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## TRUSTEE DISCRETION: THE BETTER PART OF VALOR OR VULNERABILITY?

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### I. Introduction

- A. Under a basic common law trust, the grantor transfers property to the trustee for the benefit of the current beneficiary (C) for life, then to the remainder beneficiary (R) upon the current beneficiary's death. C receives all of the net accounting income, and upon C's death, R receives the principal outright and free of trust.<sup>1</sup> The trustee has no power to withhold income from C, or to distribute principal to C (i.e., the trustee cannot withhold principal from R).
- B. The current trend in drafting trusts, and in trust legislation, is to provide the trustee with great flexibility in exercising its powers, and to move away from the traditional current income beneficiary/remainder beneficiary structure.
  1. This flexibility enables the trustee to administer the trust effectively in light of current circumstances that the grantor may not have anticipated when the trust was created.
  2. In particular, when a grantor creates a trust, it may be difficult or impossible to anticipate whether, and the extent to which, distributions to a particular beneficiary (or even an unborn beneficiary) may be necessary or desirable. This is especially true if the trust is structured to last for multiple generations, or in perpetuity. For this reason, a grantor may choose to give a trustee very broad distribution powers, not subject to restrictions or standards.
  3. Broad discretionary powers also may allow a trustee to avoid litigation involving the trust, or limit the court's intervention in the administration of the trust.
- C. In a fully discretionary trust, no beneficiary is entitled to any distributions, and must wait for the trustee to exercise its distribution powers. The trustee may favor the current beneficiary over the remaindermen by distributing principal to the current beneficiary, and may favor the remaindermen over the current beneficiary by accumulating income. The beneficiary has no property interest in the trust, and the beneficiary's interest is a "mere expectancy."<sup>2</sup>
- D. Discretionary powers may be used to give the trustee flexibility in:
  1. Providing for a beneficiary's well-being.
  2. Providing for minor or disabled beneficiaries.
  3. Addressing issues related to beneficiaries' marital problems, substance abuse and lack of productivity.
  4. Protecting the trust assets from the claims of a beneficiary's creditors, including a spouse in the event of a divorce.
  5. Protecting the trust assets from wealth transfer taxes.
- E. In addition to flexibility, discretionary powers bring with them both tax consequences and questions regarding the grantor's intent and the scope of the power. Accordingly, giving the trustee sole, absolute and uncontrolled (i.e., "extended") discretion may place a heavy burden on the trustee, who is the ultimate decision maker and steward of the trust property.

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<sup>1</sup> ROUNDS, JR. AND ROUNDS, III, LORING AND ROUNDS: A TRUSTEE'S HANDBOOK §3.5.3.2(a) (2017).

<sup>2</sup> See, e.g., N.H. REV. STAT. ANN. §564-B:8-814(c) (2008).

- F. Because the issues surrounding discretionary powers inevitably affect someone's beneficial interest in the trust, they are more likely to become a source of discussion, and possibly conflict, than, for example, questions regarding the administration of the trust.
- G. The judicial treatment of trustees granted absolute discretion originates in the common law, and varies across jurisdictions. As more states adopt the Uniform Trust Code (the "UTC") (or a variation of it), common law principles of a trustee's duties and powers when granted absolute discretion are being codified and altered.<sup>3</sup> The consequences of a grant of discretion therefore need to be considered in light of recent trends in legislation and case law.

## II. Grantor Intent

### A. Determining Intent from the Terms of the Trust Agreement

1. The benefits to which a beneficiary of a discretionary trust is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the grantor's purposes in granting the discretionary power and creating the trust.<sup>4</sup>
2. In exercising its discretion, a trustee is guided by the grantor's intent, as described in the trust agreement.<sup>5</sup> The words of the trust agreement are construed in accordance with their normal usage.
3. In some cases, examining the trust agreement as a whole will result in the discovery of conflicting messages of the grantor's intent. Only a clear expression of intent provides real insight into the discretionary distribution power.<sup>6</sup>
4. Accordingly, the language of the trust agreement itself should provide the best (and often provides the only) insight into the grantor's intent. The meaning of that language may be affected by context, the purposes of the trust, and also the purposes of the estate plan of which the trust is a part. In some situations, extrinsic evidence may be used to determine the grantor's intent (see discussion below).
5. However, grantors and their counsel often give little or no thought to the words used to guide or mandate the trustee in making distributions. If the trust agreement does not contain express statements of a grantor's intent, the trustee has little guidance regarding the exercise of its discretion.
  - a. Many drafting attorneys simply rely on their forms, and do not discuss distribution options or standards with clients, or thoughtfully consider how "boilerplate" language will impact a given set of circumstances, or a particular grantor or his family.
  - b. As a result, whatever intention the grantor had with respect to the scope of the trustee's exercise of discretion may not have been ascertained by counsel or preserved in the drafting.
  - c. To be influenced by and draw meaning from subtle details of wording may very well ignore the realities of how drafting is done by a particular lawyer, and the fact that the drafting attorney may have given little thought to the particular issue or circumstances for which it has become necessary to discover or attribute intention.<sup>7</sup>

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<sup>3</sup> Taback and Pratt, *When the Rubber Meets the Road: A Discussion Regarding a Trustee's Exercise of Discretion*, 49 REAL PROP., TR. & EST. L. J. 491, 492 (Winter 2015).

<sup>4</sup> RESTATEMENT (THIRD) OF TRUSTS §50(2) (2012).

<sup>5</sup> See, e.g., N.H. REV. STAT. ANN. §564-B:1-112 (2015) ("In interpreting or construing the terms of a trust, the settlor's intent shall be sovereign to the extent that the settlor's intent is lawful, not contrary to public policy, and possible to achieve. For the purposes of determining the benefit of the beneficiaries, the settlor's intent as expressed in the terms of the trust shall be paramount.")

<sup>6</sup> Kiziah, *Practical Issues Arising during Trust Administration* (materials from the Fall 2010 meeting of the American College of Trust and Estate Counsel, Baltimore, Maryland) (Oct. 16, 2010).

<sup>7</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment g.

- d. Accordingly, rather than relying on speculation about the import of specific details of fact or wording, it often is more instructive to analyze the variety of beneficial interests and other provisions of the trust as a whole, with any other available evidence, in a broader effort to ascertain why the trust was created and what role the particular discretionary power was to play in the trust plan.<sup>8</sup>

## B. Drafting Distribution Provisions

Drafting distribution provisions is not a “one size fits all” proposition.

1. The drafting attorney should counsel the client regarding the distribution options and their possible consequences.
2. Failure to do so may result in the trustee having no guidance in making distributions, creating in beneficiaries rights that the grantor does not intend to confer, or failing to provide for a beneficiary in a manner that the grantor intends. For example:
  - a. If the trust owns a personal residence for the benefit of the surviving spouse, who will pay for improvements?
  - b. If the surviving spouse and the grantor’s children (who are not also children of the surviving spouse) are all beneficiaries of a “pot” trust, should the interests of the surviving spouse take precedence over those of the children? If so, under what circumstances should distributions to the children be made?
  - c. Would it be better to name one individual (e.g., the surviving spouse) as the sole beneficiary of a discretionary trust, and give someone a (non-fiduciary) power of appointment over the trust property, that could be exercised in favor of the grantor’s descendants?
3. Accordingly, the drafting attorney should encourage the grantor to articulate his intentions with respect to the purpose and scope of the trustee’s discretionary powers, and incorporate those intentions into the trust agreement. Unfortunately, it is unusual to see explicit and customized expressions of intent in trust documents. This can lead to conflict among the beneficiaries with respect to the grantor’s intent,<sup>9</sup> and force the trustee to make discretionary distribution decisions with no guidance at all, which could lead to beneficiary claims of abuse of discretion.
4. In drafting distribution provisions, the attorney should consider:
  - a. The grantor’s specific purposes in creating the trust.
  - b. The personal and economic circumstances of the beneficiary.
  - c. Potential tax consequences.
  - d. Potential conflict between the beneficiaries.
5. Furthermore, the trust language should both protect the trustee from second-guessing and possible reversal by a judge, and enable the beneficiary to protect his right to receive what the grantor intended him to have.
6. The use of a distribution standard coupled with discretion (e.g., “My trustee *shall* distribute to my son so much of the net income and/or principal as the trustee, in its *sole and absolute discretion*, determines is necessary for my son’s health, support and maintenance”) provides limited insight into

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<sup>8</sup> Id.

<sup>9</sup> See, e.g., Rowe v. Rowe, 347 P.2d 968, 972 (Oregon 1959), where the court stated, “the difficulty in many if not most of these [abuse of discretion] cases is finding the purpose of the grantor with sufficient definiteness to be helpful...the grantor’s specific design in framing a discretionary trust is normally unexpressed or vaguely outlined.”

the grantor's intent and such a standard may, in fact, have a meaning other than what the grantor actually intended.<sup>10</sup> See discussion of ascertainable standards (below).

