

**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1414**

**Date:** 08-Feb-09

**From:** Steve Leimberg's Estate Planning Newsletter

**Subject:** Who Can Be Trustee

**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.<sup>TM</sup> [1]

This **LISI** commentary is a continuation of Mark's Modular Approach to Estate Planning,<sup>TM</sup> and focuses on an issue that is sure to arise in every practice at one time or another:

“When is it wise and appropriate (and safe) for a settlor, settlor's spouse, child/beneficiary serve as a *sole* trustee of an irrevocable trust?”

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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:**

When attending estate planning conferences, we often hear many “rules of thumb” regarding “who can be a trustee” of an irrevocable trust. For example, “Can (should) a settlor ever be the trustee of an irrevocable trust he/she created? “When should the surviving spouse *not* serve as a sole trustee of a credit shelter trust or an irrevocable trust?” “When should a child who is also a beneficiary not serve as a trustee?”

Many planners erroneously think that an ascertainable standard is the magic pill that cures all estate tax inclusion issues. Others will say, even if there is an estate tax inclusion issue, many states have savings statutes that will many times cure an estate tax inclusion disease.

Unfortunately, even with an ascertainable standard, savings clauses, and statutes designed to cure estate inclusion infections, there is no absolute cure - other than to know the “Who Can Be a Trustee” estate inclusion rules and plan accordingly.

Due to the complexity of the estate inclusion issues, Part 1 of this **LISI** commentary develops a three dimensional “matrix” to break down and explain the various estate inclusion issues.[2]

## **FACTS:**

When building our matrix, the following factors intertwine to determine whether there is an estate inclusion issue:

1. Whether there is a sole trustee or there are co-trustees?
2. Whether the distribution standard is discretionary (not based on an ascertainable standard) or whether the distribution standard is based on an ascertainable standard[2];
3. The relationship of the trustee to the settlor (i.e. is the trustee the settlor, settlor’s spouse, child/beneficiary, parent, brother, sister, or someone independent under IRC § 672(c));
4. Whether there is a state statute or savings clause contained within the trust that:
  - a. prohibits a trustee/beneficiary from making a distribution that would be deemed a support obligation; and/or
  - b. changes the distribution standard so that as to distributions made to the trustee they would now be limited to an ascertainable standard.

5. Finally, as to a spouse, parents, brothers, and sisters, who are related within the meaning of IRC § 672(c), some planners have expressed a possible attribution argument related to removal/replacement powers under Rev. Rul. 95-58. Conversely, other planners cite a couple of cases that predate Rev. Rul. 95-58 holding that when these persons serve as trustee there should not be an estate inclusion issue.

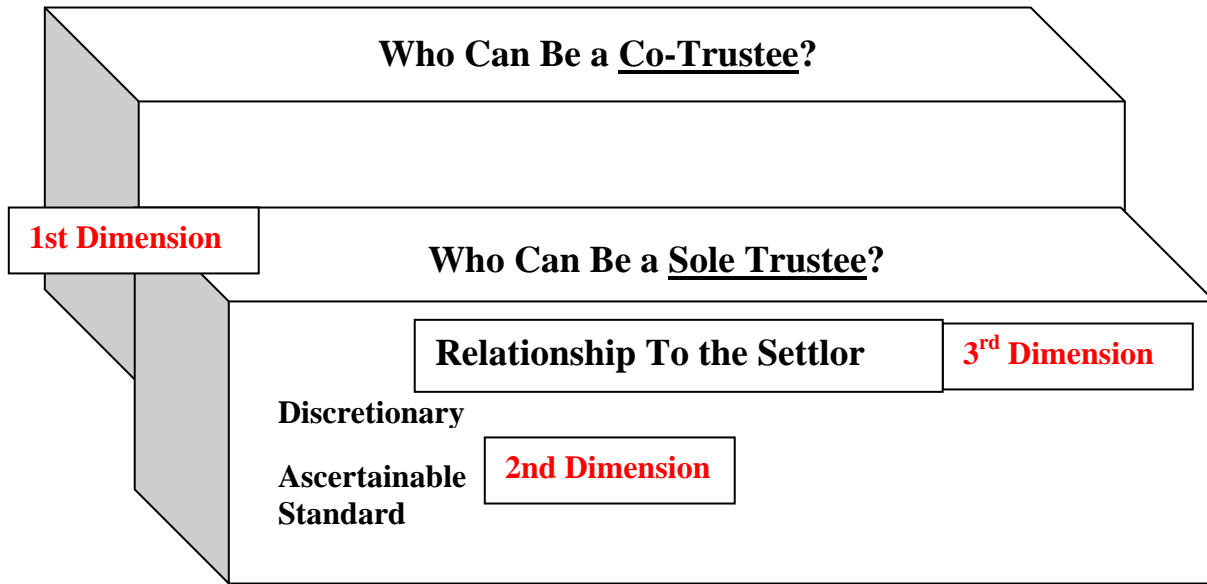
This “Who Can Be a Trustee” series assumes that the estate planner has already addressed any potential estate inclusions issues of a spousal lifetime access trusts addressed in [LISI Estate Planning Newsletter #s 1334, 1368, 1379](#).

