

Summer 2016 Newsletter-New Hampshire Trust and Tax Law Topics

A. Trusts-Ascertainable Standards and Trust Distributions: What You Should Know

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, although usually if the primary goal is asset protection we use an independent co-trustee for maximum protection. Most importantly, the ascertainable standard 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 AFR;
- 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.

B. Tax Law Update: New Basis Consistency and Reporting Requirements When Filing Federal Estate Tax Returns

On July 15, 2015, President Barack Obama signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, commonly known as the Highway Bill.

The Highway Bill imposes new requirements on some executors and beneficiaries to document adjustments to tax basis of capital assets. In general, beneficiaries are now required to use the finally determined federal estate tax value as their tax basis when reporting gain or loss on the sale or exchange of (or depreciation/amortization on) the assets received from a decedent on the beneficiary's federal income tax return (the "basis consistency rules").

Certain executors are now required to notify the IRS and beneficiaries of the finally determined federal estate tax value of the property to be received from the decedent (the "basis information reporting requirements").

Basis Consistency Rules

Under the new Internal Revenue Code Section 1014(f), a beneficiary's basis in any property acquired from a decedent must not be greater than the value finally determined for federal estate tax purposes. The finally determined value will be the value the executor reports on the decedent's federal estate tax return, Form 706, if the IRS fails to audit the return within the statute of limitations.

However, if the IRS audits the return, and the audit value is not contested by the executor before the statute of limitations has run, the finally determined value is the value stated by the IRS. If the value is litigated by the IRS, the finally determined value is the value determined by the court or under a settlement agreement with the IRS.

If there is no finally determined value, the beneficiary's basis in any property acquired from a decedent is the value provided in Schedule A to Form 8971 that the executor now must provide to the beneficiary and the IRS under Internal Revenue Code Section 6035(a). Because Section 6035(a) requires the executor to send such form/schedule(s) before the estate tax value is finally determined, the beneficiary's basis, in most cases, will be the value contained in Schedule A, at least initially.

When Is Basis Consistency Required?

The basis consistency rules apply only to a beneficiary that receives property whose inclusion in the decedent's estate increased the estate tax liability with respect to a Form 706 filed after July 31, 2015 (whether timely filed or

late). If no Form 706 is required to be filed because the gross estate plus the adjusted taxable gifts is less than the basic exclusion amount, but a Form 706 is filed solely to elect portability of the deceased spouse's estate tax exemption, then the basis consistency rules do not apply.

Property qualifying for the marital or charitable deduction does not contribute to an increase in the estate tax, so the beneficiary receiving such property is exempt from the basis consistency rules.

C. Time to Update Your Estate Planning!

Significant changes in estate tax law and New Hampshire probate and trust law can be largely beneficial to clients who have updated their estate plans. If you have not met with me to review your estate plan in the last 5 years I recommend you set up an appointment to meet with me as soon as possible in order to determine if any changes are necessary in order to take advantage of our revised federal and state laws!

HAVE A NICE SUMMER!!!!!!!!!!!!!!!!!!!!

Michael L Wood's Bio:

Michael was admitted to practice law in New Hampshire in 1992. In 1995 Michael began practicing law in New London, New Hampshire and has been a Director and Shareholder of McSwiney Semple, Hankin-Birke & Wood, PC from 2000 to the present.

Michael is also an Adjunct Professor of Law at the University Of New Hampshire Law School, teaching both the Wills and Trusts and the Estate Planning courses since 1999.

Michael's Practice Areas: Elder Law, Estate Planning Law, Probate Law, Trust Administration, Taxation Law; Business Law; Non-Profit Law, Education Law (pro-bono).

Michael serves on the Board of Directors of New London Barn Playhouse (2004 to present-longest serving Board member), the Lake Sunapee Visiting Nurses' Association (2009 to present-Chairperson 2011 and 2012) and The Fells (2014 to present).