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TOPIC: Picking Your Trustees: Be Careful Out There - Beneficiaries as Trustees.

MARKET TREND: Families often select their children to serve as trustees both to minimize trust expenses and to empower their children. The cost of making that choice, however, may be higher than clients expect, including a loss of creditor protection if a beneficiary-trustee has too much trust access or control.

SYNOPSIS: It is commonplace to have family trusts structured as dynastic trusts for descendants (children, grandchildren, etc.) because they qualify for transfer tax deferral and creditor protection according to longstanding and appropriate tax principles. Deciding to have a child or other descendant serve as a trustee of such a trust teaches the beneficiary about wealth stewardship, financial management, and fiscal responsibility in a more structured setting (possibly with the guidance of an experienced co-trustee). It also can offer flexibility, independence, security, and controlled access to trust assets. However, the clients must follow a few general guidelines in crafting such trusts or else risk exposing the trust assets to

unintended tax consequences and creditor access (potentially undermining some of a client's primary goals for the trust).

TAKE AWAYS: Clients can provide their descendants with some control over discretionary trust distributions and preserve the trust's intended estate tax treatment by naming a beneficiary-trustee who has sole distribution authority subject to an "ascertainable standard." If the family wants to enhance creditor protection, however, then naming independent co-trustees who share this distribution authority may be preferred. While not perfect solutions, families who want both creditor protection and beneficiary-trustees who hold maximum distribution authority may consider: (1) having trust assets consolidated in underlying family entities that restrict entity distributions or transfers of entity interests (2) encouraging the beneficiary-trustees to implement their own pre-marital or other creditor protection planning, and/or (3) limiting the trust amount over which a beneficiary-trustee has distribution authority.

MAJOR REFERENCE: Pfannenstiehl vs. Pfannenstiehl, 88 Mass. App. Ct. 121, 37 N.E.3d 15 (2015), rev'd 2016 Mass. LEXIS 591 (Mass. Aug. 4, 2016).

When creating trusts for their descendants, clients often struggle with who to name as trustee and how much access their descendants, particularly children, should have to trust assets. Clients want to ensure the trust offers both creditor and transfer tax protection for their beneficiaries, but they have concerns about giving an "outside" party complete discretion over trust distributions. One common solution has been to name a beneficiary as a co-trustee of the trust. However, there appears to be a trend developing among states that may eliminate part of a beneficiary's creditor protection, making trust assets available in a divorce proceeding if the beneficiary has too much trust access or control. As this trend may be of concern to many clients and can impact both existing and new trusts, clients should review their plans with the experts.

WHY BENEFICIARIES AS TRUSTEE

Clients can and do create long-term dynastic trusts because they offer transfer tax deferral and creditor protection. Part and parcel of that approach often includes appointing their children or other descendants to serve as trustees of the trusts for their benefit. When serving as a co-trustee, the beneficiary can be given the unilateral authority to make certain

distributions, subject to the limitations and considerations noted below. Having a child or other descendant hold this trustee powers over his or her own trust teaches the beneficiary about wealth stewardship, financial management, and fiscal responsibility in a potentially-guided setting (i.e., with the guidance of an experienced co-trustee). It also can provide the beneficiary with flexibility, independence, security, and controlled access to trust assets.

Appointing the beneficiary to serve as a co-trustee with a financial institution or other professional co-trustee may offer the best balance (see *WRMarketplace No. 16-25* for a discussion of trustee selection considerations). The beneficiary can participate in trust management and distributions, while the professional trustee provides fiduciary experience and insurance coverage, an independent review of trust management, and an existing infrastructure for trust administration. A professional trustee also can serve as an independent trustee, which, as discussed below, qualifies for appropriate estate tax and creditor protections.

