

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1379

Date: 02-Dec-08

From: Steve Leimberg's Estate Planning Newsletter

Subject: The Good, Bad, and Ugly of Spousal Access Trusts - Part III

Mark Merric is Principal of the **Merric Law Firm**, 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>

Rod Goodwin is the founder of **The Commonwealth Group**, a firm that 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 spousal support trust. It's part of Mark's continuing series known as the **Modular Approach to Estate Planning**.TM^[1]

EXECUTIVE SUMMARY:

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 an irrevocable trust, the trustee may make distributions to the beneficiary-spouse. However, when a settlor creates a SLAT that gives the

spouse/beneficiary an enforceable right to a distribution for support, the settlor has an estate inclusion issue. This is because the beneficiary/spouse may force the trustee to make a distribution for his or her support, which at the same time gives the settlor a right to force the trustee to make a distribution to the settlor/spouse for a support obligation of the Settlor.

FACTS:

The first installment of this **LISI** series, [Estate Planning Newsletter # 1334](#), noted the easiest way to draft out of a SLAT estate inclusion issue was to draft a discretionary trust where the beneficiary did not have an enforceable right to a distribution.

The second installment, [Estate Planning Newsletter # 1368](#), noted how the Restatement of Trusts Third ("Restatement Third") has rewritten the common law definition of a discretionary trust so that beneficiaries of virtually all discretionary trusts will almost always have an enforceable right to a distribution.

It also noted that the Restatement Third also reversed the common law regarding whether a trustee had an obligation to look to a beneficiary's resources prior to making a distribution, by taking the position that a trustee must do so.

It was noted that these two views, (1) a present right to demand a distribution and (2) a trustee requirement to look at other assets available to the beneficiary before making a distribution, if both are adopted, should mitigate the estate inclusion issue.

However, if a state court adopts the Restatement Third's new view of discretionary trusts where a beneficiary almost always has an enforceable right to a distribution but not an obligation to look to the beneficiary's resources before making a distribution, the Restatement Third would create an estate inclusion issue with almost all spousal lifetime access *support* trusts that do not contain savings language as discussed below.

In response to the SLAT issue, as well as many other problems created by the Restatement Third's new view of discretionary trust law, some states have begun codifying the Restatement Second, and for trusts sited in those states, a

common law discretionary spousal access trust does not have an estate tax inclusion issue.

Conversely, if the drafting attorney uses highly discretionary language, such language should hopefully create a discretionary interest where a beneficiary does not have an enforceable right to a distribution under the Restatement Third. For support trusts where a spouse/beneficiary has an enforceable right to a distribution, in order to prevent an estate inclusion issue with a SLAT, the drafting attorney should include either a savings clause (sometimes referred to as an "Upjohn clause"^[2]) or distribution language that requires the trustee to look to a beneficiary's resources, including the settlor's obligation to support the beneficiary, before making a distribution.

When such a savings clause or distribution language is used, there should not be an estate inclusion issue with a spousal access trust for the settlor, due to a retained right under Code Section 2036. However, a different pragmatic issue arises: As long as the settlor is alive, can the trustee make any distributions to the spouse/beneficiary? In other words, the trust gives the spouse an enforceable right to a distribution for health, education, maintenance, and support ("HEMS"). However, the trustee cannot make a distribution to the extent that the settlor/spouse has an obligation to pay for HEMS.

In the event that the settlor/spouse's support obligation is equal to or greater than the trustee's duty to distribute for HEMS, the trustee could never make a distribution to the spouse/beneficiary as long as the settlor is alive. This being the case, the purpose of the SLAT would many times be defeated because distributions most likely could not be made back to the family unit when desired unless circumstances had changed, as discussed later in this article.

Background:

A drafter has a couple of options in order to draft around the estate inclusion issues of SLAT. The simplest method is to draft a discretionary distribution interest where the spouse had no enforceable right to a distribution. Under common law, this was relatively easy.

