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Trust Distributions Part I

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Introduction

- One of the main reasons for a trust is to make distributions to beneficiaries pursuant to the settlor's intentions.
- This is a common area for disputes as beneficiaries often have insatiable wants and needs and trustees have duties to follow the trust, the settlor's intent, and be impartial as to all beneficiaries.
- The first place to look is the trust document and the settlor's intent to resolve any distribution dispute.
- This presentation will cover address many of the common issues that arise in trust distribution interpretation.

Areas Of Discussion

- The areas we will discuss are:
- Trust interpretation and construction guidelines;
- Mandatory standard for a trustee to distribute income and principal;
- Pure discretionary standard that gives a trustee broad discretion in making distributions;
- Unascertainable standards for distributions; and
- Ascertainable standards, such as HEMS.

Trust Construction

- The first place to look regarding a trustee's rights and duties is the trust document itself.
- The trustee shall administer the trust in good faith according to its terms and the Texas Trust Code. Tex. Prop. Code § 113.051.
- A party should ascertain a trust grantor's intent from the language contained in the trust's four corners and focus on the meaning of the words actually used, not what the grantor intended to write.

Trust Construction

- In interpreting a trust, a court will "(1) [c]onstrue the agreement as a whole; (2) give each word and phrase its plain, grammatical meaning unless it definitely appears that such meaning would defeat the parties' intent; (3) construe the agreement, if possible, so as to give each provision meaning and purpose so that no provision is rendered meaningless or moot; (4) [ensure that] express terms are favored over implied terms or subsequent conduct; and (5) [note that] surrounding circumstances may be considered—not to determine a party's subjective intent—but to determine the appropriate meaning to ascribe to the language chosen by the parties."
- A party "must be particularly wary of isolating individual words, phrases, or clauses and reading them out of the context of the document as a whole."

Trust Construction

- Precatory versus mandatory: precatory language means that the settlor expresses his or her desire that the trustee consider some factor but does not require the trustee to do so.
- The following words “want,” “wish,” “request,” and “desire” are ordinarily precatory in their ordinary sense and do not impose a legal obligation.
- This issue is resolved by looking to the settlor’s expressed intent as evidenced by the context of the document and surrounding circumstances, and words which are precatory in their ordinary meaning will nevertheless be construed as mandatory when it is evident that such was the testator's intent.

Trust Construction

- A party must rely on the trust's language, but there are certain terms that cannot contravene the Texas Trust Code.
- For example, a trust may not require a trustee to do an illegal or tortious act or an act that is contrary to public policy; apply exculpation provisions against the statute; limit the statute of limitations periods; limit the duty to act in good faith; limit certain court actions; or apply forfeiture clauses against the statute.
- Otherwise, the Texas Trust Code provides default rules that a trustee and beneficiary should follow absent contradiction by the trust document.
- Finally, a trustee my comply with common-law duties. Tex. Prop. Code § 113.051.

Distribution Standards

- There are three general types of standards for distributions:
- Mandatory or nondiscretionary distributions,
- Complete and unfettered discretionary distributions, or
- Limited discretionary distributions (unascertainable standards and ascertainable standards).

Mandatory Standards

- Some trusts provide that a trustee shall distribute income or principal to beneficiaries.
- When the trust document states that a trustee shall make a distribution, the trustee generally breaches its duty by failing to comply with the trust's terms.

Mandatory Standards

- Where a trustee is directed to pay the trust's income to a beneficiary for life or a designated period, the trustee is under a duty to pay the beneficiary the net income of the trust property at reasonable intervals.
- The trustee can properly withhold a reasonable amount of income receipts to meet present or anticipated expenses that are properly chargeable against income, or temporarily for the trustee's and beneficiaries' protection where there is reasonable doubt as to the amount of income properly payable to the income beneficiary.

Mandatory Standards

- Under this standard, a trustee is not allowed to accumulate income unless it is specifically authorized in the trust instrument, court order, or release agreement by beneficiaries.
- One important aspect of mandatory income distributions is that the trustee may still have discretion regarding the trust's investments and consideration should be given regarding the power to adjust and the Prudent Investor Act.