### **The “Who Can Be a Trustee” Matrix**

Our analysis begins with a three dimensional matrix, with the first three factors listed above:

- a. whether there is a sole trustee or a co-trustee;
- b. the distribution standard and whether it is based on an ascertainable standard; and
- c. the relationship of the trustee to the settlor.

To simplify the matrix, we will turn the three dimensional matrix into two separate tables [3], with “Who Can Be a Sole Trustee” on one table and “who can be a co-trustee” on the second table. For the first few installments of this article, we will only discuss the “Who Can Be a Sole Trustee” table.



### The Sole Trustee Table

Inside the matrix, the second and third dimensions of the sole trustee are the distribution standard on the vertical axis and the relationship to the settlor on the horizontal axis. However, before we begin analyzing who can be a sole trustee, the following blank table is given to visually aid with the concept.

### Sole Trustee Table

		Relationship to the Settlor (Third Dimension)				
		IRC § 672(c)	Settlor	Trustee/ Beneficiary	Settlor's Spouse	Brother, Sister, Parents
Distribution Standard (Second Dimension)	Discretionary					
	Ascertainable Standard					

As can be seen from the above diagram under the third dimension, there are

five relationships with the settlor that are analyzed. Yet, before we begin the analysis of these relationships to the settlor, we first must analyze the second dimension and define the types of distribution standards for tax purposes.

### **The Second Dimension – Types of Tax Distributions Standards**

The term “discretionary trust” has different meanings depending on the context. For creditor purposes and determining a beneficiary’s rights to a distribution, the common law definition of a discretionary trust [4](as defined by the Restatement (First) of Trusts, and Restatement (Second) of Trusts, and almost all case law) means a beneficiary does not have an enforceable right or a property interest.[5] Further, under common law, almost cases discussing discretionary trusts were coupled with some kind of standard.[6] Under the Restatement (Second) of Trusts, a discretionary trust could be limited by the ceiling[7] of an ascertainable standard. [8]

Regarding estate inclusion issues, the Internal Revenue Code divides trusts into two primary categories:

- a. those that are based on an ascertainable standard; and
- b. those that are discretionary that are not based on ascertainable standard.[9]

Examples of discretionary trusts that are not based on an ascertainable standard are as follows.

- “The trustee, in the trustee’s sole and absolute discretion, may make distributions to the beneficiaries listed in Article II.” With this distribution standard, there is no standard for making distributions.
- “The trustee, in the trustee’s sole and absolute discretion, may make distributions for comfort, welfare, and happiness.”
- “The trustee, in the trustees’ sole and absolute discretion, may make distributions for health, education, maintenance, support, comfort, general welfare, and happiness”

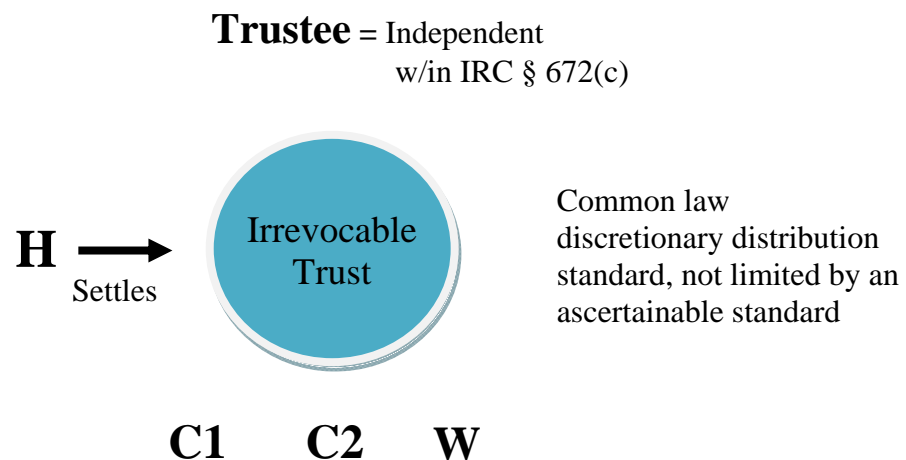
## The Third Dimension – Trustee’s Relationship to the Settlor

