



NEWSLETTER

How do you get a trustee to take care of the ones you love like you would?

SELECTING THE CORRECT DISTRIBUTION STANDARD

What every good settlor of a trust wants to know is how he (or she) can organize his trust so that it will take care of things like he would. After all, while the many tax planning, succession planning and other reasons to establish a trust are important, one of the stumbling blocks for settlors in actually putting the plan in place is always giving up control. Sometimes it is control over the assets, but, equally as often the concern is giving up control over the determination of how much money will be distributed and under what circumstances. Perhaps one of the best ways to ease these concerns is to help the settlor better understand what each of the possible distribution standards truly mean (when will they allow a beneficiary to access the funds of the trust and when will they not) and how they can best convey their intent to future trustees.

The first step is understanding what types of distribution standards are typically utilized and what they mean. The most common standard found in trust instruments is the ascertainable standard established by the Internal Revenue Service under IRC Section 2041 (b)(1)(A), “health, education, maintenance and support.” While state statutes and common law determine the specific meaning of the terms within each trust, generally health and education can be understood to mean what they would appear to, medical care and treatment and on-going tuition for the beneficiary; however, these terms have been interpreted somewhat more broadly on occasion. For example, the term health has been interpreted as including some things that a settlor might not typically expect such as gym memberships, golf club memberships and extended vacations to relieve tension and stress. The term education has been interpreted to include all levels of education from grammar school to graduate school as well as support, both during the semester and between semesters, and any related expenses. These may or may not be the intentions of the settlor. Support and maintenance are often considered to be synonymous terms. Not limited to the bare necessities of life, these terms can be interpreted to include mortgage payments, life insurance, vacations and even the needs of family living with the beneficiary. Generally it does not include enabling a beneficiary to make extraordinary gifts or to enlarge their personal estate.

While the ascertainable standard is most common, many other “unascertainable standards” are used as well. Some of these standards include terms such as comfort, benefit, welfare, and happiness. In some instances, settlors even opt to leave distributions in the complete discretion of the trustee, with no

guiding principles to follow. For a settlor who is concerned that the trustee will exercise its discretion in the same manner that he would, perhaps the best means of ensuring this predictability is to incorporate language within the trust instrument expressly defining each discretionary term, especially if the settlor’s intent is different than the common understanding of a particular discretionary standard. Absent such a definition, the trustee will be left to conclude what the settlor intends from relevant common law principles, local statutes and analysis of the facts and circumstances of the particular situation, which may not result in the settlor’s preferred outcome.

The second step is understanding what other means are available to a settlor in conveying their intent. The most simplistic means of conveying a settlor’s intent is to include a general purpose statement in the trust instrument. A general purpose statement is simply a paragraph (or maybe more if necessary) which provides the trustee with some background regarding why the settlor established the trust, what his intentions and goals are, and how he would like for the trustees to use the trust funds for those with a beneficial interest. It can be used to explain that a trust is set up with the intention of providing for a settlor’s children, but not spoil them; to support charitable endeavors and philanthropy, but, not slothfulness; to encourage education and using wealth to create opportunities rather than allow it to retard ambitions or inhibit achievement; or other facts specific to the settlor’s family.

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(continued from page 1) Often, a general purpose statement is useful not only to allow a settlor the opportunity to express what he is attempting to achieve with the trust personally, but, also to educate beneficiaries about why the trust was established and who the settlor was; what were his core values. A general purpose statement can also be useful in providing for a hierarchy with regard to trust distributions, perhaps establishing the settlor's desire that one beneficiary be considered first, and the other beneficiary's needs to be deemed secondary. One benefit of a general purpose statement is the fact that it is included within the trust instrument itself. While it intentionally does not direct the trustee as part of the trust instrument, it does impact the trustee's decision making. In addition, as part of the actual trust instrument it is more likely to be considered by a court when reviewing a trustee's actions as it would not be deemed extrinsic evidence as it falls within the four corners of the trust document.

