

Discretionary Distribution Standards: Full Speed Ahead

by Carol Warnick, Kelly Dickson Cooper, and Rebecca Klock Schroer

This article provides guidance to trustees and estate planners regarding the interpretation of distribution standards commonly found in trust documents. Additionally, it offers guidelines for trustees to consider when exercising their discretion to make distributions and for estate planners in drafting discretionary distribution standards.

When drafting distribution standards, estate planners often use the standards “health, education, maintenance, and support,” even though these may not reflect the client’s needs and desires. This article provides guidance to estate planners and trustees administering trusts for drafting and administering discretionary distribution standards that reflect the intent of clients and grantors.

To assist estate planners and trustees, this article discusses the following topics: (1) the meaning of commonly used terms in trusts that give direction and discretion to trustees; (2) the meaning of expanded discretion; (3) whether a trustee is required to consider the other resources of a beneficiary before exercising discretion and, if so, what resources should be considered; (4) when Colorado courts will interfere with the exercise of trustee discretion; and (5) when it is appropriate to use ascertainable standards to limit the trustee’s discretion for tax purposes. A trustee should consider all relevant circumstances before making a discretionary distribution, including the trust terms, intent of the settlor, tax and other purposes of the trust, and general fiduciary duties such as the duty of impartiality and the duty of loyalty.¹

Colorado Law and the *Restatements of Trusts*

Colorado law provides little guidance regarding the proper interpretation of distribution standards. As a result, estate planners and trustees should consider the extent to which the *Restatement (Second) of Trusts* and the *Restatement (Third) of Trusts* provide additional guidance. The *Third Restatement* has not been adopted by Colorado, but offers specific guidance not found in the *Second Restatement* or Colorado appellate law. In drafting or administering distribution standards, it is instructive to consider both the *Second*

and *Third Restatements* when trying to define and determine the bounds of trustee discretion. When there is no Colorado law for guidance and the *Restatements* are in conflict—such as when to consider a beneficiary’s other resources—a trustee is faced with a difficult decision. Estate planners can avoid this situation by including additional provisions in trusts.

Even though Colorado has not adopted the Uniform Trust Code (UTC), the regular movement of clients between states suggests that estate planners should consider the potential ramifications of the application of the UTC to the trusts they draft, or include governing law clauses that avoid unintended results. For trustees, the application of the UTC should be considered prior to moving a trust to another jurisdiction.

Interpreting Commonly Used Distribution Standards

The most commonly used distribution standards are health, support, and maintenance. “Support” and “maintenance” generally are considered synonymous and are interpreted to mean that a beneficiary can receive distributions to the extent necessary to maintain his or her accustomed standard of living.²

Colorado has limited case law interpreting these terms and provides little guidance to estate planners and trustees other than that the general rule applies in Colorado. In *Goss v. McCart*,³ the trust granted the trustee discretion to provide for the comfortable support, medical care, and other benefits of the settlor’s spouse and maintain the settlor’s spouse in the standard of living to which he was accustomed. The Colorado Court of Appeals held that such language meant the trustee was to maintain the surviving spouse in the standard of living he had at the time he was married to the grantor.⁴

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Colorado's limited case law makes it prudent to consider the guidance provided by the *Restatements* when interpreting these standards. The *Second Restatement* provides that the interpretation of the word "support" depends on the trust language and may range from only the sums the trustee reasonably believes to be necessary for the beneficiary's support, to the payment of the entire principal without any limitations.⁵

The *Third Restatement* provides more specific guidance regarding the meaning of the terms "support" and "maintenance." Generally, "support and maintenance" is interpreted to include support of the beneficiary and members of the household, as well as the costs of a suitable education for the beneficiary's children.⁶ The standards of support and maintenance also typically include distributions of reasonable amounts for the support of a current spouse and minor children that reside elsewhere, but whom the beneficiary either chooses to support or is required to support.⁷

