Chapter 5

Family Trust Planning

"Credit Shelter," "Bypass," "Nonmarital," or "Family" trusts are synonyms describing the portion of most estate plans that does not qualify for the federal estate tax marital deduction. Long ago that portion typically was all of the estate only if there was no surviving spouse. Today in the vast majority of estates (over 99% of the decedent population) even with a surviving spouse there will be no marital trust because the estate is below the tax threshold. So, this trust might be the entire estate dispositive scheme (other than any preresiduary specific bequests, which in most cases are de minimis).

These trusts offer "family planning" options that often are desired for a client's total integrated plan. The options are used only in this one trust simply because they cannot be used in marital deduction trusts (because they would disqualify the marital deduction). Thus, this is where flexibility is added to most estate plans, with provisions for beneficiaries in addition to (or sometimes other than) the settlor's surviving spouse. Options may include accumulations of income, discretionary distributions of principal, nongeneral powers of appointment, and so forth.

In addition, this is where we study what happens after both spouses are gone and the plan continues for surviving family beneficiaries such as descendants. These trusts could provide for others as well (but *not* for charity, as we will see in Chapter 8) but nonfamily beneficiaries are not very common and will not enter our focus here.

"Typical" Family Plan

Most family plans follow relatively predictable norms, the most common of which being represented by the provisions illustrated in this Chapter. For example, during a surviving spouse's overlife, the typical family trust frequently provides for the needs of the settlor's surviving spouse and descendants in the trustee's discretion, with a customary priority favoring the surviving spouse but not to the exclusion of others. If there is enough wealth or a need to include others, this trust is where the plan expands to embrace every intended object of the decedent's bounty.

This planning is subject, however, to the tax conscious recognition that preferably any marital deduction trust should be exhausted before any assets are moved from the family trust into the spouse's hands for potential inclusion in the surviving spouse's taxable estate at death. Moreover, the family trust itself must be drafted carefully to ensure that it will not be includible in the surviving spouse's taxable estate at death. This means that no taxable powers should be bestowed, either expressly or by virtue of trustee powers granted or imputed to the surviving spouse. The most important tax trap to avoid is any "general" or taxable power of appointment. This characterization may apply to any one of numerous forms of provision that may be exercised in favor of the powerholder, the powerholder's estate, or creditors of either. See Internal Revenue Code §2041, as discussed in Chapter 18. Trustee selection, especially considering the designation of beneficiaries as trustee, also is a critical component in an effective tax plan and is discussed in Chapter 6.

Following the death of the surviving spouse, the most common (but also the most inflexible) plans then divide into separate (typically equal) shares for children, with several alternative patterns for administration and distribution. Planning choices that provide flexibility are noted in the following sample provisions. They are indicated by *alphabetical* annotations (which, unlike normal footnotes, usually illustrate options that might fit into or replace portions of the plan. So don't ignore those!). Much of the form language in this material appear courtesy of The Northern Trust Company, www.northerntrust.com, and are reproduced with permission. Attorneys are specifically granted authority to reproduce these forms in their representation of clients.

5.01[a/] **Residue: All the residue of my estate, wherever situated, including lapsed legacies, but expressly excluding any property over which I may have power of appointment at my death,**[b/] **I give to _________, as trustee. The trust shall be designated the "Family Trust" and shall be held and disposed of as follows:**

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a/ Coming before the typical residuary family trust provision in a traditional estate plan would be a debts, expenses, and tax payment provision of the type discussed in Chapter 11; a paragraph defining the testator's family (for easy identification and as a verification that, for example, in referring to "children," the document means to include all the children who are listed, even if adopted, of the half-blood, nonmarital, or perhaps even posthumously conceived); a personal effects provision (making specific bequests that qualify for the income tax §663(a)(1) exception to avoid DNI carryout on distributions of personalty before termination of the estate); and any marital deduction provision. This plan illustrates a typical "up-front" marital bequest with residuary family trust provision. In a "reverse" plan the marital and family trusts would be reversed in both order and in how they are defined. The first sentence of paragraph 5.01 would be replaced with a formula provision defining the nonmarital bequest, but the substance of the plan would remain the same. All this is discussed in Chapter 7 dealing with marital deduction planning.

In an age of "blended" families a special set of considerations may be required to provide for children and more remote descendants. Consider the following provision as an alternative definition of family that highlights various issues that might be encountered in the future:

5.02 Income Distributions: If my spouse[c/] survives me, then commencing with my death the trustee shall pay the income from the Family Trust in convenient installments, at least quarterly, to my

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Family: My [spouse's] name is and [he/she] is herein referred to as "my spouse." I have X children now living, namely:

A, born ***

B, born ***

C, born ***

In addition, my spouse has Y children now living, namely:

D, born ***

E, born ***

F, born ***

I intend to provide by this document for all of my children and I intend to provide for all of my spouse's children as if they were my own children. Accordingly, all references in this document to "my children" or to "child" (and similar terms) shall be deemed to include each of A, B, C, D, E, and F. I also intend to treat descendants of all of these children as if they were my descendants. Further, I intend to provide for adopted children as if they were natural born [excluding, however, any individual adopted as an adult unless that individual lived with the adopting parent when the individual was a minor], I make no distinction between children born in or outside of wedlock, and children conceived before but born after the death of their biological parents shall be treated as alive at the time of conception. However, children conceived after the death of their biological parent shall not be regarded as the child of that deceased parent.

b/ This "expressly excluding" provision regarding powers of appointment is discussed at page 32, relating to inadvertent or "blanket" exercise of powers of appointment.

c/ Using gender neutral language like "spouse" here is a less personal approach to drafting but it avoids the need to convert pronouns and other gender specific references, which minimizes the risk of making errors in some planning situations. For example, planners who use gender specific references typically draft one spouse's document and then "flip" it by converting items such as "him" to "her" and "he" to "she" and substituting names in appropriate places, all to create the other spouse's plan. Often that chore is avoidable by using gender neutral terminology, but this approach is less personal and it may not suit your preferred style. Some document assembly software systems "personalize" like this better than others, based on a master template with all names and pronouns that are inserted automatically by the program. Manual conversion of pronouns and names or cross references is an invitation for mistake that is better avoided either with better software or gender neutral drafting.

spouse during my spouse's lifetime;[d/] but if the income so payable to my spouse shall at any time or times exceed the amount the trustee deems appropriate for my spouse's health and maintenance in reasonable comfort (considering my spouse's other income and means of support known to the trustee, including the income from the Marital Trust, the desirability of augmenting my spouse's separate estate, and any other circumstances and factors deemed pertinent), the trustee may pay any part or all of the excess income to any one or more of my descendants and their respective spouses from time to time living, in equal or unequal proportions, according to their respective needs for health, education (including postgraduate), maintenance, and support in reasonable comfort,[e/] or accumulate the same and add it to principal as

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d/ The balance of this provision would be deleted if mandatory income to the surviving spouse is desired.

The choice between mandatory and discretionary income is likely to be based on a number of factors during the overlife of the surviving spouse, or after the spouse's death and during the term of the next generation of beneficiaries. For example, flexibility is important in some cases, providing the trustee with the ability to distribute income to the beneficiaries most in need. The ability of various beneficiaries to manage income otherwise foisted upon them also is important, with the protection of a discretionary income payment provision or a spendthrift clause being useful in some cases but virtually irrelevant in others. The relative income tax rates of the beneficiaries and the trust play a role, although income taxation of accumulated income is less of a factor if the tax rate differential between the trust and its beneficiaries is not extreme. Distributed income will increase the beneficiary's net worth (which could be a problem for tax, creditor right, or even for divorce property settlement purposes), unless it is being dissipated through gifting or consumption. Finally, in some cases application of the §2013 previously taxed property credit at the beneficiary's death is a relevant factor, with a mandatory income provision producing a credit for taxes paid by the settlor on the trust property within ten years before or two years after the beneficiary's death. See the discussion of this planning in the marital deduction planning Chapter 7 at pages 32-34.

e/ In most situations the drafter relies on generally accepted conventions regarding the definition and understanding of terms such as health, education, maintenance, and support. These are the "ascertainable" standards referenced in the regulations under §2041, which deals with general powers of appointment, and may be the most commonly used standards in all American trust drafting as a result. But it may be wise to add definitions (usually someplace in the boilerplate provisions in the back of the document) to collar, give guidance to, or even protect the fiduciary or the beneficiary (depending on how you view the need for specificity). Consider:

The term "health" includes both mental and physical well being, payments for psychiatric and psychological counseling, and fitness programs designed to maintain and improve the beneficiary's general condition as well as to treat any specific illness, injury, or disorder. The

term "support" means payments appropriate to permit a beneficiary to maintain the standard of living to which the beneficiary was accustomed at the time of my death. The term "education" includes expenses incurred in connection with or by reason of attendance at public or private institutions, including without limitation preschool, elementary, preparatory, college, graduate, vocational, and technical institutions, all without regard to accreditation, and may include expenses related to travel, tutoring, tuition, room, board, fees, clothing, books, laboratory or other equipment or tool costs (including computer hardware and software), or other material or activities that the trustee deems to be of reasonable educational benefit or value. Each term relates solely to the individual beneficiary's personal welfare and shall not authorize unrelated distributions, such as to permit the beneficiary to aid any cause or organization (unusual or radical or otherwise).

Every so often a client worries about beneficiaries going off the deep end, or needing special incentives or protections. Each of the following provisions is directed at a specific genre of problem and might be appropriate in a special situation, but none is likely to be appropriate in vanilla estate planning situations. Each should be used with great caution.

Prohibited Distributions: The trustee shall exercise a broad discretion to determine whether the terms of this provision may apply. If the trustee suspects that a beneficiary is a member of a "cult" (any organization involving extreme devotion or attachment to or extravagant admiration for a person, principal, or other object or fixation) or is addicted to any substance, the trustee may require the beneficiary to submit within a reasonable time after actual written or oral notice to physical or psychological testing procedures (conducted by licensed professionals determined by the trustee in the trustee's absolute and unbridled discretion as appropriate) to determine whether the beneficiary is subject to any unreasonable compulsion relating to the cult or is subject to substance addiction. The trustee may require the beneficiary to undergo an appropriate clinical assessment to determine a course of treatment or conduct prescribed by licensed professionals to overcome any such compulsion or addiction, including without limitation inpatient or outpatient treatments, individual and group counseling, and attendance at support groups. All costs associated with such determinations and treatments shall be charged without interest against the beneficiary's ultimate distributive share of the trust and notwithstanding any other provisions of this document no distributions of principal or income shall be made directly to a beneficiary while suffering from such compulsion or addiction, except to the minimum extent required by any applicable law to obtain a tax benefit.

Special Considerations: I intend that no beneficiary shall depend on this trust for support and maintenance to the extent the beneficiary is mentally, emotionally, and physically capable of earning a living, and it is my desire that trust distributions never impair a beneficiary's motivation to be productive and self sustaining. I intend that a beneficiary with financial difficulties, addictive behavior (such as substance abuse, gambling, or spendthrift habits), relationship disorders or dysfunctionality, and similar maladies should address the trustee deems advisable.[f]

5.03 Principal Distributions: The trustee also may pay to my spouse such sums from the principal as the trustee deems necessary or advisable from time to time for my spouse's health and maintenance in reasonable comfort,[g] and for the health, education (including postgraduate), maintenance, and support in reasonable comfort of any child[h] of mine who may be dependent upon my spouse, considering the

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those problems that can be resolved by the beneficiary's personal industry and dedication or changes in life style and associations, and that the trustee shall be circumspect in making trust distributions in circumstances that contravene this intent. In all matters the trustee shall consider whether a beneficiary seeking assistance is productive, mature, and responsible, and may consider whether a beneficiary appropriately is unable to earn a sufficient income because of age, mental, emotional, or physical incapacity, conditions that impair the ability to manage, invest, and conserve property, or because of other sufficient reasons such as engaging in public service or being committed to raising children or providing care to dependents.

Serious Unexpected Circumstances: Notwithstanding any other provision of this instrument (but subject to the requirements of any applicable law to obtain a tax benefit), the trustee may withhold or postpone all distributions of income or principal to the extent deemed appropriate due to likely diversion or dissipation of the assets because of the beneficiary's involvement in serious litigation, bankruptcy, insolvency proceedings, or the beneficiary's financial, matrimonial, or personal circumstances; or because the beneficiary is living under a form of government or other condition making it highly likely that the distribution would be subject to confiscation or appropriation (other than "normal" taxation), or if serious and avoidable disadvantageous tax consequences are likely to result.

f/ Adding income to principal avoids the need for a special income accumulation account for fiduciary accounting and fee generation purposes. Most professional trustees impose a "base" fee on each trust that they must maintain an account for, including an income accumulation fund, which speaks in favor of minimizing any proliferation of unnecessary trusts.

g/ The following modification would be substituted for the balance of this provision if principal encroachment for the spouse alone is desired: **"considering my spouse's income from all sources and other readily marketable assets known to the trustee, but shall make no invasion of the Family Trust so long as any readily marketable assets remain in the Marital Trust."**

h/ Notice that income in paragraph 5.02 may be distributed to descendants and spouses, but corpus here only is distributable to dependent children. That is unlikely (given the age of most surviving spouses and children when the first spouse dies) and limits flexibility in a way that may not be appropriate. But it assures the surviving spouse that only excess income and not income producing corpus will be distributed away from the spouse in most cases. This easily could be changed, and paragraphs 5.02 and 5.03 could be combined. As you read other suggested language in this Chapter, look for a template for such a provision that could be the model

income of each of them from all sources known to the trustee, but shall make no invasion of the Family Trust for my spouse so long as any readily marketable assets remain in the Marital Trust.[i] No payment of income or principal to a child of mine shall be charged against the share hereafter[j] provided for the child or his or her descendants.[k]

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you would use. One skill you need to develop is to take a form such as this "off the rack" and "tailor" it to a particular situation, because you don't want forms to dictate the planning you do for your clients. Instead, you want forms to help guide your drafting much like a garment is properly fitted by taking a stitch here or letting out a hem there to fit your client's needs.

i/ Dissipation of the marital trust is dictated before invasion of the family trust because the marital trust will be includible in the surviving spouse's taxable estate at death while undistributed amounts of the family trust will not. The authority to invade corpus to permit the spouse to make inter vivos gifts should be in the marital trust to facilitate that dissipation at the spouse's cheaper gift tax rates, as discussed in Chapter 7 at pages 61, 85, 91, and 104-105.

