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Tax-Sensitive Powers Regarding The Beneficiary-Trustee

§9.1 ESTATE TAX ISSUES AND THE BENEFICIARY-TRUSTEE

A beneficiary-trustee's power to make discretionary distributions to *him or herself* as a trust beneficiary without the limitation of an ascertainable standard constitutes a general power of appointment ("the prohibited power"). IRC sections 2041(b)(1)(A) and 2514(c)(1). Additionally, a beneficiary-trustee's discretionary power over trust property that could be exercised for the benefit of the beneficiary-trustee's creditors or estate also constitutes a prohibited power.

Practice Point: To avoid the prohibited power being included in the beneficiary-trustee's gross estate, the beneficiary-trustee should disclaim the prohibited power in accordance with IRC section 2518. The beneficiary-trustee may also want to disclaim serving as trustee.¹ Having the beneficiary-trustee merely decline to serve as trustee (and not make a qualified disclaimer of the prohibited power) may result in a "release" or "lapse" of the prohibited power. A "release" or "lapse" of a general power of appointment will result in the beneficiary-trustee making a taxable gift pursuant to IRC sections 2514(b) and (e), and/or result in the prohibited power being included in the beneficiary-trustee's gross estate pursuant to IRC sections 2041(a)(2) and (b)(2).

§9.1(a) Death Of Beneficiary-Trustee

If the beneficiary-trustee holds the prohibited power and dies, the trust property will be included in his or her gross estate. IRC section 2041; Treas. Reg. §20.2041-1(b).

§9.1(b) Ascertainable Standards

Examples of ascertainable standards include:

- Support;
- Support in reasonable comfort;
- Maintenance;
- Maintenance in health and reasonable comfort;
- Support in his or her accustomed manner of living;
- Education, including college and professional education;
- Health;
- Health, education, support, and maintenance;

¹Before accepting the trust, a nominated trustee can disclaim serving as trustee. Uniform Trust Code ("UTC") section 701(b), *Restatement (Second) of Trusts* ("Restatement 2d") section 102 and *Restatement (Third) of Trusts* ("Restatement 3d") section 35. No particular formality is required for the disclaimer to be effective--it may be written or oral (however, a written disclaimer is the preferred method for tax reasons). Once a nominated trustee has accepted the trust, the trustee cannot disclaim, but can resign. UTC section 705, Restatement 2d section 106, and Restatement 3d section 36.

- Medical, dental, hospital, and nursing expenses; and
- Expenses of invalidism. Treas. Reg. §§20.2041-1(c)(2) and 25.2514-1(c)(2).

Caution: Distributions for a beneficiary’s “happiness,” “welfare,” “comfort,” or “emergency needs” are not, in and of themselves, ascertainable standards. Even though state law is determinative in ascertaining the nature and extent of powers held by a decedent, do not deviate from the standards enumerated in the regulations. *Morgan v. Commissioner of Internal Revenue Service*, 309 U.S. 78 (1940). See also, Rev. Rul. 77-60, 1977-1 C.B. 282, which states that “[a] power to use property to enable the donee to continue an accustomed mode of living, without further limitation, although predictable and measurable on the basis of past expenditures, does not come within the ascertainable standard prescribed in IRC section 2041(b)(1)(A), since the standard of living may include customary travel, entertainment, luxury items, or other expenditures not required for meeting the donee’s ‘needs for health, education or support.’ Nor does the requirement of a good faith exercise of a power create an ascertainable standard. Good faith exercise of a power is not determinative of its breadth.”

§9.1(c) Negation Of Ascertainable Standard

An ascertainable standard is rendered unascertainable for a beneficiary-trustee “if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or non-exercise of a power....” Treas. Reg. §25.2511-1(g)(2). Cf, Treas. Reg. §1.674(b)-1(b)(5)(i). Examples of powers that negate an ascertainable standard include:

- “The trustee’s exercise or nonexercise of powers and discretions in good faith shall be conclusive and binding on all interested parties.”
- “The trustee shall exercise his or her powers in his or her uncontrolled discretion.” *Estate of Friedman*, 94 Cal. App. 3d 667, 156 Cal. Rptr. 597 (1979); *Independence Bank Waukesha (N.A.) v. U.S.*, 761 F.2d 442 (7th Cir. 1985).

