SPECIAL REPORT

“The Concept of Trustee Discretion”
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A key element of any trust is trustee discretion. This presentation is going to focus on trustee discretion as it relates to making discretionary income and/or principal distributions from trusts once they have become irrevocable. A grantor of a trust can give a trustee discretion in matters relating to the administration of the trust such as making allocations of receipts and disbursements between income and principal, as well as in matters relating to making of trust investments. This presentation’s focus, however, is the trustee’s discretion regarding the distribution of income and principal to trust beneficiaries.

The traditional view of Courts in the United States and England was to not interfere with a trustee’s exercise of discretion. The courts reasoned that the grantor had selected the trustee and given the trustee discretion and it was inappropriate for courts to substitute their judgment in place of the trustee’s judgment in terms of the propriety of making distributions of income or principal from a trust. *Estate of Marre (1941) 18 Cal 2d 184; Estate of Bixby 158 Cal. App.2d 351 (1958).* This was particularly true where the express written terms of the trust gave the trustee “sole”, “absolute”, or “uncontrolled” discretion over trust distributions. In line with this principle, Cal. Probate Code §16,081 purports to give a trustee greater insulation from Court scrutiny where the terms of the trust give the trustee “sole,” “absolute,” or “uncontrolled” discretion.

However, more recently courts have adopted a more activist role in determining whether trustees have properly exercised discretion regarding principal and income distributions. *Estate of Miller (1964) 230 Cal. App 2d 164; Estate of Nicholas 177 Cal. App. 3d 1071 (1986).* Judicial oversight of trustee discretion over trust distributions was well received by the legal community because it provided a check on the potential of unfair, arbitrary and fickle conduct of trustees relative to the making of trust distributions. However, the specter of judicial oversight did not remedy the problems resulting from the vagueness and ambiguity which plagues
trust distributive provisions. When a trustee is given “uncontrolled and absolute discretion to distribute so much of the income and principal of a trust as the trustee determines is necessary for the health, education, maintenance and support of a trust beneficiary,” how does the trustee practically operate with respect to the making of distributions from the trust to the beneficiary given such a vague and ambiguous standard?

The California legislature has endorsed the judicial oversight approach to constraining arbitrary trustee discretion by enacting Cal. Probate Code §16,080. This statute provides, “Except as provided in Section 16081, a discretionary power conferred upon a trustee is not left to the trustee's arbitrary discretion, but shall be exercised reasonably.”

As indicated above, Cal. Probate Code §16081 purports to provide an exception to this “reasonable” standard by setting forth a general rule that “if a trust instrument confers "absolute," "sole," or "uncontrolled" discretion on a trustee, the trustee shall act in accordance with fiduciary principles and shall not act in bad faith or in disregard of the purposes of the trust.” Upon close examination of this language, however, one has to question whether the requirement that the trustee exercise discretion “in accordance with fiduciary principles” really gives the trustee any measurable degree of insulation from the requirements in §16080 that the trustee exercise discretion “reasonably.” The question becomes: “Is it not a violation of ‘fiduciary principles’ for a trustee to exercise any discretion unreasonably?” Nonetheless, the common wisdom is that a court will be much more reluctant to interpose its judgment in place of the trustee’s judgment regarding distributions if the trustor has expressed intent that the trustee’s discretion is “absolute,” “sole,” or “uncontrolled.”

Given the recent litigious turn which has occurred in the trust administration arena, trustees, particularly institutional and independent trustees, long for more precise terms to guide them in making trust distributions. Indeed, many such trustees would welcome unitrust or annuity distribution formulas, which would eliminate the inherent dangers in making discretionary distributions. An example of a unitrust provision for a marital trust is set forth below:
“Each calendar year during the lifetime of the Trustor’s spouse, the Trustee shall pay to or apply for the benefit of the Trustor’s spouse the greater of (1) all of the net income of the Marital Trust; or (2) an amount equal to five percent (5%) (“Marital Payment Percentage”) of the net fair market value of the Trust Property valued as of the first day of each taxable year of the Marital Trust (the “Valuation Date”).”

The advantage of this kind of a provision is that it is definite. In planning such a provision, the client must be fully informed of how such a provision will operate under a number of varying scenarios. For example, if the trust corpus devalues by a factor of 40%, the intended payments from the trust will be drastically reduced. Thus, if the primary objective of the trustor is to provide a specific income stream to a beneficiary an annuity payment approach, particularly one, which is indexed of the cost of living, may be a better approach.