### C. Impact of Trust Language on Trustee's Exercise of Discretion

1. If the trustee feels secure in its authority to exercise its discretion, the trust will be administered with optimum flexibility.
2. However, if the trustee is in doubt regarding the scope of its discretion and the grantor's intent, it is likely to be conservative in exercising its discretion and making distributions, because underpayment, in the absence of bad faith or abuse of discretion, would result merely in the beneficiary's obtaining a court order directing increased distributions.
3. But if the trustee limits distributions to the current beneficiary, it is probably limiting distributions to the person to whom the grantor intended the trustee to be the most generous.<sup>11</sup>
4. On the other hand, an overpayment could result in a suit against the trustee by the remainder beneficiaries for breach of fiduciary duty. That suit could be brought long after the funds have been paid out, and are no longer recoverable.<sup>12</sup>

### D. Abuse of Discretion

1. What may constitute an abuse of discretion by the trustee depends on basic fiduciary duties and principles, the terms of the discretion, including the proper construction of any accompanying standards, and on the grantor's purposes in granting the discretionary power and in creating the trust.<sup>13</sup>
2. An abuse of discretion may occur:
  - a. If the trustee acts dishonestly, such as when the trustee receives an improper inducement for exercising the power in question.<sup>14</sup>
  - b. If the trustee acts from an improper, but not dishonest, motive. For example, a discretionary power to make distributions for a beneficiary's "support" does not allow the trustee to make well-intentioned, even otherwise reasonable, distributions that are not support-related.<sup>15</sup>
  - c. Through the non-exercise of a discretionary power, or by allowing a beneficiary to receive payments on demand without exercise of judgment.

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<sup>10</sup> Note that both the Model UTC (§504) (Discretionary Trusts; Effect of Standard) and the Restatement (Third) of Trusts (§60) (Transfer or Attachment of Discretionary Interests) eliminate the distinction between discretionary and support trusts, unifying the rules for all trusts fitting within either of those categories. However, the comment to Model UTC §504 expressly provides: "Eliminating this distinction affects only the rights of creditors...It does not affect the rights of a beneficiary to compel a distribution. Whether the trustee has a duty in a given situation to make a distribution depends on factors such as the breadth of the discretion granted and whether the terms of the trust include a support or other standard." Model UTC §506 (Overdue Distribution) provides that regardless of whether a trust contains a spendthrift provision, a creditor can reach mandatory distribution from the trust if the trustee has not made the distribution within a reasonable period of time from the distribution date. For this purpose, the term "mandatory distribution" does not include a distribution subject to the exercise of the trustee's discretion, even if: (a) the discretion is expressed in the form of a standard of distribution; or (b) the terms of the trust authorizing a distribution couple language of discretion with language of distribution. Lawyers frequently and habitually use "shall" to mean different things, one of which is "may", and the comment to §506 of the Model UTC recognizes this, by concluding that a provision stating that "my trustees shall, in their absolute discretion, distribute such amounts as are necessary for the beneficiary's support," is discretionary, not mandatory. See Millard, *Rights of a Trust Beneficiary's Creditors under the Uniform Trust Code*, 34 ACTEC J. 58, 66 (Fall 2008).

<sup>11</sup> Halback, *Problems of Discretion in Discretionary Trusts*, 61 COLUMBIA L. REV. 1425, 1457 (1961).

<sup>12</sup> *Id.* at 1472.

<sup>13</sup> RESTATEMENT (THIRD) OF TRUSTS §50(2) and comment b.

<sup>14</sup> RESTATEMENT (THIRD) OF TRUSTS §87 comment c (2012).

<sup>15</sup> *Id.*

- (1) An abuse of this type results if the trustee, arbitrarily or without knowledge of or inquiry into relevant circumstances, fails to exercise the discretion.<sup>16</sup>
  - (2) Abuse also results if the trustee fails to exercise or otherwise abuses discretionary authority because of mistaken interpretation of the terms of the trust or power, or a misunderstanding of applicable fiduciary law.<sup>17</sup>
3. In this context, relevant fiduciary principles include:
  - a. The general duty to act, reasonably informed, with impartiality among the various beneficiaries and interests, and
  - b. The duty to provide the beneficiaries with information about the trust and its administration.
4. This combination of duties entitles the beneficiaries and the court to accounting information and to relevant, general information about the bases upon which the trustee exercises its discretion.<sup>18</sup> Appropriate disclosure usually can be provided in general terms that allow reasonable protection for confidential, private or sensitive information.

### III. Extrinsic Evidence and Letters of Wishes

- A. When the language of a trust is clear, a court will look only at that language when interpreting it.<sup>19</sup> Extrinsic evidence can't be used to contradict or change the written terms, but only to remove or explain an existing uncertainty or ambiguity.<sup>20</sup> Accordingly, when there is evidence of ambiguity regarding the grantor's intent, the court may consider extrinsic evidence.
- B. For example, post-funding affidavits may be admissible as affirmative evidence of the grantor's intent.<sup>21</sup>
- C. A letter of wishes is a written communication from the grantor to the trustee designed to offer the trustee of a discretionary trust some guidance in the exercise of his discretion. Such a letter may be useful if the trust agreement provides limited guidance, or does not address a particular circumstance.
- D. There is virtually no primary or secondary authority regarding letters of wishes to a trustee.<sup>22</sup>
- E. Is the letter of wishes part of the terms of the trust?
  1. The Model UTC (§103(18)) defines the "terms of the trust" as "the manifestation of the grantor's intent regarding a trust's provisions as expressed in the trust instrument or as may be expressed by other evidence that would be admissible in a judicial proceeding."

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<sup>16</sup> Id.

<sup>17</sup> Id.

<sup>18</sup> Historically, open disclosure of information to beneficiaries has been viewed as an indicia of a trustee acting in good faith. See RESTATEMENT (THIRD) OF TRUSTS §82 (Duty to Furnish Information to Beneficiaries). However, some states allow a grantor to create a "quiet" trust, which limits or eliminates a beneficiary's ability to request or receive information regarding the administration of the trust. See, e.g., 12 DEL. C. §3303(c) (2015) and NEV. REV. STAT. §163.004(1)(a) (2015).

<sup>19</sup> See, e.g., Harrison v. Marcus, 486 N.E.2d 710, 714 (Mass. 1985) ("Trust instruments must be construed to give effect to the intention of the settlor as ascertained from the language of the whole instrument considered in the light of the attendant circumstances.")

<sup>20</sup> See Ferri v. Powell-Ferri, 72 N.E.3d 541, 545 (Mass. 2017), *citing* General Convention of the New Jerusalem in the U.S. of Am., Inc. v. MacKenzie, 874 N.E.2d 1084, 1087 (Mass. 2007).

<sup>21</sup> See, e.g., Ferri vs. Powell-Ferri, 72 N.E.3d 541 (grantor's affidavit, executed in 2012 with respect to a trust he created in 1983, provided affirmative evidence of trustee's authority to decant, where the trust agreement neither expressly permitted nor barred decanting). See also Morse v. Kraft, 992 N.E. 2d 1021 (Mass. 2013) (court permitted grantor, drafting attorney and disinterested trustee to submit affidavits to demonstrate that they intended trust to allow distributions to new trusts without consent or approval of any beneficiary or court); and RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS §10.2 and comment g (2003).

<sup>22</sup> Bove and Langa, *Distinguishing Discretion in Discretionary Trusts – the Letter of Wishes*, MASS. LAWYERS WEEKLY (Jan. 23, 2006); RESTATEMENT (THIRD) OF TRUSTS §87.

2. The comment to §103(18) recognizes that, although the trust agreement itself is always the most important determinant of the trust's terms, the phrase "terms of the trust" is not limited to just the trust agreement. Oral statements, the situation of the beneficiaries, the purposes of the trust, the circumstances under which the trust is to be administered, and, to the extent the trust is otherwise silent, rules of construction, all may have a bearing on the trust's meaning.<sup>23</sup>
3. The comment further provides that a manifestation of a grantor's intent is not evidence of a trust's terms if it would be inadmissible in a judicial proceeding in which the trust's terms are in question. For example, state law may require that trusts of real property be in writing,<sup>24</sup> and the parol evidence rule may exclude evidence otherwise relevant to determining the terms of the trust.
4. The argument for including a letter of wishes as part of the trust is that if the purposes for which the power was conferred upon the trustee by the grantor are only revealed in the letter of wishes, then, in order to monitor and enforce their beneficial interests, the beneficiaries must be able to review both the trust agreement and the letter of wishes.<sup>25</sup>
5. However, the counter-argument is that if the trust is otherwise complete and enforceable, and the grantor provides a non-binding letter of wishes solely to advise the trustee of the grantor's state of mind in connection with the trustee's exercise of discretion in different situations, the letter of wishes should not become part of the trust or discoverable by the beneficiaries.