j/ Why do so many lawyers use here*in*after? One consequence of it would be to restrict this advancement dictate to distributions under this document and not speak to related or integrated documents or dispositions. Whichever term you resonate with, in this and so many other things you need not assume that the drafting you use as a model is "good," or client friendly. You should try to develop your own voice in drafting.

k/ The following would be substituted for the last sentence if distributions are to be treated as an advancement: **"Each distribution to a child of mine shall be treated as an advancement and charged (at its date of distribution value and without interest) against the share hereafter provided for the child or his or her descendants."** This treatment might be especially appropriate for extraordinary distributions, such as to pay for a wedding, or certain advanced higher education expenses, or to purchase a home or a business. Notice that this provision does not (but could, and in some cases should) account for income earned or appreciation in the value of the distributed property, charge interest for the early receipt of the distributed property, or reflect any difference in income, gift, estate, or generation-skipping transfer tax attributable to early distribution. Consider the following additional language to charge at values that reflect current realities without having to trace a particular distribution (which could generate significant administrative complexity):

Any shares of stock in Family Corp. (or any related or successor entity) distributed to a child of mine shall be treated as an advancement and charged at their fair market value at the time for division of this trust and not at the actual date of distribution value of that stock. The value for making an adjustment for any other distribution shall be the date of distribution value (without interest), multiplied by a fraction of which the numerator is the cost of living index as of January 1 of the year of division of this trust based on the [locale] Urban Consumer Index published by the Bureau of Labor Statistics of the United States Department of Labor (the Index) and the denominator is the corresponding Index number for January 1 of the year in which the

5.04 <u>Disclaimer:</u>[l/] A disclaimer by my spouse of any part or all of the Marital Trust or other property shall not preclude my spouse from receiving benefits from the disclaimed property in the Family Trust.[m/]

5.05 <u>Division into Shares</u>: Upon the death of my spouse, or upon my death if my spouse does not survive me,[n/] the trustee shall divide the Family Trust, including any amounts added thereto from the Marital Trust,[o/] into equal shares to create one share for each then living child

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distribution was made. If publication of the Index is discontinued, then the trustee shall use comparable statistics for the cost of living in the city of [locale] as they are computed or published by any agency of the United States or a responsible financial periodical of recognized authority reasonably selected by the trustee.

Oh, by the way, do you see the flaw in each of the text and these alternatives? To whom may distributions be made, and against what are charges computed? If, for example, distribution is made to a grandchild (or the spouse of a grandchild) will it count against the share of a child who is the grandchild's parent? The text provision addresses the *converse* situation and does not mention the in-law distribution situation at all. Is that to say those distributions *will* be charged? If so, will interest be calculated, and at what values? Certainly this provision is not as extensive as needed to avoid litigation on the issue. See the difference in 5.06 at page 10.

<u>l</u>/ This provision is authorized by §2518(b)(4)(A). Without it postmortem estate planning of the variety discussed in Chapter 7 at pages 16-20 would not be embraced by many surviving spouses.

<u>m</u>/ If this trust might receive disclaimed property it must deny the surviving spouse any power of appointment (inter vivos or testamentary) as to that disclaimed property. This form does not grant the surviving spouse a power to appoint at all, which may be too restrictive. See page 21 regarding powers of appointment. If the trust might receive disclaimed property it also must collar any authority the spouse might have as trustee to make distributions to anyone. As drafted that would not be a problem with *this* form, but changes made to it would require careful thought if the spouse might be or become trustee.

<u>n</u>/ A very common drafting error is the assumption that the settlor's spouse will survive the settlor. This simple clause avoids the dispositive glitch that otherwise would exist if division were dictated only "upon the death of my spouse." Another, more terse, way to state the time for division would be "upon the death of the survivor of my spouse and me."

<u>o</u>/ The typical pattern would be to combine both spouses' property in this one trust following the surviving spouse's death. Even if the surviving spouse wishes to plan separately, this form combines all the wealth of the first spouse to die in this one trust after the survivor's death.

If the settlor does not wish to divide into shares *for descendants* the language following the death of the surviving spouse needs to be a little different, but the model is not that difficult. Consider the following template:

of mine and one share for the then living descendants, collectively, of each deceased child of mine.[p/]

. . . divided into as many equal shares as needed to distribute * share(s) to X if (s)he survives me, * share(s) to Y if (s)he survives me, and * share(s) to Z if (s)he survives me. [The share that would have been distributed to a named individual if he or she had survived me shall be distributed to his or her descendants by right of representation or, if there are none, the bequest to that individual shall lapse.]

p/ Another common drafting error is failure to anticipate death of a child before division of the trust into shares for children, especially if the deceased child left descendants who should represent the child.

Another important issue is dealing with survivorship and "simultaneous" death (which is the term used loosely to refer to the situation in which two people die under circumstances such that the order of their deaths cannot be established by proof). State law often addresses this issue as between a testator and a beneficiary, but in this context the issue can be important as between one beneficiary (the second spouse to die, for example) and another (children), because the disposition of property could change if, for example, a child was deemed to have survived the division event and died immediately thereafter or died an instant before the time for division. One way to address this issue is to require that the child survive the division event by a period of time (such as 120 hours under the Uniform Probate Code or, probably preferable for a number of reasons, 30 days). A second approach is to include a simultaneous death provision such as the following, geared to the order of deaths between beneficiaries:

In all events notwithstanding any state law to the contrary, if the order of deaths between my spouse and me cannot be determined by sufficient evidence my spouse shall be treated as [surviving/predeceasing] me, and if the order of deaths between any other individuals cannot be determined by sufficient evidence the order of their deaths shall be treated as the younger of them having died first.

The presumption adopted in this provision is probably the exact opposite of what most folks would predict and is informed predominantly by tax motives. Consider the net result, for example, if a child and a grandchild were to die in a common disaster and the order of their deaths could not be determined. The grandchild will be presumed not to have survived, which makes the dispositive document govern disposition of the share the grandchild would have received if living rather than any estate plan of the grandchild (or state law intestacy if the grandchild had no other estate plan). That likely is what the average client would prefer if they thought about the issue. In a case like the grandchild it probably would send the grandchild's share to other grandchildren if the grandchild died without descendants, and that probably produces the same result as if the grandchild survived long enough to take and died intestate. But perhaps not (for example, if the grandchild was married it might preclude the grandchild's surviving spouse from benefiting), and drafting for those uncertainties is what this endeavor is all about! If there was only the one grandchild who was the child's descendant it likely would send the property to the child's other siblings, which would be a taxpayer preferable result because it would reduce or

5.06 <u>Distribution of Descendants' Shares</u>:[q/] Each share created for the descendants of a deceased child shall be distributed per stirpes to those descendants, subject to postponement of possession as provided below.[r] Each share created for a living child shall be held as a separate trust and disposed of as hereafter provided.

5.07 <u>Income Distributions From Child's Share</u>: The income from a child's share shall be paid in convenient installments, at least quarterly, to the child until complete distribution of the share or his or

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eliminate the generation-skipping transfer tax that otherwise would apply if the property went to the grandchild for an instant and then passed from the grandchild's estate to potentially the same individuals. Avoiding such a tax result is the true motivation for this provision.

q/ In this plan division into shares for the children is postponed until death of the surviving spouse, on the assumption that the typical client wants to provide first for the spouse, making the children wait until the survivor's death before being in line to take a share outright. In some circumstances this will be contrary to the client's intent, especially if the children are from a former marriage or the client wants the children to receive some property during the years of their greatest need, regardless of whether a surviving spouse still is alive. In such a case, the following provision would be substituted for paragraphs 5.02 through 5.05 and the succeeding paragraphs would be renumbered accordingly.

5.02 <u>Division into Shares</u>: The trustee shall forthwith divide the Family Trust into equal shares to create one share for each child of mine living at my death and one share for the then living descendants, collectively, of each deceased child of mine.

In addition, the first clause of paragraph 5.12 at page 14 would be altered to read **"If upon my death, or at . . . ,"** to account for the possibility that it might apply while the surviving spouse still was alive. Furthermore, the marital deduction pour over provision would be altered to provide for addition:

proportionately to the shares into which the Family Trust has been divided, provided that, if any share has been distributed in whole or in part, the property directed to be added thereto shall be distributed in the manner and to the extent provided with respect to the share as if it or the part or parts thereof were then being distributed.

r/ See paragraph 5.13 at page 15. The theory behind this treatment is to vest shares in grandchildren or more remote descendants to avoid Rule Against Perpetuities and certain generation-skipping transfer tax problems and to minimize administrative problems in what are likely to be smaller shares (due to the number of descendants involved). A full-fledged trust for this level of beneficiary could be drafted along virtually the same lines as the illustrative provisions in the text, if it is likely that sufficient assets will be involved and if these other issues are addressed properly. Those multiple trusts are likely to be pretty small in most cases, which accounts for this form being less concerned about them. But the converse might be true, depending on growth in the assets and size of the family.

her prior death,[s/] except that, while the child is under the age of ** years,[t/] the trustee shall pay to or for the benefit of the child so much or all of the income from the child's share as the trustee deems necessary or advisable from time to time for the child's health, education (including postgraduate), maintenance, and support in reasonable comfort, adding to principal any income not so paid.

5.08 <u>Principal Distributions From Child's Share</u>: The trustee shall pay to the child such sums from the principal of his or her share as the trustee deems necessary or advisable from time to time for the child's health, education (including postgraduate), maintenance, and support in reasonable comfort, considering the income of the child from all sources known to the trustee.[u/]

5.09 <u>Right of Withdrawal</u>:[v/] After division of the Family Trust

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s/ Delete the balance of this provision if mandatory income is desired. Substitute the following if a unitrust distribution is desired in lieu of an income entitlement (supplemented by invasions of principal):

In each calendar year the trustee shall pay to the child an amount (the unitrust amount) equal to *% of the net fair market value of the trust assets (including all accrued and accumulated income) valued as of the first business day of each calendar year of the trust. The unitrust amount may be distributed in convenient installments, at least quarterly, it shall be paid first from income and then from principal to the extent income is not sufficient, and any income in excess of the unitrust amount shall be added to principal.

Note that unitrust drafting can become much more complex (for example, by using a "smoothing" approach that distributes a percentage of the average fair market value for a three year or longer prior period).

t/ Any age could be selected here. Usually something in the early to mid 20's is appropriate. Delete all of this provision prior to this point if discretionary income for the life of the child is desired. Note that you could then marry paragraphs 5.07 and 5.08 together and eliminate some redundancy. Conversely, if the age were increased substantially it might be appropriate to mirror paragraph 5.02 by allowing distributions to a child's spouse and descendants.

u/ Consideration of more than just income may be appropriate, such as with the following substitution for the clause following the last comma: **"considering the income and other assets available to the child and the advisability of supplementations, the child's character, habits and diligence, progress and aptitude in acquiring an education, ability to manage money prudently and usefully, and ability to assume responsibilities of adult life and self support."** Also consider whether this paragraph should permit invasions for a child's spouse, dependents, or descendants.

v/ The theory behind this right of withdrawal (rather than a mandatory distribution provision) is to avoid forcing beneficiaries to accept property that they would prefer to leave in trust. This right eliminates the need for a child to accept a distribution and then create a new trust (which would be particularly unfortunate if the child were incompetent at the time for

into shares and after a child has reached[w/] the age of ** years,[x/] the child may withdraw any part or all of the principal of his or her share at any time or times, but not to exceed in the aggregate one-half in value thereof prior to reaching the age of ** years.[y/] The value of the share

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distribution, if the child could not be located, or if spendthrift protection would be lost in the process). For all tax purposes, however, to the extent the beneficiary does not exercise the withdrawal right the ongoing trust would be treated as if the share had been created by the beneficiary.

Substitute the following for paragraph 5.09 if mandatory distribution of the child's share is desired:

5.09 Distribution of Shares: When a child reaches the age of ** years, or upon division of the Family Trust into shares if he or she has then reached that age, the trustee shall distribute to the child half in value of the principal of his or her share then held hereunder; and when a child reaches the age of ** years, or upon division of the Family Trust into shares if he or she has then reached that age, the trustee shall distribute to the child the balance of his or her share.

Quaere whether a mandatory force out provision ever is appropriate. Yet virtually every form you will see mandates distribution.