Conversely, the Restatement Third rewrote the definition of a discretionary trust to specifically create an enforceable right to a distribution in most discretionary interests, with the result that only highly discretionary distribution language would avoid creating an enforceable right to a

distribution.

The Restatement Third mitigates this issue by also reversing the common law and requiring a trustee to look to a beneficiary's resources before making a distribution.

Unfortunately, absent a statutory fix that codifies the Restatement Second, a court may only adopt the newly created enforceable right discretionary trust view of the Restatement Third, and ignore the need to review the other resources available to the beneficiary before exercising discretion.

With this considerable uncertainty created by the Restatement Third, drafting attorneys cannot hope and pray that either a court will reject the Restatement Third's new view of discretionary trust law or hope that it adopts all of it in its entirety, including an obligation to look to the settlor's resources available to support the beneficiary. Rather, as one alternative, drafters should use highly discretionary language that to the greatest extent possible will not create an enforceable right in a beneficiary to demand a distribution, or site the trust in a jurisdiction that has codified the Restatement Second.

For drafters who wish to use an ascertainable standard, which will always create an enforceable right to a distribution under the Restatement Third and many times depending on the rest of the distribution language under the Restatement Second, there are the following two methods that are commonly used to mitigate the settlor's estate inclusion issue with a spousal access trust:

1. Including a savings clause that prevents the trustee from making a distribution that would discharge the settlor's support obligation;
or
2. Require the trustee to look to the beneficiary's other resources, specifically including a settlor's obligation to support a beneficiary, before making a distribution.

For the most part, these techniques are similar in result, but are discussed separately because one is a "savings clause" and the second restricts the distribution language.

Drafting Around the Restatement (Third) of Trusts

For SLAT, the use of a discretionary trust that does not create an enforceable

right to a distribution is by far the most preferable option. This is because generally the primary purpose of a SLAT is to be able to distribute trust property back to the family unit without severe limitations.

As noted in our prior LISI, if a court adopts the Restatement Third position, only some of the most discretionary distribution language will keep the spousal access trust so that the beneficiary does not have an enforceable right to a distribution. I am hopeful the following language would accomplish this purpose:

My Trustee may distribute as much of the net income and principal as my Trustee, in its sole, absolute, and unfettered discretion, determines to any beneficiary listed in Section 1.07. My Trustee, in its sole, absolute, and unfettered discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them. Also, my Trustee, in its sole, absolute and unfettered discretion may distribute all of the income and principal of this Trust to one of the beneficiaries and exclude all other beneficiaries from any of the Trust Property. The power to make a distribution, in my Trustee's sole, absolute, and unfettered discretion, includes the power to withhold making a distribution to any beneficiary in my Trustee's sole, absolute, and unfettered discretion.

In keeping with the wholly discretionary nature of this trust and all separate trusts created hereunder, no beneficiary, except as regards to any irrevocable vesting in the beneficiary's favor, shall have any ascertainable, proportionate, actuarial or otherwise fixed or definable right to or interest in all or any portion of any trust or its property. It is my intent that the trustee have all of the discretion of a natural person, and that a potential distribution beneficiary holds nothing more than a mere expectancy. It is also my intention that the above language be interpreted so as to provide my Trustee with the greatest discretion in making distributions allowed under law.

Distributions made to a beneficiary under this Article shall not be considered advances and shall not be charged against the share of such beneficiary that may be distributable under other provisions of this agreement. Any undistributed net income shall

be accumulated and added to the principal of the trust."

While I am hopeful that the above language is so discretionary that a beneficiary does not have an enforceable right to a distribution, the Restatement Third provides no guidance on how this is achieved.

Uniform Trust Code

Whether the Uniform Trust Code follows the Restatement Third's view of creating an enforceable right to a distribution in discretionary trusts has been highly debated. This is still the case, even after the 2005 Uniform Trust Code amendments were made in response to concerns expressed over this and other asset protection issues.