F. A letter of wishes may be problematic because it:

1. May contain ambiguities
2. May conflict with the trust agreement.
3. May contain information that would be hurtful to the beneficiaries.
4. May have adverse transfer tax consequences (i.e., it may result in the grantor's transfer to the trust being an incomplete gift, or the inclusion of the trust property in the grantor's gross estate)<sup>26</sup>.
5. Will not address all situations that the trustee could encounter in the exercise of his discretion.

G. Rather than relying on a letter of wishes, the better course of action is to include the ideas in the trust agreement. However, that may not always be possible (e.g., circumstances change after trust is created).

1. If a letter of wishes is used, it should be clear that it is not binding on the trustee, so that it doesn't become part of the trust "documents", and thus discoverable or enforceable by the beneficiaries.
2. Discretion is a function of objective judgment, and binding instructions can interfere with the concept of full discretion, and undermine or diminish the opportunity for exercising that judgment.<sup>27</sup>

#### IV. Ascertainable Standards

##### A. General Considerations

1. The scope of discretion is frequently limited by the standard of "health, support, maintenance and education" (often referred to as a "HEMS standard").

<sup>23</sup> RESTATEMENT (THIRD) OF TRUSTS §4 comment a (2012).

<sup>24</sup> Absent a specific statutory provision, such as one that requires transfers of real property to be in writing, a trust need not be evidenced in writing. Model UTC §407 (comment).

<sup>25</sup> RESTATEMENT (THIRD) OF TRUSTS §82 comment a (2012); RESTATEMENT (THIRD) OF TRUSTS §87.

<sup>26</sup> See Treas. Reg. §25.2511-2 (incomplete gift) and Code §2036(a)(2) (inclusion in gross estate).

<sup>27</sup> Bove and Langa, *supra* note 22.

- a. Because these words are so commonly used, the trustee must interpret them in light of the grantor's frame of reference and intent as otherwise expressed in the terms of the agreement.
  - b. When a HEMS standard is accompanied (as it typically is, by habit or custom, if nothing else) by words modifying (i.e., enlarging) the trustee's discretion, such as sole, absolute, unfettered or uncontrolled, the scope of the standard becomes even more uncertain.<sup>28</sup>
2. As explained in footnote 10, both the Restatement (Third) of Trusts (§60) and the Model UTC (§504) decouple the rights of a beneficiary's creditors from the beneficiary's power to enforce a trust, regardless of whether the trust is purely discretionary or imposes a standard for distributions, because the distinction between a discretionary trust and a support trust is, according to these sources, arbitrary and artificial, and attempting to differentiate them leads to different results, on a case-by-case basis, even where the beneficiaries appear to be similarly situated.<sup>29</sup> However, some states have expressly maintained the distinction between discretionary and support trusts, and reject the positions of the Restatement and Model UTC in this regard.<sup>30</sup>
  - a. There is a continuum of discretionary trusts, with the terms of the distributive powers ranging from the most objective (e.g., an ascertainable standard under §2041 of the Internal Revenue Code (the "Code")) to the most open-ended or vague (e.g., "happiness"), or even with no standard at all (for which the court may impose a standard of reasonableness – see discussion below).
  - b. A trust may use any combination of terms and standards to structure the scope of the trustee's distribution powers (i.e., the trust may mix discretion with a standard), but all of the possibilities are still subject to the principle that the court will interfere only to prevent abuse.
3. Words used to modify the grant of discretion to the trustee do not have transparent and unchanging meanings, but instead vary greatly, depending on the circumstances in which they are used, and by whom they are used. The trustee always must interpret the language of the trust agreement within the grantor's frame of reference.<sup>31</sup>
4. The words "health, support, maintenance and education" are terms of art in the tax code, and often (but not always) are used to limit a trustee/beneficiary's discretion in order to avoid adverse transfer tax consequences for the trustee/beneficiary.
5. A trustee's power to distribute trust property is a general power of appointment for federal wealth transfer tax purposes<sup>32</sup> if the power may be exercised for the trustee's direct or indirect benefit. This generally is an issue only if the trustee is also a beneficiary.
6. A "general power of appointment" is any power that may be exercised in favor of one or more of the following: (a) the powerholder, (b) the powerholder's estate, (c) the powerholder's creditors, or (d) the creditors of the powerholder's estate. Code §2041(b)(1)(A) and §2514.
7. The exercise or lapse of a general power of appointment may result in the trustee making a gift, or having the property that is subject to the power included in the trustee's estate for estate tax purposes.

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<sup>28</sup> Bove and Langa, *supra* note 22.

<sup>29</sup> RESTATEMENT (THIRD) OF TRUSTS §60 comment a.

<sup>30</sup> *See, e.g.*, S.D. CODIFIED LAWS §55-1-25 (2015).

<sup>31</sup> Kiziah, *supra* note 6.

<sup>32</sup> In *Jenkins v. United States*, 428 F.2d 538 (5<sup>th</sup> Cir. 1970), *cert. denied*, 400 U.S. 829 (1970), an inter vivos power to appoint property to the powerholder or the powerholder's creditors was held sufficient to make the power a general power of appointment for estate tax purposes. The statutory definitions of general powers of appointment under Code §2041(b) (estate tax) and §2514(c) (gift tax) are identical, as are the definitions provided by the applicable regulations. *See* Treas. Reg. §20.2041-1(c)(1) and §25.2514-1(b)(1). Powers of appointment thus have the same meaning under both the gift and estate tax provisions and are construed together. *See* Rev. Rul. 75-351, 1975-2 C.B. 368.



8. If the exercise of a power is limited or restricted in such a way that the power is not the equivalent of ownership, the power is not a general power of appointment. Code §2514(c) provides that a power of appointment is not a “general power” for gift tax purposes if either:
  - a. The power is limited by an ascertainable standard relating to the health, education, support, or maintenance of the donee; or
  - b. The power is held jointly with either: (i) the person creating the power; or (ii) a third person who has a substantial interest in the appointive property that would be adversely affected by exercise of the power in favor of the other joint holder.
9. Accordingly, it is not unusual to see a grant of discretion to a trustee modified by the standard of “health, support, maintenance and education.” Although the use of these words will avoid conferring a general power of appointment upon a trustee/beneficiary (and thus eliminate adverse transfer tax consequences for a trustee/beneficiary), using them in the absence of tax reasons for doing so (e.g., because a beneficiary can never serve as trustee) may not make the trustee’s job any easier.<sup>33</sup>
  - a. It is unlikely that the grantor has read the tax code, and truly appreciates the meaning of the ascertainable standard.
  - b. The trust agreement should provide guidance with respect to the exercise of the trustee’s discretion beyond the use of these terms.
10. The question, then, is what effect the definitions of the terms in the tax code and regulations should have – beyond their tax implications – when used to set the parameters of a trustee’s discretion.
11. State law determines property rights and interests, and federal law determines how to tax them.<sup>34</sup> In other words, state law, not the tax code or regulations, will be used to interpret the language of a trust agreement. The tax code and regulations merely will determine how the tax laws apply to the property interests that language creates.
12. Some states’ laws contain “default” rules, so that the meaning of the words “health, support, maintenance and education”, for state property law purposes, is the same as for federal tax law purposes.<sup>35</sup> The Model UTC also contains a definition of “ascertainable standard,” and a limitation on the ability of a trustee/beneficiary to distribute trust property to or for the benefit of himself, that is consistent with the ascertainable standard definitions that apply in the transfer tax context.<sup>36</sup>
13. If the property is being held in trust solely as a tax-induced substitute for an outright gift (i.e., to avoid the imposition of estate taxes upon the beneficiary’s death), or to eliminate the ability of a beneficiary’s creditors to reach the trust property, the use of any ascertainable standard at all should be limited to situations in which the beneficiary is also the trustee, and the trust agreement should clearly state that the trustee is authorized and encouraged to distribute the trust property liberally to or for the benefit of the beneficiary, if that is, in fact, what the grantor actually intends.

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<sup>33</sup> See also comment to Model UTC §814, which states that the UTC’s curative provisions (including the imposing an ascertainable standard on the discretion of a trustee/beneficiary) “are often overbroad, applying not only to trusts intended to qualify for tax benefits, but also to smaller trust situations where taxes are not a concern.”

<sup>34</sup> *U.S. v. Rogers*, 461 U.S. 677, 689 (1983).

<sup>35</sup> See, e.g., N.H. REV. STAT. ANN. §564-A:3(a)(1)(A) (2005) (“Due to the inherent conflict of interest that exists between a trustee who is a beneficiary and other beneficiaries of the trust, unless the terms of a trust refer specifically to this paragraph and provide expressly to the contrary, any power conferred upon a trustee...shall not include the following: (A) To make discretionary distributions of either principal or income to or for the benefit of such trustee, except to provide for that trustee’s health, education, maintenance, or support as described under Internal Revenue Code sections 2041 and 2514.”)