The foregoing provisions need not use a two stage withdrawal or distribution. See comment y for an illustration of a three stage provision. Also note how this provision anticipates the issue explained in the next comment below of a child already being the specified age when the trust or share is created ("when . . . or upon . . .").

w/ Note that this does not say "*When* the child reaches" the specified age, because this provision must apply even if the child reached that age before division of the trust into shares, and this right is an on-going entitlement, not a one-time event, making an occurrence-"triggering" provision inappropriate.

x/ This could be any age, although typically it will be later than the age used in paragraph 5.07 to determine when (if ever) the beneficiary will begin receiving all income from the trust.

y/ This age typically is five to ten years older than the age when the first withdrawal right became exercisable, the expectation being that the beneficiary will learn a few lessons from any mistakes that were made with respect to earlier withdrawals, without risking his or her entire inheritance. If the child's share will be large enough to justify withdrawal in three stages, substitute the following for the provision prior to this point:

5.09: Right of Withdrawal: After division of the Family Trust into shares and after a child has reached any one or more of the following ages, the child may withdraw from the principal of his or her share at any time or times not to exceed in the aggregate:

One-third in value after ** years of age;

Half in value (after deducting any amount subject to withdrawal but not actually withdrawn) after ** years of age; and

The balance after ** years of age.

shall be determined as of the child's first exercise of this withdrawal right, plus the value of any additions made thereafter (determined at the time of the addition). The trustee shall make payment without question upon the child's written request. This right of withdrawal shall be a privilege that may be exercised only voluntarily and shall not include an involuntary exercise.[z/]

5.10 Testamentary Power of Appointment:[aa/] Upon the death of the child before receiving his or her share in full, the child's share shall be held in trust hereunder or distributed to or in trust for such appointee or appointees, with such powers and in such manner and proportions as the child may appoint by his or her will making specific reference to this power of appointment, except that any part of the child's share not subject to withdrawal prior to the death of the child may be appointed only to or for the benefit of any one or more of the child's surviving spouse, the child's descendants and their respective spouses, and my descendants (other than the child) and their respective spouses. For purposes of this provision, the term "spouse" shall include a widow or widower, regardless of remarriage.[bb/]

Notice that allowing withdrawal of "one-third" of the share following *each* triggering date will not permit withdrawal of the entire share, making the declining denominator the necessary drafting method. If you don't believe this just run a simple illustration: the trust is $30 to begin and the child withdraws $10. When it is worth $20 how much should the child be able to draw down: $10 or one-third of $20?

z/ This provision is similar to a spendthrift clause, which otherwise might not apply to this withdrawal right. This provision may not be effective, but what is to be lost for inclusion?

aa/ This is a general testamentary power of appointment for wealth transfer tax purposes, but only to the extent the child is treated for tax purposes as the owner of the trust because of the power of withdrawal in paragraph 5.09. In some cases it will be preferable for this power to be available inter vivos as well. Furthermore, for generation-skipping transfer tax purposes some drafters make the entire trust subject to §2041 inclusion in the child's estate at death by granting a general power of appointment over the entire trust even if death occurs before the age specified for withdrawal. Another method of causing inclusion is appropriate exercise of a nongeneral power of appointment to trigger the Delaware tax trap of §2041(a)(3), as explained in Blattmachr & Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the "Delaware Tax Trap,"* 24 REAL PROP., PROB. & TRUST J. 75-94 (1989), abridged in *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J. TAX'N 242-248 (1988). Other drafting issues in this provision are addressed in detail beginning at page 21.

bb/ Why does this form not provide similar breadth elsewhere? For example, a child's descendants become beneficiaries after a child's death, even if the child's surviving spouse is still alive. If the child and spouse were dependent on this trust the child's death could be devastating to the spouse's well being. The standard trust does not provide for the child's

5.11 Default Distribution: Upon the death of a child any part of his or her share not effectively appointed[cc/] shall be distributed per stirpes to his or her then living descendants, or if none, then per stirpes to my then living descendants, subject to postponement of possession as provided below,[dd/] except that each portion otherwise distributable to a descendant of mine for whom a share of the Family Trust is then held hereunder shall be added to that share.[ee/]

5.12 Contingent Distribution: If there is no living descendant of mine upon the death of the survivor of my spouse and me, or at any time thereafter but prior to complete distribution of the Family Trust, any trust property then held under this article and not vested or effectively appointed shall be distributed half to my heirs-at-law and half to my spouse's heirs-at-law, the heirs-at-law and the proportions they respectively shall take to be determined in each case according to the laws of descent of the State of *** as if my spouse and I had both died at that time.[ff/]**

5.13 Postponement of Possession: Each share of the Family Trust that is distributable to a descendant who has not reached the age of **

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surviving spouse unless the child does so through exercise of this power of appointment, which is just one of several reasons why powers are so important.

cc/ Notice that this provision refers to a failure to *effectively* exercise the power, not to a mere failure to exercise the power, making this default provision applicable if the beneficiary exercised in violation of the Rule Against Perpetuities or in favor of impermissible appointees or otherwise in violation of the power of appointment.

If a mandatory distribution of the child's share is dictated, substitute the following for the foregoing: **"If a child dies before receiving his or her share in full, then upon the death of the child his or her share . . . ."**

dd/ See paragraph 5.13.

ee/ This "add to shares" provision is designed to avoid a multiplicity of shares for any particular descendant.

ff/ Without this definition of the applicable law, the heirs-at-law would likely be determined as of the respective deaths of the settlor and surviving spouse, meaning that distribution could be required to individuals who no longer are alive (including either spouse as heir of the other). Consider whether the designated state law provides that a surviving spouse of the settlor's remarried surviving spouse is an heir-at-law and whether this settlor would want the surviving spouse's widow(er) to benefit. That issue could be addressed elsewhere by a definition provision in the boilerplate, or here by leaving 100% to the settlor's heirs-at-law. Also consider that use of the law when distribution occurs is easier than ascertaining the law when the settlor executed this document or when the settlor died, but introduces an element of uncertainty to the extent changes in the law prior to operation of this provision are incorporated by the adoption. Designation of the appropriate state law merely eliminates conflict of law disputes.

years[gg/] shall immediately vest in the descendant but the trustee shall (a) establish with the share a custodianship for the descendant under a Uniform Gifts to Minors Act or a Uniform Transfers to Minors Act, or (b) retain possession of the share as a separate trust, paying to or for the benefit of the descendant so much or all of the income and principal of the share as the trustee deems necessary or advisable from time to time for his or her health, education (including postgraduate), maintenance, and support in reasonable comfort, adding to principal any income not so paid, and distributing the share to the descendant when he or she reaches the age of ** years[hh/] or to the estate of the descendant if he or she dies before receiving the share in full.[ii/]

5.14 Facility of Payment: Income or discretionary amounts of principal payable to a minor or to a person under legal disability or to a person not adjudicated disabled but who, by reason of illness or mental or physical disability, is in the opinion of the trustee unable properly to manage his or her affairs shall be paid or expended only in such of the following ways as the trustee deems best: (a) to the beneficiary directly if applicable law requires direct payment to obtain a tax benefit; otherwise (b) to the legally appointed guardian of the beneficiary; (c) to a custodian for the beneficiary under a Uniform Gifts to Minors Act or a Uniform Transfers to Minors Act; (d) by the trustee directly for the benefit of the beneficiary; or (e) to an adult relative or friend in

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gg/ Because this share is vested, this could be any age without concern about violating the Rule Against Perpetuities.

hh/ Because these are vested shares, the designated age could be any number the settlor selects.

ii/ Substitute the following if a retained share might be of sufficient size to warrant distribution in two stages:

> **5.13 Postponement of Possession: Each share of the Family Trust that is distributable to a descendant who has not reached the age of ** years shall immediately vest in the descendant but the trustee shall retain possession of the share as a separate trust, paying to or for the benefit of the descendant so much or all of the income and principal of the share as the trustee deems necessary or advisable from time to time for his or her health, education (including postgraduate), maintenance, and support in reasonable comfort, adding to principal any income not so paid (except that, after the descendant has reached the age of ** years, the trustee shall pay to him or her all the income from the share in convenient installments, at least quarterly), and distributing half in value of the principal of the share to the descendant if he or she has then reached or at such time thereafter as he or she reaches the age of ** years and the balance to the descendant when he or she reaches the age of ** years or to the estate of the descendant if he or she dies before receiving the share in full.**

reimbursement for amounts properly advanced for the benefit of the beneficiary.[jj]

Group Trust for Children

The foregoing plan anticipates a fund large enough to justify division into separate shares for children no later than the death of the surviving spouse. The following alternative anticipates that the trust will be held as a single fund until some time after the death of the surviving spouse (or after the death of the settlor, if the trust is not to be held for the benefit of a surviving spouse), at which time it will be divided into shares.[kk]

5.05 Group Trust: After the death of my spouse, or after my death if my spouse does not survive me, the Family Trust, including any amounts added thereto from the Marital Trust, shall be held and disposed of as hereafter provided.

5.06 Income and Principal Distributions: Until the time hereafter fixed for division into shares, the trustee shall pay so much or all of the income and principal of the Family Trust to any one or more of my children and descendants of a deceased child of mine from time to time living, in equal or unequal proportions and at such times as the trustee deems appropriate, for the health, education (including postgraduate), maintenance, and support in reasonable comfort of my children and those descendants, individually and as a group, considering their needs, other income and means of support, and any other circumstances and factors that the trustee deems pertinent, adding to principal any income not so paid. No payment made for a child or other descendant of mine shall be charged against the share hereafter provided for the child or descendant or his or her ancestor or descendants.

5.07 Division into Shares: If upon or whenever after the death of the survivor of my spouse and me there is no living child of mine under the age of ** years,[ll] **the trustee shall divide the Family Trust into equal**

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jj/ This "reimbursement" notion is critical to marital deduction qualification in a marital deduction trust context and is mimicked here because usually just one facility of payment provision is included in any document. Note that if desired a withdrawal right could be used here as well. But a power of appointment would not be very appropriate because these shares are vested already.

kk/ Some comments with respect to the foregoing provisions are equally relevant with respect to the next several illustrations but are not repeated.

ll/ Notice how elegantly this provision anticipates division regardless of the order of deaths of the settlor and settlor's spouse and the ages of the children at the death of the survivor. It also does not describe the "youngest living child" reaching the specified age, thus reflecting the possibility that the *youngest* child may never reach that age or (even more unlikely but still possible) that *no* child will reach that age. This provision applies when all

shares to create one share for each then living child of mine and one share for the then living descendants, collectively, of each deceased child of mine.[mm]

5.08 <u>Distribution of Descendants' Shares</u>: Each share created for the descendants of a deceased child shall be distributed[nn/] per stirpes to those descendants, subject to postponement of possession as provided below. Each share created for a living child shall be held as a separate trust and disposed of as hereafter provided.

Here the provisions of paragraphs 5.07 through 5.14 from the former illustration would be renumbered and used for the balance of the trust provisions.

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living children have reached the designated age *or* if all children have died. In either case, no *living* child would be *under* the specified age.

The age you select is a function of why you used a group trust. For example, consider those criteria noted beginning at page 20. If the motivation was equality of treatment in paying for education, most folks would select an age such as 25. That is not too low as to thwart graduate school education or to hamper a child on "the extended plan," but not so high as to delay everyone while a "perpetual student" continues to defer getting on with their life. If the rationale for the group trust was to provide a safety net for a disabled child, however, it may be that division or distribution should not occur until that child's death. Note that with an older age it might be wise to include descendants and surviving spouses of deceased children. Also consider how these criteria inform selection of trustee, the size for a small trust termination provision, and other elements in the draft.

<u>mm/</u> If distribution is to occur immediately upon division rather than having the shares held for children until a later age, substitute the following for paragraphs 5.07 through 5.12 from the former illustration:

5.07 <u>Distribution of Shares</u>: If upon or whenever after the death of the survivor of my spouse and me there is no living child of mine under the age of ** years, the trustee shall distribute the Family Trust per stirpes to my then living descendants, subject to postponement of possession as provided below.

Here the provisions of paragraphs 5.12 through 5.14 from the former illustration would be renumbered and used as the balance of the Family Trust provisions. Notice again how such a plan could disfranchise the surviving spouse of a child who might become destitute as the settlor's grandchildren become independently wealthy. Also note that a per stirpes distribution need not be selected; other alternatives are available.

<u>nn/</u> A predeceased child could be given a power to appoint this share, effective immediately upon division. Such a power might be a good way to finesse the surviving spouse problem, although consider the default provision to the extent the child does not effectively exercise the power.

Group Trust With "Peel-Off" Provision

In some circumstances the Family Trust will be held as a group trust, as above, but never divided into shares, either for immediate distribution or to be separately held until a child reaches an older age. A good illustration of when this might be appropriate is a family with many children or with children whose ages are quite disparate, or both. Separate shares may be uneconomical or unfair, because older children benefited from the larger trust for education and other major expenses until its division into equal shares, while the younger children must consume their separate shares for some of these items that come up after division. But a traditional group trust also may be unwise because it potentially makes older children wait too long for distribution because their younger siblings have not yet reached the age for distribution.

To address these conflicting concerns, the following format permits each child to "peel-off" a share as the child reaches a specified age. Although it would be more complex, this pattern could make a fraction of a child's share subject to a power of withdrawal and hold the balance under a plan like the more traditional group trust plan last illustrated. It even could give a child a testamentary power of appointment if death occurs before distribution. Administrative and valuation problems in identifying the relative shares of the various children probably make these approaches undesirable in most cases, however.

5.05 Group Trust: After the death of my spouse, or after my death if my spouse does not survive me, the Family Trust, including any amounts added thereto from the Marital Trust, shall be held and disposed of as hereafter provided.

5.06 Income and Principal Distributions: Until complete distribution of the Family Trust, the trustee shall pay so much or all of the income and principal of the Family Trust to any one or more of my children from time to time living (exclusive of any children to whom or to whose descendants distribution has been made pursuant to the following provisions),[oo/] in equal or unequal proportions and at such times as the trustee deems best, for their health, education (including postgraduate), maintenance, and support in reasonable comfort, considering the needs, other income and means of support, and best interests of my children, individually and as a group, and any other circumstances and factors that the trustee deems pertinent, adding to principal any income not so paid. No payment of income or principal to

oo/ This parenthetical is essential to preserve the pattern of this plan that a child benefits only until distribution of the child's portion of the trust. This parenthetical might be deleted if a hybrid plan were used by which a child did not receive a full share by peel-off distribution, although distributions to such a child probably should be only for extraordinary purposes and then only if other funds are not available to that child.

a child of mine shall be charged against the share hereafter provided for the child or his or her descendants.

5.07 Distribution of Shares: If upon or whenever after the death of the survivor of my spouse and me a child has reached the age of ** years,[pp] the trustee shall distribute to the child that fraction of the then principal of the Family Trust of which the numerator is one and the denominator is the number of children of mine then living and then deceased leaving one or more descendants then living, exclusive of any child or children to whom or to whose descendants a distribution previously has been made.[qq]

5.08 Share of Deceased Child: If a child dies before reaching the age of ** years, then upon the death of the last to die of my spouse, the child, and me,[rr] the share of the principal of the Family Trust that the child would have received if the child had then reached the age of ** years shall be distributed[ss] per stirpes to his or her then living descendants, or if none, then per stirpes to my then living descendants, subject to postponement of possession as provided below, except that the share otherwise distributable to a child of mine who has not then reached the age of ** years shall be retained as a part of the principal of the Family Trust[tt] and except further that any share distributable to

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pp/ This age probably needs to be higher than in the prior group trust illustration, so as to hold more of the wealth for the younger beneficiaries, but not so high as to deny benefits while a child is most in need of the money.

qq/ To understand how this provision works, consider a trust with three children: the oldest will receive one-third of the corpus upon reaching the specified age, the next child will receive half, and the last will receive the balance. A withdrawal right could be used instead of mandatory distribution, but the accounting and valuation problems this would raise probably dictate against it in most cases.

rr/ This terse but understandable triggering provision will operate regardless of the order of the three possible deaths.

ss/ Work an example to persuade yourself that this distribution of the deceased child's peel-off share is essential and properly crafted to make certain the entire trust is distributed if the last child dies before reaching the specified age and, on the death of any other child, to preserve equality to those children to whom (or to whose descendants) a distribution previously has been made. A predeceased child could be given a power to appoint this share, effective immediately upon division.

tt/ The net effect of this provision is to give a share of the deceased child's peel-off entitlement to those children (or their descendants) who already have received distributions, while retaining the balance of the deceased child's share for those children to whom distribution has not yet occurred. Again, work an example, only now assume it was the second child of three who died, childless, after one received distribution and while the third child still is a beneficiary of the trust. Half of the second child's "share" would go to the oldest child and the other half would remain in the trust for the youngest child, awaiting final distribution when that child reaches age.

a descendant other than a child of mine for whom a share of the Family Trust then is being held hereunder shall be added to that share.