Alternatively, a settlor may choose to express his intent in a separate document known as a "letter of wishes." Similar to a general purpose statement, a letter of wishes is used to state the settlor's intentions for the trust. While the letter of wishes does not bind the trustee, it is persuasive evidence of the settlor's intent and thus useful in determining the settlor's goals and preferences. In addition, another useful means of ensuring that the trustee's distribution practices will align with the settlor's intent is the use of a direction adviser or committee. The direction adviser can be given the power to direct the trustee, consent to distributions or simply consult with the trustee, dependent upon what is established within the trust instrument. Often, to ensure the maximum benefit of using a direction adviser, the settlor chooses a close friend or family member to fill this role; someone who is familiar with the family members for whose benefit the trust is established and the settlor's relationship with each. This is particularly useful in situations where a settlor has concerns regarding substance abuse or addiction of a beneficiary. Someone close to the beneficiary (or his family) will likely have greater contact with the beneficiary and his family and is therefore more likely to know of problems and



better able to assess whether a distribution to such individual would be beneficial or harmful. In addition, a close friend or family member will be more familiar with what the settlor themselves would have preferred under the circumstances.

A third means of conveying the settlor's intent is to include prerequisites within the trust instrument which must be met prior to permitting distributions. This may mean anything from requiring that the trustee consider a beneficiary's other available resources, consider their standard of living or even that the trustee obtain advice from experts prior to making a distribution to a beneficiary. The simplest of these is the requirement that a trustee consider a beneficiary's other available resources. Often this is included in a trust where a settlor has a particular concern that the trustees limit distributions to essential needs so as to preserve trust assets over multiple generations or to ensure that a beneficiary is living the lifestyle that the settlor intended. Standard of living provisions are used to help the trustee ensure that the beneficiary continues to live in the manner that he or she had become accustomed to either at the time of the settlor's death or at the time that the trust was created. The standard of living established at that time will most closely approximate that which the settlor intended. The use of experts is often used in determining if a particular

type of distribution is appropriate, particularly in areas where trustees may not have the knowledge required to make the determination, such as a request for money to start a business.

No matter what a settlor's hesitation when setting up a trust, the best approach for any trustee is to do as much as possible to understand the settlor's intent. These techniques can be quite useful to a settlor in ensuring that his intent is as clear as possible. Knowing that the trustee is doing everything to understand his intent and providing the settlor with the opportunity to maximize his statements of intent both within and outside of the trust instrument may give a settlor the comfort that he needs to move forward with his trust planning. As with anything else, it is always good to know that although you are giving up control, things will continue to be taken care of as if you were doing it yourself.

DELAWARE LEGISLATIVE UPDATE: Effective August 1, 2011, Trust Act 2011 was signed into law by Governor Jack Markell in mid-July. There are a number of changes to the Title 12 of the Delaware Code relevant to trust administration. Among these changes was the defining of the term "wrongdoing" as it relates to fiduciary conduct. The term "wrongdoing," used to clarify the meaning of the term willful misconduct, is now defined as intentionally "malicious conduct or conduct intended to defraud or seek an unconscionable advantage" rather than simply conduct that a fiduciary knows to be incorrect. This is intended to clarify the fact that a trustee will not be held liable under the Code simply because it feels that some other course of conduct may have been better. Of note is the fact that willful misconduct is the standard applied to a directed trustee acting upon the direction of an adviser under Section 3313(b) of Title 12 of the Delaware Code.

Please see our website for additional information as to the other 2011 legislative updates at www.comtrst.com.

