

What Does Discretion Mean to a Trustee?

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Trust distributions can subject a trustee to unwanted scrutiny. Consider the situation in which a trustee is administering a trust for an unemployed, free-spending beneficiary. The trust contains real estate and liquid investments, and although the beneficiary's numerous requests for distributions threaten to deplete the liquid investments during the beneficiary's lifetime, the beneficiary insists that continuing the historical trust distribution pattern is appropriate. The beneficiary states that his parents' "intent" was that all liquid trust assets could be depleted for his benefit during his lifetime, as long as the real estate stayed intact as a trust asset and was passed down to the grandchildren. The trustee now must decide what type of distributions can be made going forward based on the trustee's duty to both the lifetime trust beneficiaries (the beneficiary child) and the trust remainder beneficiaries (the grandchildren).

The first thing the trustee should do is review the trust document and see what the trust says. If the trust has mandatory distribution provisions, such as all income must be distributed but no principal can be distributed or the beneficiary can require a fixed-dollar amount from the trust every year, that usually makes for a quick and relatively simple analysis. More often, the trust contains a provision requiring the trustee to utilize independent judgment as to whether a trust distribution should be made. Those standards are referred to as discretionary distribution standards.

Common Discretionary Standards

1. HEALTH, EDUCATION, MAINTENANCE AND SUPPORT (HEMS).

The HEMS standard is probably the most common discretionary standard used in trusts. Interestingly, the HEMS standard originated in federal tax regulations as a means to avoid estate tax inclusion when a trustee who was also a trust beneficiary exercised discretionary distribution powers. The HEMS standard was not a provision specially crafted to provide insightful guidance to trustees when making distribution requests. That has led to some trustee confusion when determining what constitutes a valid HEMS distribution.

- a. "Health" includes standard medical care, medication, surgery and hospitalization, as well as extended nursing care and mental health treatment. The use of the term "health" under HEMS is often considered duplicative because health expenses are also covered under the term "support."
- b. At first glance "education" seems easy to interpret. However, consider the case of a 30-year-old trust beneficiary who has yet to obtain an undergraduate degree. How long does the trustee have to keep paying her tuition and living expenses? Each state is different but, in general, undergraduate college education and vocational training is covered. Graduate level education expenses may not be covered unless specifically permitted by the trust. Primary and secondary school expenses are usually covered. Most clients know what type of education expenses they want their trust to cover. That makes it simple to draft a trust that defines exactly which education expenses are covered and which expenses are not covered. Also, if you want to limit the ages at which distributions can be made for education, that can easily be written into the trust document.
- c. The words "support" and "maintenance" are considered synonymous and are not intended to limit distributions to the bare necessities of life. Living expenses include things such as mortgage payments, property taxes, suitable health insurance or care and casualty insurance. Vacations and charitable gifting are acceptable expenses under this standard provided the expenditures are in accordance with the beneficiary's past expenses.

2. COMFORT.

The term “comfort,” even when used as a modifier (“comfortable support”), is the same as the term “support” if a beneficiary already has a comfortable lifestyle. If a beneficiary leads a modest lifestyle, the inclusion of the term “comfort” may allow for increased distributions.

3. BEST INTERESTS AND WELFARE.

The phrase “best interests and welfare” authorizes the trustee to be liberal in making distributions to increase a beneficiary’s standard of living above and beyond what distributions would be appropriate under a “support” standard. There is case law suggesting this standard entitles a beneficiary to maintain a higher standard of living and purchase certain luxury items.

4. HAPPINESS.

The inclusion of the word “happiness” in a distribution standard suggests an intention that the trustee’s judgment be exercised generously. It also helps immunize the trustee from challenge by remainder beneficiaries for most distributions. At the same time, a trustee is always required to act prudently. For example, if a beneficiary’s distribution requests would result in a depletion of the trust’s assets and the trust does not specifically authorize the trust assets to be depleted for the beneficiary’s benefit, there still may be grounds to refuse a “happiness” request.

5. UNFETTERED DISCRETION.

Some trusts simply authorize the trustee to make distributions in their sole and absolute discretion. At first glance, this appears to give a trustee broad authority to make distributions as they wish. However, states generally impose a duty on trustees to act in good faith and in the best interests of the beneficiaries. That means a trustee must act reasonably in making discretionary distributions based on the terms of the trust and the grantor’s intent. This converts a seemingly broad grant of authority into a somewhat vague standard. In the trustee world, clarity is preferred over vagueness.

