

Trusts & Estates

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Feature: Asset Protection

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The Fully Discretionary Ascertainable Standard

It's a hybrid standard that establishes both tax and creditor protections—a terrific strategy in the right circumstances and jurisdictions

Agraying widower hires you to reduce his looming estate tax burden and to shelter the wealth he passes on against potential creditors of his descendants. He has three children and seven grandchildren keeping him happy and busy, and he wants to ensure their security after he's gone. Your client agrees to settle a multigenerational trust to house annual exclusion gifts and to purchase life insurance on his life. He is amenable to other advanced planning techniques as well, to ensure that the bulk of his wealth passes to his multigenerational trust in a tax-efficient manner. But as you begin drafting the trust, you come to a major impasse.

Asset protection attorneys are careful to draft trusts in a manner that avoids giving a beneficiary any rights to receive trust property, because, if a beneficiary has a right to receive trust property, so too will his creditors. Asset protection attorneys avoid conferring such rights by providing trustees with full discretion to distribute trust assets to, or for the benefit of, any beneficiary to the exclusion of others, for any or no reason. This distribution scheme, sometimes called a “fully discretionary standard,” establishes maximum creditor protection because the trustee, and not the beneficiary, controls whether and why distributions are made.

Austin W. Scott, William F. Fratcher and Mark L. Ascher have noted in their treatise, *Scott and Ascher on Trusts*, Section 15(3): “When the terms of a trust entitle a ben-

eficiary to only so much of the income or principal as the trustee, *in its uncontrolled discretion*, chooses to distribute, the beneficiary is generally unable to compel the trustee to pay or apply anything. . . . Thus, as a general rule, the assignee of such a beneficiary's interest cannot compel the trustee to pay, nor can the creditors of such a beneficiary reach, any part of the trust property” (emphasis added).¹

The Problem

Unfortunately, lawyers can't always use a fully discretionary standard for trust distributions. Imagine if our aging widower finds it too distressing to entrust his hard earned assets to any trustee other than his most responsible child. By allowing only one child to serve as trustee, the fully discretionary standard becomes unviable from an estate tax perspective with respect to that particular child, because it provides him with a general power of appointment over trust property.

The Internal Revenue Service taxes at a beneficiary's death any trust property over which that beneficiary maintains a general power of appointment.² A general power of appointment provides beneficiaries with the power to make distributions to themselves, their estates, their creditors or the creditors of their estates.³ With a fully discretionary standard, a beneficiary-trustee certainly has the power to decide whether and why he receives trust assets. Absent a savings clause provided by state law,⁴ all trust assets would be taxable in that beneficiary-trustee's estate, eviscerating one of the main functions of multigenerational estate planning.

In such circumstances, lawyers must turn to an “ascertainable standard” for trust distributions. An ascertainable standard directs trustees to distribute trust assets to, or for the benefit of a beneficiary for objective, measurable purposes, such as needs relating to health,



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education, maintenance or support.⁵ As distributions are dictated by the standard itself, a beneficiary-trustee generally does not have the power to independently decide whether or why he receives trust assets. Without such discretion, the beneficiary-trustee does not have a general power of appointment and trust property will not be included in the beneficiary-trustee's estate. For your client, shifting to an ascertainable standard revives the tax benefits of his multigenerational estate planning.

Unfortunately, however, an ascertainable standard does not provide the same creditor protections as a fully discretionary one. An ascertainable standard generally entitles beneficiaries to distributions (for example, for health, education, maintenance and support needs)—which can include such things as living expenses, mortgage payments, property taxes, property insurance, health care, health insurance, education, technical training and accustomed patterns of vacationing.⁶ The key concept of an ascertainable standard is entitlement; it creates a property right. And if beneficiaries have enforceable rights to trust distributions, so too will their creditors.⁷

State law dictates the full extent of creditor rights created by an ascertainable standard, and jurisdictions differ greatly in this area. Some have clear black-letter statutory law while others have fact-sensitive case law hinging upon:

- (1) the intent of the settlor;
- (2) the specific language of the ascertainable standard;
- (3) the presence and parameters of a spendthrift clause;
- (4) the needs and resources of the debtor-beneficiary;
- (5) the nature of the debt;
- (6) and/or the relationship of the creditor to the debtor-beneficiary.⁸

For example, in New York, if a trustee is not explicitly given the right to accumulate income (that is to say, the trustee lacks full discretion with regard to trust income), statutory law provides that a creditor can reach all income above that necessary for the education and support of a beneficiary.⁹ In New Jersey, case law holds that when a creditor supplies necessities such as housing, food or health care and the ascertainable standard

directs distributions for such support, this creditor can reach trust assets even in the presence of a spendthrift clause.¹⁰ This is just one of several exceptions to spendthrift clauses that exist for creditors of beneficiaries entitled to trust distributions.¹¹

Regardless of the jurisdiction, an ascertainable standard undoubtedly opens the door to creditors in a manner that does not occur with a fully discretionary standard. The question thus becomes: Can a lawyer draft an ascertainable standard that protects against the estate tax and yet avoids providing beneficiaries (and their creditors) with enforceable rights to distributions?