DECANTING: MAKING SURE THAT UPDATING THE TRUST DOESN'T CAUSE A LOSS OF GENERATION-SKIPPING TRANSFER TAX EXEMPTION OR GIFT TAX

Decanting has become a hot topic in the past few years as it is a great way to take an older trust and modernize its administrative provisions. Put simply, a trustee who has authority to distribute the trust principal to or for the benefit of a beneficiary, may instead exercise that authority by distributing the assets to a wholly new irrevocable trust for the benefit of that same beneficiary. Currently, approximately ten states have enacted decanting statutes which allow this type of trust self-correction, including Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, New York, North Carolina, South Dakota and Tennessee. While this sounds like an easy way to fix inherited problems within an irrevocable trust, it is not something that a trustee should do without careful consideration as to its possible tax consequences. This is particularly true of trusts which involve generation-skipping transfer (GST) tax exemptions.

THE GST ISSUE: While the Treasury Regulations provide safe harbors regarding the modification of GST grandfathered trusts, a trustee must be particularly careful that the modifications that they are contemplating do not fall outside of the protections. Generally speaking, the safe harbors applies where the (1) exercise of decanting power does not cause a beneficial interest to be shifted to a beneficiary in a lower generational slot for GST purposes (as defined by IRC § 2651) than the person who held the beneficial interest prior to the decanting; and (2) the distribution to a new trust does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, it is essential that the vesting period not be delayed.

There are certain permissible extensions of time that can be effected with regard to a GST exempt trust pursuant to the Treasury Regulations, so long as there is no delay in the vesting of interests. Again, the IRS has provided certain safe harbors for a practitioner intending to extend the duration of a GST exempt trust. In pertinent part, the Regulation provides that a decanting will not result in loss of GST exempt status so long as (1a) state law permitted a trustee to appoint the trust principal in further trust without the consent or approval of any beneficiary or court at the time the trust became irrevocable, or (1b) the terms of the governing instrument authorize distributions to the new trust without the consent or approval of any beneficiary or court and (2) the terms of the governing instrument of the new trust do not extend the time for vesting of any beneficial interest beyond any life in being at the date the original trust became irrevocable plus a period of twenty-one years.

As to the first prong of the test, no grandfathered GST exempt trusts will be able to pass under 1a as the first decanting statute was not passed until 1992, seven years after the effective date of the GST tax. Instead, grandfathered trusts will need to have specific language within them which permits the distribution of funds to another trust. Alternatively, there is an argument to be made that a

particular state's common law would have permitted the decanting despite the lack of a decanting statute, but, this will be more difficult to prove. If the

irrevocable trust in question is a new trust, established after the effective date of its state's decanting statute; it would successfully move on to the second prong of the test and be permitted to extend the duration where the beneficiary is not putting off vesting beyond its lifetime or that of another person living at the time the trust was formed or became irrevocable.

THE GIFT TAX ISSUE: The second area of concern when determining the tax consequences of a decanting is the area of gift taxation. Generally speaking, there are two central concerns with regard to the gift tax consequences of a decanting. The first issue is in regard to a beneficiary/trustee who is exercising discretion to affect the decanting. If a beneficiary/trustee is singly responsible for determining whether or not a decanting distribution can be made, he or she may be deemed to be exercising a power of appointment and thus deemed to have made a taxable gift to the new trust. In many states, this issue is easily resolved through the use of state savings laws. These laws prohibit a beneficiary/trustee from making any distribution which would be deemed a taxable gift for gift tax purposes by making the trustee's exercise of discretion subject to an ascertainable standard of health, education, maintenance and support, thus limiting the beneficiary/trustee's ability to make distributions. In states with no such saving clause legislation, there still might be savings language within the trust document which could provide assistance to the beneficiary/trustee; however, absent such a provision, the beneficiary/trustee will likely be deemed to have exercised a general power of appointment and thus have made a taxable gift.