It may be desirable to limit the beneficiary-trustee’s power.

Drafting Example: Limitation Of Trustee’s Powers. No trustee who is a beneficiary of the trust in question shall possess any power or discretion that is “conclusive,” “sole,” “absolute,” or “uncontrolled” with respect to the exercise or nonexercise of such power or discretion under that trust; and such beneficiary-trustee’s power or discretion in that regard shall at all times be exercised or not exercised in a reasonable manner, be limited by a reasonably definite standard, and shall be subject to review and judicial scrutiny.

§9.1(d) Co-Trustee With Substantial Adverse Interest

The appointment of a co-trustee (including an independent co-trustee) to serve with the beneficiary-trustee does not protect the beneficiary trustee unless: (1) the consent of the co-trustee is required for any discretionary distributions; and (2) the co-trustee has a substantial adverse interest in the trust. IRC section 2041(b)(1)(C)(ii); Treas. Reg. §20.2041-3(c)(2); Pvt. Letter Rul. 9030032. See also, IRC section 2514(c)(3)(B). Alternatively, the power to make discretionary distributions can be vested exclusively in the independent co-trustee (who need not have a substantial adverse interest). This will prevent attribution of the prohibited power to the beneficiary-trustee.

A person has a “substantial adverse interest” if he or she has a present or future right to obtain a personal benefit from the property that is subject to the power. *Maxant Estate v. Commissioner*, 40

T.C.M. 1328 (1980). A co-holder of a power is considered to have a substantial adverse interest in the exercise of a power over trust property if the co-holder is the remainder beneficiary of the trust. Treas. Reg. §20.2041-3(c)(2), Example 1.

An interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in §20.2031-7 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in §20.2031-1.

A taker in default of appointment under a power has an interest which is adverse to an exercise of the power.

A **co-holder** of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the decedent's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate.

Treas. Reg. §20.2041-3(c)(2).

Practice Point: Having a co-trustee with a substantial adverse interest may still result in the prohibited power being included in the beneficiary-trustee's gross estate if the adverse-trustee predeceases the beneficiary-trustee and the beneficiary-trustee is the sole remaining trustee.

Drafting Example: *Power To Make Discretionary Distributions Vested In Independent Trustee.* The power to make discretionary distributions of principal or income to a beneficiary hereunder who is also a trustee, shall be vested exclusively in (and be exercisable only by) the Independent Trustee.² If the incumbent trustee is not an Independent Trustee, the incumbent trustee may appoint an Independent Trustee to serve as co-trustee with the incumbent trustee. The Independent Trustee so appointed shall serve concurrently with the appointing trustee until the appointing trustee resigns, dies, or becomes incapacitated and is succeeded by a successor trustee.

§9.1(e) Beneficiary-Trustee's Power Of Withdrawal

A beneficiary-trustee, or any beneficiary, can be given a power of withdrawal over trust principal and income without the power of withdrawal being included in his or her gross estate—provided the beneficiary (the “withdrawal right beneficiary”) does not die during the time period the power of withdrawal is exercisable and the power has not lapsed. The power of withdrawal must be limited to the safe harbor amounts described in IRC sections 2514(e)(1) and (2) and 2041(b)(2), which is currently \$5,000 or five percent of the trust estate (5x5). If the withdrawal right beneficiary dies while the power of withdrawal is exercisable (i.e., has not yet lapsed), the amount of the property subject to the right of withdrawal will be included in the beneficiary's gross estate under IRC section 2041, as a general power of appointment, and the deceased withdrawal right beneficiary will become the “new” transferor of the unlapsed power for GST tax purposes. Any GST tax exemption previously allocated by the grantor will be wasted. Treas. Reg. §26.2652-1(a)(2). Hence, it may not be appropriate to grant a 5x5 withdrawal power to a beneficiary of the credit shelter trust or to the beneficiary of a trust that is designed to be GST tax exempt. *See*, Paragraph 3.6(D) (alternative 1) of Sample MD Trust.

§9.1(e)(1) Lapse Of Power Of Withdrawal

² *See*, Paragraph 6.3(I) of Sample MD Trust for a comprehensive definition of an Independent Trustee.