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# **DISCRETIONARY TRUST DISTRIBUTIONS**

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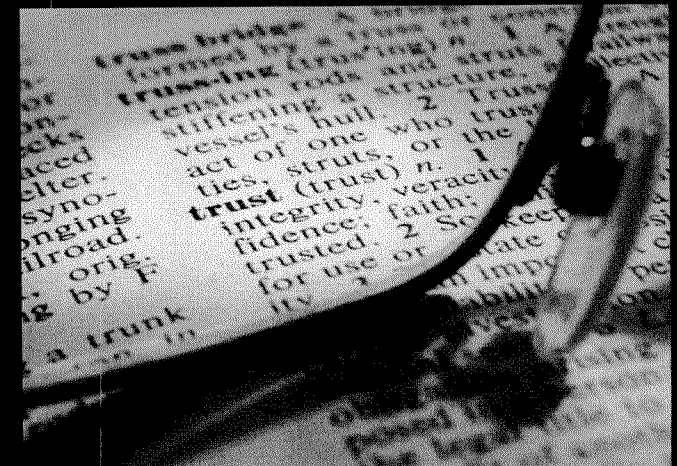
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# TRUSTEE'S DISCRETION AND TRUST DISTRIBUTIONS



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# Issues to be Covered

- Distributions as defined in Trust Agreement
- Distributions Limited to Standards
- Pure Discretionary Distributions
- Special or Custom Drafted Distributions
- Fiduciary Responsibilities and Liability

# Defined Distributions

- All income to A for life –
- Issues can still arise – what if income is not being earned?
- Power to Adjust or Unitrust Options
- QTIP – IRC requires ability to convert unproductive assets to productive by spouse
- IRA payable to trust – EPTL says 10%

# When and how to Adjust or Unitrust

- Corporate Trustees can be rigid in applying distributions to beneficiaries
- Good returns of Interest and Dividends in current market are scarce and almost non existent
- To keep the peace between income beneficiaries and remainders

# Income tax Issues

- PTA or Unitrust – for income tax purposes trust beneficiary is taxed on actual income earned and the rest is a non-taxable distribution of principal unless trust allows discretion in trustee to allocate capital gains.

# Asset Protection Issues

- If all income is to be paid to a beneficiary, then it will all be available to the creditors of that beneficiary
- Attachable by levy or judgment of creditor and served on trustee
- No way to avoid in QTIP – IRC requires all income to be paid to Spouse to get marital deduction

# IRA to QTIP Pitfalls

- Three types of “income” with an IRA
- One is the annual MRD as required by IRC
- Second is the actual Income Earned on the IRA assets
- Third is EPTL 11-A 4.9 10% statutory Income Definition for retirement assets



# IRA to QTIP con't

- In order to get Marital Deduction for IRA payable to a QTIP, the trust must conform with RR 2006-26
- IRA and Trust both must comply with IRC 2056 so all income of IRA must pass to Spouse – Spouse to take greater of Income or MRD or compel the trustee to do so – must be in trust

# IRA QTIP Clauses

**No Unitrust distributions or Mandatory:** "I direct that my wife shall have the power, exercisable annually or more frequently, in her absolute discretion, to compel my Trustees to withdraw from any IRA, of which the Marital Trust in this Article is named as a beneficiary, an amount equal to the income earned on the assets held by each such IRA during the year. If my wife exercises such power, my Trustees shall treat distributions from any such IRA for such year as income of the trust to the extent that the distributions represent income generated or deemed to be generated by each such IRA and withdrawn from the account pursuant to my wife's exercise of her power described herein, notwithstanding the treatment of such portion of the distribution under any law concerning the determination of income and principal for trust accounting purposes, and my Trustees shall not charge to income any expense properly chargeable to the nonincome portion of the distribution. The power in this paragraph shall be exercised by means of a letter signed by my wife and delivered to my Trustees. If my wife does not exercise the power in this paragraph in any year, such power with respect to the income earned that year shall lapse and may not be carried forward to the following year".