Examples of appropriate expenses that can be paid under a support standard include:

- 1) regular mortgage payments;
- 2) property taxes;
- 3) suitable health insurance or care;
- 4) existing programs of life and property insurance; and
- 5) continuation of accustomed patterns of vacation and charitable and family giving.⁸

Under the *Third Restatement*, the inclusion of the term "health" in a trust's distribution standard does not provide for greater distributions, because the money necessary for the beneficiary's health care

typically is included in the interpretation of support and maintenance.⁹

Estate planners often include another term in trust distribution standards—education. Colorado does not have case law interpreting the term "education" in the context of a distribution standard. Nationally, the definition of "education" varies from requiring the support of a beneficiary's lifelong educational pursuits to requiring only distributions for the education of a minor.¹⁰ Although the *Second Restatement* tends to follow the trustee's determination of education, whether it is broad or restrictive, the *Third Restatement* specifically includes in its definition higher education and payment of living expenses and costs while in school.¹¹ Because many clients have an idea of what education means to them, estate planners should discuss this with clients and consider providing a customized definition in the trust agreement.

Expanding or Restricting the Trustee's Discretion

If a client wishes to expand the distribution standards in his or her trust, estate planners should consider including terms such as "comfort," "benefit," and "happiness," which have been used to broaden discretion beyond support. However, some courts have interpreted comfort and benefit to be similar to support and maintenance, so happiness should be included if the goal is to expand a trustee's discretion beyond the typical standards of health, education, maintenance, and support.¹²

Colorado law and the *Second Restatement* do not specifically address the meaning of comfort, benefit, and happiness as discre-

tionary standards, but the *Third Restatement* provides definitions for all three terms. If the beneficiary's lifestyle already was comfortable, comfort adds nothing to the standard of support. "Generous" support may be broader than support.¹³ "Benefit" and "happiness" grant the broadest discretion compared to the other terms discussed in this article. Happiness is so broad it likely will protect the trustee from challenge by a remainder beneficiary for almost any reasonably affordable distribution.¹⁴

When a client wishes to restrict the distribution standards in the trust, estate planners should consider including terms such as "emergency" and "hardship," which have been interpreted to restrict the trustee's discretion when compared with a typical health, education, maintenance, and support standard. Colorado law and the *Second Restatement* do not provide a definition for these terms, but the *Third Restatement* provides that terms such as "emergency," "severe hardship," and "disability" authorize distributions only when the described conditions or circumstances arise. In addition, even if the described conditions or circumstances have arisen, the trustee's discretion can be exercised only to the extent appropriate to alleviate the emergency, hardship, or special need.¹⁵ As a result, estate planners should consider including these terms only when the client has expressed an ardent desire to restrict distributions from the trust.

Consideration of a Beneficiary's Other Resources

In *Dunklee v. Kettering*,¹⁶ the Colorado Supreme Court held that when trust distributions are limited to the beneficiary's needs and the trust is silent regarding whether the trustee should consider other resources of the beneficiary, the beneficiary's other resources should be considered before the trustee exercises discretion. Colorado trustees should pay careful attention to this ruling when a trust falls within its guidance, because the *Second* and *Third Restatements* contain conflicting positions on whether a beneficiary's other resources should be considered by a trustee prior to making a distribution. Estate planners can alleviate trustee confusion by providing in the trust language whether a beneficiary's resources must be considered; should be considered; should not be considered; and, if considered, what the term "resources" means.