After defining the second dimension by dividing the analysis between discretionary trusts not based on an ascertainable standard and trusts with distribution standards that are based on an ascertainable standard, the third dimension must be defined. The third dimension divides the estate inclusion issues and potential issues based on the relationship of the trustee to the settlor with particular emphasis on those that related to the settlor within the meaning of IRC § 672(c). This LISI commentary will discuss the following five relationships to the settlor:

1. An independent person within the meaning of IRC § 672(c);
2. The settlor himself or herself serving as a trustee;
3. A trustee/beneficiary – either spouse or child;
4. The settlor’s spouse when he or she is not a beneficiary of the trust
5. Parents, brothers, and sisters.

### Independent Person Within the Meaning of IRC § 672(c)

The following diagram depicts an independent trustee as the trustee, who can make discretionary distributions that are not based on an ascertainable standard. An independent person is anyone who is not the settlor’s brother, sister, spouse, parents, descendant by blood or adoption or anyone the settlor sends a W-2 to. An independent person is a trust company, CPA, attorney, aunt, uncle, cousin, spouse’s brother or sister, or any friend.



If the trustee is unrelated to the Settlor within the meaning of IRC 672(c), [10] there is no estate tax issue, unless the trust is created to provide for a support

obligation of the settlor.[11]

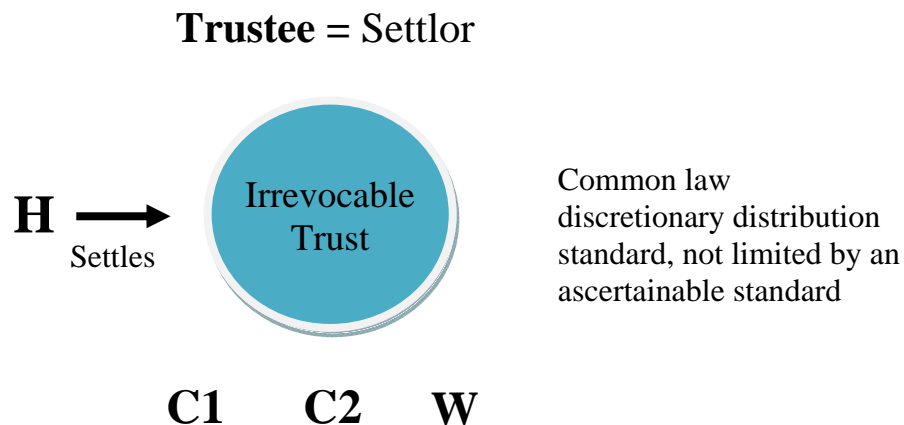
As I previously discussed, in the spousal lifetime access trust **LISI** series, the simplest way to avoid the estate tax inclusion issue was to create a common law discretionary trust, since there was no requirement that the trustee make distributions to the spouse, she had no enforceable right to a distribution and there was no estate tax inclusion issue.

Since the spouse did not have an enforceable right to a distribution, when the settlor created the trust, there was no requirement that the trustee provide for a support obligation of the settlor. The same would be true for any child who was under age of majority or was disabled. In this respect, an independent trustee creates no estate inclusion issue for a common law discretionary trust.

On another note, there is also no grantor trust tax classification by virtue of an independent trustee serving as a trustee. This is because the independent trustee exception of IRC § 674(c) turns off the general grantor trust status created under IRC 674(a).

### Settlor as a Trustee of a Discretionary Trust

The following diagram depicts the settlor as the trustee of a common law discretionary trust that is not limited by an ascertainable standard.



Under, IRC § 2036(a)(2) the right to designate the persons who shall possess or enjoy the property or income there from creates an estate inclusion issue. Also, under § IRC 2038, the power to alter, amend, revoke, or terminate

includes a power affecting the time and manner of enjoyment creates and estate inclusion issue.[12]

In U.S. v. O'Malley, [13] the settlor was one of three trustees of a discretionary trust, not based on an ascertainable standard, and the U.S. Supreme Court held the trust was included in the decedent's estate pursuant to the predecessor of IRC § 2036(a)(2). Also see, Estate of Grossman; [14] PLR 200419011, and Rev. Rul. 73-153 where "The value of an inter vivos trust is includible in the settlor-trustee's gross estate if he was empowered to invade corpus for unspecified 'special needs' of the beneficiary, but not if the 'special needs' were limited to support and education."