Drafting Tips

Regardless of the distribution standard used, a few interpretation issues frequently arise. The primary source of authority is the trust document. Therefore, to prevent these issues from arising and being subject to later interpretation by the trustee or the courts, it is helpful to address these issues in the drafting stage, whenever possible.

1. BALANCING BETWEEN CURRENT AND REMAINDER BENEFICIARIES.

Trusts commonly create a class of beneficiaries consisting of the settlor’s spouse and the settlor’s descendants. In that case, it would be helpful if the trust states who should be considered the primary beneficiary (usually the spouse).

Now assume the surviving spouse is named as the exclusive current beneficiary while they are alive. Does that mean principal can be invaded for their benefit, even if it results in the trust assets being exhausted? It is not uncommon for primary beneficiaries to believe they should get increased distributions but remainder beneficiaries to think that the trustee should keep the principal intact for the benefit of remainder beneficiaries. Addressing this in the trust instrument creates a clear statement of intent by the settlor.

2. CONSIDERATION OF OUTSIDE INCOME/ASSETS.

There is case law discussing whether a beneficiary’s nontrust assets should be considered when reviewing a discretionary distribution request, but why rely on case law? Case law can change and can also be hard to apply on a case-by-case basis. If the intent is to consider a beneficiary’s outside income or assets when evaluating discretionary distribution requests, state it in the trust agreement. If you don’t want them considered, that should be stated instead.

Another area where this arises is when the beneficiary is the beneficiary of two or more trusts. Should the other trusts be considered when evaluating a discretionary distribution request from Trust X or should those other trusts be required to be exhausted before making any trust distributions from Trust X? A common example is when a surviving spouse is a beneficiary of both a marital trust and a bypass trust. Should the marital trust be required to be exhausted before making distributions from the bypass trust? That would ensure that the bypass trust is preserved for the children and the assets in it will pass to the children free of estate tax. Without stating that, however, it is not required.

3. STANDARD OF LIVING.

What is the relevant lifestyle when evaluating discretionary distribution requests to a trust beneficiary for support or because the trust dictates that distributions shall be made to maintain the beneficiary’s standard of living? It is common for kids from a first marriage to believe the surviving second spouse should not be able to maintain the lifestyle enjoyed during the second marriage to the wealthier deceased spouse. Again, this can be handled in the trust agreement rather than relying on legal presumptions. The trust can state whether the standard of living applied should be the lifestyle the

surviving second spouse enjoyed before the marriage, or the lifestyle enjoyed while they were married. If the couple enjoyed luxurious vacations and luxury cars while they were married, should the surviving second spouse be able to continue that lifestyle? If not, the trust can place restrictions on those expenses.

Additional Considerations

Trust discretionary distribution standards need to be flexible to allow trustees to make decisions based on the situation that exists when a discretionary distribution request is made. That means discretionary distribution standards cannot, and should not, attempt to cover every possible scenario. Unfortunately, this can also result in beneficiaries second-guessing a trustee's decision. Courts will generally not interfere with a trustee's exercise of discretion, provided the trustee acted in good faith. Having said that, no trustee wants to go to court to have a court enforce that rule. The best strategy to avoid that from happening is to make your intentions regarding commonly disputed items clear in the trust document itself. A clear expression of intent in the trust agreement goes a long way toward avoiding disputes later on.

Another way of providing guidance is by having the settlor provide the trustee with a "letter of wishes." A letter of wishes sets forth the settlor's views, beliefs and intent regarding a variety of trust issues, including what to consider when making discretionary distributions. At the same time, the trustee has flexibility to deal with unforeseen circumstances. This can be helpful, especially when the trustee did not personally know the settlor. A letter of wishes is generally used when the settlor is reluctant to provide certain guidance in the trust agreement itself because of concern over the beneficiaries' reaction or after a trust is created but circumstances change. A letter of wishes is intended to be private but could be subject to disclosure if litigation ensues. Given that possibility, a letter of wishes should not serve as a forum for the settlor to "privately" air their grievances against anyone.

Many people view analyzing trust discretionary distribution requests as a straightforward process. The reality is that it is more art than science. If you have any questions about your trust or estate administration needs, our trust and estate planning experts are available to help.

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