The *Second Restatement* is more liberal on this topic from the beneficiary's perspective than the *Third Restatement*. The *Second Restatement* infers that the beneficiary's other resources do not need to be considered¹⁷ and the *Third Restatement* states the opposite—that a trustee is required to consider a beneficiary's other resources before making a distribution.¹⁸

Also, the *Third Restatement* provides specific guidance to a trustee regarding when and in what situations the trustee should consider a beneficiary's other resources. For example, if the beneficiary is entitled to mandatory distributions of income or payments from another trust with the same settlor or payments as part of a coordinated estate plan with another, these payments should be considered before making a discretionary distribution.¹⁹ Further, the *Third Restatement* provides that no matter how broad the discretionary standard—even happiness—the trustee's consideration of the beneficiary's other resources still is a factor in determining whether the trustee's exercise of discretion was reasonable.²⁰

What Resources to Consider

If the trustee has decided to consider (or is required to consider) the other resources of the beneficiary in exercising his or her dis-

cretion, the next step is to determine what resources should be considered. Colorado law and the *Second Restatement* do not provide an answer to this question and case law varies significantly by jurisdiction. Some courts have held that the beneficiary is not required to liquidate other assets before receiving discretionary distributions,²¹ although it also has been held that a beneficiary needs to exhaust all assets before receiving discretionary distributions.²²

Due to the varying national holdings and the lack of Colorado law on this topic, a trustee may consider the guidance provided by the *Third Restatement*. It provides that a trustee should consider:

- 1) the beneficiary's independent income;
- 2) annuity payments;
- 3) court-ordered support payments;
- 4) income payments from the trust; and
- 5) the principal of the beneficiary's estate.²³

The *Third Restatement* also states that there may be instances where the beneficiary's non-income assets should be taken into account depending on: (1) the liquidity of the assets; (2) the terms and purposes of the discretionary power; (3) other purposes of the trust, such as tax purposes; and (4) the settlor's relationships and objectives regarding all the beneficiaries.²⁴ For example, if a trust is exempt from generation-skipping transfer tax, it may be prudent for the trustee to consider the principal assets of a beneficiary who is a generation below the settlor and not to consider the principal assets of beneficiaries who are more than one generation below the settlor.

In addition to considering the beneficiary's other resources, a trustee should consider the beneficiary's liabilities and whether the

beneficiary has any creditors that will be entitled to the distribution before exercising discretion to make a distribution.²⁵ The settlor's purpose and intention also should be considered. For example, a trustee should consider whether the creditor of the beneficiary is a person whose needs the settlor would normally expect to be met by distributions.²⁶

The Effect of Words of Expanded Discretion

Generally, a grant of expanded discretion—"full and absolute," "sole judgment," or "unfettered"—does not relieve the trustee from acting in good faith and in a state of mind contemplated by the settlor. A grant of expanded discretion does not permit the trustee to act dishonestly or from an improper motive.

The *Rippey v. Denver U.S. Nat'l Bank*²⁷ opinion evaluated the effect of a trustee who was granted discretion and sole judgment to sell trust property. The U.S. District Court for the District of Colorado held that even a grant of expanded discretion using the words "sole judgment" does not permit the trustee to have unlimited or absolute discretion and the trustee still must act reasonably and within the bounds of prudent judgment. The court explained that, even if the trustee were granted absolute and uncontrolled discretion, he or she cannot act recklessly or with a willful abuse of discretion.²⁸

Pursuant to the *Second Restatement*, the grant of expanded discretion, such as absolute, unlimited, or uncontrolled discretion, eliminates the need for the trustee to act reasonably, but still requires the trustee to act in a state of mind contemplated by the settlor and not

from an improper motive.²⁹ The trustee still must exercise judgment and cannot act arbitrarily.³⁰ The *Third Restatement* does not say that expanded discretion dispenses with the standard of reasonableness, but states that it gives the trustee additional latitude.³¹ As a result, the ultimate question of interpretation is the degree of latitude the trustee is entitled to have in exercising discretion.

Discretionary Distributions for Multiple Beneficiaries

When a trust has multiple beneficiaries, the trustee should deal with them impartially, regardless of whether the beneficiaries are simultaneously or successively entitled to interests in the trust property.³² Impartial does not necessarily mean equal treatment; it requires equitable treatment in light of the purposes of the trust.