Furthermore, several Uniform Trust Code state committees have responded by making more comprehensive changes to their state statutes to address the enforceable right and other asset protection issues.

- The Missouri, and proposed Michigan Uniform Trust Code, provide that the beneficiary of a discretionary trust has "neither an enforceable right nor a property interest."^[3]
- The New Hampshire Uniform Trust Code provides that subject to a good faith standard of review, the beneficiary of a discretionary trust has neither a property interest nor an enforceable right, but holds only a mere expectancy.^[4]
- The North Carolina, South Carolina, Wyoming, and Ohio Uniform Trust Codes define a discretionary interest.^[5] Unfortunately, these statutes do not address the key issue of whether the beneficiary of a discretionary interest holds an enforceable right to a distribution or not.

While not directly mentioned in the Florida Statute, the Legislative Position Request Form notes the reason for the 2007 modification to Section 504 of the Florida Trust Code was to recognize that a beneficiary's discretionary interest may not be a property interest.^[6]

However, the Florida UTC does not define a discretionary interest. Therefore, it is uncertain exactly what discretionary language would protect a SLAT trust

from inclusion in the settlor's estate in Florida.

As far as UTC statutes addressing the enforceable right issues, I find the proposed Michigan UTC Article 5 and Section 814 provides the best UTC solution. The Missouri UTC provides the second best solution.^[7] In addition to some of the UTC states, one of the lead trust jurisdictions, South Dakota (a non-UTC state), has fully addressed the issue by codifying the discretionary–support distinction under common law.^[8]

Therefore, other than for trusts sited in South Dakota, Michigan (if the proposed version of their UTC is adopted), and most likely Missouri,^[9] other drafters of discretionary trusts most likely need to use highly discretionary language similar to that provided above to avoid the settlor inclusion issue.

Drafting Around Support Trust Inclusion Issues

As noted in Part I of this series, the term "support trust" means any trust where a beneficiary has an ability to force a distribution based on a standard. In most cases, such a trust will be based on an ascertainable standard, typically, health, education, maintenance, or support. Based on PLR (TAM) 8504011, *Colonial-American Nat'l Bank v. U.S.*,^[10] and analogous PLR 8113079, the following two methods may be used to mitigate an estate inclusion issue for a support trust:

1. Including a savings clause that prevents the trustee from making a distribution that would discharge the settlor's obligation to support a beneficiary; or
2. Requiring the trustee to look to the beneficiary's resources, specifically including a settlor's obligation to support the beneficiary, before making a distribution.

Discussion of Upjohn Savings Clause

A common savings clause found in most trusts is that the trustee may not make a distribution to any beneficiary that would relieve a support obligation of the trustee.^[11] This savings clause is to prevent an estate inclusion issue if a beneficiary is *also* serving as a trustee.

Conversely, it is not broad enough to prevent an estate inclusion issue for the

settlor of a spousal lifetime access *support* trust. With a spousal lifetime access *support* trust, the issue is whether the settlor created a trust and the trustee must distribute for a support obligation of the settlor due to an enforceable demand right by the spousal beneficiary under the standard in the document.

Therefore, a savings clause would need to say, the trustee cannot make any distributions for an item that is a support obligation of the settlor.

Distribution Language Looking to A Beneficiary's Resources – The Pragmatic Issue

If the trustee of a spousal lifetime access support trust is required to look to the available resources of the beneficiary, including the legal obligation of the settlor/spouse to support the beneficiary, the question is raised, when, if ever, could a trustee make distribution to the spouse/beneficiary?

The answer to this question in turn depends on what exactly does health, education, maintenance, or support (HEMS) mean in the context of available distributions to the beneficiary. To a certain extent this will depend on the exact language used by the drafter. Assume that the trust only permits distributions for HEMS, what does this language actually mean in the pragmatic world of distributions?