Mandatory Standards

- Settlors can also provide that a trustee shall distribute portions of principal to a beneficiary.
- For example, it is common for a trust to provide that a trustee must distribute a portion of the trust's principal to a beneficiary upon certain age attainments.
- Where a trust provides that a trustee must make certain principal distributions, a trustee must make those distributions unless the trustee obtains judicial relief to the contrary or the beneficiary consents and releases the trustee from that duty.

Mandatory Standards

- It should be noted that a trustee needs the beneficiary to assist it in making the mandatory distribution.
- The trustee may need a directive or request, information on where to send the assets, information on whether the assets should be liquidated or transferred in kind, etc.
- Until a beneficiary complies with these reasonable requests, a trustee may not have a duty to transfer the assets.

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Mandatory Standards

- Generally, trust distributions are considered the separate property of the beneficiary.
- However, trust income received by a married beneficiary is community property if the receiving spouse “is entitled, or becomes entitled” to distributions of trust corpus.
- A settlor should consider the community property implications that arise when a trustee has a mandatory duty to make income or principal distributions.

Discretionary Standard

- A settlor may want to imbue a trustee with the ultimate discretion on whether to make a distribution or not.
- Historically, courts in Texas have uniformly held that where a trustee has complete discretion in making distributions, a beneficiary cannot sue the trustee for breach of fiduciary duty for not making a distribution.
- In a discretionary trust situation, a court cannot substitute its discretion for that of a trustee.

Discretionary Standard

- Some courts, however, have held that trustees do not have unfettered discretion, even if the trust document says as much.
- "Even where a trustee is vested with broad discretion, courts may assert control over the trustee's exercise of power 'to prevent the frustration of the fundamental intent of the settlor' and compel the trustee's performance of his duty."

Discretionary Standard

- In 2009, the Texas Legislature created a statutory limitation on trustee discretion.
- "Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of terms such as 'absolute,' 'sole,' or 'uncontrolled,' the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries." Tex. Prop. Code § 113.029.

Discretionary Standard

- The Texas Property Code provides that the "trustee shall administer the trust in good faith according to its terms and this subtitle." Tex. Prop. Code § 113.051.
- Section 111.0035(b)(4)(B) states: "[t]he terms of a trust prevail over any provision of this subtitle, except that the terms of a trust may not limit . . . a trustee's duty . . . to act in good faith and in accordance with the purpose of the trust." *Id*. at § 111.0035(b)(4)(B).
- Accordingly, even in a discretionary trust situation, a trustee cannot act arbitrarily and must act in good faith and in accordance with the terms and purposes of the trust and for the interests of the beneficiaries.

Unascertainable Standard

- A settlor may want to create a trust that has some standards for distributions (more than just the sole discretion of the trustee) but which allow for broad discretion to the trustee.
- A distribution standard will usually be considered unascertainable without an objective manner to determine whether a distribution fits within the instrument's distribution standard.
- Generally, the following terms imply an unascertainable distribution standard: pleasure, desire, comfort, happiness, benefit and welfare." Treas. Reg. § 20.2041-1(c)(2) (2017) and Treas. Reg. § 1.674(b)-1(b)(5)(i).

Unascertainable Standard

- Unascertainable standards may be used when the settlor is less concerned about maintaining the trust principal for the remainder beneficiaries or when he or she wants the trustee to have more flexibility in making distributions.
- Due to the potential tax implications, these standards should be used with caution and only with independent trustees.

Unascertainable Standard

- Using an unascertainable standard will provide the trustee with as much discretion as a pure discretionary trust would provide.
- In *Lehman v. United States*, 448 F.2d 1318 (5th Cir. 1971), the Fifth Circuit held that the term “comfort” resulted in the wife/trustee possessing an “unrestricted and discretionary right—at least in the absence of evidence of actionable fraud—to consume the property, governed only by her own personal assessment of her own personal need.” *Id*.