Under the *Third Restatement*, a trustee performs a case-by-case analysis to determine equitable distributions. The *Third Restatement* provides that the trustee's analysis should include consideration of the following:

- 1) the terms of the discretionary powers;
- 2) the purpose and size of the trust;
- 3) the beneficiaries' circumstances; and
- 4) the beneficiaries' relationship to one another and their relationship to the settlor.³³

For example, depending on the circumstances, the top of a line of descendants may be favored over his or her descendants, or a spouse may be favored over children.³⁴ Favored status simply means that in absence of compelling considerations, the trustee is to give priority to beneficiaries with favored status to ensure that they have what is needed to continue their lifestyle, appropriate care, and other suitable benefits.³⁵

When there are multiple beneficiaries, tax issues may be a consideration. For example, when the group of beneficiaries consists of a surviving spouse and descendants, it may make sense to give little or no principal distributions to the surviving spouse and make principal distributions to a child or grandchild.³⁶

Court Intervention

Colorado courts generally will not intervene in the exercise of a trustee's discretion unless there is an abuse of that discretion—for example, if the trustee makes an arbitrary decision or a decision from an improper motive, or acts recklessly.³⁷ In deciding whether to intervene, a court may consider some of the following factors and circumstances to determine whether there was an abuse of discretion:

- 1) the extent of the discretion conferred on the trustee by the terms of the trust;
- 2) the purposes of the trust;
- 3) the nature of the power;
- 4) the existence or nonexistence and the definiteness or indefiniteness of an external standard by which the reasonableness of the trustee's conduct can be judged;
- 5) the motives of the trustee in exercising or refraining from exercising the power; and
- 6) the existence or nonexistence of an interest of the trustee that conflicts with that of the beneficiaries.³⁸

Use of Ascertainable Standards for Tax Reasons

If a trustee also is a beneficiary of the trust (often referred to as an interested trustee), there are potential tax issues that need to be

addressed. When the interested trustee can make discretionary distributions to or for the trustee's own benefit, under Internal Revenue Code (Code) § 2041, the trustee will have a general power of appointment over the trust, resulting in inclusion of the trust in the trustee's gross estate. However, if the trustee's discretion is limited by ascertainable standards, which are health, education, maintenance, and support of the beneficiary,³⁹ the power of appointment is considered to be limited and avoids inclusion in the trustee's gross estate. Variations from the approved language can lead to unexpected results and should be carefully considered.

If called on to determine whether language qualifies as an ascertainable standard under federal tax law, a court will examine the state law that governs the trust.⁴⁰ Due to the variation in rulings from state courts on this issue, it is difficult to anticipate whether trust language will qualify as an ascertainable standard as stated in Code § 2041.⁴¹ Therefore, it is safest to include the exact language from § 2041 when drafting ascertainable standards for a trust. Another way to avoid inclusion of the trust estate in an interested trustee's gross estate is to permit an interested trustee's discretion to be exercised in conjunction with another person having a substantial interest in the trust that is adverse to the exercise of discretion in favor of the interested trustee.⁴²

Even if a trust includes properly drafted ascertainable standards, an estate tax issue still may arise if the trust language permits an interested trustee to make distributions from the trust that would satisfy a legal obligation of the trustee. For example, if a parent is the trustee and, as such, makes distributions to a child (who is a

minor beneficiary of the trust) in a way that satisfies the trustee's legal obligation of support to the child, the trustee will be considered to have a general power of appointment over the trust.⁴³ Including ascertainable standards to limit the trustee's discretion does not eliminate this problem. To avoid this issue, the trust document should prohibit the trustee from exercising discretion in a way that would satisfy the trustee's own legal obligations.

There are a few rulings that are instructive regarding what is considered a legal obligation. Depending on the circumstances, private schooling, as well as tuition and room and board for higher education, were considered a legal obligation of a parent or guardian.⁴⁴ The IRS has ruled that a parent does not have a legal obligation to support adult children.⁴⁵ In this situation, it is important to consider the context, because the issue of legal obligations often arises in a divorce proceeding, which may be analogous to the trust context.