<sup>36</sup> Model UTC §103(2) (definition of “ascertainable standard”) and §814(b)(1) (a trustee/beneficiary with the power to distribute trust property in his discretion can only exercise that power for his own benefit in accordance with an ascertainable standard).

## B. Meaning of Terms

### 1. Health

- a. The term “health” is not defined in the Treasury Regulations. Instead, the Regulations provide that the term “health”, and the phrase “medical, dental, hospital and nursing expenses and expenses of invalidism,” create ascertainable standards.<sup>37</sup>
- b. The Restatement provides clarification, stating that the terms “health” and “medical care” refer to benefits “like those normally implied by a support standard,” and not some special form of expensive home care, unless the trust agreement further elaborates on the terms.<sup>38</sup>
- c. However, the Restatement cites no cases solely defining the term “health”, so, without additional guidance in the trust agreement, the trustee may have very little upon which to base its decision to exercise its discretion for a beneficiary’s health. For example, if the grantor had a practice of paying for a beneficiary’s health care during the grantor’s lifetime, then presumably the grantor would want to continue those payments after his death.
- d. Due to the lack of guidance regarding the definition of “health”, courts sometimes resort to the dictionary for guidance.<sup>39</sup>
- e. Permissible distributions for health may include those for emergency medical treatment, psychiatric treatment, psychological treatment, routine health care examinations, dental care, eye care, and health insurance premiums.

### 2. Support and Maintenance

- a. The Treasury Regulations provide that the terms “support” and “maintenance” are synonymous, and that their meanings are not limited to the basic necessities of life.<sup>40</sup>
- b. However:
  - (1) A discretionary power to make payments for a beneficiary’s support or maintenance is not a particularly broad power, and probably doesn’t authorize the trustee to distribute trust property for various marginal purposes that fall within the scope of other standards or supplemental language.<sup>41</sup>
  - (2) For example, the terms do not authorize the trustee to make distributions to enlarge the beneficiary’s personal estate, or to enable the beneficiary to make extraordinary gifts.<sup>42</sup>
- c. Support covers:
  - (1) A beneficiary’s normal living expenses, such as the payment of property taxes, premiums on life and property insurance, and interest on debts.<sup>43</sup>
  - (2) The continuation of accustomed patterns of vacation and of charitable and family giving. “Luxuries”, such as a special vacation of a type the beneficiary has never

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<sup>37</sup> See Treas. Reg. §20.2041-1(c)(2).

<sup>38</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(3).

<sup>39</sup> See *In re Brooks*, 2014 Mich. App. LEXIS 2046 (2014) (appellate court found that trial court properly examined traditional dictionary definitions for the word “health” and found it to include such concepts as mental health and the health of one’s mind, spirit and soul, but not “anything that makes a person ‘feel good’”).

<sup>40</sup> Treas. Reg. §20.2041-1(c)(3); RESTATEMENT (THIRD) OF TRUSTS §50 comment d(2).

<sup>41</sup> Halback, *supra* note 11, at 1435.

<sup>42</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(2); *Gwinn v. Gwinn*, 2016 IL App. (2d) 150851 (Illinois 2016).

<sup>43</sup> See, e.g., *Akers v. Fidelity & Columbia Tr. Co.*, 234 SW 725 (Kentucky 1921); Halback, *supra* note 11, at 1435 (footnote 56).

before taken, may be borderline as entitlements, but may be within the permissible range of a trustee's judgment, even without the grant of extended discretion.<sup>44</sup>

- (3) Expenses related to maintaining the beneficiary's accustomed standard of living, even if the trust agreement does not specifically state that.
  - (a) The accustomed manner of living for these purposes generally is that enjoyed by the beneficiary at the time of the grantor's death, or when an irrevocable trust is created.
  - (b) The distributions appropriate to that lifestyle increase to compensate for inflation, and also may increase to meet subsequent increases in the beneficiary's needs resulting, for example, from deteriorating health or from added burdens appropriate assumed for the needs of another.<sup>45</sup>
  - (c) Distributions allowing the beneficiary an increased standard of living also may be appropriate if, in light of the productivity of the trust estate, the eventual result would otherwise favor the remainder beneficiary over the present beneficiary to a degree unlikely to have been intended by the grantor.<sup>46</sup>
- d. Inferences regarding the intended manner of support will be affected by the size of the trust, relative to the purposes for which distributions are to be made.
  - (1) A small trust may limit the amount that the trustee distributes for the support of any beneficiary, and the trustee may end up making distributions that are less than those actually necessary to support the beneficiary or maintain the beneficiary's accustomed standard of living. If the trust is small, the word "comfort" could serve to prevent a trustee or court from narrowly construing "support" to confine it to bare essentials, as long as premature exhaustion of the corpus is not a danger.<sup>47</sup>
  - (2) The trustee (and the court, upon a petition for instructions) would have great difficulty determining the proper distribution amount if the trust estate was sufficiently large to support the beneficiary for his lifetime, but those distributions would result in little or nothing being left for the remainder beneficiaries. Without supplemental language in the trust agreement, the trustee or the court would be left with a "guesswork solution".<sup>48</sup>
  - (3) Conversely, a beneficiary's rights under a large trust normally would not be enlarged to whatever the trust will bear.<sup>49</sup>
- e. With respect to a married beneficiary, the term "support" usually is construed to mean that the beneficiary is entitled to distributions sufficient to support the beneficiary himself and also the beneficiary's spouse and minor children.<sup>50</sup>
  - (1) Absent specific language in the trust agreement to the contrary, it is unlikely that a grantor intends to provide for the support of an individual beneficiary and "let [the beneficiary's] wife and children go without."<sup>51</sup>

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<sup>44</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(2).

<sup>45</sup> Id.

<sup>46</sup> Id.

<sup>47</sup> Halback, *supra* note 11, at 1440.

<sup>48</sup> Halback, *supra* note 11, at 1439 (footnote 74).

<sup>49</sup> Halback, *supra* note 11, at 1435.

<sup>50</sup> Kiziah, *supra* note 6.

<sup>51</sup> Robison v. Elston Bank & Trust Co., 48 N.E.2d 181, 189 (Indiana 1943).

- (2) A support standard normally covers costs suitable for the education of the beneficiary's children.
  - (3) However, these are questions of construction, and should not be confused with the legal question of whether a beneficiary's interest in a spendthrift or discretionary trust is subject to satisfaction of a claim based on a support or alimony decree.<sup>52</sup>
  - (4) Even if distributions for the support of the family members of a beneficiary are proper, those family members themselves are not, by association, beneficiaries of the trust. Rather, such family members have no rights of their own, but are merely relevant factors in determining the amounts required to maintain the designated beneficiary in his accustomed manner of living.
- f. In general, parents bear the primary obligation to support their child.
- (1) The child's resources should be used for the child's basic needs only if the parents are financially unable to fulfill the obligations themselves.<sup>53</sup>
  - (2) The trustee's discretionary authority normally should be exercised only to provide types of support or other benefits that fall beyond the parental obligation, especially when the parent is a trustee.
  - (3) However, it may be determined through interpretation that a particular grantor intended to provide for, or allow, the beneficiary's full support to come from the trust, and thus to assist and benefit the parent directly.
- g. Justifying support distributions for luxury items can be problematic, especially if there has been no history of such distributions, and the regular distributions wouldn't cover the requested expense (e.g., a trip to Europe), even though the trust estate is sufficiently large to permit the expenditure.<sup>54</sup>
- (1) Stronger language, such as "generous" support, may permit and encourage the trustee to allow, and may even require, some reasonable enhancement of the beneficiary's lifestyle, but it falls short of the "happiness" standard, because benefits still must be support related.<sup>55</sup>
  - (2) Ideally, the trust agreement will make clear whether, and the extent to which, distributions for such luxury items are permissible.
- h. It is unclear whether, in the absence of express language in the trust agreement, "support" includes the expenses of a beneficiary's last illness and funeral.<sup>56</sup> However, the presumption is that the trustee has discretion to pay these expenses.
- i. The trustee should be cautious about exercising its discretion to make distributions for the purpose of allowing the beneficiary to make gifts of the distributed property.

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<sup>52</sup> Halback, *supra* note 11, at 1437. See also Pfannenstiehl v. Pfannenstiehl, 55 N.E.3d 933 (Mass. 2016) (beneficiary's interest in a discretionary trust not considered part of the marital estate).

<sup>53</sup> Rounds and Rounds, *supra* note 1, citing Armstrong v. Armstrong, 544 P.2d 941, 943 (Calif. 1976). See also RESTATEMENT (THIRD) OF TRUSTS §50 comment e(3).

<sup>54</sup> Halback, *supra* note 11, at 1436, citing Kimball v. Reding, 31 N.H. 352 (1855) (where trust was large and discretion wasn't subject to clear standards, major expenditures were approved for travel and vacationing by a beneficiary who had been frugal and who had not customarily traveled or enjoyed luxuries).