Ascertainable Standard

- A settlor may want to provide a trustee with less discretion and use ascertainable standards by which the trustee will determine distributions.
- Although a settlor can use other terms to create an ascertainable standard, most frequently, a settlor uses the terms health, education, maintenance and support ("HEMS").
- There are several reasons for doing so, including limiting a trustee's discretion and also important tax and creditor protection implications.

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Ascertainable Standard: Tax Implications

- If a trustee is also as a beneficiary, and the trust gives the trustee complete discretion to make distributions to himself or herself, then the IRS will disregard the trust and consider the trust's assets as part of the trustee's estate.
- The IRS has created ascertainable distribution standards, and if those standards are in the trust document, then the assets will not be considered as part of the trustee/beneficiary's estate.
- Ascertainable standard can also impact and protect a beneficiary from gift tax liability when he or she holds the right to make distributions to others.
- If the power of a trustee to distribute corpus is limited by a "reasonably definite standard," it may not cause the trust income to be taxed to the settlor for federal income tax purposes.

Ascertainable Standard: Creditor Protections

- The Texas Trust Code provides that “When, however, the trust has a spendthrift provision and the beneficiary’s power is limited by an ascertainable standard relating to the beneficiary’s health, education, support, and/or maintenance, a creditor in Texas generally cannot attach the beneficiary’s interest on the basis that the beneficiary holds a distribution right or power.” Tex. Prop. Code § 112.035.

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Ascertainable Standard: Limited Discretion

- In Texas, the use of the words “support” and “maintenance” in a trust instrument evinces the creation of “support trusts.”
- A support trust does not afford trustees unbridled discretion.
- Rather, the trustee’s discretion must be reasonably exercised to accomplish the purposes of the trust according to the settlor’s intention and his exercise thereof is subject to judicial review and control.

Ascertainable Standard: Health

- The Restatement of Trusts provides that the standard of "health" is generally thought to include the following: emergency medical treatment; psychiatric treatment; psychological treatment; routine health care examinations; dental; eye care; cosmetic surgery; Lasik surgery; health, dental, or vision Insurance; unconventional medical treatment; home health care; gym memberships; spa memberships; golf club memberships; and extended vacations to relieve tension and stress.

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Ascertainable Standard: Health

- A trustee has a more difficult time deciding whether alternative treatment options should be paid for by a trust.
- Alternative treatment options include, but are not limited to, "acupuncture or homeopathic remedies, as well as elective medical procedures such as plastic surgery, laser eye surgery, cosmetic dentistry, non-diagnostic full body scans, over the counter lab tests, tattoo removal, and concierge medicine."

Ascertainable Standard: Education

- Under the Restatement, the standard of "education" is thought to include the following: grammar, secondary and high school tuition; graduate school; post-graduate school; medical school, law school, or other professional school; support of the beneficiary while in school; support of beneficiary while not in school (between semesters); studies for the student that makes a career out of learning; technical school training; career training; and college as part of a study abroad program.

Ascertainable Standard: Education

- The term "education," without elaboration, is ordinarily construed as extending to payment of living expenses as well as fees and other costs of attending an institution of higher education, or the beneficiary's pursuit of a program of trade or technical training, and the like, as may be reasonably suitable to the individual and to the trust funds available for the purpose."
- A trustee can also make distributions for a beneficiary's dependent's educational expenses.

Ascertainable Standard: Support and Maintenance

- The terms “support” and “maintenance” are considered synonymous.
- The following expenses are generally included: food; transportation; regular mortgage payments; property taxes; suitable health insurance or care; existing programs of life and property insurance; continuation of accustomed patterns of vacation; continuation of family gifting; and continuation of charitable gifting.

Ascertainable Standard: Support and Maintenance

- The following expenses might be included: reasonable additional comforts or luxuries; and special vacations of a type the beneficiary had never taken before.
- The following expenses are generally not included: payments unrelated to support which merely contribute to the beneficiaries' contentment or happiness; distributions to enlarge the beneficiaries' personal estate; and distributions to enable the beneficiary to make extraordinary gifts.

Ascertainable Standard: Support and Maintenance

- A trust may use words of restriction.
- A trust may provide that distributions may only be made for support of a beneficiary where there is an emergency, hardship, or special need.
- When those words are used, they restrict the trustee's discretion to make distributions.