Here the provisions of paragraphs 5.12 through 5.14 from the original illustration would be renumbered and used for the balance of the trust provisions.

Family Planning Considerations

Each of the foregoing illustrations demonstrated a plan that would be appropriate based on a number of competing factors. Many questions must be resolved in balancing those factors; here are a few:

How large is the available fund, and will maintenance of separate shares for individual children produce trusts that are uneconomically small, relative to trustee fees and other costs? For example, a good benchmark regarding size would be if the trustee's base fee exceeded half the income earned, or if the threshold for computing the base fee was greater than the trust corpus.

Who will be trustee and what fees and other costs will be involved? In this respect, we will learn in Chapter 6 that anyone can be trustee if the drafter is careful in drafting the document.

How does the settlor feel about equality among the children? For example, should division into separate shares be delayed until all children have been educated out of the total pot, with only the balance being divided, or does division into shares after some have been educated but before others have finished their schooling create an inequity of no great significance, given the amount of wealth involved? Alternatively, are some of the children "perpetual" students whose failure to leave academe and enter the "real" world should not be a financial burden on all the children?

Do extraordinary needs of some children dictate that the fund be held as a group trust so that all children share in the costs to support all of the children? Indeed, should the trust be held through the lives of all children (rather than presume, as do all the foregoing provisions, that at some date during the lives of the children the fund will divide and ultimately be distributed)? Generation-skipping transfer tax planning becomes important in this respect, particularly with respect to the generation-skipping tax deferral provisions, but only if the wealth involved exceeds the generation-skipping transfer exemption amount (for example, $1.5 million in 2004). Also worthy of consideration is whether descendants of all degree should be made permissible beneficiaries of both income and principal during the life of the children, with consideration of generation-skipping and discharge of obligation problems. Further, should the trust provide for surviving spouses of deceased descendants?

Do additional tax factors dictate a particular structure in the trust? For example, because compression of the income tax rates reduces the tax benefits of maintaining separate trusts, is there any other tax motivated reason to create separate trusts for each child? Should charity play a role in any of the planning involved? And how much marital deduction is appropriate in light of the client's family planning objectives?

If taxes are the primary motivation for a disposition in trust instead of outright, should the trust include a termination provision that allows escape if the wealth transfer tax laws are repealed? If so, it should apply only if the termination provision will not cause other tax problems to the powerholder (e.g., an individual trustee who might face §678 pseudo-grantor trust income tax problems, as mentioned in Chapter 17).

How much enjoyment or control does the settlor want to bestow on the beneficiaries, notwithstanding any tax consequences of that decision? In this respect, it makes sense to ask the client to describe the preferred family plan if taxes were nonexistent, and only then try to accommodate those desires with a tax conscious plan to the extent possible, making affirmative choices to the extent necessary between the desired disposition and any negative tax ramifications.

These questions all involve uncertainty and planning for whatever the future may bring. Some provisions in this plan are designed to deal with that uncertainty, such as the contingent distribution, postponement of possession, and the facility of payment provisions. The task of planning for uncertainty can be accomplished only partially by any drafter, no matter how omniscient. Beyond a certain degree, some uncertainty about the future needs of the family must be left to be resolved in the future.

Powers of Appointment

Astute estate planners resort to powers of appointment primarily to deal with uncertainty. Powers provide the ability to exercise more flexibility, by giving someone a "second look" at the estate plan in the future. "The power of appointment is the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out. . . . Lawyers . . . have discovered . . . that the power of appointment is the answer to more of the problems that face the draft[er] of wills and trusts than any other device." Leach, *Powers of Appointment*, 24 A.B.A.J. 807 (1938).

Plainly no human foresight is adequate to frame in advance dispositions which will meet the exigencies of the maximum period of control or even the comparatively small fraction thereof commonly utilized by testators and settlers. Births and deaths in varying combinations, the commercial success of some family members and the failure of others, the varying capacities of individuals as to the husbanding of resources, fluctuation in income returns and the value of the monetary unit, legislative action and constitutional amendment reflecting social and political change — all these are factors whose unpredictability indicates the folly of rigid predetermined future limitations and the desirability of gifts containing a substantial element of flexibility. The power of appointment . . . is the most efficient device yet contrived by which an owner may obtain such flexibility while still controlling the general purposes to which . . . property shall be devoted.

3 RESTATEMENT OF PROPERTY Ch. 25, Introductory Note (1940).

Powers to appoint can take many forms, including inter vivos or testamentary powers of appointment, powers of withdrawal limited by a §2041(b)(1)(A) ascertainable standard, a "five or five" provision (explained below), powers in the role of trustee or distribution director, and powers of the most extreme variety to terminate, alter, or amend. As a planning tool, all are much more useful than disclaimer, which seldom is the answer to the need for flexibility. This is because documents usually are not adequately drafted to provide that a beneficiary's rejection of property will cause its disposition in the manner desired, particularly to reflect changing circumstances or unanticipated events, such as tax law changes. Sometimes a disclaimer can avert or salvage a disaster in waiting, but seldom is disclaimer the answer to most trust flexibility problems. Disclaimers defeat rather than amend, they reallocate but do not reform, and they accelerate but seldom extend trust provisions. Powers to appoint can surmount all these limitations

Tax consequences seem to cloud the focus of many estate planners when powers to appoint are involved. The most significant rationale for creating powers of appointment is to afford the flexibility of a second look at some future date, and we can finesse the tax issues when they are important. Nevertheless, we need to be aware of the tax issues.

General or Nongeneral Power?

Powers of appointment serve several useful functions for tax purposes, but also may generate unexpected liabilities. A general power of appointment is defined in §2041 as any power permitting the powerholder to benefit the powerholder, the powerholder's estate, or creditors of either. Any other permissible appointee is acceptable but irrelevant. General powers are taxable under the tax rules and, with very few exceptions, nongeneral powers are not.

Why would a donor ever give a beneficiary a general power of appointment if property over which a beneficiary holds a general power of appointment is includible in the powerholder's gross estate and it is possible to provide flexibility in a dispositive plan with nongeneral powers of appointment and limited invasion authority? The answer is that, today, there are four legitimate reasons to grant a general power of appointment, only one of which relates to providing flexibility in an estate plan.

- The first reason relates to the marital deduction. General powers of appointment were widely used before 1982 to qualify trust property for the federal estate and gift tax marital deductions under §§2056(b)(5) and 2523(e). These marital deduction power of appointment trusts are not frequently employed today because of the §§2056(b)(7) and 2523(f) QTIP marital deduction trust, introduced in 1982, which allows the marital deduction without granting control to the spouse by means of a general power of appointment. Since 1982, old-style general power of appointment marital deduction trusts are used typically if the trust is employed for management or protection purposes rather than to deny control to the surviving spouse, and often the spouse is also named as trustee or the general power is exercisable inter vivos as well as at death.
- A second use of general powers of appointment is in drafting §2503(c) qualified minors' trusts for gift tax annual exclusion purposes. Frankly, these trusts are not used very often because, as we will learn in Chapter 12, so-called Crummey powers or five or five withdrawal rights are regarded as more useful and less problematic.

In each of these two situations, the general power of appointment is granted to the powerholder as a trade-off for some tax advantage to the donor. The marital deduction or annual exclusion benefits to the donor are bestowed at the cost of inclusion to the powerholder generated by the general power of appointment. This quid pro quo explains why a general power is required in each of these situations to qualify for a particular tax benefit.

- A third use of general powers of appointment is for generation-skipping transfer tax avoidance. This use — either pursuant to a formula grant of the power, the exercise of trustee discretion, or the Delaware tax trap — is designed to attract estate or gift tax to the extent those excises are cheaper than the generation-skipping transfer tax. See Chapter 18 at page 13. Thus, the general power of appointment is again a tool to obtain a tax benefit. The only difference here is that the powerholder is the beneficiary of the tax savings generated as well as the payor of the tax liability incurred as the price for it.
- Finally, general powers of appointment frequently are granted to beneficiaries to permit immediate withdrawal of trust principal. We learned at page 11 that family planning often appropriately makes a trust available for withdrawal after a beneficiary reaches a certain age but does not mandate distribution if the beneficiary does not wish to (or simply is unable to) assume responsibility for management of the property. In this way the beneficiary (or someone acting on their behalf) need not create a new trust to hold distributed

property. Instead, the beneficiary merely allows the general power of withdrawal to go unexercised. In cases such as this, because the trust property will be fully includible in the beneficiary's taxable estate at death, typically the withdrawal power is coupled with a general testamentary power of appointment, exercisable if the beneficiary dies after the withdrawal power becomes available. The testamentary general power to appoint guarantees that the beneficiary need not withdraw just to control ultimate distribution of the property.

Aside from these four situations, general powers of appointment probably are created only by inadvertence, mistake, or malpractice.

Scope of Nongeneral Powers

Congress has been quite generous in defining the powers that can be given to a beneficiary without causing the appointive property to be includible in the powerholder's estate for wealth transfer tax purposes. A donor who wants to give a beneficiary maximum flexibility in the form of powers of appointment could give any or all of the following powers without tax consequences to the powerholder.

- An *ascertainable standard invasion power* to withdraw so much or all of the trust principal as necessary for the beneficiary's health, education, maintenance, and support (HEMS). The trust may dictate that other resources available to the beneficiary be considered in determining the amounts needed for these purposes or, to provide maximum benefits, the trust may state that any amounts needed are to be "determined without regard to other resources available" for the stated purposes. See Treas. Reg. §20.2041-1(c)(2). If the latter approach is employed, the beneficiary may reach trust corpus for all the beneficiary's basic needs (house payments or rent, food bills, clothing and transportation costs, medical bills and insurance, and taxes), all without regard to the beneficiary's other income or resources.
- A noncumulative annual *power to withdraw* $5,000 or 5% of the value of the trust, exercisable with no showing of need, freeing the beneficiary from dependence on the trustee or the need to determine whether a particular withdrawal is permitted under the HEMS ascertainable standard. The lapse of such a five or five power is specifically made nontaxable by §2514(e) but a §678 pseudo grantor trust income tax problem can exist, as discussed in Chapter 12 at pages 22-23 and Chapter 17 at pages 14-15.
- A *nongeneral power to appoint* trust principal, exercisable either during life or at death in favor of any appointee other than the powerholder, the powerholder's estate, or creditors of either.

- If drafted properly, the beneficiary may be named trustee of the trust, giving the power to manage and invest trust property. Although subject to basic fiduciary standards, the beneficiary would have broad latitude to manage the property almost as if the beneficiary owned it.

Less than all of these alternatives may be granted in any given case (this is a summary of the *most* a donor can bestow) but it is an impressive array of options. And it is in addition to enjoyment of income and principal under more defined trust circumstances.

Unexpected Sources of Power of Appointment Tax Liability

Of concern to estate planners are a number of potential sources of unintentional or inadvertent tax liability caused by possessing or exercising certain trust administration provisions that add flexibility to the document. These need not be a concern unless the situation is large enough to be subject to the wealth transfer tax (now or by likely growth, or due to future changes in the law).

Revolving Door Power

For example, discussed in greater detail in Chapter 6 at page 12 is a provision often included in a trust authorizing the removal and replacement of trustees. This "revolving door" provision may cause the government to attribute all the trustee's powers to the holder of the removal and replacement authority. This especially is true if the powerholder may appoint the powerholder personally as a successor trustee, with potential general power of appointment consequences if those trustee powers are not properly constrained.

According to Treas. Reg. §20.2041-1(b)(1), a beneficiary's power to remove the acting trustee and appoint the beneficiary as a successor trustee is sufficient to cause the trustee's powers to be imputed to the beneficiary, as if the beneficiary already acted. If those powers in the beneficiary's hands would constitute a general power of appointment, §2041 inclusion would be dictated by the existence of the removal and replacement power, even if the power was not exercised.

It is important to find ways to include a revolving door power without causing the trust corpus to be includible in the powerholder's estate. This is because the revolving door power is a valuable check on the trustee, giving the powerholder a valuable degree of control if the trustee proves to be a poor choice for administration of the trust. As such, even a revolving door power that precludes appointment of the powerholder as a successor trustee is a very strong entitlement. "If the power in a beneficiary to fill a vacancy [with someone else] is combined with an unrestricted power to remove any trustee who occupies the office . . . [t]he combination powers to fill and remove give the beneficiary a powerful weapon to put pressure on the trustee to exercise the trustee's powers the way the beneficiary wants them exercised." 3A Casner, ESTATE PLANNING §12.0 at 85 n.3 (5th ed. 1986).

The government's concern is that the powerholder will appoint and remove trustees at will until one is found that will do the beneficiary's bidding. See Private Letter Rulings 9113026, 9043052, and 8916032. Based on this the government's original position was that the power to remove and replace the trustee was sufficient to impute the trustee's powers to the powerholder, even without the power to name the powerholder as a successor. See Rev. Rul. 79-353, revoked by Rev. Rul. 95-58 in the wake of Estate of Wall v. Commissioner, 101 T.C. 300 (1993), which held that Rev. Rul. 79-353 "is supported neither by cogent argument nor by cited cases supporting the conclusion reached." The Tax Court concluded that the government was wrong in its fundamental premise that a trustee subject to removal and replacement will do the bidding of the holder of a revolving door power. The court stated that established fiduciary law principles would be violated if a trustee "acquiesced in the wishes of the [powerholder] by taking action that the trustee would not otherwise take." Thus, absent proof of some prearrangement between the powerholder and the trustee, the assumption inherent in the Ruling could not be supported and the power therefore did not generate an interest that caused estate tax inclusion.

The government's revised position, stated in Rev. Rul. 95-58, is that the power to remove and replace individual or corporate trustees at will is not adequate to regard the powerholder as possessing the trustee's control over trust distributions, *provided that* any individual or corporate successor is "not related or subordinate to the [powerholder] (within the meaning of §672(c))." If you're willing to limit the scope of potential replacement trustees the concerns of Rev. Rul. 79-353 appear to be a thing of the past. Informal comments by government officials at the 1995 American Bar Association Annual Meeting indicated that Rev. Rul. 95-58 is a safe harbor ruling and that other cases may not be litigated even if not within the "not related or subordinate" confine.