A Solution

Case and statutory law indicate that a hybrid distribution standard—what we call a “fully discretionary ascertainable standard”—can indeed protect trust assets from both the estate tax and creditors.

A fully discretionary ascertainable standard provides trustees with full discretion to distribute trust assets to, or for the benefit of any beneficiary, to the exclusion of others, for a beneficiary's health, education, maintenance or support. Providing a trustee with full discretion over “whether” to make distributions prevents beneficiaries (and their creditors) from having enforceable rights to distributions. Once a trustee decides to make distributions, however, limiting “why” those distributions can be made (for example, to needs relating to health, education, maintenance or support) continues to protect trust assets from the estate tax.

In the estate tax arena, it is the “why” of distributions that is essential to protecting trust assets. As long as trustees are limited to an ascertainable standard for why distributions are made, providing discretion over whether to make distributions is of no consequence. In gauging the presence of an ascertainable standard, the Tax Court noted in the 1974 case of *Cutter v. Commissioner*: “[E]ven where the power is granted in terms of the ‘sole’ or ‘uncontrolled’ discretion of the trustee, [a court] will review [the trustee's] action to determine whether in light of the standards fixed by the trust instrument, such discretion has been honestly exercised.”¹² Because the presence of the ascertainable standard allows a court of equity to review trustee actions, such actions are not akin to the unbridled discretion that Internal Revenue Code Sections 2036 and 2038 aim to capture.¹³ Simply put,

there is no inclusion of trust assets in a beneficiary-trustee's estate if the "why" of distributions is limited to an ascertainable standard.

In fact, a fully discretionary ascertainable standard was at issue in the precedent-setting case out of the U.S. Court of Appeals for the Second Circuit, *Jennings v. Smith*.¹⁴ Issued in 1947, this was one of the first cases in the nation to recognize the tax-protective nature of an ascertainable standard.

In *Jennings*, the executors of an estate brought a refund claim against the Internal Revenue Service to recover an estate tax overpayment.¹⁵ The Service countered by claiming an additional estate tax liability, in an amount greater than the overpayment, based on property the decedent transferred into trusts for the benefit of his two sons.¹⁶

As co-trustees of the trusts the decedent and his sons maintained the power, in their absolute discretion, to distribute trust income for the support, maintenance and education of trust beneficiaries. He and his sons also maintained the power to distribute trust principal to offset the prolonged illness or financial misfortune of beneficiaries.¹⁷

Though the decedent maintained absolute discretion over whether to distribute trust assets, the Second Circuit held that neither trust income nor principal was includible in the decedent's estate—because the "why" of such distributions was limited to an ascertainable standard. That is, the court found enough of an external standard, even with absolute discretion over whether to distribute assets, to hold that the decedent did not have the sort of unbridled discretion that would cause inclusion of trust assets in his estate.

In the creditor arena, it is the "whether" of distributions that is essential to protecting trust assets. An emerging state law consensus (codified by the Uniform Trust Code that was adopted in 21 jurisdictions as this article went to press) provides that as long as trustees maintain control over whether to distribute trust assets, limiting why distributions can be made to an ascertainable standard is of no consequence.¹⁸

Kevin D. Millard, partner in Denver's Chorney & Millard LLP, noted in a 2008 *ACTEC Journal* article that, in the context of creditor rights, this emerging state law consensus brings the ascertainable standard more in line with the level of protection afforded by the fully discretionary standard. Specifically, he wrote: "[T]he elimination of the discretionary/support trust

distinction actually increases protection from claims of creditors other than exception creditors [spouses and children with judgments for support and maintenance]. Under traditional theory, a creditor who had supplied necessities to the beneficiary of a support trust could recover from the trust. The Uniform Trust Code (UTC) treats a trust where the trustee's discretion is expressed in the form of a standard of distribution as a discretionary trust, and a creditor (other than an exception creditor) cannot reach such a trust even if the trustee has not complied with the standard or has abused its discretion. The fact that the beneficiary might be able to compel a distribution is irrelevant to the creditor's claim."¹⁹

Thus, under emerging trust law theory, when a trustee has discretion over whether to distribute trust assets, creditors cannot compel distributions, even if such discretion is merged with an ascertainable standard.