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Ascertainable Standard: Style of Living

- "Support" and "maintenance" distribution standards extend beyond a beneficiary's bare necessities to include the beneficiary's accustomed style of living.
- Although the general starting point on which to base a beneficiary's accustomed style of living is when a trust became irrevocable, distributions for a higher standard of living over time may be appropriate.

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Ascertainable Standard: Style of Living

- A trustee should investigate and document the beneficiary's activities; this might include visiting the beneficiary and following up on distributions for major expenses, vacations, and education.
- However, a trustee may be justified in giving lower levels of distributions if the trust estate is modest in relation to the future needs of the beneficiary.

Ascertainable Standard: Other Resources

- Settlors often state that a trustee is to consider a beneficiary's other resources in determining whether to make a support distribution and how much of a distribution to make, but sometimes the trust is silent on this issue.
- There are three approaches: (1) ignore other resources, (2) consider them but not require the beneficiary to exhaust them, or (3) beneficiary must rely completely on their own resources unless they are inadequate.
- Texas law follows the moderate path of assuming the beneficiary's other means of support should be considered, but it does not require a beneficiary to exhaust such outside resources.

Ascertainable Standard: Other Resources

- A trustee may also take into account public benefits or the obligations of others to support the beneficiary.
- "When a trustee asks about a third-party's obligation, beneficiaries and their family members may find such questions intrusive; others may refuse to respond. However, the information is necessary because the law charges the trustee with duties, regardless of whether the parents are satisfying their duty to support a child or whether the need for maintenance and support truly exists."
- *Keisling v. Landrum*, 218 S.W.3d 737, 739 (Tex. App.—Fort Worth 2007, pet. denied) ("other financial resources" meant income and cash flow from other sources).

Ascertainable Standard: Due Diligence

- A trustee has a duty to investigate and have a factual basis for any discretionary act.
- A trustee has a duty to investigate the needs of the beneficiary and to make support distributions, and that duty arises when a trustee accepts the appointment.
- A beneficiary has a duty to provide the trustee with the information necessary to assist it in making the determination on distributions.

Ascertainable Standard: Due Diligence

- The trustee should solicit information from the beneficiary regarding his or her financial needs, wants, resources, and standard of living, and may seek underlying documents.
- The trustee generally may rely on the beneficiary's representations and on readily available, minimally intrusive information requested of the beneficiary. This reliance is inappropriate, however, when the trustee has reason to suspect that the information thus supplied is inaccurate or incomplete.

Ascertainable Standard: Catch-Up Distributions

- If a trustee has incorrectly withheld support distributions or calculated them wrong, then a beneficiary may be entitled to a catch-up distribution.
- For example, in *Keisling v. Landrum,* the court held that the trial court had a duty to go back and "determine what that standard of living was and then make trust distributions to compensate [the beneficiary] from the date of [her husband's] death." *Id.* at 745.
- So, the trustees had to make the beneficiary whole by paying her for prior years when she was not distributed appropriate amounts.

Ascertainable Standard: Beneficiary's Dependents

- Distributions made for the support of a beneficiary's spouse and minor child can be considered a HEMS distribution for the beneficiary parent because the beneficiary parent has an obligation to support his or her spouse and minor child.
- *First Nat'l Bank of Beaumont v. Howard*, 229 S.W.2d 781 (Tex. 1950) (HEMS distributions to a parent beneficiary was held to include the educational expenses of the beneficiary's dependents).
- Texas law provides that a trustee subject to a HEMS distribution standard may be required to make distributions for the support of the beneficiary's child where there is a child support obligation. Tex. Fam. Code § 154.005.
- Generally, a trustee may make direct distributions to the non-beneficiary parent for the benefit of the minor beneficiary.

Conclusion

- There are may issues related to a trustee making distributions to beneficiaries.
- The first hurdle is to understand the standard in the trust and what it means.
- Whether mandatory, completely discretionary, or with an ascertainable standard, a trustee should act in good faith and pursuant to the terms of the trust.
- Part II of this presentation will address many other interesting issues that arise in distribution disputes.