There are additional ways to protect the powerholder from revolving door power inclusion, as discussed in Chapter 6 at pages 13-14. The challenge with any alternative is in creating sufficient ability to reflect changing circumstances while making the power sufficiently strong to serve as a useful deterrent to unacceptable trustee conduct.

Discharge of Legal Obligation of Support

Let's put a second source of unexpected power of appointment tax liability into perspective. Consider the common occurrence of a grandparent making a gift to a grandchild by creating a Uniform Transfers to Minors Act account with the grandchild's parent as custodian (or by creating a trust with the parent as trustee). If the parent had created the account (or trust), Treas. Reg. §20.2036-1(b)(2) would treat the parent as having retained enjoyment that would cause estate tax treatment of the account (or trust) balance at the death of the parent as if the property was still owned by the parent. Here the parent did not create the account (or trust), so the issue is whether the parent has a power of appointment under §2041 that would require similar inclusion in the parent's estate at death (or gift taxation under §2514 if the account or trust terminates during the parent's life).

Relying on Treas. Reg. §20.2041-1(c)(1), inclusion is premised on the theory that distributions from the account may discharge the parent's legal obligation to support the grandchild. This would cause those distributions to be regarded as for the parent's indirect benefit and give the parent a general power of appointment. Fortunately, the theory of indirect benefit through the discharge of obligation is insupportable in most cases. See 2 Casner & Pennell, ESTATE PLANNING §§7.1.1.10.1 and 12.4.2 (6th ed.). State law in the vast majority of American jurisdictions does not support the government's fundamental theory that distributions from a trust serve to discharge the parent's support obligation. In fact, the exact opposite is true: distributions are ignored in determining the child's needs for support unless the trust was created for the express purposes of supplanting that obligation or the parent is financially unable to provide that support. Therefore there is no discharge of the parent's obligation and no benefit to the parent from making distributions to the child.

Nevertheless, the discharge theory is embodied throughout the regulations. See Treas. Reg. §§20.2036-1(b)(2), 20.2041-1(c)(1), 1.677(b)-1, and 1.678(c)-1. The discharge theory has not been asserted by the government recently, but nothing indicates that the government has abandoned it (or ever will). Therefore, again the question arises: how can unwanted tax consequences or disputes be avoided in planning such a transfer in which the trustee or custodian may hold property for a dependent?

Notwithstanding the fact that the parent is being treated as the indirect beneficiary of all distributions to the dependent beneficiary, the curious aspect of this problem is that use of the HEMS ascertainable standard (noted at page 24) to restrict all distributions to the beneficiary is not an effective solution. Treas. Reg. §§20.2041-1(c)(2) and 25.2514-1(c)(2) clearly dictate that an ascertainable standard will protect against general power of appointment treatment only if it relates to the health, education, maintenance, and support of the *powerholder*. Here it would relate to the needs of the powerholder's dependent beneficiary.

The solution is to prevent the theory from being applied. Rather than judicially challenging the discharge of obligation theory itself, the parent simply should be precluded from making any distribution that would have the effect under state law of discharging the parent's legal obligation to the beneficiary. This requires a so-called Upjohn clause. Such a provision is not too restrictive to be acceptable planning because the parent usually is current in satisfying the legal obligation. This means that there is no outstanding obligation to be discharged by any distribution the fiduciary chooses to make and the theory therefore falls flat.

More importantly, the parent's legal obligation cannot be discharged by distributions under the law of most states. This means that no distribution actually would be precluded by this provision (because no distribution would have the prohibited effect). Instead, all the provision does is place the burden of proof on the government. The provision requires the government to prove the impossible by showing that distributions could have been made that would discharge the parent's legal obligation. The government cannot establish this in most states in the first instance, and the clause precludes it in any event.

Oddly (and inappropriately) enough, if a client already is acting as trustee or custodian for the benefit of a minor child, existing authority suggests that the parent can merely resign to avoid unwanted tax exposure. See Rev. Rul. 59-357 (but consider the second clause of §2041(a)(2) in conjunction with Treas. Reg. §20.2036-1(b)(2)). This is a situation in which there hardly is anything to be lost for trying to avoid tax exposure by merely stepping out of harm's way. And for planning purposes the message usually is: find some other fiduciary and avoid these issues entirely.

Incidents of Ownership

Yet another source of potential unexpected tax exposure relates to incidents of ownership with respect to insurance held by an insured in a fiduciary capacity. For example, imagine X as the insured under a policy of insurance held in a trust created by S with X as trustee. The concern is that those fiduciary powers held by X over that insurance will cause taxation of the insurance proceeds to X's estate if X dies while acting as trustee. A similar concern could exist if X could control the policies of insurance through the exercise of a nongeneral power to appoint trust assets.

The issues have been partially solved by the promulgation of Rev. Rul. 84-179, as discussed in detail in Chapter 6 at pages 7-8 and Chapter 9 at pages 45-46. However, because that ruling has a number of significant caveats, prudent drafters also typically deny to the insured any control over insurance on the insured's life, either by excluding that insurance from the reach of a power of appointment or by appointing an "insurance advisor" or special trustee to exercise any incidents of ownership held in a fiduciary capacity. We will discuss this again when dealing with trustee selection in Chapter 6 as well.

Have you begun to notice how many different variables you need to consider in planning an estate? Fortunately most are tax generated and most estates will not be taxable. Still, we need to be careful, and many planning approaches developed in the tax conscious environment don't change in smaller situations.

Estate of Regester

Consider the following examples to illustrate the most important source of unexpected tax liability. These all involve a powerholder's exercise of a nongeneral power of appointment that causes gift tax liability:

D is the income beneficiary of a trust that will be held for D for life, remainder to D's descendants. D also possesses a nongeneral power to appoint trust principal among the remainder beneficiaries. When D is age 65 and doing well D exercises the power to appoint $100,000 to those descendants. To determine the government's view of the gift tax consequences of this exercise you would read Treas. Reg. §25.2514-1(b)(2), Rev. Rul. 79-327, and Estate of Regester v. Commissioner, 83 T.C. 1 (1984); to the contrary is Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956), and Commissioner v. Walston, 168 F.2d 211 (4th Cir. 1948). See Note, *Taxation: Special Powers of Appointment and Transfer Taxation — It Is the Courts' Move*, 34 OKLA. L. REV. 907 (1981). You have learned that nongeneral powers are not taxable. So, what could the gift be here? It is the value of D's income interest in the $100,000.

Assume that D also is trustee of the trust and has authority to make distributions of principal to D's descendants. As trustee D distributes an additional $50,000 to the same descendants (in a transfer that does not violate an Upjohn clause precluding distributions that would have the effect of discharging any obligation D may have to support any of those descendants). To evaluate the government's view of the gift tax consequences of this distribution you would read Treas. Reg. §25.2511-1(g)(2).

It would make a difference in either of these situations if D's descendants were entitled to receive only so much of the income as an independent trustee distributes in its unfettered discretion. See Private Letter Ruling 8535020. So would insertion of a HEMS ascertainable standard. Reread Treas. Reg. §25.2511-1(g)(2). Does that make any sense to you? The most important lesson of this learning is that ascertainable standards provide protection in a wide variety of unexpected situations, so wise drafters use them unless special circumstances clearly dictate otherwise.

Drafting Powers of Appointment

As a means of addressing additional issues that should be reflected in drafting an effective power of appointment, consider the following sample powers of appointment, taken for illustration purposes from an old-style general power of appointment marital deduction trust:

My [spouse] may at any time or times[uu/] during [his/her] life by instrument in writing delivered to the trustee appoint any part or all[vv/] of the principal of the trust estate to or in trust[ww/] for any one or more[xx/] of my descendants and their respective spouses and charitable, scientific or educational purposes, with such powers and in such manner and proportions as (s)he may appoint, and the trustee shall reimburse [him/her] from the remaining principal for the amount of any gift tax incurred thereby.

In addition, my [spouse] may withdraw at any time or times from the principal of the trust estate not to exceed in the aggregate during any calendar year the greater of $5,000 or 5% of the value of the trust estate at the time of exercise.[yy/] The trustee shall make payment without

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uu/ Meaning that the power is not a one-time-only opportunity.

vv/ Meaning that the spouse may exercise the power in one lump sum or in portions, including appointment of the entire fund.

ww/ The authority to appoint "to or in trust" and "with such powers and in such manner and proportions" as the powerholder appoints are designed to clarify the state law ability to appoint in further trust, with interests that are less than a fee simple absolute, and otherwise to assure the fullest flexibility in designing any alternative to the plan originally drafted by the settlor. This is critical for flexibility.

xx/ The permission to appoint to "any one or more" of the permissible appointees establishes that this power is an exclusive entitlement. A nonexclusive power of appointment is nearly an oxymoron. If the donor truly wants every permissible appointee to get something (nonexclusive means no one may be excluded) it would be far better to give each permissible appointee that minimum portion and then allow the powerholder to appoint any excess to whomever the powerholder selects from within the class.

yy/ This power of appointment allows the powerholder to obtain a modest amount of corpus in any year. This is a marital deduction trust that will be fully includible in the powerholder's estate at death. As such this power need not be limited to such a small amount. In a family trust, the five or five power might be the maximum entitlement the settlor is willing to bestow, consistent with preventing inclusion of the trust in the powerholder's estate and preservation of the trust for the benefit of the permissible appointees or the default takers.

Notice the careful definition of the amount subject to withdrawal. It is the aggregate amount defined by §2514(e) in any calendar year, with the value of the trust being determined at the time of any exercise for purposes of measuring the 5% withdrawal right. Omitted is a provision limiting exercise of the power to a given day or other abbreviated period during the year. In a family trust the drafter might attempt in this manner to avoid §2041(a)(2) inclusion of any amount available for withdrawal but not withdrawn at the time of death. There is no authority establishing whether such a power of appointment will avoid tax if death occurs on any other date, and that limitation is not needed in this marital deduction trust because the trust will be includible in all events.

question upon [his/her] written request.[zz/] This right of withdrawal is a privilege that may be exercised only voluntarily and shall not include an involuntary exercise.[aaa/]

Upon the death of my [spouse] the principal and any accrued and undistributed income of the trust estate shall be held in trust hereunder or distributed to or in trust for such appointee or appointees (including the estate of my [spouse]),[bbb/] with such powers and in such manner and proportions as [he/she] may appoint by a valid will making specific reference to this power of appointment.[ccc/]

Upon the death of my [spouse] any part of the principal and accrued and undistributed income of the trust estate not effectively appointed shall be added to or used to fund the Family Trust, except that, unless my [spouse] directs otherwise by [his/her] will, the trustee shall first pay from the principal of the trust estate, directly or to my

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zz/ Some drafters require trustee consent as a tool to protect the powerholder from a forced withdrawal, such as by creditors or other predators. This withdrawal privilege is meant to be free from outside interference, being exercisable solely in the discretion of the powerholder. Not even the trustee may question its exercise.

aaa/ The last sentence seems a bit schizophrenic, given the intent of the immediately preceding sentence. It is consistent with protection of the powerholder's free exercise, however, because it seeks only to preclude an involuntary exercise (such as in response to a demand by a creditor or other predator). The trustee presumably will have sufficient information upon which to ascertain whether any exercise of the power is voluntary, and it is expected that any involuntary exercise would be difficult to disguise. Although these assumptions may not be realistic, the only objective here is to give the powerholder a provision to hide behind if exercise is coerced and not what the powerholder wants.

bbb/ This a general testamentary power of appointment, granted in this old-style all income, general power of appointment trust to qualify for the marital deduction under §2056(b)(5). In addition to those aspects about this power noted in the presently exercisable nongeneral power, several added provisions are worthy of note. The first is the specification that the power extends to not just principal but also any accrued but undistributed income on hand at the death of the surviving spouse. This is required for §2056(b)(5) marital deduction purposes and probably is desirable because the powerholder wants to distribute the entire trust, not just part of it. Also necessary for marital deduction purposes is the parenthetical, specifying that the power is a general power for marital deduction purposes by including the estate of the spouse in the class of permissible appointees. You know from the discussion at page 22 that without the tax benefit in trade for the general power of appointment it likely would not be desirable to give a general power otherwise.

ccc/ The important aspect is the requirement that exercise be by a will "making specific reference to this power of appointment." The rationale for this provision is to preclude an inadvertent or "blanket" exercise of the power, which is the topic discussed next below.

[spouse]'s personal representative as the trustee deems advisable, the amount by which the estate and inheritance taxes assessed by reason of the death of my [spouse] shall be increased as a result of the inclusion of the trust estate in [his/her] estate for such tax purposes. The trustee's selection of assets to be sold to pay that amount, and the tax effects thereof, shall not be subject to question by any beneficiary.[ddd/]

Inadvertent Exercise

Inadvertent exercise of a power of appointment may occur in either of two ways. In some states a "silent" residuary provision in the powerholder's will (for example, "all the residue of my estate shall be distributed . . . ") is deemed to exercise all testamentary powers available to the powerholder unless it can be proven that the powerholder specifically intended *not* to exercise the power. It would be next to impossible to prove that a powerholder formulated a positive intent not to exercise a power of appointment if the powerholder had no knowledge of the power. Even with knowledge of the power it is an uphill battle to establish the intent not to exercise. In silent exercise states the ability to prove the absence of an intent to exercise would not suffice. See, e.g., Cal. Prob. Code §641, N.Y. Est., Powers & Trusts Law §10-6.1(a)(4); 60 Okla. Stat. §299.10.

Unwitting exercise also may occur by virtue of a "blanket" exercise provision in a will (for example, "all the residue of my estate, *including any property over which I may have power of appointment*, shall be distributed . . .") that seeks to exercise all available powers, whether the powerholder knows of the power or is just shooting in the dark.