The second area of concern with regard to gift taxation is related specifically to a beneficiary's actions, regardless of whether or not he or she is serving as trustee at the time of the decanting. If a beneficiary either consents or acquiesces to a decanting which eliminates his or her beneficial interest, the beneficiary may be deemed to have made a taxable gift of that interest. That is to say that the beneficiary's consent to the decanting distribution may be



(continued from page 3) deemed either a release or lapse of a general power of appointment over the trust assets. This concern is most commonly seen in trusts with mandatory distributions, for example outright distributions required at ages 25, 35 and 40. If a beneficiary consents to a distribution of the trust assets to a new trust without these mandatory distributions, it may be viewed as having affirmatively permitted the distribution as the beneficiary would otherwise have become in control of the assets in question at those mandatory distribution ages. In these cases, the IRS may view the decanting distribution to the new trust as a release of a general power of appointment by the beneficiary, effective at each of the mandatory distribution ages. If this is the case, the effect would be as if the beneficiary received the distributions at the mandatory distribution ages and then contributed them to the new trust. This would override any spendthrift clause contained in the trust document and may cause the trust to be viewed as a self-settled trust as to the portion previously subject to the mandatory distribution, effective as of either the date of the decanting or the mandatory distribution. This means that where a decanting involves a GST exempt trust, it may not be

advisable to pursue a court decanting if it requires the beneficiaries to consent to the petition, as is commonly the practice in the state of Delaware. Instead, the trustee may need to rely solely on its own confidence as to the advisability of the exercise of the discretion to make the distribution without consents or releases from the beneficiaries. This is a substantial risk to trustee and should not be taken lightly.

One potential solution to mitigate the trustee's risk in making a decanting distribution to a new trust without beneficiary consent or release is to simply send notices to the beneficiaries informing of the trustee's intended action and providing a period for objection. It would be important to require no active participation by the beneficiaries such as consent or acknowledgement. In so doing, a trustee can arguably gain some comfort in knowing that while the beneficiaries have not consented to the distribution, they have not objected either. The fact that the beneficiaries were notified of the change and did not object may be persuasive should there ever be an issue before the court with regard to the trustee's exercise of discretion in decanting.



DELAWARE FIDUCIARY LITIGATION UPDATE:

In re Irrevocable Asset Protection Trust of Henry C. Rohlf, 2011 WL 3201798 (Del. Ch., July 12, 2011). In a recent matter before the Delaware Court of Chancery, Vice Chancellor Glasscock confirmed the court's commitment to honor the settlor's intent. In his opinion, the Vice Chancellor confirmed the court's commitment to defer to the language of the trust instrument when a conflict arises between the language of the trust instrument and common law rules, relying on the language of Title 12, Section 3303 of the Delaware Code. More specifically, a corporate trustee was held to the standard of good faith with regard to a matter of permissible self-dealing where the trust instrument stated that self-interested transactions would be permitted in the discretion of the trustees, who would not be liable for their exercises of discretion made in good faith.

Another important thing to learn from the case is the importance of including specific language within a trust instrument if the settlor intends to negate common law rules or statutory standards that would otherwise apply. Where a settlor intends to

hold a trustee to varying standards, it is essential to specifically draft language into the trust instrument which states that intention to deviate. An even better manner of insuring the enforceability of such a provision is to expressly acknowledge the otherwise settled law with the instrument. This will illustrate the settlor's understanding of the law and clearly relate his or her intention to deviate. This is routinely done in the area of investing, but, should also be considered for distribution standards and the defining of terms.

Additional Cases to Consider:

- *Bessemer Trust Company of Delaware, N.A. v. Wilson*, 2011 WL 4484409 (Del. Ch. September 28, 2011).
- *PHL Variable Ins. Co. v. Price Dawe 2006 Ins. Trust*, 2011 WL 4360034 (Del. Supr. Sept. 20, 2011).
- *In re: Beulah Williams*, 2011 WL 3925690 (Del. Ch. August 25, 2011).
- *In the Matter of Trust for Grandchildren of William L. and Genevieve W. Gore dated April 14, 1972*, 2011 WL 3444569 (Del. Ch. July 29, 2011).
- *Paradee v. Paradee*, 2010 WL 3959604, (Del. Ch. October 5, 2010).