Given the vagaries of the economy and the personal circumstances beneficiaries, most clients want to give their trustees the discretion to make distributions to compensate for a depressed economy or an unfortunate turn in the financial or health circumstances of their beneficiaries. As a result most trusts involve some element of trustee discretion over trust distributions even if the discretion is limited to financial hardship or medical emergency. For example, the unitrust provision set forth above could be tempered with a provision, which allowed the trustee to make discretionary distributions of principal to the surviving spouse to alleviate financial hardship or medical emergency. For example, the following language could be added to the unitrust provision:

“The Trustee may also pay to or apply for the benefit of the Trustor’s spouse from time to time as much of the principal of the Marital Trust as the Trustee determines necessary to alleviate a bona fide financial emergency or a medical emergency endangering the health of the Trustor’s spouse. During the lifetime of the Trustor's spouse, no person, including the Trustor's spouse, shall have any power whatsoever to appoint any part of the income or principal of the Marital Trust to any person other than the Trustor's spouse.”

As the above discussion illustrates, trustee discretion remains an important element in most situations because it provides a trust with the flexibility to provide for a beneficiary’s exigent needs and
to compensate for financial reversals not contemplated by the grantor. However, in drafting trust instruments it is important to provide express terms and provisions, which serve to guide the trustee in the exercise of distributive discretion as well as to protect the trustee when such discretion is actually exercised.

**General Drafting Constraints for Discretionary Distributive Provisions**

Most drafters are concerned that discretionary distributive provisions, which are not limited by the “health, education, support or maintenance” standard set forth in §2041 of the Internal Revenue Code, will risk the trust corpus being included in the gross estate of the beneficiary on the theory that the beneficiary has a general power of appointment over the trust corpus. **Internal Revenue Code §2041.** In relevant part this statute provides:

“The term “general power of appointment” means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that—A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.”

This concern is certainly applicable when the beneficiary is a trustee or co-trustee of the trust. Under the general rule of §2041, if a beneficiary has the right as trustee or otherwise to appoint assets in favor of himself or herself, the beneficiary will have a general power of appointment if the discretionary power over the trust corpus is not limited by the “ascertainable standard” set forth in the statute. Treasury Regulation §20.2041-1(c)(2) explains the parameters of this standard as follows:

“A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder’s duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words “support” and
“maintenance” are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder’s “support,” “support in reasonable comfort,” “maintenance in health and reasonable comfort,” “support in his accustomed manner of living,” “education, including college and professional education,” “health,” and “medical, dental, hospital and nursing expenses and expenses of invalidism.” In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.”

As a consequence, it has long been the practice to limit all discretionary standards over income and principal by the ascertainable standard so as to prevent a beneficiary who is a trustee or might become one from having an inadvertent general power of appointment. Below is an example of such a provision:

“During the lifetime of the beneficiary, each year the Trustee shall pay to or for the benefit of the beneficiary, quarter annually or at more frequent intervals, the entire net income of the beneficiary’s trust. If the Trustee considers such income payments insufficient, the Trustee may pay to or for the benefit of the beneficiary those sums from principal as the Trustee, in his or her sole absolute and uncontrolled discretion, considers necessary for the beneficiary’s proper health, education, support or maintenance after taking into consideration, to the extent the Trustee considers advisable, any other income or resources of the beneficiary’s made known to the Trustee and reasonably available for those purposes.”

In truth, this ascertainable standard language is only necessary to avoid the general power of appointment issue posed by §2041 where a beneficiary is also the trustee of a trust for his or her benefit. Where a true independent trustee is acting for the trust, the limitations of the ascertainable standard are not necessary to prevent the trust corpus from being included in the beneficiary’s estate by reason of §2041. Nonetheless, because of the many situations where surviving spouses and children are named as trustees for trusts in which they are also beneficiaries, the standard practice has been to limit virtually all discretionary distributive
provisions by the “health, education, maintenance and support” standard. As a practical matter, the so-called “ascertainable standard” is sufficiently vague and ambiguous so as to not be a significant restraint on a trustee’s discretion. Further, a broader standard such as “the trustee may distribute so much of the income and principal of the trust to or for the benefit of the beneficiary as the trustee in the trustee’s sole, absolute and uncontrolled discretion deems fit” is thought by most clients and practitioners to give the trustee too much arbitrary power over trust distributions.

Further, Federal Tax Cases considering the issue of whether particular trust language fell outside the lines of the proscribed “ascertainable standard” under §2041 supported the rote adherence to the “health, education, support or maintenance” language to limit and define trustee discretion. These cases tended to focus on the terms themselves rather than how the discretion was actually exercised and in some cases found that use of the terms such as “comfort” and “well being” rather than the precise terms “health, education, maintenance and support” resulted in the power held by the trustee/beneficiary to constitute a general power of appointment and the assets in trust being includible in the power holder’s gross estate. Jones Estate v. Commissioner (1971) 56 TC 35.