Exercise of all available powers of appointment is consistent with the intent of most powerholders and, if the power is unknown, the thought often is expressed that the powerholder's disposition through exercise is bound to be better than the default disposition. In many cases nothing could be

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ddd/ The final provisions of this paragraph all relate to payment of taxes in the estate of the powerholder, recognizing that this general power of appointment will cause inclusion of the value of the trust corpus in the powerholder's estate. A waiver of this tax payment directive is permitted if the powerholder would prefer to use other assets for payment of the tax. Otherwise, this provision is more generous than the reimbursement entitlement created by §2207, which is a pro rata allocation of taxes caused by inclusion. This provision directs payment of the incremental taxes caused by inclusion. Any other property also subject to an incremental apportionment provision (such as a QTIP marital trust subject to the §2207A right of reimbursement) should be considered and the two provisions must be coordinated. Finally, the trustee is protected from challenge by any beneficiary who objects to the selection of assets for payment of this liability. Usually the trustee will consult with the beneficiaries to determine whether any particular assets should be preserved but, lacking unanimity, the trustee ought to be protected from a disgruntled beneficiary's challenge. All of these tax payment concerns are addressed in Chapter 11.

further from the truth, especially because the default disposition often is the same as the powerholder's appointment. That being the case, there are a number of excellent reasons not to exercise unknown powers.

For example, creditors of the holder of a general testamentary power of appointment usually may reach appointive assets only to the extent the power is exercised and the powerholder is insolvent. See RESTATEMENT (Second), DONATIVE TRANSFERS §13.4 (1982); RESTATEMENT, PROPERTY §§327, 329-331. If the powerholder is insolvent, the appointive assets (often passing by default to the powerholder's descendants) may be the only property those descendants will receive when the powerholder dies. These assets ought to be protected from creditor claims. By inadvertent exercise under state law or a blanket exercise provision the powerholder instead inappropriately opens the door to creditors.

In addition, exercise without knowing the specific terms of the power runs a good chance of invalidity due to a designation of impermissible appointees (this is less likely if the power is a general power, as in this case, but might arise even with a general power that is narrowly drafted) or because of a violation of the Rule Against Perpetuities. This is extremely likely because the period of the Rule that applies to appointive assets usually runs from creation of the power (when the instrument creating the power became irrevocable). Most planners think to measure any interest that might run afoul of the Rule under the powerholder's estate plan from the powerholder's death. Were this a presently exercisable general power the rule would be otherwise but, because it *is* a testamentary power, the likelihood of invalid appointment is significant if the powerholder's estate planner did not inspect the trust granting the power.

Fiduciary liability also may arise due to an inadvertent exercise. For example, payments might be made unintentionally in violation of the appointment if the power was exercised but the trustee of the trust granting the power did not know it (because the powerholder's will did not refer to the power and no one knew to inform the trustee). That is not likely in this case but, if the power was exercised invalidly, the powerholder's estate might have a claim to the appointive assets under the doctrine of capture, and could be obliged to act under the doctrine of marshaling, both imposing an obligation on the powerholder's personal representative. Who needs that?

Given these factors it seems reasonable for the donor to protect against unwitting exercises by requiring the powerholder to be knowledgeable about the power to effect an exercise. Presumably this will be accomplished if the powerholder must make specific reference to the power to exercise it, on the theory that the power will be inspected at the time the specific reference is crafted.

In addition, wise estate planners usually protect against inadvertent exercise by their clients who may be powerholders: they simply insert a nonexercise provision in the client's will. For example, "all the residue of my estate, *but expressly excluding any property over which I may have power of appointment.*" This express nonexercise provision recognizes the general conflict of laws rule that the law of the donor's domicile, not that of the powerholder's domicile, governs issues such as validity of an exercise of powers of appointment. This, however, is subject to a modern trend to apply the law of the powerholder's domicile. See 5A Scott & Fratcher, THE LAW OF TRUSTS §642 (4th ed. 1989). Drafting to avoid the question always is wise if it is not clear which rule may apply.

Chapter 6

TRUSTEE SELECTION AND SUCCESSION

Fiduciary selection is an ebb and flow phenomenon, particularly with respect to long term trustee relationships. Relatively short term personal representatives for estate administration or for an incapacitated person during life (either as a durable power holder or a court appointed guardian, conservator, or custodian) tend to differ and are not our focus.

For years there was a definite trend away from selection of entities (such as banks) as trustees. That was followed by a resurgence of professional (both individual and entity) fiduciaries when the economy proved that being a successful investor requires more acumen than just buying and holding technology stock. As the fiduciary winds blow, good estate planners cling to the notion that flexibility is important because change is inevitable.

Selection of the "right" trustee requires debunking the myth that individuals cannot (or should not) be selected as trustee because their use is dangerous from a tax perspective. This simply is not true, *if* the planner is a careful technician. It is safe to select an individual (including the settlor or a beneficiary) as trustee, but doing so may require certain restrictions and proper planning and drafting (the most effective illustration of which being effective use of standards to collar the trustee's discretion). This Chapter is designed to assist you in selecting and drafting for employment of whomever is most appropriate for the fiduciary role in a given trust, whether corporate or individual, professional or amateur.

Please note throughout: this discussion is not meant to advocate or denigrate the use of any particular class of fiduciary, nor to opine about the quality or capability of any potential choice. That is a supremely personal topic on which opinions rightly differ, and every situation has unique elements that impact the fiduciary selection process. Were it not for tax considerations, the trustee selection and succession decision could turn solely on factors such as the following:

- What special skills does the fiduciary possess (or lack) and which skills are necessary or desirable to administer the particular trust? For example, basic traits such as reliability, integrity, and fiscal responsibility should be a given. Fiduciary accounting, tax compliance, and investment capability, prudence, and acumen usually can be purchased. Gut level managerial and "people" skills, the ability to operate a particular business, and the sensitivity to apply family-appropriate distribution discretion usually cannot.

- What are the attitudes or philosophies and the track record of the trustee and do they portend difficulties or unsatisfactory treatment of the trust and its beneficiaries? For example, is the trustee loathe to retain the family farm or closely held business stock, is it reputed to be too conservative in investing, does it tend to go overboard in restricting expenditures by or for the benefit of beneficiaries or, alternatively, would it have trouble denying inappropriate requests by profligates?
- What unique problems or exposures does the trustee present? For example, conflicts of interest due to other activities or relationships, the special nature of the trust or its beneficiaries? Particular demands on the trustee's time may make it difficult to prioritize the difficult and demanding chore of acting as a prudent fiduciary. Some trustees create special exposure to regulations generated by the type of assets held by that trust and by the trustee personally.
- What special problems does the trust present? For example, are assets located in several jurisdictions, some restricting or prohibiting involvement of certain types of fiduciary? Is there a need for unique insight into the family to inform distributions to beneficiaries?

For a more detailed discussion of nontax aspects of trustee selection see Bromberg & Fortson, *Selection of a Trustee: Tax and Other Considerations*, 19 SW. L.J. 523 (1965). These are not new or very difficult equations.

Selection of an individual trustee often is the result of a process of elimination or of designation by default, with many potentially suitable entity fiduciaries being rejected or unwilling to serve.[1] Unfortunately, experience shows that often little thought is devoted to objective criteria that appropriately might be weighed in making the trustee designation.[2]

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1. Among commonly expressed reasons for rejecting an entity or other professional fiduciary are: cost; a perception that corporate fiduciaries are too conservative, cautious, and parsimonious (an especially serious concern to adult beneficiaries, such as a surviving spouse, who fear becoming supplicants); a strong criticism of investment performance, including both comparative returns and an almost universal reluctance to experiment with nontraditional investments such as precious metals, gems, or collectibles (although professional fiduciaries probably are *more* likely to invest in sophisticated financial products, such as derivatives); restrictions such as alien land laws that corporate fiduciaries are more likely to honor; and a more general sense that professional fiduciaries know or understand various laws better than others and often comply (to the trust's disadvantage) when another less knowledgeable trustee would not. Obviously some (and perhaps all) of these objections are ill advised!

2. It has been suggested that many people select a fiduciary with less sophistication than they use in buying a new car. See Weiss, *The Fiduciary: Guidelines for Selection, Powers and Succession*, 33 N.Y.U. INST. FED. TAX'N 273, 274 (1975).

In most respects selection of an entity (such as a bank or other institutional trustee) is safe for tax planning purposes, but it may not be appropriate for a particular case. This Chapter focuses particularly upon tax consequences and exposure flowing from selection of beneficially interested individual trustees. Typically corporate fiduciaries have no special concerns in that regard. And tax consequences to the settlor seldom are a concern, even in an inter vivos trust. Nevertheless, on occasion the tax consequences to a settlor (or a related or subordinate party) acting as trustee can be important, and they are noted after we deal with easier and more common situations.

We will learn that naming most individuals as trustee (even those with a beneficial interest) is not difficult or dangerous. But naming the trust settlor as trustee in a tax sensitive situation is not particularly desirable. It can be done, but it tends to invite close scrutiny by the government and ultimately may result in litigation.

This Chapter also discusses a number of unexpected sources of inadvertent tax liability flowing from the selection of trustees. But most of what commands our attention in this arena is obvious, pervasive, and easy to address.

Assume A Testamentary Trust

Let's begin with an assumption that the settlor no longer is in the picture. That is both the more common case and a much easier context in which to address planning and drafting regarding trustee selection. Let's also assume that the trustee is beneficially interested (or is related to a beneficiary of the trust), such that exposure may flow from the individual trustee's powers to distribute corpus or income, or otherwise to administer the trust.

Powers Over Corpus

Potential wealth transfer tax liability may flow from any power to make distributions of corpus to (or for the benefit of) the trustee individually, to his or her estate, or to the creditors of either. The lapse or termination (due to death or resignation) of a power to make distributions to the trustee personally, as beneficiary, or to someone the trustee is obligated to support may trigger either §2041 or §2514 general (taxable) power of appointment estate or gift tax liability.[3]

A significant issue lurks if the trustee has discretion to make distributions of corpus to the trustee personally *and* to other beneficiaries.

3. An exception applies to this general rule for gift tax purposes only. Under the five or five limitation of §2514(e) the lapse of a power in any year is not a taxable gift to the extent the trustee's power to make withdrawals of corpus is limited to an annual maximum of $5,000 or 5% of the value of the trust. But note carefully that the termination of a five or five power at the death of an individual *is* a §2041(a)(2) estate taxable event, causing estate tax inclusion of the amount subject to the power as of the date of death. And there are §678 income tax consequences of a five or five power. This means that the five or five restriction is a solution only to gift tax exposure.

Exercise of that authority to benefit others may constitute a taxable termination of the trustee's power to make distributions to the trustee individually. In addition, distributions may be treated as made to the trustee directly if those other beneficiaries are individuals to whom the trustee owes a legal obligation of support. These also would attract gift taxation to the powerholder trustee.

Finally, the right to distribute trust corpus to a trustee individually may cause trust income to be taxed to the trustee under §678, even if no income or corpus actually is distributed (to the trustee or to anyone else). This is "pseudo grantor trust" exposure and in some cases it is regarded as *favorable*. We explore these consequences beginning at page 6.

One effective drafting mechanism for avoiding all this wealth transfer and income tax exposure is to limit the trustee's powers over corpus. This limit can be effected in either of two ways.

One is by making the trustee's powers subject to an adverse party's consent. This need not be a cofiduciary: consent will suffice regardless of the capacity in which the adverse party is acting. The difficult aspect of this alternative is finding a sufficiently adverse party who nevertheless will give consent in appropriate circumstances, permitting adequate flexibility as intended by granting the trustee discretion to make distributions in the first instance.

Treas. Reg. §20.2041-3(c)(2) Example (1) contains an illustration of a sufficiently adverse party, in that case involving the taxpayer and a remainder beneficiary as trustees, with the remainder beneficiary being adverse to exercise of the taxpayer's power to distribute corpus currently. The problem is that this remainder beneficiary would not be adverse with respect to powers over current income, which illustrates a major limitation on the use of adverse parties. Often they are not adverse with respect to enough of the trust to serve as an adequate protection. Use of the adverse party consent alternative is not common for this and a number of less obvious reasons.

The second alternatively is to use an "ascertainable standard" as defined for §§2041 and 2514 purposes is effective to avoid wealth transfer tax liability. Under a different name the use of similar standards can protect against unwanted income tax exposure too. Use of such standards is so important and common that it is discussed in more detail separately, beginning at page 10.

A third alternative is to deny the tax sensitive power altogether, lodging the desired discretion instead in another individual who has no similar exposure. Worthy of consideration is the use of a "special" trustee (in this case, a "distribution director") whose sole function is to exercise discretion otherwise denied to the individual trustee. For example, if two children were to be made trustees of their own separate trusts, child A might be named as distribution director with respect to distributions to child B, and vice versa. This approach entails less restriction than naming a full-fledged cofiduciary for all purposes (including some for which that individual is unnecessary and maybe even undesirable) while denying inappropriate distribution authority to the beneficially interested trustee.

Beware, however, several issues that might apply. One concern is the "reciprocal trust doctrine" explored at page 14. Even though there is no direct authority for this proposition in this particular context, it might apply in the example given of child A directing distributions to child B and vice versa. The doctrine basically would "uncross" the reciprocal provisions to treat child A as distribution director for child A and child B as distribution director for child B. If applicable the doctrine would defeat this form of protective planning. Another caution is that any power of a trustee to control a special trustee (such as a distribution director) may generate exposure under the "revolving door" theory elaborated upon beginning at page 12. Finally, any finding of a prearrangement or an agreement-to-agree between the trustee and the special trustee also could result in the mechanism being regarded as a sham. Appearances, bona fide planning, separation, and independence are important in this (as in all things).

In addition to the foregoing rules that relate to the individual trustee's power to enjoy distributions, a power to make distributions to a dependent of the individual trustee also could generate estate or gift tax liability. The theory, discussed in Chapter 5 at page 26, easily is avoided by using the "Upjohn" limitation that prohibits the trustee from making any distributions that would have the *effect* of discharging any person's legal obligation to support the beneficiary.

A final source of exposure to an individual trustee flowing from a power to make distributions of corpus is illustrated by Treas. Reg. §25.2514-1(b)(2), Estate of Regester v. Commissioner, 83 T.C. 1 (1984), and Rev. Rul. 79-327, all as discussed in Chapter 5 at page 29. These authorities apply if the trustee also is an income beneficiary of the trust and, as trustee, distributes corpus to a third party. These corpus distributions constitute gifts of the trustee's income interest in that corpus. The best avoidance of this exposure is under Treas. Reg. §25.2511-1(b)(2), providing that an ascertainable standard limiting the trustee's distributions of corpus prevents the distribution from constituting a gift. An alternative noted earlier also would work here: repose the power to distribute corpus in a special trustee.