<sup>55</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(2).

<sup>56</sup> Halback, *supra* note 11, at 1438. See also Wells Fargo Bank, N.A. v. Estate of Mansfield (In re Trust Created by Hansen), 798 N.W.2d 398 (Neb. 2011) (trustee did not violate its fiduciary duty by declining to pay the amount of a beneficiary's last-illness expenses to the beneficiary's estate following her death).

- (1) The terms “support” and “maintenance” do not authorize distributions to enlarge the beneficiary’s personal estate or allow the beneficiary to make extraordinary gifts.<sup>57</sup>
- (2) The terms probably would permit distributions to allow the beneficiary to make gifts to family members, especially if those gifts continued a pattern of gifting that existed before the grantor’s death.<sup>58</sup>
- (3) However, enlargement of a beneficiary’s estate by release of his debt to the trust, even though the debt constitutes a major portion of the trust assets, may be permitted if the beneficiary’s “comfort, welfare and happiness” are express purposes of the discretionary power.<sup>59</sup>
- (4) If the trustee makes distributions to the remainder beneficiaries of a marital trust with the spouse’s consent (i.e., as gifts from the spouse), the trust will no longer qualify for the estate tax marital deduction.<sup>60</sup>

### 3. Education

- a. The term “education” is not defined in the Treasury Regulations. Instead, the Regulations provide that the term “education” creates an ascertainable standard.
- b. The Restatement provides clarification, stating that the term “education” usually means the payment of living expenses, fees and other costs of attending an institute of higher education.<sup>61</sup>
- c. The trust agreement should make clear the level of education intended, or whether other types of training or broadening experiences are to be included. The agreement also should specify how long the educational benefits should continue. In particular:
  - (1) Is the trustee authorized to pay for the education of an adult beneficiary, or do payments for education cease after a beneficiary has reached a certain age, or achieved a certain level of schooling?
  - (2) Can the trustee pay for the beneficiary’s expenses incurred between college semesters?
  - (3) Does education include the costs of private education before college?
- d. Sample language:

The Trustee, in its sole and absolute discretion, may pay out of the net income or principal, or both, to or for the benefit of the primary beneficiary of such trust (i.e., the grandchild in whose name the trust is established) such amount or amounts as the Trustee, in its sole and uncontrolled judgment, determines is reasonably necessary to cover the costs of the primary beneficiary’s post-secondary education. Any net income not so paid shall be added to principal. In exercising this discretion, it is the Grantor’s wish (but not direction) that when possible, the Trustee will make distributions directly to the educational provider(s) instead of to the primary beneficiary himself or herself. For purposes of this Paragraph, the costs of the primary beneficiary’s post-secondary education may include, but are not limited to, tuition, fees, room, board, books, supplies and transportation. The Trustee’s determination of what expenses constitute costs of the primary beneficiary’s post-secondary education shall be final and not subject to question by any person interested in the trust estate.

<sup>57</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(2).

<sup>58</sup> See, e.g., *Estate of Hartzell v. Comm’r.*, T.C. Memo 1994-576.

<sup>59</sup> Halback, *supra* note 11, at 1439, citing *Combs v. Carey’s Trustee*, 287 S.W.2d 443 (Kentucky 1955).

<sup>60</sup> Under Code §2519, a spouse who makes a lifetime gift of her income interest in a QTIP trust is deemed to have made a taxable gift of the remainder interest in the trust property.

<sup>61</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(3).

### C. Other Terms

Trust agreements often contain other terms ostensibly intended to guide the trustee. But, without clear statements of grantor intent, how will a trustee know exactly what those terms mean, and how they will be interpreted by a court? The use of these terms may cause uncertainty regarding the circumstances under which the trustee may exercise its discretion.

#### 1. Comfort.

- a. The Treasury Regulations provide that the term “comfort,” when used alone, is not an ascertainable standard.<sup>62</sup> However, the terms “support in reasonable comfort” and “maintenance in health and reasonable comfort” are ascertainable standards.
- b. The word “comfort” often accompanies a support standard, but the term adds nothing to the usual meaning of the term “support” for a beneficiary whose lifestyle is already reasonably comfortable.
- c. However, the term “comfort” may allow for an elevated standard of support if the beneficiary’s lifestyle has been more modest.
- d. Courts are often asked to interpret the meaning of the term “comfort,” and grantors and drafters would be wise to modify the term, and provide the trustee with additional guidance, with respect to what the grantor actually means by the term.

#### 2. Welfare and Happiness.

- a. The terms “welfare” and “happiness” are often considered to be synonymous. They are not ascertainable standards.
- b. The term “happiness” is considered to be a much broader term than the term “support”, and suggests an intention that the trustee exercise its judgment generously and without relatively objective limitations.<sup>63</sup>
- c. The primary effect of the term “happiness” is to immunize from challenge by remainder beneficiaries almost any reasonably affordable distributions. This, however, does not mean that the trustee cannot properly resist any reasonable request by the beneficiary, because the decision remains one within the fiduciary discretion of the trustee.<sup>64</sup>

#### 3. Emergencies.

- a. If the trustee is a beneficiary, and the trustee can make distributions for “emergencies”, the trustee/beneficiary may have a general power of appointment.<sup>65</sup>

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<sup>62</sup> Treas. Reg. §20.2041-1(c)(2).

<sup>63</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(3). See also Amoskeag Trust Co. v. Wentworth, 111 A.2d 198 (N.H. 1955) (trust agreement that directed payment of income to sole beneficiary “in order that his personal necessities and needs may be paid” ruled out payments that might contribute to beneficiary’s happiness, contentment and peace of mind, regardless of his need for them).

<sup>64</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(3).

<sup>65</sup> See, e.g., Estate of Sowell v. Comm’r., 708 F.2d 1565 (10<sup>th</sup> Cir. 1983), *rev’g* 74 T.C. 1001 (1980) (“The Tax Court erred in its underlying assumption that the word ‘emergency’ has an inherent meaning broader than health, education and support. The key characteristic of the meaning of ‘emergency’ is that of need. The Tax Court also erred in concluding that the concept of an ‘emergency’ included broader uses than for support or maintenance...We have exhaustively researched this issue and have not discovered a case which broadly construes the term ‘emergency’ so as to allow a general power of appointment, sufficient to render a fund taxable to an estate.”) But see PLR 7841006 (6/19/1978) (trustee’s power to invade corpus of trust in cases of illness or emergency created a general power of appointment).

- b. “Emergency” and similar terms accompanying discretionary powers generally are strictly construed, and usually refer to extreme need.<sup>66</sup>
- c. However, “emergency” does not only encompass things such as injury, illness and economic catastrophe, but also extends to general inadequacy of resources and of earning capacity.<sup>67</sup>
- d. The term is construed as authorizing distributions only when the described circumstances arise, and then only to the extent appropriate to alleviate the emergency.<sup>68</sup>

## V. Other Tax Considerations

### A. Legal Obligations of Support

1. If a trustee/beneficiary has a legal obligation to support another beneficiary (e.g., the trustee’s minor child is also a beneficiary), and the support obligation may be satisfied by a distribution from the trust in the trustee’s discretion, the trustee’s discretionary distribution power is a general power of appointment, even if it is measured by an ascertainable standard relating to the health, education, support, or maintenance of the beneficiary (see below).<sup>69</sup>
2. For this reason, trusts often include an “Upjohn” provision that prohibits the trustee from making distributions that would discharge the trustee’s legal obligations of support.<sup>70</sup>
3. The trust income may be taxable to the grantor (i.e., the trust may be a grantor trust) if the trustee has discretion to distribute the income for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, and actually makes the distribution.<sup>71</sup>
4. Sample language for a revocable trust:

No Trustee (other than the Grantor) may: (1) make any distribution to or for the benefit of a beneficiary of the subject trust that would discharge such Trustee’s legal obligation to support such beneficiary; or (2) participate in the exercise of any discretionary power to distribute income or principal to or for the benefit of himself or herself (unless subject to an ascertainable standard).

### B. Removal and Replacement of Trustee

1. If a trustee has discretion to make distributions to a beneficiary, and the beneficiary has the power to remove and replace the trustee, and appoint a successor trustee who is related or subordinate to the beneficiary, or to appoint the beneficiary himself as the successor trustee, then the beneficiary will have a general power of appointment.<sup>72</sup>
2. A draftsperson considering granting a trust beneficiary the power to remove or replace a trustee who has the power to make discretionary distributions to that beneficiary should add the restriction that the replacement trustee cannot be the beneficiary himself or a trustee who or which is related or subordinate to the beneficiary.

<sup>66</sup> Halback, *supra* note 11, at 1440.

<sup>67</sup> Halback, *supra* note 11, at 1441, *citing* Application of Sabol, 191 N.Y.S.2d 773 (Sup. Ct. of N.Y. 1959).

