Ascertainable Standards and Trust Distributions: What You Should Know

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Almost all estate plans include a trust of some kind, and most clients want to know what limits are placed on how much of the trust's assets a beneficiary can have access to. Often, their questions revolve around knowing how much and when can a trustee distribute trust assets to a beneficiary. More often than not, these decisions are based on criteria called ascertainable standards.

Background.

A common type of trust used in estate plans is a discretionary trust. A discretionary trust is a trust where the Trustee has the power to determine when and if income and/or principal should be distributed to a beneficiary. However, in order to ensure that the trust accomplishes the estate planning goals of the Grantor, this power is usually limited by what it is called an "ascertainable standard." An ascertainable standard is a standard that restricts the power of the Trustee to make distributions to a beneficiary to an extent measurable by the beneficiary's needs for health, education or support.

Having an ascertainable standard allows a beneficiary to be able to serve as trustee without causing the trust's assets to be included in the beneficiary's estate. It also helps to protect the beneficiary from having to use trust assets to pay creditors. Most importantly, it serves to restrict how much and when a trustee can distribute trust assets, which helps preserve trust assets.

One commonly accepted standard used in discretionary trusts is called the Health, Education, Maintenance and Support standard ("HEMS"). The general language found in discretionary trusts that applies the standard typically states that "the Trustee shall distribute to the Beneficiary as much of the net income and principal of the trust as the Trustee may at any time and from time to time determine...for the recipient's health, education, maintenance or support in his or her accustomed manner of living."

Defining HEMS.

I. Health.

A Trustee can make distributions to a beneficiary for his/her health. The definition of the health standard generally encompasses regular medical or dental expenses, physical or mental therapies and payment of insurance premiums. Examples of expenses that would fall within this standard are distributions for:

- Emergency medical treatments
- Hospital expenses not covered by insurance
- Routine health care exams
- Dental care
- Eye care
- Prescription drugs

2. Education.

Trustees can also make distributions for a beneficiary's education needs. The education standard generally refers to payment of living expenses, as well as fees and other costs for attending institutions of higher education as well as primary and secondary education. It also includes costs for attending trade or technical training programs. Examples of expenses that would qualify as distributions for education are:

- Tuition for graduate courses or degrees
- Tuition for continuing education classes
- Fees for career training such as accounting or real estate licensing courses

3. Maintenance and Support.

A Trustee can make distributions to maintain and support a beneficiary in his/her accustomed manner of living. This standard generally entitles a beneficiary to distributions sufficient for accustomed living expenses.

For example, assume the market is down again like in 2008, and the beneficiary has lost his/her job. Due to this downturn, the beneficiary's income is lower than what it normally is on a year-to-year basis. Consequently, the Trustee could distribute money to the beneficiary to help cover usual living expenses such as mortgage payments, property taxes, health insurance premiums, life or property insurance premiums.

In order to determine what a beneficiary's "accustomed manner of living" entails, the Trustee should have the beneficiary create a monthly or annual budget and review the beneficiary's tax returns. The trust is there to "maintain and support" a beneficiary's habitual lifestyle patterns. For example, if year after year, the beneficiary usually takes a short vacation to the Bahamas for $1,500, the Trustee could make a distribution from the trust to help pay for that yearly vacation. Having a monthly or annual budget greatly helps to define what counts as accustomed expenses.

Specific Issues to Consider.

1. Other Means of Support.

Discretionary trusts often provide that when a Beneficiary-Trustee makes distributions to him/herself, such Trustee must consider all resources reasonably available to him/herself. This means that before making a distribution, a Beneficiary-Trustee must look at his/her own sources of income and other assets outside the trust that could reasonably be used to pay for the expense.

2. Loans.

One issue that often arises outside of restrictions on distributions is the Trustee's ability to make loans. When making loans either to a beneficiary or to other individuals (e.g. friends), the Trustee has a legal liability, as a fiduciary, to make sure the IRS will properly respect the loan. This is because a loan is considered a trust asset that must be properly managed as an investment. Thus, any loan made by a Trustee should include the following:

- A promissory note that adequately spells out the rights, duties and obligations of both parties (ex. amount borrowed, interest rate, issue of late payments, payment schedule, etc.);
- A reasonable interest rate that meets or exceeds the applicable APR;
- A fixed maturity date and schedule for repayment; and
- Sufficient secured collateral.

Careful adherence to the terms of the loan once set is also necessary to insure the loan is not considered a taxable distribution or gift.

3. Recordkeeping.

The Trustee should keep records of all distributions, including information detailing the amount of the distribution, some sort of document to support the expense (ex. bill, invoice, etc.), and a short description for why the distribution was allowed. This will help to protect the Trustee in case there is ever any scrutiny by the IRS or a court over distributions that the Trustee made.

The HEMS standard is a commonly used standard for Trustee distribution restrictions. It helps to keep trust assets outside of a beneficiary's estate, while also protecting assets from potential creditors. Most importantly, it provides set requirements for when and why a Trustee can make distributions to beneficiaries. Such restrictions serve to protect and preserve trust assets, while helping to ensure that the trust lasts for the beneficiary's lifetime.