Because of such Federal Tax Cases, the legal community caused the legislature to add §16081(c) so as to statutorily impose the “ascertainable standard” into every trustee/beneficiary trust provision unless the drafter specifically opts out of having the standard statutorily imposed. This section provides:

“Unless a settlor or a testator clearly indicates that a broader power is intended by express reference to this subdivision, a person who is a beneficiary of a trust that permits the person, as trustee or cotrustee, to make discretionary distributions of income or principal to or for the benefit of himself or herself may exercise that power in his or her favor only for his or her health, education, support, or maintenance within the meaning of Sections 2041 and 2514 of the Internal Revenue Code. Notwithstanding the foregoing and the provisions of Section 15620, if a power to make discretionary distributions of income or principal is conferred upon two or more trustees, the power may be exercised by any trustee who is not a current permissible beneficiary of that power; and provided further that if there is no trustee who is not a current permissible beneficiary of that power, any party in interest may apply to a court of competent jurisdiction to appoint a trustee who is not a current permissible beneficiary.
beneficiary of that power, and the power may be exercised by the trustee appointed by the court.”

Toward Greater Clarity

There are a number of drafting considerations for tightening up discretionary distributive provisions. First, understand the difference between the words “may” and “shall.” If one uses the word “may,” it greatly increases the trustee’s discretion because the trustee does not have to make any distributions at all. The word “may” allows the trustee to completely withhold distributions to a beneficiary. On the other hand, the word “shall” arguably requires the trustee to make some distribution, although the amount of the distribution would be in the discretion of the trustee.

The words “sole,” “absolute,” and “uncontrolled” are important because they greatly increase the amount of trustee discretion. A court is much more likely to abstain from intervening on a matter of trustee discretion where the trustor has expressly indicated that the discretion is to be sole, absolute and uncontrolled. Cal. Probate Code §16,081.

Some commentators suggest defining the terms “health,” “education,” “maintenance,” and “support” so that these terms have greater precision. Other commentators warn that if the definitions are too broad, the practitioner risks drafting a provision which will not be within the safe harbor afforded by Treasury Regulation §20.2041-1(c)(2) set forth above. Despite this concern, most commentators believe it is important to precisely define the term “education” so that it is clear as to the type of education, the scope of the educational expense, and the intended duration of the educational support. Below is an example, of a trust provision defining “education”:

“As used in this Agreement, the term "education" shall be given a broad interpretation, and may include, but is not limited to, the following activities, as long as they are pursued to advantage by the beneficiary:

1) Education at public or private elementary or high schools (including boarding schools);

2) Undergraduate, graduate, post-graduate, and non-degree program of study in any and all fields whatsoever, whether of a professional character or otherwise, at public or private universities, colleges, or other institutions of higher learning;
3) **Vocational training or specialized formal or informal training in music, the stage, the handicrafts or the arts, whether by private instruction or otherwise; and**

4) **Any other activity, including foreign or domestic travel, which tends to develop fully the talents and potential of the beneficiary, regardless of age.**

   *The term "education" may also include, in the Trustee’s discretion, reasonable living and travel expenses relating to the above activities. The activities described in this paragraph may be carried on either in the United States or elsewhere."

The strong language of §16,081 (c) which imposes the “ascertainable standard” on discretionary distributive provisions drafted into California trusts, unless there is a provision in the trust expressly opting out of the protection of the statute by specific reference to it, alleviates much of the concern about defining what is meant by the individual terms “health, education, maintenance and support.” For example, if the trustor intends that the particular beneficiary be supported and maintained in the “manner of the lifestyle that he or she enjoyed during our marriage” then arguably such an indication should be expressly set forth in the distributive provisions of the trust document.

It is also important to let the trustee know whether or not the trustee is to consider other means of support available to the beneficiary. For example, in the instance of a minor beneficiary it is important for the trust provision to clearly indicate whether the trustee is expected to supplant the support obligation of the parent of the child. *Armstrong v. Armstrong (1976)* 15 Cal 3d 942. Under this case, the Court reaffirmed that unless the trust documents indicates a clear intention to be the primary source of support for a minor beneficiary, the child’s funds cannot be used to provide for the child’s basic support needs in derogation of the child’s parents’ support obligations, unless the parents are proven to be financially unable to provide for these basic support needs.