<sup>68</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(4).

<sup>69</sup> Treas. Reg. §25.2514-1(c)(1) and §20.2041-1(c)(1).

<sup>70</sup> See Upjohn v. U.S., 72-2 USTC ¶12,888 (W.D. Mich. 1972). §814(b)(2) of the Model UTC contains a similar provision (“A trustee may not exercise a power to make discretionary distributions to satisfy a legal obligation of support that the trustee owes another person.”).

<sup>71</sup> The mere possibility that the trust income may be used to discharge the legal obligation of the grantor or the grantor’s spouse to support someone does not itself cause a trust to be taxable to the grantor under Code §677(b), unless the individual whose support may be paid is the grantor’s spouse.

<sup>72</sup> Treas. Reg. §20.2041-1(b)(1) and Treas. Reg. §25.2514-1(b)(1). See also Rev. Rul. 95-58, 1995-2 C.B.191 and PLR 201702016 (9/19/2016).

3. Sample language for a revocable trust:

If any individual (other than the Grantor) is removed as a Trustee hereunder, and such individual is authorized to appoint a successor Trustee, such individual shall not participate in any decision to appoint such successor Trustee. If any individual (other than the Grantor) is serving as a Trustee hereunder, and such individual is authorized to remove such Trustee, such individual shall not participate in any decision to remove himself or herself as a Trustee.

Notwithstanding the provisions of [applicable state law], after the Grantor's death, the persons designated below (the "Removal Powerholder") shall have the power remove the Trustee designated below for any reason. The removal of a Trustee shall be accomplished by an instrument signed by the Removal Powerholder and mailed or delivered to such Trustee and the person(s) authorized to appoint a successor Trustee. Such removal shall become effective only upon the written acceptance of a successor Trustee. Upon removal of any Trustee, a successor Trustee shall be appointed as provided in Paragraph \_\_\_\_ above; provided, however, that if the Removal Powerholder is the person authorized to appoint a successor Trustee, then such successor Trustee shall not be the Removal Powerholder himself or herself, or related or subordinate [within the meaning of Code §672(c)] to the Removal Powerholder.

VI. Scope of Discretion

- A. When a trustee has simple discretion, it has discretion that is not "sole", "absolute" or "unlimited". Use of those words as modifiers will enlarge the scope of the trustee's discretion. Such enlarged discretion is referred to as "extended discretion". The difference between simple and extended discretion is probably one of degree, and not of kind.<sup>73</sup>
- B. If the trust agreement grants the trustee "sole and absolute" discretion, not modified by an ascertainable standard, the trustee still must act honestly and in the state of mind contemplated by the grantor.
- C. Sample language:

The Trustee may pay out of the net income or principal, or both, of the Family Trust such amount or amounts (whether equal or unequal and whether the whole or a lesser amount) as the Trustee, in its sole and absolute discretion, determines to or for the benefit of such one (1) or more persons then living as the Trustee, in its sole and absolute discretion, may select out of a class composed of the Grantor's wife and the Grantor's then living issue; provided, however, that while any such beneficiary is serving as Trustee, the beneficiary as Trustee: (1) may distribute net income or principal, or both, to himself or herself only at such times and in such amounts as is necessary for his or her health, maintenance, support, and education; and (2) shall not exercise discretion to make any distributions to any person in such class that will relieve any legal obligation of the beneficiary to support such person. Any net income not so paid shall be added to principal. In exercising this discretion, the Trustee may, but need not, consider any other resources of the Grantor's wife and issue, and it is the Grantor's hope, but not direction, that the Trustee will give primary consideration to the needs and desires of the Grantor's wife.

- D. The Restatement provides that it is a matter of interpretation to ascertain the degree to which the grantor's use of language of extended discretion manifests an intention to relieve the trustee of normal judicial supervision and control in the exercise of a discretionary power over trust distributions.<sup>74</sup>
- E. §814 of the Model UTC provides that even if the trust agreement confers upon a trustee extended discretion, the trustee still must exercise its discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries. The Model UTC does not permit a grantor to waive this rule in the trust agreement.<sup>75</sup>

<sup>73</sup> Halback, *supra* note 11, at 1433.

<sup>74</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment c.

<sup>75</sup> Model UTC §105(b).



- F. The Model UTC does not define the term “good faith”. The comment to §814 states that the trustee’s obligation to act in good faith is a fundamental concept of fiduciary law, “although there are different ways it can be expressed.”<sup>76</sup>
- G. In general, the trustee’s duty to act in “good faith” means that the trustee has a duty to act honestly, and without fraud or collusion. It also may require the trustee to observe the common standards of decency, fairness and reasonableness in accordance with the terms of the trust, the trust’s purposes and the interests of the beneficiaries, as those interests are defined in the terms of the trust.<sup>77</sup>
- H. The trustee cannot act in bad faith or for a purpose or motive other than to accomplish the purposes of the trust. A trustee who exercises discretion in bad faith does so for fraudulent, selfish or improper purposes.<sup>78</sup>
- I. The trustee also cannot act capriciously, from careless good nature, or from the desire to relieve himself of trouble, but only after consideration of all of the circumstances.<sup>79</sup>
- J. Extended discretion may discourage challenges by remainder beneficiaries to the generosity of trustees. However, it also may make it difficult for a discretionary beneficiary to obtain judicial intervention when a trustee’s judgments are highly conservative with respect to matters that fall within the grantor’s authorized purposes.
- K. There is little case law relating to the standard to be applied in deciding the appropriateness of a trustee’s exercise of a power to make distributions from a trust where the discretion is unlimited.

## VII. Court Intervention

- A. In every U.S. jurisdiction, a trustee’s exercise of discretionary authority, including absolute discretionary authority, is subject to judicial review.<sup>80</sup> The courts of some states, however, may be more hesitant to review the challenge of a trustee’s exercise of its discretion.
- B. In general, the exercise of discretion by a trustee who has extended discretion (“sole”, “absolute”, “sole and absolute”) cannot be upset unless the exercise is unreasonable (see discussion of reasonableness, below).<sup>81</sup> These terms provide the trustee with greater latitude in exercising its discretion, but do not give it unlimited latitude.<sup>82</sup>
  - 1. A grantor cannot relieve a trustee of all accountability.
  - 2. If the beneficiaries have no rights enforceable against the trustee, there is no trust.

<sup>76</sup> See comment to Model UTC §1012 (Protection of Person Dealing with Trustee), which states, “The Code does not define ‘good faith’ for purposes of this and the next section [Certification of Trust]. Defining good faith with reference to the definition used in the state’s commercial statutes would be consistent with the purpose of this section, which is to treat commercial transactions with trustees similar to other commercial transactions.”

<sup>77</sup> See, e.g., N.H. REV. STAT. ANN. §564-B:103-30(A) (2017) (defining “good faith” with respect to a fiduciary and beneficiary “as the observance of common standards of honesty, decency, fairness, and reasonableness in accordance with the terms of the trust, the trust’s purposes, and the interests of the beneficiaries as their interests are defined under the terms of the trust”).

<sup>78</sup> Rounds and Rounds, *supra* note 1.

<sup>79</sup> *Id.*

<sup>80</sup> Taback and Pratt, *supra* note 3, at 492.

<sup>81</sup> Porter, *Exercising Discretion and Managing Intergenerational Conflicts* (materials from the Chicago Estate Planning Council Meeting) (May 13, 2009), p. 20. However, state statute may limit the extent to which a court may review a trustee’s distribution discretion. See, e.g., S.D. CODIFIED LAWS §55-1-43(3), which provides: “A court may review a trustee’s distribution discretion only if the trustee: (a) Acts dishonestly; (b) Acts with an improper motive; or (c) Fails, if under a duty to do so, to act.” The statute further provides, “A reasonableness standard may not be applied to the exercise of discretion by the trustee with regard to a discretionary interest. Other than for the three circumstances listed in this subdivision, a court has no jurisdiction to review the trustee’s discretion or to force a distribution.”

<sup>82</sup> Kiziah, *supra* note 6.