# IRA QTIP Clauses

**Power to allocate between Principal and Income:** "To allocate, in the absolute discretion of the trustees, in whole or in part, to principal and income, all receipts and disbursements for which no express provision shall be made under the law of the State governing this Will provided, however, that the income of a trust created under this Will shall include all distributions received by such trust from each qualified retirement plan and Individual Retirement Account, or portion thereof, of which such trust shall be beneficiary to the extent that such distributions represent ordinary income (e.g., interest and dividends) earned in such qualified retirement plan or Individual Retirement Account during the calendar year in which such distributions shall be received by such trust or with respect to which such distributions shall be attributable, notwithstanding the classification of such distributions as principal or income for trust accounting purposes, and further provided that the balance of such distributions shall be deemed principal and that all expenses of such trust allocated to principal, including income tax on such distributions, shall be charged to principal".

# Ascertainable Standard

Ascertainable standard: HEMS Distributions limited to Health, Education, Maintenance or Support.

Defines an easy to follow roadmap for trustee (sometimes)

It is safe drafting for no Estate tax Inclusion

It avoids GPOA on entire corpus for creditors claims

# When I use a HEMS

- When drafting a SLAT (spousal Access Trust) to allow gift splitting
- When I want to avoid a Section 2036 Estate tax inclusion if Grantor or Benny is trustee
- When I want to avoid a grantor trust
- In a CST to let Spouse have self access
- When I create a POA for a 678 Trust so trust is grantor trust to a beneficiary

# When I don't Use a HEMS

- For Asset Protection Trusts
- Just because its in the form
- For QTIP trusts if second or third marriage etc. (unless clients asks for it)
- In Medicaid trusts for surviving spouse

# Ascertainable Standard to avoid gift by TTE/Benny

**Treasury Regulations 25.2511-1(g)(2):** If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. **A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard.** The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.

# Ascertainable Standard to avoid GPOA in Grantor

**Treasury Reg. 20.2041-1(c)(2):** *Powers limited by an ascertainable standard.* 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.



# Ascertainable Standard in Benny to avoid corpus in Estate of Benny

**Treasury Reg. 20.2514-1(c)(2):** *Powers limited by an ascertainable standard.* A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor is, by reason of section 2514(c)(1), not a general power of appointment. A power is limited by such a standard if the extent of the possessor'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.

# Ascertainable Standard Boobytraps

“Welfare” – Welfare added to “health, education and support” is an ascertainable standard according to *Leopold v. United States*, 510 F.2d 617 (1975). However, welfare alone is not an ascertainable standard, i.e. “welfare and happiness”.

“Best Interests” – Best interests is not an ascertainable standard according to *Old Colony Trust Co. v. United States*, 324 F.2d 601 (1970).

“Necessary and proper” – Necessary and proper is not an ascertainable standard according to *Leopold*.

# "Support and Maintenance"

"Support and Maintenance": includes beneficiaries normal living expenses depending on standard of living enjoyed by the beneficiary during the grantor's or testator's lifetime, i.e., food, clothing, housing, medical care

(See *Hartford-Connecticut Trust Co. v. Eaton*, 36 F. 2d 710 (2d Circ. 1929), *In re Levinson's Will*, 5 Misc. 2d 979, 162 N.Y.S.2d 287 (1957); *Hill v. Comm'r*, 88 F.2d 941 (8<sup>th</sup> Cir. 1937); *Equitable Trust Co. v. Montgomery*, 44 A.2d 420 (Del. Ch. 1945).

# **"Care and Maintenance" for a Spouse**

"Care and Maintenance" payments to spouse means "care and maintenance to which spouse was accustomed while living with testator". *In re Morse's Will*, 198 Misc. 364, 98 N.Y.S2d 43.

