ALI-ABA Course of Study

Representing Estate and Trust Beneficiaries and Fiduciaries

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DISCRETIONARY DISTRIBUTIONS VERSUS TOTAL RETURN TRUSTS: WHICH IS BEST?

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The Schiff Hardin & Waite Estate Planning and Administration Group welcome your questions or comments about these seminar materials. Please feel free to contact any member of the Estate Planning and Administration Group.

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DISCRETIONARY DISTRIBUTIONS VERSUS TOTAL RETURN TRUSTS:
WHICH IS BEST?
I. Introduction

A. The trust professional's involvement with distribution standards takes place on two levels.

1. The trust professional may have an opportunity to be involved at the planning stage, in educating the client about the standards to be used for determining what distributions are appropriate and the impact of various alternatives.

2. He or she also faces the practical application of those standards during the administration of a trust. The trust professional, often with the assistance and guidance of a discretionary distribution committee, will have to apply his or her judgment to the beneficiaries' situations, and determine if a distribution is appropriate.

B. Both levels require a firm understanding of the common meanings given to the distribution language used in trusts. These materials review the judicial interpretations of common distribution provisions, and suggest alternative provisions that can be used to provide more guidance. The materials also examine various ways in which lawyers are trying to provide greater flexibility in trusts, and to respond creatively to the demands of the "trust consumer."

C. The materials also discuss recent state law changes in the treatment of income and principal. These changes, such as Principal and Income Act provisions allowing trustees to provide current beneficiaries with a unitrust interest instead of an income interest, are a response to total return investment concepts. At its core, though, these developments are also responses to clients' demands for greater flexibility and for more consumer friendly trusts.

D. The heart of the trust business is service. Good service requires an understanding of trust distribution standards and a willingness to work with unique versions of those standards.

II. Particular Standards of Distribution: What Does the Trust Language Mean?

A. When creating a trust, clients often ask about the meaning of various standards of distribution. What, for example, is the real difference between "support and maintenance" and "best interests and welfare" in terms of what access the beneficiaries will have to the trust assets? Or, what factors related to the beneficiary's other resources, lifestyle, etc. will the trustee take into account in making distributions?

1. Most attorneys have a standard procedure for addressing these issues and answering the client's questions. For instance, many clients have been told that "support and maintenance" allows the beneficiary to maintain his or her
accustomed standard of living, whereas "best interests and welfare" could include distributions for luxury items -- a Mercedes Benz or a trip to Europe.

2. The brevity of focus on these issues is often necessary for very practical reasons -- many clients cannot afford to have the attorney spend hours exploring the client's goals and drafting unique, specific provisions governing distributions. However, some can afford, and indeed expect it. In these situations, often involving the bank's most important customers, trusts are likely to contain very customized distribution provisions.

3. Any decision regarding the appropriate distribution standard for a trust must take into account the transfer tax consequences of using the distribution standard. A trustee who has the discretionary power to distribute trust property to himself as a trust beneficiary possesses a general power of appointment unless the discretionary power is limited by an ascertainable standard related to his or her health, education, support or maintenance. IRC §§ 2041(b)(1)(A); 2514(c)(1).

B. The interpretation of terms which set out a standard of distribution, such as "best interests," "support" and "comfort," is governed by state law. Therefore, the meaning of a particular term may be more or less restrictive, depending on the law of the state that governs the interpretation of the instrument.

C. In general, if the trustee's authority to make distributions is discretionary, and the trustee uses its judgment and makes a reasonable decision, a court will not disturb the trustee's decision to distribute or withhold trust assets unless there has been evidence of bad faith or an abuse of discretion. Where the trustee's discretion is "absolute" or "uncontrolled," a court will grant the trustee's decision even more deference. Bogert § 811.

D. "Support" and "maintenance"

1. Support and maintenance encompasses more than bare subsistence. Hartford-Connecticut Trust Co. v. Eaton, 36 F.2d 710 (2d Cir. 1929). These terms include the beneficiary's normal living expenses, such as housing, clothing, food, and medical care, depending on the standard of living enjoyed by the beneficiary during the settlor's or testator's life. In re Levinson's Will, 5 Misc. 2d 979, 162 N.Y.S.2d 287 (1957); Hill v. Comm'r, 88 F.2d 941 (8th Cir. 1937); Equitable Trust Co. v. Montgomery, 44 A.2d 420 (Del. Ch. 1945).

2. In many states, if a trustee may distribute principal for a beneficiary's support, the trustee also may distribute principal for the support of the beneficiary's spouse and children. The beneficiary's legal obligations of support are a part of his living expenses. See In re Sullivan, 12 N.W.2d 148 (Neb. 1943);
Robinson v. Robinson, 173 Misc. 985, 19 N.Y.S.2d 44 (Surr. Ct. 1940); Seattle-First National Bank v. Crosby, 254 P.2d 732 (1953); Akers v. Fidelity & Columbian Trust Co., 234 S.W. 72 (1921). However, one court limited the permissible distributions to those for the support of the beneficiary alone, and not for the support of his wife and dependent children. Cavett v. Buck, 397 P.2d 901 (Okla. 1964). If the settlor wishes to allow the trustee to make distributions to spouses of the settlor's descendants, he or she should include a specific provision in the trust instrument.

SAMPLE TRUST PROVISION: In the trustee's sole and uncontrolled discretion, the trustee also may distribute income or principal to any individual who at any time was married to a descendant of mine in such amounts as the trustee, other than the distributee, deems necessary for the distributee's health and support in reasonable comfort in light of the distributee's role within the family of that descendant of mine.

E. "Comfort"

1. In some states, the term "comfort" is limited to an ascertainable standard related to the beneficiary's health and support. Estate of Vissering, 990 F.2d 578 (10th Cir. 1993).

2. In other states, the standard is broader than "support or maintenance," and encompasses a beneficiary's enjoyment, pleasure, happiness, satisfaction, or peace of mind.

3. In applying this standard, one court allowed distributions to purchase an automobile to enable the beneficiary's daughter to visit the beneficiary because her visits "did much to ease the mind" of the beneficiary. In re Mirfield's Estate, 126 N.Y.S. 465 (Sur. Ct. 1953).

4. "Comfort" has also been construed as relating to the grantor's, rather than the beneficiary's, accustomed standard of living. The Mississippi Supreme Court ruled that the term "comfort" should be construed according to the grantor's understanding of the word, which could be discovered by looking at the grantor's standard of living. Gulf National Bank v. Sturtevant, 511 So. 2d 936 (Miss. 1987).

F. "Best interests" or "best interests and welfare"

1. Under these standards, the trustee may make distributions to allow the beneficiary to enjoy a high standard of living, including extensive travel or the purchase of luxury automobiles and jewelry.

2. The term "best interests" has been interpreted to allow distributions for more