3. The comment to Model UTC §814 provides that no grant of discretion is ever absolute, and that the grant of discretion simply establishes a range within which the trustee may act. The greater the grant of discretion, the broader the range.
- C. A court generally will not instruct a trustee on how to exercise its discretion. It will, however, intervene in the exercise of a trustee's discretion:
1. To prevent misinterpretation or abuse of discretion by the trustee.<sup>83</sup>
  2. To prevent a trustee from acting in bad faith, or without regard to the terms and purposes of the trust or in the interests of the beneficiaries, or for some purpose or motive other than the accomplishment of the purposes of the discretionary power.<sup>84</sup>
  3. To prevent the trustee from failing to act, either arbitrarily or from a misunderstanding of the trustee's power or duty.<sup>85</sup>
  4. If (in the absence of extended discretion) it finds that the distributions made, or not made, are unreasonable as a means of carrying out the terms of the trust (see discussion of reasonableness, below).<sup>86</sup>
- D. Judicial intervention is not warranted simply because the court would have exercised the discretion differently.<sup>87</sup>
1. In fact, it is reversible error for a court to "improve upon" the trustee's reasonable decision to distribute amounts it deems necessary and proper for a beneficiary's support and maintenance.<sup>88</sup>
  2. This is because judicial interference may undermine the grantor's intent in granting broad discretion to the trustee.<sup>89</sup>
  3. If the trustee abuses its discretion, it breaches its fiduciary duty, and the breach may result in surcharge.<sup>90</sup>
  4. What constitutes an abuse depends on the terms and purposes of the trust, and particularly on the terms and purposes of the power and any standards or guidance provided for its exercise, as well as on applicable principles of fiduciary duty.
- E. The Model UTC requires the trustee to exercise its discretion in accordance with the terms and purposes of the trust, and the "interests" of the beneficiaries.<sup>91</sup>
1. Note that the Model UTC does not require the trustee to exercise its discretion in the "best" interests of the beneficiaries. Rather, the trustee must consider the interests of the beneficiaries.
  2. §103(8) of the Model UTC defines the "interests of the beneficiaries" as the beneficial interests as defined in the terms of the trust, and not as determined by the beneficiaries.<sup>92</sup> Absent some other restriction, a grantor is always free to specify the trust's terms to which the trustee must comply.<sup>93</sup>

<sup>83</sup> RESTATEMENT (THIRD) OF TRUSTS §50(1) and §87.

<sup>84</sup> RESTATEMENT (THIRD) OF TRUSTS §87 comment d.

<sup>85</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment c and §87 comment d.

<sup>86</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment b.

<sup>87</sup> Id.

<sup>88</sup> Halback, *supra* note 11, at 1429.

<sup>89</sup> Taback and Pratt, *supra* note 3, at 493.

<sup>90</sup> Comment to Model UTC §814. See also Model UTC §1001(b) (remedies for breach of trust).

<sup>91</sup> Model UTC §814.

<sup>92</sup> Comment to Model UTC §103 and §105. The comment to §105 states: "With only limited exceptions, the...rights and interests of a beneficiary are as specified in the terms of the trust."

<sup>93</sup> Comment to Model UTC §105.

- F. Extended discretion makes it difficult for a discretionary beneficiary to obtain court intervention when a trustee makes conservative judgments that clearly fall within the grantor's authorized purposes.<sup>94</sup>
- G. Because the words contained in the discretionary distribution provision are often the only indication of the grantor's intent, it is important that the drafter consider the choice of words carefully. Using the same terms in every trust, for every grantor, is inappropriate, and makes it difficult to determine what the grantor was, in fact, trying to accomplish.

## VIII. Reasonableness

- A. Ideally, the trust agreement will include a statement of the purposes of a trust, the purposes for which the trust was created, and of the general frame of mind in which the grantor wants the trustee to act.
- B. Litigation involving a trustee's abuse of discretion frequently involves a claim that the trustee, in exercising a power, has acted unreasonably (i.e., beyond the bounds of reasonable judgment).<sup>95</sup>
- C. A court might impose a general standard of reasonableness even if the trust agreement does not expressly provide one.<sup>96</sup>
  - 1. In some cases, there is an objective standard by which the reasonableness of the trustee's conduct can be measured, but expressed standards are not necessary in order for a good faith decision of the trustee to be found unreasonable.
  - 2. In either event, judicial intervention on the ground of abuse is called for, not because the court would have exercised the discretion differently, but because the trustee's decision is one that would not be accepted as reasonable by persons of prudence.<sup>97</sup>
- D. §814 of the Model UTC (Discretionary Powers) does not impose an obligation that a trustee's decision be within the bounds of reasonable judgment, although such an interpretive standard may be imposed by the courts if the document adds a standard whereby the reasonableness of the trustee's judgment can be tested.<sup>98</sup>
- E. It is difficult to find cases in which the court has upheld an exercise of discretion that, in the circumstances, truly appears to have been unreasonable (even if the trustee has extended discretion).<sup>99</sup>
- F. The reasonableness standard can be eliminated through drafting. It's important to eliminate it because the standard is "mushy" and gives a court considerable discretion to overrule a trustee's exercise of discretion.<sup>100</sup>
- G. Sample language for eliminating reasonableness standard of review:

The exercise of any Trustee's discretionary power shall be final unless such Trustee has acted in bad faith. The Grantor recognizes and intends that an effect of the preceding sentence is to eliminate the application of the reasonableness standard to the Trustee's exercise (or non-exercise) of its discretion to distribute the property of a fully discretionary trust created hereunder.

## IX. Fiduciary Duties in Decision Making

### A. Duty to Act

- 1. In general, a trustee must administer a trust in good faith, in accordance with the terms and purposes of the trust, and in the interests of the beneficiaries.<sup>101</sup>

<sup>94</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment c.

<sup>95</sup> RESTATEMENT (THIRD) OF TRUSTS §87 comment c.

<sup>96</sup> State law, however, may eliminate the reasonableness standard with respect to a trustee's discretion to make distributions.

<sup>97</sup> See, e.g., S.D. CODIFIED LAWS §55-1-43 (see discussion of court intervention, above).

<sup>98</sup> Id.

<sup>99</sup> Comment to Model UTC §814, *citing* RESTATEMENT (SECOND) OF TRUSTS §187 (similar).

<sup>100</sup> RESTATEMENT (THIRD) OF TRUSTS §87.

<sup>101</sup> Porter, *supra* note 81, at 28.

2. A trustee must consider whether to exercise discretion or not – it can't fail to deliberate, and can't remain passive. A trustee breaches its duty if it refuses to make a determination regarding the exercise of discretion.
3. When exercising its discretion, the trustee should consider the distribution request in light of prior requests, and how the trustee has responded to them.
4. The trustee should evidence in writing any exercise of its discretion, to create for the trust file a readily accessible history of distribution requests and decisions. This will be valuable for both the current fiduciary and any successor fiduciaries.
5. Examples of what documents should be obtained to support the approval or denial of distribution requests include:<sup>102</sup>
  - a. A written distribution request, including the reason the beneficiary is requesting the distribution (a request from a minor beneficiary should be made by the beneficiary's parent).
  - b. Documents evidencing the information the trustee takes into account when considering distribution requests (e.g., tax returns, budgets, information about a beneficiary's other resources, etc.).
  - c. A memo or other document evidencing the trustee's consideration of the beneficiary's interest in the trust. If there are multiple beneficiaries, this should include an assessment of their interests, to ensure that the distribution is consistent with the trustee's duty of impartiality.
  - d. Written approvals of all of the fiduciaries.

## B. Duty to Be Informed

### 1. In General

- a. When exercising its discretion, the trustee must be reasonably informed. The beneficiaries are entitled to general information regarding the bases upon which the trustee's discretionary judgments have been or will be made.
- b. The trustee must be intimately familiar with the terms of the trust agreement. This means that the trustee must read the entire agreement, and ideally, prepare an abstract of the most important provisions.
  - (1) It will be impossible for the trustee to exercise its discretion, or fulfill its other fiduciary duties, if the trustee is unaware of the nature and extent of those duties and its discretion, or of the grantor's intent, as expressed in the trust agreement.
  - (2) Even if the trustee acts in good faith, its decision regarding the exercise of discretion may be reversed if the trustee improperly interprets the trust agreement.<sup>103</sup>

### 2. Standard of Living.

- a. Trusts sometimes give a trustee discretion to make distributions to maintain a beneficiary's "standard of living" or "accustomed manner of living". What does that mean?

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<sup>101</sup> Model UTC §801 (Duty to Administer Trust) and §105(b)(2) (providing that the terms of the trust agreement cannot override the trustee's duties described in §801).

<sup>102</sup> If the trust is a directed trust, the trust protector should prepare and compile the documents and information described, and then provide the trustee with a written direction to make the distribution.

<sup>103</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment c, Illustration 3.

- b. If the trust agreement is silent on the issue, the beneficiary's standard of living generally is determined to be that at the time of the grantor's death, or when the trust became irrevocable.<sup>104</sup>
- c. If the standard is determined at the time of the grantor's death, the surviving spouse may be disadvantaged. For example, if the grantor was ill for a prolonged period of time before death, the surviving spouse may have lived a more modest lifestyle during that period than she would have had the decedent spouse been healthy until his death.
- d. Also, it may be difficult to establish definitively what a beneficiary's standard of living was at any given point (due to lack of detailed records of expenditures, or how spouses (especially in a second marriage) allocated expenses between themselves.)<sup>105</sup>
- e. It may be especially difficult to establish the appropriate standard of living for a beneficiary other than the grantor's spouse, because the trustee probably will have limited or no access to information regarding the beneficiary's lifestyle, other than what the beneficiary is willing and able to provide to the trustee.