The typical HEMS language is similar to: "The Trustee shall/may make distributions to the beneficiary for the beneficiary's health, education, maintenance, or support." While the discretionary term "may" is certainly preferable from a limitation on the beneficiary's rights, *that* is not the issue being addressed in this article.

The issue being addressed is what is the trustee to take into consideration in making distributions for HEMS and at what period of time is this determined? In the Restatement Second, ¶128, Comment e states:

d. Trust for support. By the terms of the trust it may be provided that the trustee shall pay or apply only so much of the income and principal or either as is necessary for the education or support of the beneficiary. In such a case the beneficiary cannot compel the trustee to him or apply for his benefit more than the trustee in the exercise of sound discretion deems necessary for his education or support.

One practitioner refers to this as the "May I take the money (from the credit shelter trust) and travel around the world?" question. The response is if you were not doing that when the trust became irrevocable no, you generally may not. A trustee may not make distributions that exceed the HEMS amount.^[12] The "maintenance" and "support" portion of the the HEMS standard is generally interpreted to mean the beneficiary's accustomed standard of living.^[13]

TIMING OF DETERMINATION OF HEMS NEEDS

In *Hartford-Connecticut Trust Co. v. Eaton*^[14], the statement, ". .the purpose was to provide for his wife as she had been living." strongly implies that the effective date is the date when the irrevocable trust is created, which in this case was the date of death of the settlor.

The Restatement Third makes a slight divergence and expansion from the *Hartford case*. Restatement Third comment § 50(d)(2) states:

"The accustomed manner of living for these purposes is ordinarily that enjoyed by the beneficiary at the time of the settlor's death or at the time an irrevocable trust is created. The distributions appropriate to that lifestyle not only increase to compensate for inflation but also may increase to meet subsequent increases in the beneficiary's needs resulting, for example, from deteriorating health . . . Also, if a beneficiary becomes accustomed over time to a higher standard of living, that standard may become the appropriate standard of support if consistent with the trust's level of productivity and not inconsistent with an apparent priority among beneficiaries or other purpose of the settlor . . ."

Applying this legal principle to the spousal access trust, the question is presented as to when may distributions be made from an inter vivos trust for the HEMS needs of a beneficiary when the settlor-spouse's obligation of support must be considered. Armed with the following three legal principles that:

- (1) a trustee may not make distributions for items if a settlor's obligation to support the beneficiary of a spousal access trust

makes the settlor-spouse responsible for those items;

- (2) a spouse must support a spouse according to the supporting spouse's means and ability;¹⁵¹ and
- (3) the time the irrevocable trust is created or the death of the settlor is the time the needs of the beneficiary is to be determined,

the following examples demonstrate some unanticipated pitfalls that the drafter may not have considered when creating a spousal lifetime access *support* trust. To simplify the analysis assume the spouse/beneficiary is not employed and has no significant assets and the settlor is still living.

Example 1 – Ascertainable standard determined at the time the irrevocable trust was created. Trust has been around for five years. Several years later, settlor's earnings have not changed.

In this circumstance, assuming the settlor is continuing to support the beneficiary as the beneficiary was being supported when the trust was executed, the trustee may make little, if any, distributions to the spouse/beneficiary, let alone to buy a new house, expensive boat, a new business adventure, a trip around the world, or an investment to be held outside the trust.

This is one of the many reasons why many drafters prefer using a discretionary trust that does not create an enforceable right to a distribution in the spouse (or other beneficiaries) over a support trust.

Example 2 – Ascertainable standard determined at time irrevocable trust created. Several years later, settlor subsequently has financial difficulties.

Because the beneficiary's needs are to be determined at the time the settlor was doing well, to the extent the beneficiary's "station in life" has been reduced due to the settlor's financial difficulties, distributions may be made for HEMS.

Example 3 – If ascertainable standard is determined at the time of distribution and when several years later the settlor has financial difficulties.