THE "ASCERTAINABLE STANDARD"

A beneficiary can serve as a trustee without undermining the estate planning goals of the trust if the beneficiary-trustee's power to make distributions for his or her own benefit is limited by an "ascertainable standard," which ensures the trust assets are not later included as part of the beneficiary-trustee's taxable estate. For this purpose, the "ascertainable standard" must restrict distributions to specific, identifiable needs or categories, such as for a beneficiary-trustee's health, education, maintenance, or support ("**HEMS**"). The standard can be further customized within these categories, but caution must be exercised, as an over-expansion of the standard (such as to provide for "comfort" or "happiness") could result in inclusion of the trust assets in the beneficiary-trustee's estate.

To offer distribution flexibility beyond this standard, clients can appoint an unrelated and independent co-trustee who has authority to make discretionary distributions for any purpose. To provide checks and balances, the beneficiary-trustee can have the power to remove and replace the independent trustee with another independent trustee.

BUT PROCEED WITH CAUTION

Clients should understand, however, that a beneficiary-trustee's distribution powers, even when limited by an ascertainable standard, may subject the trust assets to creditor claims or, in particular, to spousal claims in the event of a divorce or disinheritance of a surviving spouse (again, potentially undermining a primary objective of the family in creating the trust). There is a trend developing among some states that could cause a loss of creditor protection in the context of a beneficiary's divorce.

For example, in the recent divorce case of *Pfannenstiehl vs. Pfannenstiehl,* the Massachusetts Supreme Court just overturned lower court rulings that had included as part of a couple's divisible marital estate the husband's discretionary interest in a trust created by his father. The trust was designed to benefit all the father's current and future descendants, and it had 11 current beneficiaries at the time of the divorce proceedings. The trust included a spendthrift provision and a distribution provision subject to an ascertainable standard, which provided that the trustees (at the time, H's brother and a family attorney):

> shall pay to, or apply for the benefit of, a class composed of any one or more of the Donor's then living issue such amounts of income and principal as the Trustee, in its sole discretion, may deem advisable from time to time, whether in equal or unequal shares, to provide for the comfortable support, health, maintenance, welfare, and education of each or all members of such class.

The husband was not a trustee, and, based on the above, the trustees had discretion to make distributions in equal and unequal shares among all beneficiaries. The lower courts, however, found that the ascertainable standard ***required*** distributions for a beneficiary's support, health, etc., thus giving the husband had a present enforceable right to distributions from the trust. Based on this issue, combined with the pattern of prior trust distributions to the husband and the deemed lack of impartiality of the trustees, the lower courts found that the husband had a vested interest in $1/11^{th}$ of the trust's $25 million value. Accordingly, $2.27 million was includible in the divisible marital estate, with half owed to W as part of the divorce.

The Massachusetts Supreme Court, however, ***recently overturned the lower court rulings***. Focusing on the trust's terms and the settlor's intentions, the high court noted that the settlor did not intend to benefit ex-

spouses of trust beneficiaries, but only the settlor's descendants. In addition, the discretionary nature of the husband's interest eliminated any "vested" or possessory right in the trust assets. Accordingly, the trust interest did not constitute a "marital asset" for division purposes.

Additionally, in reversing the lower court's understanding, the high court held that an "ascertainable standard" ***operates to limit discretion, not to mandate distributions***, so trust distributions to the husband were not required for his support, health etc. Also, the trustee had discretion to make distributions in equal or unequal shares among the entire class of beneficiaries, further invalidating the notion that the husband had a simple fractional interest in the entire trust value. Given the pattern of unequal distributions among the beneficiaries, periods of no trust distributions at all, and the spendthrift clause, the Supreme Court ruled that the trust agreement clearly indicated that the wife was not to benefit from the trust.