### C. Duty of Impartially

- 1. The trustee must administer the trust, and make distributions, impartially,<sup>106</sup> and give due regard to the beneficiaries' respective interests (e.g., the current and the remainder beneficiaries).<sup>107</sup>
- 2. The duty to act impartially doesn't require the trustee to treat the beneficiaries equally. The trustee must treat the beneficiaries equitably in light of the terms and purposes of the trust. If the grantor wants the trustee to favor the interests of one beneficiary over those of others, he should include appropriate guidance for the trustee in the trust agreement.<sup>108</sup> Even under the broadest grant of fiduciary discretion, a trustee must act honestly and in the state of mind contemplated by the grantor.
- 3. The trust agreement also should state whether the trustee is authorized to deplete the trust principal in its entirety in favor of the primary beneficiary.
- 4. Sample language:

The Grantor desires (but does not direct) that the Trustee of any further family trust created hereunder will exercise its discretion hereunder and make distributions to or for the benefit of the Grantor's child, as the primary beneficiary of such trust, in accordance with the needs and desires of the primary beneficiary, as determined by the disinterested Trustee, in its sole and uncontrolled judgment, and such needs and desires will take precedence, even if such distributions deplete the trust estate in its entirety, leaving nothing for the secondary beneficiaries (i.e., the issue of the primary beneficiary). The Trustee's exercise of discretion to distribute or not to distribute trust income or principal to or for the benefit of the primary beneficiary shall not be subject to question by any person interested in the trust estate.

- 5. If the trust agreement contains no specific guidance, the trustee will exercise its discretion in a way that benefits the current beneficiary without causing harm to the remainder beneficiaries.<sup>109</sup>

### X. Other Resources

Whether the trustee must consider a beneficiary's other resources before making a discretionary distribution is a frequently litigated issue.

<sup>104</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment d(2).

<sup>105</sup> Conetta, *Decision Making for Discretionary Distributions* (materials from the Fall 2010 meeting of the American College of Trust and Estate Counsel, Baltimore, Maryland) (Oct. 16, 2010), p. 29.

<sup>106</sup> RESTATEMENT (THIRD) OF TRUSTS §79(1) (2012).

<sup>107</sup> Model UTC §803.

<sup>108</sup> Comment to Model UTC §803, *citing* RESTATEMENT (SECOND) OF TRUSTS §183 comment a (1959).

<sup>109</sup> Conetta, *supra* note 105, at 32.

- A. If the trust agreement is silent on the consideration of other resources, it is unlikely that the grantor specifically considered the issue. Accordingly, a review of the agreement probably will not reveal the grantor's intent with respect to the issue. One then must consider what would the grantor have intended, if the lawyer had presented the question to him.
- B. The general rule of construction is that the trustee must consider the beneficiary's other resources, but has some discretion in the matter.<sup>110</sup>
- C. However, there are numerous cases holding both for and against consideration of a beneficiary's other means of support, including state or local public assistance.
  1. The court will be in a difficult position when asked either for instructions or to resolve an actual contest regarding the trustee's decisions.<sup>111</sup>
  2. Although the court may find it necessary to base its decisions on the grantor's choice of words, it is unlikely that the precise language used in the trust agreement was selected in a meaningful fashion by a drafting attorney who failed to deal specifically with the question of other resources.
  3. As a result, the same wording that is stressed in one case may be disregarded in the next.<sup>112</sup>
- D. The drafting attorney should be certain to include in the trust agreement a statement regarding whether a beneficiary's other resources must, shouldn't, or may be considered when the trustee is exercising its discretion, because the question inevitably will arise.
- E. If the trustee must or may consider a beneficiary's resources, the trustee must determine which resources will influence the trustee's exercise of discretion.
  1. A beneficiary's other resources usually include the beneficiary's income and other periodic receipts, such as pension and other annuity payments, and court-ordered support payments. In considering these resources, the trustee also should take into account:
    - a. Whether an unemployed or underemployed beneficiary is unable or simply unwilling to work.
    - b. Whether the beneficiary's spouse has financial resources available to the beneficiary.
    - c. Whether the beneficiary's parents have a legal obligation to support the beneficiary.
  2. The trustee also may be required to consider the principal of the beneficiary's personal estate, depending on the terms and purposes of the discretionary power and the terms of the trust. If the beneficiary's estate can be considered:
    - a. Should the trustee consider non-liquid assets?
      - (1) Can the beneficiary be forced to sell his appreciated property (and incur capital gains tax) before the trustee makes a distribution?
      - (2) What if the beneficiary's non-liquid assets are not marketable (e.g., a closely-held business)?
    - b. Can the trustee consider the equity in the beneficiary's home?
  3. In evaluating other resources, the trustee also should keep in mind any tax purposes the trust may serve.

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<sup>110</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment e. Note, however, that the position of the Restatement (Third) is contrary to the position of the Restatement (Second) on this issue.

<sup>111</sup> Halback, *supra* note 11, at 1442.

<sup>112</sup> Halback, *supra* note 11, at 1448.

- F. The trustee must act in a reasonable manner in attempting to ascertain the beneficiary's resources that may appropriately and reasonably be available to the beneficiary for purposes relevant to the discretionary power.
  1. The trustee generally may rely on the beneficiary's representations and on readily available, minimally intrusive information requested of the beneficiary. For this purpose, the requested information probably will include the beneficiary's income tax returns, financial statements, balance sheet and budgets, as well as information regarding any other sources of support for the beneficiary (e.g., public benefits, alimony, parental support, etc.).
  2. Reliance on the beneficiary's representations will be inappropriate, however, when the trustee has reason to suspect that the information supplied is inaccurate or incomplete.<sup>113</sup>
  3. The trustee may find that the beneficiary is unwilling to provide the requested information.
    - a. In exercising a discretionary power, a trustee is only required to use reasonable diligence.<sup>114</sup>
    - b. The grantor may wish to protect the beneficiary's privacy and authorize the trustee to rely solely on information provided by the beneficiary, as long as the trustee has no actual knowledge of circumstances indicating that the beneficiary is misrepresenting the facts.<sup>115</sup>
- G. If the trust agreement allows, but does not require, the trustee to consider a beneficiary's resources, the trustee affirmatively must determine under what circumstances it will consider them (if at all)
- H. If the trust agreement does not require or permit the trustee to consider a beneficiary's resources, before exercising its discretion to make additional distributions, the trustee still may want to consider how the beneficiary is using distributions the trust already has made to him (e.g., mandatory income), and possibly whether someone else has a legally enforceable obligation to support the beneficiary.
- I. If the trustee must consider the beneficiary's other resources, the trustee must take into account the legal obligation of another person to support the beneficiary.
  1. If the trustee didn't take that into account, then someone other than the named beneficiary will indirectly receive the benefit of the trust, by being relieved of his obligation of support.
  2. If the support duty of another is to be considered, the trustee still may be required to make supplemental payments, if the support from the other source is inadequate to supply the type of support needed to justified by the trust.

## XI. Best Practices for Trustees

When administering trusts, trustees should adopt policies and procedures for addressing the discretionary distributions. Some "best practices" may include:

- A. Read the trust agreement, and any amendments, letters of wishes or affidavits from the grantor regarding the grantor's intent. Prepare a concise but accurate abstract of the agreement for reference by the trust administrator and staff.
- B. Determine and document the standard, if any, for making discretionary distributions, including any precatory language in the trust agreement intended to guide the trustee in exercising its discretion.

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<sup>113</sup> RESTATEMENT (THIRD) OF TRUSTS §50 comment e(1). See also *In re Murray*, 45 A.2d 636 (Maine 1946) (trustees who distributed money to beneficiary upon her request were surcharged because they did not use their discretion or judgment in authorizing distribution to beneficiary, and did not discover information regarding the beneficiary's financial situation that was readily available to them).

<sup>114</sup> Halback, *supra* note 11, at 1451, citing *In re Clark's Will*, 19 N.E.2d 1001 (N.Y. 1939).

<sup>115</sup> Halback, *supra* note 11, at 1451.

- C. For trusts with multiple current beneficiaries, determine whether any beneficiary is the “primary beneficiary”, and, if so, determine the circumstances under which discretion might be exercised in favor of the non-primary beneficiaries.
- D. Keep complete, accurate and current records of the trust assets.
- E. Determine whether and which resources of the beneficiary must be considered when exercising discretion, and document the procedure for requesting or otherwise obtaining information about the resources.
- F. Document all beneficiary requests for distributions, as well as the trustee’s response to them (i.e., decision to distribute or not distribute, and the basis for the decision).
- G. Document whether there any conditions that must be satisfied in order for a distribution to be made (e.g., beneficiary must be a certain age, have attained a certain level of education, etc.).
- H. Coordinate the trust’s investment policy with required or anticipated distributions.