Though a survey of all state laws on creditor rights is beyond the scope of this article, it's worth noting that New York provides a longstanding, distinctive example of the creditor protections that can be afforded by a fully discretionary ascertainable standard.

Indeed, in the 1926 New York case of *Hamilton v. Drogo*,²⁰ a judgment creditor sought to attach a lien to the Duke of Manchester's income interest in a multi-beneficiary, discretionary trust established by his mother, the Duchess of Manchester.²¹ The trust at issue had a fully discretionary ascertainable standard, directing the trustee to make distributions "for the maintenance and support or otherwise, for the benefit of all or any one or more exclusively of the other or others of him my said son his wife and children or other issue."²² The trustee had no right to accumulate income.²³ Thus, though the trustee had full discretion over whether to distribute trust assets to any particular beneficiary, at least annually the trustee had to distribute income according to a standard.²⁴

Notwithstanding this hybrid distribution scheme, because the trustee had full discretion over whether to distribute assets to any particular beneficiary, the court held that only actual distributions made to the Duke of Manchester could be attached by his creditor.²⁵ The appeals court noted: "In the present case no income may ever become due to the judgment debtor. We may not interfere with the discretion which the testatrix has vested in the trustee any more than her son may do so. Its judgment is final."

This holding gave birth to "Hamilton orders," where-

by a lien attaches to trust assets in a discretionary trust if, and only if, the trustee exercises its discretion in favor of a debtor.

Be Careful!

We must caution that the emerging state law consensus, as codified by the UTC and illustrated by New York case law, is not applicable in all states. Before using the fully discretionary ascertainable standard, lawyers must carefully review the law in jurisdictions relevant to the trust.

Emerging theory: creditors can't compel distributions if a trustee has discretion over whether to distribute trust assets, even if the discretion has an ascertainable standard.

But when applicable, the fully discretionary ascertainable standard establishes the same creditor protections as a fully discretionary standard and the same estate tax protections as an ascertainable standard. Providing full discretion over whether to make distributions, and limited discretion over why, merges these standards into one that avoids both negative estate tax and creditor consequences.

Although not fool proof (because of evolving trust theory and variations among states), when faced with the inability to use a fully discretionary standard for distributions, the fully discretionary ascertainable standard is the next best alternative. It appears lawyers can rely on this standard in a situation when a settlor

would like a beneficiary to be the sole trustee, with little fear of sacrificing the protections afforded by a well-crafted estate plan. **TE**

Endnotes

1. Austin W. Scott, William F. Fratcher and Mark L. Ascher, *Scott and Ascher on Trusts*, Section 15(3) (5th ed. 2007).
2. Internal Revenue Code Section 2041(a); Treasury Regulations Section 20.2041-1.
3. IRC Section 2041(b)(1); Treas. Regs. Section 20.2041-1(c)(1).
4. See, for example, N.J.S.A. 3B:11-4.1.
5. IRC Section 2041(b)(1)(A).
6. *Restatement (Third) of Trusts*, Section 50(2), illustration 5 (2003).
7. *Ibid*, Section 60.
8. *Ibid*, Comments c, e, e(1).
9. N.Y.E.P.T.L. Section 7-3.4.
10. See, for example, *Constanza v. Verona*, 48 N.J. Super. 355 (Ch. Div. 1958).
11. See Anthony F. Vitiello, "Absolute Discretion: A fully discretionary trust will shield assets from a beneficiary's creditors," *New Jersey Law Journal*, at p. 413 (Feb. 5, 2007).
12. *Cutter v. Commissioner*, 62 T.C. 351, 356 (1974).
13. See, for example, *Budd v. Comm'r*, 49 T.C. 468, 474 (1968); See also Treas. Regs. Section 25.2511-1(g)(2) (providing that in the gift tax arena, an ascertainable standard, even if couched within discretionary terms, can protect a beneficiary-trustee's distributions from the gift tax).
14. *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).
15. *Ibid*, at p. 75.
16. *Ibid*.
17. *Ibid*, at p. 79, notes 1-2.
18. See Uniform Trust Code Section 504(b)(1) ("[A] creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if . . . the discretion is expressed in the form of a standard of distribution.")
19. Kevin D. Millard, "Rights of a Trust Beneficiary's Creditors under the Uniform Trust Code," *ACTEC Journal*, at pp. 58, 70-71 (Fall 2008).
20. *Hamilton v. Drago*, 241 N.Y. 401 (1926).
21. *Ibid*, at p. 403.
22. *Ibid*.
23. *Ibid*.
24. *Ibid*, at pp. 404.
25. *Ibid*, at pp. 404-05.