PRACTICAL ALTERNATIVES

As shown in *Pfannenstiehl*, the extent of marital asset inclusion for, or creditor access to, trust assets is very fact specific and will depend on applicable state law, including whether the state recognizes or allows "ascertainable standards" under its state trust, marital, and creditor laws and how state courts interpret those laws and the applicable trust. However, trust agreements that provide for the following may provide greater assurances:[1]

- **"Fully-Discretionary" Trusts**. The trust agreement authorizes, but does not require, the trustees to make distributions to trust beneficiaries. For the greatest protection, the discretion likely should be absolute (i.e., distributions for any purpose), although a beneficiary-trustee cannot hold such absolute authority. An ascertainable standard may be used if applicable state law clearly supports the use of the standard as a limit on the exercise of discretion (e.g., for HEMS only) rather than as a mandate for such distributions. If using an ascertainable standard, avoid using the word "shall" when drafting; rather, have the trust agreement say the trustee "may" make distributions for HEMS.

- **Unequal and Irregular Distributions**. The trust agreement provides that the trustee (1) has discretion to make distributions in favor of any one, all, or none of the beneficiaries, in equal or unequal shares, (2) need not treat the beneficiaries equally or proportionally with regard

to any or all trust distributions, and (3) need not follow any pattern set in any prior distribution(s) for any later distributions. Further, as part of its administration, the trust does not make standardized or regularly-scheduled distributions to trust beneficiaries.

- **Potential Changes to Beneficiary Class**. The trust agreement allows future persons to be added to the class of beneficiaries and/or allows removal of existing beneficiaries. For example, the client can create the trust for the benefit of generations of his or her descendants. Alternatively, the trust agreement can authorize someone else, like a trust protector, to remove existing beneficiaries or add other persons, such as additional family members or charities, to the beneficiary class.

- **Independent Trustee**. The trust appoints one or more "independent" trustees who hold sole distribution authority over discretionary distributions or share such authority over distributions (and cannot be out-voted or overruled by any non-independent trustee(s)). The administration and circumstances of the trust also should support the true independence of these trustees from the family and trust beneficiaries.

- **Clearly-Stated Exclusions/Intentions**. The spendthrift and/or other provisions of the trust agreement clearly state that trust assets are not intended as part of the marital estate of any beneficiary and ex-spouses are not intended to be direct or indirect beneficiaries of the trust, whether through divorce or other legal proceedings.

Note that, even with the above, ***creditor concerns likely will be an issue if a beneficiary-trustee has sole authority*** to make distributions to him or herself, whether or not limited by an ascertainable standard. If clients still want to provide this flexibility in their trusts, they may want to consider one or more of these potential, albeit imperfect, options:

(1) Have trust assets consolidated in underlying family entities, like family limited partnerships or limited liability companies, which can impose restrictions on the transfer/alienation of entity interests or on the ability to receive entity distributions (note that the level of protection may vary by state law);[1]

(2) Encourage pre-marital planning for children and descendants to support future creditor protection (although such planning can be difficult to discuss and even harder to implement)

(3) Have the trust agreement limit the portion of the trust over which the beneficiary-trustee has distribution control, such as based on a percentage of the trust (likely only a partial solution as the amount over which the beneficiary-trustee has control may remain exposed).

TAKE AWAYS

- Clients can provide their descendants with some control over discretionary trust distributions and preserve the trust's intended estate tax treatment by naming a beneficiary-trustee who has sole distribution authority subject to an "ascertainable standard."

- If the family wants to enhance creditor protection, however, then naming independent co-trustees who share this distribution authority may be preferred.

- While not perfect solutions, families who want both creditor protection and beneficiary-trustees who hold maximum distribution authority may consider: (1) having trust assets consolidated in underlying family entities that restrict entity distributions or transfers of entity interests (2) encouraging the beneficiary-trustees to implement their own pre-marital or other creditor protection planning, and/or (3) limiting the trust amount over which a beneficiary-trustee has distribution authority.

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[1] *See e.g.,* Lisa M. Rico and Judith A. Saxe, "The Planning Implications of '*Pfannenstiehl*'," *The Daily Record Newswire*, as posted in *Detroit Legal News*, Feb. 4, 2016.