# "Education and Health"

*In the Matter of the Estate of Wallens, 9 N.Y.3d 117 (2007):*

"Trustees can distribute to beneficiary for proper support, education, maintenance and general welfare"

Trustees withheld these distributions and Court held education and medical expenditures to beneficiary were permitted based on terms of trust.

A trustee is required to act reasonably and in good faith in attempting to carry out terms of trust - even if trust grants trustee with broad discretion over distributions. AND EVEN IF THE TRUSTEES ARE THE KIDS FROM FIRST MARRIAGE!

# "Comfort"

*Definition includes financial, emotional and physical comfort so it is very broad if used in trust*

*In re Mirfield's Estate*, 126 N.Y.S.2d 465, even the purchase of an automobile by trustee for the daughter of spouse to visit her at the hospital was permissible since the testator's intent to provide fully for the "comfort, maintenance and support" of wife was clear.

# "Best Interests"

Very Broad distribution provision - but not broad enough to collapse a trust in NYS

"Trust permitted payment to life beneficiary of all of the net income and so much of principal as trustees may deem for 'best interests' of beneficiary. Court held trustees not authorized even in good faith to terminate the trust by paying the entire principal to the life beneficiary so that she could utilize the funds for better support and education of children and obtain tax advantages since the power to use the principal of the trust could not be enlarged into a power to terminate it." (*Kemp v. Paterson*, 6. N.Y.2d 40 (1959)).

# **“Extraordinary Expenses/Emergencies”**

*This can be construed as a very broad expansion since emergencies are subjective!!!*

*In re Gatehouse Will, 127 N.Y.S.2d 697 (1953): Terms of testamentary trust provided that trustees could invade corpus to provide for “hospital or medical attention or other extraordinary expenses that may be necessary for the care and comfort of my wife”. Court held expenses incurred by the widow during last illness, which were serious, were payable out of the principal of the trust. However, funeral expenses were disallowed (not authorized by Will and she left an estate of her own more than sufficient for purpose and testator was first husband and at time of her death she was widow of another).*



# Pure Discretion Trusts

- Used invariably in Asset Protection Trusts
- Useful for child trusts where beneficiary is financially or emotionally challenged
- Good for later generations or dynastic trusts

# Absolute Discretion is Non Reviewable in NYS

*Well Generally Speaking – see Ledyard's Estate*

“Where testator had specified no standard or criterion of distribution of income of residuary trust, but reposed in his trustee an absolute discretion without limitation to pay net income to use of person or persons belonging to class composed of his wife and his descendants, the exercise of trustee's discretion would not be subject to review, at least unless it were unquestionably arbitrary and capricious”. *In re Ledyard's Estate*, 21 N.Y.S.2d 860 (1939).

# Absolute Discretion – maybe not really non reviewable in NYS

It is Reviewable if "If discretion is conferred upon the trustee in the exercise of a power, the court will not interfere unless the trustee in exercising or failing to exercise the power acts dishonestly, or with an improper even though not a dishonest motive, or fails to use his judgment, or acts beyond the bounds of reasonableness."

Court held in *Matter of Stillman*, 107 Misc. 2d 102, 433 N.Y.S.2d 701 (1980), the trustees abused their "absolute and uncontrolled discretion" in denying requests to invade principal because the distributions were not needed since the beneficiaries could use their own funds and get money otherwise by mortgage borrowing. Court stated that the standard applied by the trustees in refusing to invade principal was too strict.

"Standards for the trustees can be found in the will from which the testator's intention was gleaned and in those factors that the court has taken into account in determining that the rejection of the requests was unreasonable and arbitrary".

"Other means available to these beneficiaries can be a consideration but not a controlling one if a modest invasion request is presented and if the estate of the requesting income beneficiary does not then rival the size of the trust and thereby risk substantial estate taxes or other creditors."