From a gift tax perspective, the Settlor never relinquished dominion and control, because the Settlor retained the power to change the interests of the beneficiaries as between themselves. [15] Therefore, there was no completed gift when transfers were made to the trust.

Finally, from an income tax perspective, if the Settlor serves as a trustee, since the distribution standard is not limited by a "reasonably definite standard," the trust will be classified as a grantor trust. [16]

## **COMMENT:**

This first installment of "Who Can Be a Trustee" began with a three dimensional matrix. The first dimension noted that there is a difference between the rules between sole trustees and co-trustees. Therefore, this dimension was split into two separate tables:

- (1) the sole trustee table; and
- (2) the co-trustee table.

The second dimension notes that whether there is an estate inclusion issue also depends on whether the distributions standard is a discretionary trust that is not based on an ascertainable standard or whether the distribution standard is based on an ascertainable standard.

The third dimension gives five different relationships to the settlor, noting that whether there is an estate inclusion issue also depends on these relationships.



Regarding the sole trustee table under the discretionary distribution standard the following two relationships were analyzed in this **LISI** installment with the following conclusions.

- a. An independent person within the meaning of IRC § 672(c) is the most conservative option to solve a potential estate tax inclusion issue of who can be the sole trustee of a discretionary trust that is not limited by an ascertainable standard.
- b. The settlor should not serve as the sole trustee of a discretionary trust that is not based on an ascertainable standard due to the estate inclusion issues of IRC § 2036(a)(2) and IRC § 2038.

The next installment of this article discusses possible estate inclusion issues when the settlor's spouse, brother, sister, or parents serve as a trustee of a discretionary trust that is not limited by an ascertainable standard.

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

*Mark Merric*

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[2] A later installment of this LISI shall discuss whether the ascertainable standard must provide both a ceiling, which is the greatest amount the trustee may distribute, as well as a floor, which is a minimum amount that the trustee may distribute.

- [3] For purposes of this article, the matrix is three dimensional, but the tables are two dimensional.
- [4] The term “discretionary trust” in this paragraph is referring to one where the trustee has been granted uncontrolled discretion by using words such as “sole, absolute, or uncontrolled discretion.”
- [5] Contrary to the assertion of a couple of UTC proponents, the vast majority of discretionary case law holds that a discretionary interest is not a property interest.

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

- [6] Contrary to the virtually unsupported view apparently expressed by certain UTC proponents, in hundreds of cases, regarding the discretionary-support distinction, virtually all of them, if not all of them, contained a distribution standard. The same is

true regarding the tax cases discussing discretionary trusts - to the author's knowledge all of these discretionary trust cases also contain a distribution standard.

- [7] A discretionary distribution standard that limits distributions than to no more than health, education, maintenance, and support is referred to as discretionary trust limited by an ascertainable standard. The Second Restatement primarily focus on whether the distribution language uses words of unfettered discretion, such as “sole, absolute, uncontrolled, or unfettered” as the strongest factor indicating the settlor wished to create a discretionary trust.
- [8] Regarding this point, it appears the Restatement Third has not gained acceptance by the courts regarding its attempt to rewrite the definition of a discretionary trust. Since its definition is not relevant for discussion estate inclusion issues attributable to trustees, it is not discussed in this article. Rather, possible estate inclusion issues under the Restatement Third were discussed in Spousal Lifetime Access Trusts LISIs (Estate Planning Newsletters # 1334; # 1368; and # 1379) and Self Settled Estate Planning Trusts (Estate Planning Newsletter # 1339).
- [9] 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).
- [10] A person is related to the settlor within the meaning of IRC 672(c) if the person is a brother, sister, spouse, parent, child, grandchild, great grandchild or any person the settlor sends a W-2 too.
- [11] *Commr. V. Dwight’s Estate*, 205 F.2d 298 (2<sup>nd</sup> Cir. 1953); *First Ntl. Bank of Montgomery v. U.S.*, 211 F. Supp. 403 (D. Ala. 1962); and *Est. of Stephen L. Richards*, TC Memo 1965-263.
- [12] Treas. Reg. 20-2038-1(a).
- [13] *U.S. v. O’Malley*, 383 U.S. 627 (1966).
- [14] *Estate of Grossman*, 27 TC 707 (1957)
- [15] Treas. Reg. 25.2511-2(c) and the above example, the power was not a fiduciary power limited by a fixed or ascertainable standard).
- [16] Without a reasonably definite standard[16], the general rule under IRC § 674(a) applies, since the distribution language fails to meet the exceptions of IRC § 674(b)(5) and § 674(d).

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