetts	*D.L. v. G.L.*, 811 N.E. 2d 1013 (Mass. App. 2004).
Minnesota	*U.S. v. O'Shaughnessy*, 511 N.W.2d 574 (Minn. 1994).
Missouri	M.S. 456.5-504.
New Jersey	*Pulizzoto v. U.S.*, 1990 WL 120670 (D. N.J. 1990) – not reported.
New York	*In re Duncan's Will*, 362 N.YS.2d 788 (N.Y.Surr. 1974).
Ohio	*In re Eley*, 331 B.R. 353 (Bkrtcy S.D. Ohio 2005) – Bankruptcy §541(c)(2).
Pennsylvania	*Lang v. Comm., Dept. of Public Welfare*, 528 A.2d 1335 (PA. 1987).
South Dakota	*First Northwestern Trust Co. of South Dakota, v. IRS*, 622 F.2d 387 (D Ct. 1980) and SDCL 55-1-43.
Texas	*Bass v. Denney*, 171 F.3d 1016 (5th Cir. 1999); *In re Watson*, 325 B.R. 380 (Bkrtcy S.D. Tex 2005); *In re Shurley*, 171 B.R. 769 (BkrtcyW.D. Tex. 19940).
Tennessee	*In re Cassada*, 86 B.R. 541 (Bkrtcy E.D. Tenn. 1988) §541(c)(2).

In addition to the above cases holding that a discretionary interest is neither an enforceable right nor a property interest, *Restatement (Second) Section 155 (1) and comment b.* explains it is the nature of the beneficiary's interest, not spendthrift protection, that prevents a creditor from reaching a beneficiary's interest.

[[12]] *Restatement (Second) Sec. 187 comment j. and Section 122.* While this is not the judicial standard of review adopted by all courts, it is by far the most common discretionary trust judicial review standard with courts from 14 states and two countries using it.

Colorado	*In re Jones*, 812 P.2d 1152 (Colo. 1991); *In re Guinn*, 93 P.2d 568 (Colo. App. 2004)
Connecticut	*Auchincloss v. City Bank Farmers Trust Co.*, 70 A.2d 105 (Conn. 1946)
Iowa	In re Tone's Estates, , 39 N.W.2d 401, (Iowa 1949); *Wright v. Wright*, 2002 WL 1071934 (Iowa App. 2002) – not cited for publication

Illinois	*Croslow v. Croslow,* 347 N.E. 2d 800 (Ill. App. 1976)
Kansas	*Simpson v. State, Dept. of Social and Rehabilitation Services***,** 906 P.2d 174 (Kan.App. 1995); *Kansas Dept. of Social and Rehabilitation Services***,** 866 P.2d 1052 (KS 1994)
Maryland	*First Natl. Bank v. Dept. of Health & Mental Hygiene,* 399 A.2d 891(Md. 1979).
Massachusetts	*Town of Randolph v. Roberts,* 195 N.E.2d 72 (Mass. 1964).
New York	*Vanderbilt Credit Corp. v. Chase Manhattan Bank, Natl. Assocn.* 473 N.Y.S.2d 242 (N.Y. 1984).
Ohio	*In re Ternansky's Estate,* 141 N.E. 2d 189 (1957); *Culver v. Culver,* 169 N.E. 486 (1960); *Thomas v. Harrison,* 191 N.E.2d 862 (1962)
Oregon	*Barnard v. U.S. Natl. Bank,* 495 P.2d 766 (Or. App. 1972).
Pennsylvania	*Lang v. Commonwealth, Dept. of Public Welfare,* 528 A.2d 1335 (Pa. 1987)
Rhode Island	*Chenot v. Bordeleau,* 561 A.2d 891 (R.I. 1989)
South Dakota	SDCL 55-1-43(3)
Texas	*Ridgell v. Ridgell,* 960 S. W. 2d 144 (Tex. App. 1997)
England	*Re Trafford's Settlement: Moore v. Inland Revenue Commissioners,* 1 All E.R. 1108 (Ch. D.) 1984
Canada	*Minister of Community & Social Services v. Henson,* C.C.L. 3069 (Ont. C.A.) – because trustees have unfettered discretion as to whether to pay income or principal to handicapped beneficiary, beneficiary cannot compel payment, so beneficiary has no "liquid assets" that disqualify him for an allowance as a disabled.
	In re Maw, 1 D.L.R. 365 (Man.) 1953

[[13]] *Restatement (Second) Section 187 comment j.*