Colorado Law Regarding Ascertainable Standards

Colorado has a statute that automatically limits the discretionary powers of a trustee who also is a beneficiary of the trust to the ascertainable standards of health, education, maintenance, and support. It also prohibits the trustee from making distributions to satisfy legal obligations.⁴⁶ This statute provides a savings clause in the event the drafter did not provide these limitations. It is important to keep in mind that this is a state statute and will not apply if the governing law of the trust changes from Colorado to another state or is not Colorado due to a governing law clause.

Practical Considerations

When meeting with a client, practitioners should try to get as much information as possible about the client's intent, so that additional language can be included in the trust document that will provide important and valuable guidance to a trustee. To clarify the client's intent, the client should be asked several questions:

1. Should the trustee consider the other resources of the beneficiary before making a discretionary distribution and, if so, what resources?
2. Are there multiple or preferred beneficiaries?
3. Does the client want the trustee to exhaust the trust assets to provide for the beneficiaries?

Courts heavily rely on the settlor's intent and a practitioner should consider adding purpose statements to trust documents to explain the settlor's perspective regarding trust distributions. When drafting a trust document, terms should be defined to clarify the settlor's meaning instead of leaving it up to later interpretation. In particular, the definition of "education" varies significantly and it is best to define it in the trust document.

If there is an interested trustee, it is safest to use the language of ascertainable standards as provided in the Code. However, when ascertainable standards are not necessary, they should be avoided when the settlor's desire is to give the trustee broad and unfettered discretion. Regardless of the extent of the trustee's discretion, whether expanded or restricted, courts will require the trustee to act in good faith and in a state of mind contemplated by the settlor.

Even if a trust is created and administered in Colorado, a trustee should consider the governing law and *situs* clause. Estate planners should be mindful that the language they draft may be interpreted pursuant to state law other than Colorado. In light of this possibility, and the fact that many states still follow the *Second Restatement* and others have adopted the UTC, estate planners should consider including expanded language for distributions or provide which body of law is intended to apply to the trust.

Conclusion

Because Colorado law provides only limited guidance in the interpretation and administration of discretionary distribution standards, estate planners should look for opportunities to provide direction for trustees within the four corners of the trust agreement. Trustees should consider all of the facts and circumstances before exercising their discretion to make distributions to beneficiaries.

Notes

1. Case law and the *Restatements* are cited throughout this article in reference to the general rules regarding the meaning of trust language. Each instrument is different and will be interpreted by the court in light of that trust and the particular facts and circumstances.

2. *Restatement (Third) of Trusts* § 50 cmt. d(2) (2003).
3. *Goss v. McCart*, 847 P.2d 184 (Colo.App. 1992).
4. *Id.* at 184, 187.
5. *Restatement (Second) of Trusts* § 128 cmt. i (1959).
6. *Restatement (Third) of Trusts* § 50 cmt. d(2) (2003).
7. *Id.*
8. *Id.*
9. *Restatement (Third) of Trusts* § 50 cmt. d(3) (2003).

10. *New Britain Trust Co. v. Stoddard*, 179 A. 642 (Conn. 1935); *Lanston v. Children's Hospital*, 148 F.2d 689 (D.C.Cir. 1945); *Security Trust Co. v. Smith*, 145 S.W.2d 512 (Ky.App. 1940); *Epstein v. Kuwin*, 95 A.2d 753 (N.J. Super. 1953); *In re Wolfe's Estate*, 299 N.Y.S. 99 (Sur.Ct. 1937).

11. *Restatement (Second) of Trusts* § 128 cmt. e (1959); *Restatement (Third) of Trusts* § 50 cmt. d(3) (2003).