Powers Over Income

The foregoing discussion addresses powers to distribute corpus. The following deals with powers to distribute income and our concerns are fewer. For example, it is not entirely free from doubt but it appears that §2041 does not apply to powers over income only. This is made somewhat questionable by loose language in Treas. Reg. §§20.2041-1(b)(1) and 20.2041-1(c)(2), in each case referring to powers to affect trust property *or its income*, notwithstanding the clear reference in §2041 itself to powers over "property" with no mention of the income from it. Maybe the foregoing discussion regarding powers over corpus should be considered in relation to income also, in which case the same forms of protection ought to suffice.

Otherwise, our focus with respect to income distributions is §678. This "pseudo grantor trust" income tax provision causes taxation of all trust income to the trustee to the extent the trustee's powers permit distributions of income to the trustee as beneficiary. Distributions of corpus to the trustee as beneficiary trigger application of §678 because the corpus carries the right to all future income from the distributed corpus. But typically §678 is a concern with respect to a naked income interest. In addition, §678(c) attributes income to a trustee to the extent that income actually is distributed for the support or maintenance of someone the trustee is obliged to support or maintain.

Four exceptions to §678 exist, but only two provide reasonably useful planning or drafting opportunities. For example, §678(b) entirely eliminates exposure to the extent income is taxable to the trust's settlor under §§671-677. This is helpful in some inter vivos trust cases but is not useful here because we assumed for this discussion that the settlor is deceased. In addition, §678 applies only to the extent the trustee's powers are exercisable alone, so joint powers protect against undesirable income tax exposure to the trustee. Better than under §2041, this exception is available even if the joint holder of the power is not an adverse party. Thus, a distribution director would work quite well here. Nevertheless, because adverse party consent is required under §2041, and because it is likely that avoidance of both sections will be desired in a given situation, this joint power exception is of limited utility if not drafted to operate under §2041 too. Thus, an adverse party likely will be necessary and, as discussed above, this restricts the utility of this exception.

More importantly, the trustee's powers will be disregarded for §678 purposes under limited but consistent authority[4] if the trustee's powers are constrained by a reasonably definite standard (of the same type that would apply for §674(b)(5)(A) and 674(d) purposes). The standards that qualify are at least as broad as the ascertainable standard that will protect against §2041, so this protection *is* useful. We will discuss it more in detail at page 10.

Finally, §678(c) provides its own limitation that applies to the extent exposure exists in the first instance because of the trustee's power to distribute income for the support or maintenance of someone the trustee is obliged to support or maintain. This limitation simply restricts the amount of income taxable to the trustee to that amount actually distributed for such support or maintenance (rather than the full amount that *could* have been distributed for those purposes). Caution is required in drafting for the

4. The authority is old and scant. See United States v. De Bonchamps, 278 F.2d 127 (9th Cir. 1960); Funk v. Commissioner, 185 F.2d 127 (3d Cir. 1950); Smither v. United States, 108 F. Supp. 772 (S.D. Tex. 1952).

protection of this limitation, however, because it is unlike the discharge theory under §2041. Indeed, the Upjohn clause protection recommended under §2041 will not work under §678. This is because a careful reading of §678(c) and Treas. Reg. §1.662(a)-4 reveals that *discharge* of the obligation of support or maintenance is not required. Thus, a simple prohibition against distributions that discharge those obligations is not effective. Instead of including an Upjohn clause, the document must prohibit distributions for the support or maintenance of anyone the trustee is obliged to support or maintain, and this may be an unacceptably severe restriction of the trustee's discretion. That would depend on the purposes of the trust and the intended scope of trust income distributions.

Note, however, that §678 taxation of trust income to the powerholder may be desirable, for several reasons. One is that the rate of tax in trusts or estates is the highest under the Internal Revenue Code, so taxation to *any* individual could produce a smaller income tax liability than if the income were taxed to the entity. Furthermore, some planners appreciate the notion that a beneficiary can receive income that is taxed to the trustee individually. This is the functional equivalent of the trustee making a tax free gift to the beneficiary in the amount of the income tax the beneficiary need not pay. The parties are better off because *someone* is going to pay the income tax and a savings exists if the difference in the income tax rate of the trustee and the beneficiary is not greater than the gift tax avoided on this implied transfer. It pays to consider whether §678 income tax liability is favorable if the trustee is willing to make this tax free transfer to the beneficiary. Because the income will be taxed to someone (or to the trust itself), in this corner of planning and drafting the appropriate question is to whom that income would *best* be taxed. *Avoiding* income taxation to the trustee may *not* be the intuitive choice.

Administrative Powers

In addition to issues caused by trustee powers over corpus or income, other issues may arise from control over trust administration. These tend to be more specific and less extensive concerns. For example, exposure to §2042 estate tax inclusion of life insurance proceeds may arise if the trust holds insurance on the life of the trustee and the trustee holds "incidents of ownership" over that insurance (such as the power to change beneficiaries, or to borrow against a policy). This is most likely to occur with a spouse acting as trustee of a "spouse owned insurance trust" and, fortunately, this is not very common (because the unlimited marital deduction makes spouse owned insurance a thing of the past. See Chapter 9 at pages 27-28).

Further, the law is not uniform in deciding whether possession of incidents of ownership in a fiduciary capacity will cause insurance to be includible in the estate of the trustee pursuant to §2042. Indeed, Rev. Rul. 84-179 indicates that the government no longer intends to pursue this "incidents as fiduciary" theory in the main. As illustrated in Chapter 9 at pages 45-46, however, caution is required because the protection of the

Ruling is not available in three circumstances that may swallow the rule:

- If the incidents are exercisable for the trustee's personal benefit.
- If the policy originally was owned by the trustee, who became fiduciary with respect to it as part of a prearranged, integrated transaction.
- If the trustee individually transferred any of the consideration for purchasing or maintaining the policy.

In the most common case, a trustee is the insured and is paying premiums on the policy while acting as trustee. This is not protected by Rev. Rul. 84-179. The easy solution is to deny the insured-trustee any incidents of ownership over the insurance. If it is important that someone be able to exercise those incidents, then the answer is to name a special trustee as "insurance advisor" to act with respect to the insurance.

The other common administrative power that might prove disadvantageous is a form of "small trust termination" provision that may create §2041 taxable power of appointment exposure to the trustee. Typically these provisions permit termination of a trust and distribution to the current income beneficiaries if the trust corpus drops below a specified dollar amount. Some drafters grant termination powers using trigger thresholds that give the trustee discretion, exercisable for example whenever the trustee determines that continued administration of the trust no longer is "economical." Arguably this discretion is a taxable power to appoint any portion of the trust that the trustee would receive as a corpus distributee on termination. Easy solutions to this exposure include using only a specified termination figure in trusts in which the trustee also is a beneficiary who could receive a terminating distribution, precluding the trustee from sharing in the terminating distribution under a discretionary termination provision, or placing the power to determine when termination should occur in a special trustee.

These forms of exposure to a beneficiary-trustee are not very extensive, and the planning limitations to minimize or avoid problems are reasonable and easy to implement. Which leads to the simple conclusion that anyone can be trustee if a little thought and care is put into the planning and drafting. Anyone, that is, *except* the settlor, and then only if avoiding tax treatment as if the settlor still owned the trust property is to be avoided. We now turn our attention to that more difficult chore.

While The Settlor Is Alive

A trust settlor who wishes to be trustee of a trust created inter vivos faces gift, estate, and income tax exposure as if the property still was held by the settlor individually. If the intent is to avoid these results, then a wise planner simply will not recommend that the settlor act as trustee. Thus, as a practical matter, self-trusteed trusts usually are found only when gift tax is not applicable, estate tax inclusion is expected, and income shifting is not desired.

Consider the gift tax issue first. The concern is whether transfers made to the trust will be regarded as completed (and therefore immediately taxable) gifts. The presumption is that the settlor cannot make a completed gift for gift tax purposes if the settlor retains control over the property in the capacity as trustee. The settlor probably should not act as trustee if a completed gift is intended, unless the most carefully crafted trust is involved. Only very brave planners would do this, it is not commonplace, and the need for settlor involvement as trustee should be very high before undertaking this kind of endeavor.

On the estate tax side of this equation, the settlor usually wishes to avoid subsequent estate tax inclusion if a completed inter vivos gift is intended. Although very careful drafting could permit a settlor to continue to act as trustee, as a practical matter this also very rarely would be attempted. To be successful requires that the trust not own insurance on the life of the settlor (or that any incidents of ownership over policies on the settlor's life be granted to an insurance advisor or another special trustee). In addition, the settlor as trustee must be denied any power, even in a fiduciary capacity, to vote controlled corporation stock transferred to the trust. This should avoid §2036(b) inclusion of the full value of the stock in the settlor's gross estate at death. And then, while fiduciary powers of an administrative, managerial, or ministerial nature could be retained (such as to allocate receipts between income and principal and powers to direct or veto trust investments),[5] trustee powers of a nature that affect beneficial enjoyment of trust income or corpus would need to be limited by a "definite external standard"[6] of the type discussed at page 10. Finally, although not limited to situations in which the settlor is acting as trustee, application of the discharge of obligation theory under §2036(a)(1) and Treas. Reg. §20.2036-1(b)(2) should be precluded by use of an Upjohn clause (in the same manner discussed at page 5 and in Chapter 5 at page 26 for eliminating §2041 exposure to any other trustee under the same flawed governmental theory).

Avoidance of income tax liability is a far different story. The unexpected reality is that a sizeable amount of planning seeks to cause income tax "grantor trust" exposure to the settlor, causing the trust to be disregarded for income tax purposes and all income tax consequences being applied as if the settlor never made a transfer into the trust but,

5. See United States v. Byrum, 408 U.S. 125 (1972); Old Colony Trust v. United States, 423 F.2d 601 (1st Cir. 1970); and Lowndes, Kramer, & McCord, FEDERAL ESTATE AND GIFT TAXES §8.9 at 158 and §9.20 at 226 (3d ed. 1974).

6. Also established only by old and sparse caselaw and not defined in any manner by the Code or Treasury Regulations. See United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Estate of Ford v. Commissioner, 53 T.C. 114 (1969); Estate of Budd v. Commission, 49 T.C. 468 (1968); Estate of Pardee v. Commissioner, 49 T.C. 140 (1967), acq., 1973-2 C.B. 3; Estate of Kasch v. Commissioner, 30 T.C. 102 (1958); Estate of Weir v. Commissioner, 17 T.C. 409 (1951).

instead, still was owner of the trust assets. Known as "intentionally defective grantor trusts," this planning is done for numerous reasons (such as to avoid capital gain if the settlor engages in otherwise realization transactions with the trust) but we need not explore those here. See instead Chapter 17 at pages 14-15. Suffice it to say only that acting as trustee is not a requisite to intentionally defective grantor trust liability. It usually is generated in other ways. And the income tax grantor trust rules operate independently of the gift and estate taxes. Thus, skilled planners can create defective trusts for income tax purposes while accomplishing a completed gift with no estate tax inclusion, all dehors the trustee situation.

The topic of income tax grantor trust planning is a separate endeavor; it should be carefully considered, but it really exists quite independently of the trustee selection and succession issue. Sometimes it is encountered in the form of prohibitions on distributions for the support or maintenance of anyone the grantor is obliged to support or maintain. Similarly for anyone the grantor's spouse, if any, is obliged to support or maintain — there being an income tax "spousal unity" rule. Sometimes it is encountered in the form of denying any power (to the grantor or the grantor's spouse) to deal with or to borrow trust assets for less than adequate interest or security. Sometimes it is encountered in provisions ensuring that all administrative powers are exercisable only in a fiduciary capacity by the trustee, whomever that is. And sometimes limitations are imposed on the flexibility of the trustee, known as "reasonably definite (external) standards" (as discussed next below).

Use and Definition of Standards

Several different standards were mentioned in the foregoing discussions, including the ascertainable standard of §§2041 and 2514, the reasonably definite (external) standard for grantor trust purposes, and the definite external standard of §2036. As explored (in gagging detail) in Pennell, *Estate Planning: Drafting and Tax Considerations in Employing Individual Trustees*, 60 U.N.C. L. REV. 799, 803 et seq. (1982), these are not the same standard even though several of them are worded in almost exactly the same manner. Of them, the ascertainable standard of §§2041 and 2514 is the most commonly utilized, the most frequently litigated, and the most difficult to satisfy. This means that a standard meeting the definition of an ascertainable standard will meet all the other definitions as well.

Although the ascertainable standard definition is the most difficult to meet, in terms of precision of wording, and is the least flexible of the different standards available, it is recommended that drafters use ascertainable standards for *all* purposes in which a standard is the device used for protection. This recommendation reflects several practical realities. First, because it is the best known and most commonly used, and because it is the most extensively litigated, the ascertainable standard is the best understood standard in terms of what is known to qualify. Second, simplicity and consistency are served by using the same standard for all purposes and this requires that the most restrictive standard be used throughout. In addition, litigation involving terms that may qualify as ascertainable can be unpredictable, making it desirable to use an ascertainable standard because this alone is the standard articulated or defined in "safe harbor" terms by Treas. Reg. §20.2041-1(c)(2).

By way of example, litigation involving the term "emergency" has gone both ways on the question whether it is an ascertainable standard. Treas. Reg. §25.2511-1(g)(2) (a gift tax rule) refers to "a reasonably fixed or ascertainable standard which is set forth in the trust instrument" and gives as an example "a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency." This language virtually parrots similar regulations under §§2041 and 2514, with the exception of the reference to "emergency," as to which the government's position elsewhere is that the term relates to the "timeliness" of a distribution rather than the need for it in terms of health, maintenance, support, or other ascertainable standards. Therefore, the government believes that "emergency" does not qualify.[7] Similar uncertainty surrounds terms like "care," "comfort" (standing alone rather than as part of the phrase "in reasonable comfort"), and even "happiness." See 3 Casner & Pennell, ESTATE PLANNING §12.3.2.4.

Although some planners worry that an ascertainable standard is not as flexible as the law might permit under one of the more liberal standards, the loss of flexibility is so slight (and the need for the difference in flexibility even smaller) that this should not concern you. For example, does anyone really know the difference between alternative terms that might be utilized such as "welfare" (not ascertainable) and "support or maintenance" (ascertainable)? Perhaps more importantly, in a friendly family situation, who would challenge the exercise of discretion under any standard used, and how common is litigation whether a certain payment was proper?