# Sole and Absolute Discretion of a HEMS

Its not really sole trustee discretion at all in NYS if HEMS

“Sole” Discretion: The trustee shall make distributions to beneficiary for such beneficiaries maintenance, education and support in such trustee’s sole discretion. Trustee must make distributions based on such limited standard. (See *Kolodney v. Kolodney*, 503 A.2d 625 (Conn. App. 1986)).

# Custom Distributions

- Define a fixed amount to be paid out annually

Eg. My Trustee shall pay my son the sum of \$40,000 per year until the trust is depleted; Such amount shall be paid first from income then from principal

# Trustee Liability

- Unless the trustee fails to distribute due to self interests or bad faith, there will likely be no damages, surcharges or other liability - other than being forced to make the distribution
- The costs of the legal defense could be an issue if the trust does not provide such language that these costs can be paid to defend claims against the trustee

# Circular 230 Disclosure

The Treasury Department has newly promulgated Regulations effective June 20, 2005, that applies to those attorneys and accountants (and others) practicing before the IRS that require such individuals to provide extensive disclosure in certain written communications to clients. In order to comply with our obligations under these Regulations, we want to inform you that since this communication is not intended to and does not contain such disclosure, you may not rely on any tax advice contained in this document to avoid tax penalties.

## **David J. DePinto, Esq., LL.M., CPA, MST, CELA**

**David J. DePinto** practices in the areas of trusts, estate planning, asset protection, charitable entities, business and succession planning for closely held businesses, estate and gift taxation, income taxation, elder law, guardianship, probate and administration of trusts and estates, estate litigation and also provides representation to Guardians, Trustees and other fiduciaries. He acts a Property Guardian for wealthy individuals and in the role of Executor and Trustee on a wide range of Trusts and Estates. He has been retained by private clients as an expert witness at trial for litigation cases involving trusts and related issues and also appointed as estate planning counsel on complex and high value cases including forensic review of trust and estate planning documents before the State Supreme Court.

Before going into private practice in 1999, Mr. DePinto spent seven years with a mid-sized NYC firm where he practiced in their Trusts and Estates department, handling a broad range of matters including estate planning, Wills and Trusts, estate taxation, taxation of charitable organizations, probate and administration of estates. He also worked in the IRS District Counsel Office for the Northeast, handling tax litigation matters for the Government.

Mr. DePinto received his LLM Master of Laws degree from NYU Law School, his JD degree from Brooklyn Law School and his Master of Science degree in Taxation, with academic honors, from Long Island University CW Post and his BBA degree from Hofstra University. He is a NYS Certified Public Accountant (CPA) and a (CELA) Certified Elder Lawyer certified by the National Elder Law Foundation as accredited by the American BAR Association. He is the recipient of the Edith Blum Foundation Award for Excellence in Taxation and the professor's Award for Academic Achievement in Taxation. He was recently named to the 2013 list of Super Lawyers®.

He is an adjunct professor in the Masters Program at Long Island University. He has spoken for the New York State BAR Association on complex trust and Estate Planning topics and regularly lectures before the Nassau and Suffolk BAR Association centers for continuing Legal Education, and their committees and sub committees. He is frequently asked to speak on trust topics for (NBI) the National Business Institute and other providers of legal education. He was technical editor for the publication "Fundamentals of Trust Accounting Income and Principal under the Revised NYS Laws" (ABA Publication 2013). Known in the community for his expertise on trusts and related matters, he acts as counsel to many large and small law firms, providing advice and guidance in his areas of concentration.

He is a former Part 36 Court fiduciary, a mentor with the Elder Law Section of the NYSBA attorney mentoring program, member of the American, New York State, Nassau County and Suffolk County bar associations, and also a former member of the American Association of Attorney-CPAs, American Institute of Certified Public Accountants and the New York State Society of Certified Public Accountants. He was treasurer for the Estate Planning Committee for the Nassau County Chapter of the NYSSCPA and is also currently admitted to practice before the United States Tax Court.