12. *See Equitable Trust Co. v. Montgomery*, 44 A.2d 420 (Del. Ch. 1945); *Amoskeag Trust Co. v. Wentworth*, 111 A.2d 198 (N.H. 1955); *Rock Island Bank & Trust Co. v. Rhoads*, 187 N.E. 139 (Ill. 1933).

13. *Restatement (Third) of Trusts* § 50 cmt. d(3) (2003).

14. *Id.*

15. *Restatement (Third) of Trusts* § 50 cmt. d(4) (2003).

16. *Dunklee v. Kettering*, 225 P.2d 853 (Colo. 1950) (the trustee had discretion to distribute "as may be necessary to provide him with the necessities of life").

17. *Restatement (Second) of Trusts* § 128 cmt. e (1959).

18. *Restatement (Third) of Trusts* § 50 cmt. e (2003).

19. *Id.*

20. *Id.*

21. *Barnett Banks Trust Co. v. Herr*, 546 So.2d 755 (Fla.App. 1989); *In re Patten's Estate*, 21 Cal.Rptr. 767 (1963).

22. *Matter of Hogeboom*, 219 N.Y.S. 436 (1927).

23. *Restatement (Third) of Trusts* § 50 cmt. e(2) (2003).

24. *Id.*

25. *Id.* at § 50 cmt. e(5) (2003).

26. *Id.*

27. *Rippey v. Denver U.S. Nat'l Bank*, 273 F.Supp. 718, 736 (D.Colo. 1967).

28. *Id.*

29. *Restatement (Second) of Trusts* § 187 cmt. j (1959).

30. *Id.*

31. *Restatement (Third) of Trusts* § 50 cmt. c (2003).

32. *Restatement (Second) of Trusts* § 183 cmt. a (1959) (terms of a trust may give the trustee discretion to favor one beneficiary over another and the court will not interfere except to prevent an abuse of discretion). *See also Restatement (Third) of Trusts* § 79 (duty of impartiality).

33. *Restatement (Third) of Trusts* § 50 cmt. f (2003).

34. *Id.*

35. *Id.*

36. *Id.*

37. *Goss*, *supra* note 3; *Rippey*, *supra* note 27 at 718. *See Restatement (Second) of Trusts* § 187 (1959).

38. *Restatement (Second) of Trusts* § 187 cmt. d (1959).

39. *See* IRC § 2041(b)(1)(A).

40. *Finlay v. U.S.*, 752 F.2d 246 (6th Cir. 1985). *See Estate of Vissering v. C.I.R.*, 990 F.2d 578 (10th Cir. 1993) (state law determines the legal rights and interests created by a trust and federal law determines the tax consequences of those rights).

41. For trust language that was considered an ascertainable standard, *see Vissering*, *supra* note 40; *Sowell's Estate v. C.I.R.*, 708 F.2d 1564 (10th Cir. 1983); *Hunter v. U.S.*, 597 F.Supp. 1293 (W.D.Pa. 1984); *Finlay*, *supra* note 40. For trust language that was not considered an ascertainable standard, *see Lehman v. U.S.*, 448 F.2d 1318 (5th Cir. 1971); *Independence Bank Waukesha v. U.S.*, 761 F.2d 442 (7th Cir. 1985); *De Oliveira v. U.S.*, 767 F.2d 1344 (9th Cir. 1985); *Estate of Penner v. C.I.R.*, 67 T.C. 864 (1977); *Estate of Jones v. C.I.R.*, 56 T.C. 35 (1971); *Estate of Little v. C.I.R.*, 87 T.C. 599 (1986).

42. *See* IRC § 2041(b)(1)(C)(ii).

43. Treas. Reg. § 20.2041-1(c)(1).

44. *Stone v. C.I.R.*, T.C. Memo 1987-454; *Braun v. C.I.R.*, T.C. Memo 1984-285.

45. Rev. Rul. 79-154, 1979-1 C.B. 301.

46. CRS § 15-1-1401. ■