Finally, it is crucial that the discretionary distributive provision indicate whether there are preferred beneficiaries. For example, if a trust is established primarily for the benefit of a surviving spouse there should be express language in the provision, which indicates that the
surviving spouse is the primary beneficiary of the trust and that the interests of the remainder beneficiaries are secondary to his or her support needs. Language, which makes such an indication, gives the trustee of such a trust a tremendous amount of comfort in making distributions toward the support of the surviving spouse as a beneficiary. Without that language, the strict application of Cal. Probate Code §16003 may deter a trustee from making distributions to a surviving spouse which may be appropriate but necessarily critical to the spouse’s support needs. This probate code sections provides: **“If a trust has two or more beneficiaries, the trustee has a duty to deal impartially with them and shall act impartially in investing and managing the trust property, taking into account any differing interests of the beneficiaries.”**

There are two general types of multi beneficiary trusts. The first type is the vertical multi beneficiary trust, where there is a life beneficiary and then remainder beneficiaries who take upon the death of the beneficiary. The second type is the horizontal multi beneficiary trust, where there are a number of beneficiaries within a class all of whom have the current present ability to receive discretionary distributions of principal or income from the trust. These horizontal multi beneficiary trusts present an additional set of challenges. Consider the issues that arise from the following language:

**“So long as any issue of the Trustor who survive the Trustor is living, the Trustee may pay to or apply for the benefit of those issue of the Trustor who are then living so much of the net income and principal of the Trust as the Trustee, in the Trustee’s sole, uncontrolled and absolute discretion, deems necessary for the proper health, education, maintenance and support of any one or more such issue, after taking into consideration, to the extent the Trustee deems advisable, any other income or resources of such beneficiary made known to the Trustee and reasonably available for those purposes. The Trustee is authorized at any time or from time to time to pay to or apply for the benefit of any person who is within the class of beneficiaries described above, for any of said purposes, a greater amount or proportion of said net income and principal than the Trustee pays to or applies for the benefit of any other person or persons who are within**
the class of beneficiaries described above. All decisions of the Trustee as to the
person or persons to whom and the purposes for which, such payments are to be
made and the amount or amounts, if any, to be paid out of the trust from time to
time are within the Trustee's sole, absolute and uncontrolled discretion and shall be
final and incontestable by anyone. Any income net expended under the foregoing
provisions of this paragraph shall be accumulated and added to the principal of the
trust at such time or times as the Trustee in the Trustee's sole, absolute and
uncontrolled discretion determines."

**Single Beneficiary Trust**

At the outset is important to distinguish the single beneficiary separate share trust from the
multi beneficiary “family pot” trust. Many single beneficiary separate share trusts are set up primarily
for the purpose of asset protection and tax planning. In these kinds of trusts, the objective is to give
the trustee, who may also be the primary beneficiary, as much discretion as possible over the assets
of the trust without causing the trust corpus to be exposed to the trustee/beneficiary’s creditors or
includible in the trustee/beneficiary’s gross estate for federal estate tax purposes. In drafting a trust
with discretionary provisions which meet these objectives, it is critical to understand the importance
of having an “ascertainable standard” be construed as limiting the trustee/beneficiary’s discretion as
well as have the appropriate asset protection provisions afforded by Cal. Probate Code §15,300 et
seq.

Questions? Comments? Please contact us by telephone or e-mail...
About the Author…

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A Note from Frank Doyle:

I have been working in this area of law for over thirty years…. I am a member of the State Bar of California and certified by the Cal Bar as a legal specialist in Taxation Law and Probate, Estate Planning and Trust Administration. I am also an educator and I enjoy teaching and sharing the stories of the challenging legal conundrums that I have solved in my practice over the years. I remember it well; I walked in the door and told my wife, "I quit my job today". She looked at me (holding our 6-week old son) and said, "What are we going to do?" It was at that point that I decided to break out on my own and start my estate planning practice. I hit the road and began to set up the alliances, a network of associates and the expertise to build a thriving international estate planning practice.

Over the years, I have continued to teach law school and present MCLE courses nationwide. I was frustrated with the fact that I have never found the information that would allow an attorney to capture the basics of developing and expanding a thriving estate planning practice, so I have created them for you now. I am the founder of WealthPLAN and bring over 30 years of experience in tax, estate planning, litigation, probate and trust administration. I have taken all of my experiences and legal expertise to create the Advanced Legal Training Institute, foundation course entitled, Integrated Estate Planning Seminar Series (I-IV). This set of 17-AudioCDs include over 30 hours of legal information that will give you a jump start to get yourself into this lucrative and growing legal niche. I have taken the best ideas from all of my presentations, case studies and professional experience to provide you with a step-by-step program to support our aging population. I am now working with some of the children and grandchildren of my original clients. The Advanced Legal Training Institute tapes and workbooks offer checklists, templates, forms and articles to provide an in-depth educational experience for attorneys and other estate planning professionals. P.S. My 6-week old son, John, is now grown and a practicing attorney himself.