If a family situation is not friendly, however, it may be appropriate to suggest that the trustee either should not be a beneficially interested individual or that all discretion ought to be limited in such a manner as to foster the greatest degree of equanimity possible. Certainly there are circumstances in which the foregoing logic is not correct, but the starting

7. See Estate of Sowell v. Commissioner, 708 F.2d 1564 (10th Cir. 1983), rev'g 74 T.C. 1001 (1980). Hunter v. United States, 597 F. Supp. 1293 (W.D. Pa. 1984), held "for the comfortable support and maintenance . . . or should any emergency arise" was ascertainable because it was less liberal than the clearly ascertainable term "support in an accustomed manner of living"; Wahlfeld v. United States, 47 A.F.T.R.2d 1565 (C.D. Ill. 1980), aff'd in an unpublished opinion (9th Cir. 1980), held that "financial emergency . . . as a result of accident, illness, or other unusual circumstances" was ascertainable because it was tied to health, education, support, or maintenance. Private Letter Ruling 9012053 held "to relieve emergencies" is ascertainable but only because the government felt compelled to follow the authority of Martin v. United States, 780 F.2d 1147 (4th Cir. 1986), and made it clear that in a different Circuit it would argue for a different result, as it did in Technical Advice Memoranda 9044081, 8346008, and 8339004.

point for prudent drafting is that each standard in every document be ascertainable, and then any liberalizing changes be made based on specially considered circumstances, identity of the trustee, and the needs of the beneficiaries.

Deemed Trustees

The following discussion of "deemed trustees" informs the perceived wisdom of a conservative approach to drafting standards. Simply put, drafters today never know what theory the government may propound in the future to allege that an individual should be deemed to possess all the powers of the trustee. In that regard, in a number of circumstances the government has consistently taken the position that someone other than the actual trustee should be treated as the trustee, or as possessing the powers of the trustee, with the result that tax consequences not anticipated by the drafter were imposed.

Probably the best known of these circumstances is based on the "revolving door" power involved in Rev. Rul. 79-353, in which the government held that a settlor possessed all the powers of a trustee because the settlor had the power to remove and replace the trustee at will. Even though the settlor could not be named as successor trustee (which the drafter knew would cause the result advocated by the government, under Treas. Reg. §§20.2036-1(b)(3), 20.2038-1(a)(3), and 20.2041-1(b)(1)), the government's theory was that the mere power to install trustees and remove them at will gave the holder of the revolving door power sufficient control over the trustee that the holder of the power should be deemed to possess the trustee's powers.

The revolving door power is a very important control over trustees whose track record is unknown or whose personal interest may make it more likely that impartial administration may yield to personal prejudice. Many drafters virtually always use such a revolving door power to permit the beneficiaries to maintain a degree of control over the trustee (often thought to be critical with entity fiduciaries, but reality shows it is even more important with individuals who had no track record to predict their actual performance). According to Rev. Rul. 95-58 (the government's current position on this issue), a revolving door power to replace trustees at will does not cause the powerholder to be treated as possessing the trustee's control over trust distributions, provided that any successor trustee is "not related or subordinate to the [powerholder] (within the meaning of §672(c))."

In addition, the government has approved a definition of removal for "cause" that also will avoid the revolving door issue. In Private Letter Rulings 9303018 and 9328015[8] the revolving door powers were held by

8. Both Rulings involved trusts with multiple trustees but, excepting the wording of the parenthetical in item 10, this did not appear to be an essential aspect of either Ruling. Given the lack of specificity in such standards as "mismanagement," "abuse," "inattention," or "unreasonable compensation" authorized by the government, this definition ought to be

trust beneficiaries who could remove and replace any disinterested trustee. Court orders were obtained to modify the revolving door provisions to clarify the settlor's intent that they be exercisable only for any of a list of 13 permissible items. The same attorneys obtained both Rulings on behalf of the same clients, involving different trusts, and the government blessed the same verbiage to incorporate in each court order. Thus, the approach approved seems likely to be a safe way to address this issue in modifying any existing trust. In addition, the definitions of cause provided in both Rulings appear to be an appropriate way to draft either a court ordered clarification of an existing trust or any new provision inserted into documents being drafted currently.

Because the ability to remove and replace trustees is so valuable and appropriate, especially when using an individual trustee who has no fiduciary track record or experience, the government's approved definition of cause is reproduced here in its entirety. You could use any or all of the listed items.

Removal of a trustee for "cause" shall mean any one of the following:

1. The legal incapacity of a trustee.
2. The willful or negligent mismanagement by the trustee of the trust's assets.
3. The abuse or abandonment of, or inattention to, the trust by the trustee.
4. A federal or state charge against the trustee involving the commission of a felony or serious misdemeanor.
5. An act of stealing, dishonesty, fraud, embezzlement, moral turpitude, or moral degeneration by the trustee.
6. The use of narcotics or excessive use of alcohol by the trustee.
7. The poor health of the trustee such that the trustee is physically, mentally, or emotionally unable to devote sufficient time to administer the trust.
8. The failure by the trustee to comply with a written fee agreement or other written agreement in the operation of the trust.
9. The failure of a corporate trustee to appoint a senior officer with at least five years of experience in the administration of trusts to handle the trust account.
10. Changes by a corporate trustee in the account officer responsible for handling the trust account more frequently than every five years (unless such change is made at the request of or with the acquiescence of the other trustee).
11. The relocation by a trustee away from the location where the trust operates so as to interfere with the administration of the trust.

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adequate to provide sufficient latitude in most trusts to remove a trustee whose performance or personal prejudices make continued service undesirable.

12. A demand from the trustee for unreasonable compensation for such trustee's services.
13. Any other reason for which a [state] court of competent jurisdiction would remove a trustee.

This listing of items that constitute cause illustrates that the government is being flexible in terms of the types of concerns it has about the misuse of revolving door powers to gain effective control over the administration and distribution of a trust.

Another approach to the trustee removal and replacement issue without worrying about the §672(c) (not related or subordinate) safe harbor is to make the trustee's powers harmless even if imputed to the powerholder. Administrative and ministerial powers will not cause §2041 general power of appointment includibility if the trustee may not enlarge or shift beneficial interests. Treas. Reg. §20.2041-1(b)(1). And trustee powers over income or principal are harmless if limited by the simple use of ascertainable standards throughout the document and insertion of an Upjohn clause. If §678 exposure also is to be avoided, a provision denying the ability to make distributions for the support or maintenance of beneficiaries the trustee is obliged to support or maintain could be added (but that frequently is a greater degree of limitation than is thought to be acceptable).

It also may be adequate to "bifurcate" the revolving door power, giving the power to remove to one individual and the replacement power to another. If the two powerholders do not act in concert, the argument is that neither has the requisite degree of control to cause §2041 exposure. One concern with this alternative is that the power to remove alone might be deemed sufficient to trigger imputed-trustee status, on the theory that the holder of the removal power will continue to remove trustees until the holder of the replacement power appoints a suitable successor trustee. Similarly, suggested by the facts and holding in Private Letter Ruling 9043052 (but not the basis for the government's conclusion there), a requirement that a committee exercise the power and act only by majority vote may protect against exposure if no individual commands a majority of the votes.

A final common source of litigation and unexpected exposure from trustee appointment and succession provisions is application of the so-called reciprocal trust doctrine. As traditionally formulated in cases like United States v. Estate of Grace, 395 U.S. 316 (1969), the doctrine usually has been applied in situations in which two individuals, often spouses, create trusts with each other as trustee or as beneficiary. In Technical Advice Memorandum 8029001 the government was presented with an unusual fact situation that nevertheless raised the reciprocal trust doctrine. In that case F created two trusts, one with child A as trustee for child B and the other with B as trustee for A. As in most reciprocal trust cases, presumably this "crossing" was done by F because the trustee powers were not appropriate for A to hold as trustee for A and for B to hold as trustee for B.

Under a traditional reciprocal trust application, "uncrossing" occurs at the settlor level. Thus, assume that H created a trust for W with H as trustee and W created a trust for H with W as trustee. The doctrine would regard W as the settlor of the trust with H as trustee for W as beneficiary, and vice versa for the trust created by H. This would create tax consequences relating to trusts with retained enjoyment. In the Memorandum, with F as settlor of both trusts, that kind of uncrossing would work no change. So the Memorandum deemed the trusts uncrossed at the trustee level, causing B to be deemed the trustee of the trust for B and A to be deemed the trustee of the trust for A. Under such an application of the doctrine, imputed trustee powers to A and B might then cause §2041 inclusion of trust assets at each beneficiary's death.

Similarly, Private Letter Ruling 9235025 determined that a decedent, D, possessed a general power of appointment over a trust as to which D and D's sibling were cotrustees with discretion to distribute principal for D's "support, maintenance, comfort, emergencies, and serious illness." The government urged application of the reciprocal trust doctrine despite the application of New York Est. Powers & Trusts Law §10-10.1 (1992), which precluded D from participating as trustee in any decisions to make distributions to D personally. Because D and the sibling also were trustees over an identical trust for the sibling, the government relied upon Estate of Grace and *In re* Estate of Spear, 553 N.Y.S.2d 985 (Surr. Ct. 1990) (similar reciprocal trusts involving grandchildren), to conclude that this "reciprocal" trust and trustee arrangement meant that D effectively controlled distributions to the sibling and the sibling similarly controlled distributions to D. This is an "I'll scratch your back if you'll scratch mine" application of the doctrine.

Thus, the Ruling held that "it can be objectively inferred that [D] and [the sibling] would exercise their respective distributive powers on a reciprocal basis. That is, because of the reciprocal nature of the parties' distributive powers," D could ensure receipt of desired distributions from D's trust. The nature of this ruling was not that D held the powers of D's sibling directly, which would have been harmless because, as powerholder, D already was precluded by state law from making distributions for D's own benefit. Instead, the Ruling treated D as effectively controlling the sibling and, by virtue of that control, D was deemed to hold the sibling's unrestricted power to make distributions to D.

In contrast, Estate of Green v. United States, 68 F.3d 151 (6th Cir. 1995), *aff'g* an unpublished opinion (N.D. Ohio), rejected application of the reciprocal trust doctrine. This case involved grandparents who created separate identical trusts, one for each of their two grandchildren. He named her as trustee for the benefit of one grandchild and she made him trustee for the benefit of the other. The government asserted that the reciprocal trust doctrine would uncross the trusts to cause him to be regarded as trustee of the trust he created and her as trustee of the trust she created. This would then allow §§2036(a)(2) and 2038(a)(1) to apply by virtue of their retained powers over beneficial enjoyment of trust benefits by the respective grandchildren. Because neither settlor could benefit personally, the court rejected application of the reciprocal trust doctrine, stating that it requires that the settlor be in "the same economic position" as if no crossing occurred on creation of the trusts. According to the court there can be no economic position upon which the doctrine can apply if there is no economic benefit to the settlors.

Moreover, the court held that the government cannot "extend the reciprocal trust doctrine to include retained non-economic discretionary fiduciary powers . . . until the core mandate of retained economic benefits by the settlor/trustee has been satisfied," referencing *Grace* and the fact that it involved settlors who named each other as beneficiary of reciprocal trusts. A well reasoned dissent argued that the settlors did maintain "the same economic position" as if the trusts had not been crossed because their powers constituted an economic benefit as much as would retained personal enjoyment. The dissent also concluded that the retained economic enjoyment that the majority regarded as "the core mandate" of *Grace* was merely the operative fact of that case and not an immutable requirement for application of the doctrine.

The point here is that simplistic efforts to dodge unwanted liability are likely to generate litigation and potential failure. This crude form of "crossing" has proven unsuccessful in cases in which the trusts were found to be "interrelated," meaning that the trusts had substantially identical terms, were created at approximately the same time, and to the extent of their mutual value had the same economic effect as if crossing had not occurred.[9] Estate of Levy v. Commissioner, 46 T.C.M. (CCH) 910 (1983), determined that the reciprocal trust doctrine would not apply if the terms of the two trusts differed to any significant extent. In that case the effective difference was existence of a nongeneral power of appointment in one trust that was omitted in the other. No one knows whether such a minor difference would carry the day in litigation of this issue today. The *Levy* court failed to make clear what standard it was using to determine whether differences in the terms of the trusts were "significant" for purposes of the reciprocal trust doctrine. As a result, the approach may be unreliable. Nevertheless, the expectation is that *Levy* may be an effective device in appropriate cases in which limitations on the powers of a trustee are unacceptable. Otherwise, rather than rely on obvious and often ineffective schemes to disguise reality, if the doctrine might apply at all, then the "fix" is to make the trustee powers harmless if held by each beneficiary or settlor as trustee. As illustrated by the confusion among authorities, one conclusion is clear: it presently is imprudent to merely cross trustees if avoidance of tax liability is important.

9. See United States v. Estate of Grace, 395 U.S. 316 (1969); Krause v. Commissioner, 57 T.C. 890 (1972); Rev. Rul. 69-505.

Final Thoughts

What would you recommend if you encountered a client who already was acting as trustee under circumstances making it appear that undesirable tax liability will attach? As it turns out, resignation as trustee may be gift tax free, depending upon the gift tax consequences that applied when the trust was created (and your client's involvement in that). See Rev. Rul. 59-357. The second clause of §2041(a)(2) might suffice to dictate estate tax inclusion notwithstanding resignation (inclusion will result if resignation is followed by the client's enjoyment of interests or powers that would cause inclusion to a trust settlor under §§2036-2038). However, it probably is safe to say that the client has nothing to lose by resigning, if no present gift tax consequences will attach. Similarly, §678(a)(2) may continue to apply notwithstanding a resignation, but again the risk flowing from resignation probably is sufficiently slight to make it worth considering.

Finally, a number of summary conclusions seem appropriate. The first, and perhaps the most effective (and least difficult to accomplish), is to use ascertainable standards whenever sensitive trustees are involved. Although a degree of flexibility may be lost, often this is a slight price to pay. The use of cofiduciaries often increases costs (because each fiduciary must consent to all actions taken by any of them), so the use of special trustees (investment or insurance advisors, and distribution directors) often makes better sense. And last, but most important, usually it is safe to use whomever is the best suited fiduciary, provided that the drafter does an adequate job of drafting around the tax liabilities that may attach. No one (not even the settlor) is precluded from being trustee if proper, careful planning is employed.