The beneficiary's ability to demand a distribution should decrease at the same

time as the settlor's financial difficulties because the settlor's financial position is the determinate of distributable amounts when the date of distribution is the time at which the obligation of support is to be determined. This would result in the worst of both worlds. The drafter created a SLAT so that distributions could be made back to the family unit if in need. However, in example 3, the beneficiary's right to a distribution decreases to approximately the same as the settlor's obligation of support, little if any distributions can be made.

Hopefully, a court would not follow such a view, and adhere to the Restatement Third view for determining the effective date for a beneficiary's needs under a support trust. In order to prevent the possible application of Example 3 some drafters may wish to draft around this possibility as follows:

"The Trustee shall make distributions for the beneficiary's health, education, maintenance, or support, taking into consideration the beneficiary's highest standard of living in the previous four (4) years. In making any distribution hereunder, the Trustee shall take into consideration all assets available to the beneficiary, including the settlor's obligation to support the beneficiary. If the beneficiary's standard of living has declined over the previous four years, the Trustee may use the beneficiary's highest standard of living since the creation of the trust. ¹⁶"

Conclusion:

If the settlor creates a SLAT where the spouse/beneficiary has an enforceable right to a distribution for maintenance or support, there is an estate inclusion issue for the settlor. This is because the settlor may force the trustee to make a distribution to the settlor's spouse for a support obligation.

The simplest way to avoid the estate inclusion issue is to draft a common law discretionary trust where the beneficiary does not have an enforceable right to a distribution. In the event the drafter wishes for the spouse/beneficiary to have an enforceable right to a distribution (i.e. a common law support trust), then there are two drafting methods that mitigate the settlor's estate inclusion issue.

- The first method is where a savings clause may be added that prohibits the trustee from making any distributions that is a support obligation of

the settlor.

- The second method is to include language in the distribution standard where the trustee is to look to the beneficiary's resources before making a distribution, including any support obligation of the settlor.

While either one of these methods should mitigate the estate inclusion issue, they both create a pragmatic issue – for so long as the settlor is living, when, if ever, may the trustee make a distribution to the settlor's spouse. Remember, the primary purpose of a SLAT is so that, if needed, distributions could be made back to the family unit through the settlor/spouse. When distribution language limits distributions to HEMS, distributions may generally be made based on the beneficiary's accustomed standard of living.

Conversely, distributions generally cannot be made to buy a new house, expensive boat, a new business adventure, a trip around the world, or an investment to be held outside the trust.

On the other hand, in the event that the settlor's earnings capacity decreases subsequent to the creation of the irrevocable trust, distributions should be able to be made to the spouse/beneficiary to the extent of the decrease in standard of living.

To ensure that this is the case, drafters may wish to specify that HEMS is to be computed over a period of time or at a certain time such as the creation of the trust.

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

Mark Merric

Rod Goodwin

CITE AS:

LISI Estate Planning Newsletter # 1379 (December 2, 2008) at <http://www.leimbergservices.com/> Copyright 2008 Leimberg Information Services Inc. (LISI). Reproduction in Any Form or Forwarding to Any Person Prohibited – Without Express Permission.

CITES:

- ^[1] The "modular approach to estate planning" is trademarked by Mark Merric.
- ^[2] *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.
- ^[3] M.S. 456.5-504; Proposed Michigan UTC Section 504.
- ^[4] N.H. Rev Stat. § 564-B:8-814. The New Hampshire approach that codifies part of the discretionary protections of a common law is a bit confusing as well as possibly internally inconsistent. First unlike common law, §§ 501 through 504 of the New Hampshire UTC does not prevent attachment of a discretionary interest. This leads to the question, if a beneficiary does not have a property interest under § 814, what type of interest did the exception creditors attach to under § 503? Also, if a beneficiary does not have a property interest or an enforceable right under § 814 and the trust did not contain a spendthrift provision, how could any creditor attach a non-interest under § 501? Further, § 814 would imply that if a judge found that a distribution should be made in good faith for whatever reason, the beneficiary now has an enforceable right and a property interest. As noted in Mark Worthington's, *The Impact of the Uniform Trust Code on Third Party Special Needs Trusts*, NAELA Annual convention 2006 outline Black's Law Dictionary (6th Ed.) said that "good faith [has] no technical or statutory meaning" and defined "bad faith" as the opposite of "good faith." The 8th Edition under a new editor does not say that, but says the concept is "elusive," quoting from Brownsword's "Good Faith in Contracts." Mr. Worthington's outline details many problems and possible interpretations created for discretionary trusts when the UTC uses a one "good faith" judicial level standard of review, instead of the dual judicial common law standard of review. This outline may be downloaded at:
<http://www.internationalcounselor.com/NAELAINstitute2006%20-%20Worthington.pdf>
- ^[5] N.C. G.S. 36C-5-504(a)(2); S.C. S.C. Code § 62-7-504; W.S. § 4-10-103(a)(xxix); and OH St. § 5801.01(Y)(1).
- ^[6] The Legislative Fact sheet states, "These changes are intended to clarify that the protection given to discretionary trusts trumps the rights given to exception creditors in § 736.0503(2) and that it includes not only the inability to compel distributions but the right to attach a beneficiary's interest or expectancy in a trust. Reference to "if any" and "might have" in (2)(b) is intended to avoid any implication that the beneficiary of a purely discretionary trust has an interest more than a mere expectancy.
- ^[7] There are three parts to codifying the discretionary asset protection provided by the Restatement Second: (1) defining a discretionary trust interest; (2) stating the legal effect of a discretionary interest (i.e. the

beneficiary does not have an enforceable right or a property interest); and (3) providing a judicial review standard that does not create an enforceable right. South Dakota does this in SDCL § 55-1-23 through § 55-1-43. The proposed Michigan UTC does all of this. The Missouri UTC only covers the second issue, which is the most important of the three issues.

- ^[8] Currently, South Dakota has the most comprehensive classification of trusts statutes. SDCL § 55-1-23 through § 55-1-43.
- ^[9] Missouri's UTC § 814(a) and § 504 appear to be inconsistent. Section 814(a) that discusses the judicial review standard implied a beneficiary has an enforceable right based on a reasonableness standard if the trust contains an ascertainable standard. However, § 504 states the beneficiary of a discretionary interest has "neither an enforceable right nor a property interest." How a court will resolve the apparent conflict between these two code sections is unclear.
- ^[10] Colonial-American Nat'l Bank v. U.S., 243 F.2d 3112 (4th Cir. 1957).
- ^[11] As noted by Susan Porter in her incredible outline, *Exercising Discretion in Discretionary Trusts*, at Lonnie McGee's 28th Annual Southern California Tax and Estate Planning Forum, October 15-18, 2008, many states have savings statutes that provide that a trustee/beneficiary is limited to making distributions based on an ascertainable standard. Ms. Porter cites the Uniform Trust Code, § 814(b)(1) that has been adopted by over 20 states; Cal Prob Code § 16081, NJ. Stat. § 3B:11-4.1.,
- ^[12] Bogert Hess, Third Edition, Thompson, § 811 footnote 36
- ^[13] The Restatement Third comment § 50(d)(2), citing several cases, concludes that maintenance and support are synonymous terms, and that support and maintenance refer to the "beneficiary's customary lifestyle."
- ^[14] Hartford-Connecticut Trust Co. v. Eaton, 36 F.2d 710 (2nd Cir. 1929).
- ^[15] CJS Husband and Wife §66
- ^[16] *Pyle v. Commissioner*, 766 F.2d 1141, (7th Cir. 1985) holds that the station in life is objectively measurable and an ascertainable standard, not a general power of appointment. The use of a period of time over which the HEMS standard is measured should not decrease the objective ascertainable nature of an HEMS standard, but this approach will afford more flexibility to the trustee in making distributions