Since the presentation is to non-attorneys as well as attorneys, this paper is prepared somewhat differently than if prepared solely for attorneys. The information in this paper and presentation is not intended to be legal advice, it is intended for discussion purposes only. One should only make decisions after consultation with an attorney who has carefully analyzed the facts of the situation, as well as applicable case law, statutory law and the impact of tax law including income tax, estate tax, gift tax and generation skipping tax.
ASSET PROTECTION AND
TRUST DISTRIBUTION CLAUSES
(BUILDING AN AP TRUST
FOR A CHILD OR GRANDCHILD)

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I. OVERVIEW

With the increase in the federal estate tax exemption (at least until 2013), more estate planners and settlors have turned their attention to creditor protection for the children’s inheritance. In many cases, the greatest threat to inherited wealth may not be taxes but rather the threat of litigation by a child’s creditor.

If an outright gift is made to a child through testator’s will or revocable trust, the assets transferred will be available to the child’s creditors. While inherited assets are considered a spouse’s separate property in Kansas,\(^1\) once a divorce action is commenced such assets will be considered marital property and subject to division by the court.\(^2\) The divorce court often awards the inherited property back to that spouse, but the value of the property is taken into account in the division. Often a spouse will place an inheritance into a joint tenancy account or title, thus subjecting the property to the claims of creditors of either spouse unless it is considered exempt property, for example a “homestead”, an asset protected from creditor claims under Kansas law.\(^3\)

Estate planners concerned with protecting assets for trust beneficiaries will wish to understand the ramifications of the common law rules\(^4\) concerning spendthrift clauses and trust distribution clauses. The planner will also want to understand the ramifications of the Kansas statutes adopting portions of the Uniform Trust Code. Finally, it will be helpful for the planner to be aware of new
designs for irrevocable trusts for children and grandchildren. In the last few years, planners have begun to design irrevocable trusts for the benefit and protection of beneficiaries which attempt to withstand creditor claims and give the beneficiary more control over the assets.\textsuperscript{5} I term such trusts “Protector-Controlled Trusts.” Depending on the powers given to a protector, another concept can be added to the mix and that is to make sure that the beneficiary is living up to the settlor's expectations and purposes for the trust.

\section*{II. THE COMMON LAW}

\subsection*{A. DOES THE BENEFICIARY HAVE A PROPERTY INTEREST IN THE TRUST?}

Under the common law, whether a creditor could reach the interest of the beneficiary in a trust to satisfy the claim depended upon whether the distribution clause gives the beneficiary \textit{a property interest} under state law. In order to determine this, some courts attempted to determine whether the beneficiary’s interest had ascertainable value, in other words is there an interest which can be sold or exchanged? Other courts looked to determine whether the beneficiary had an enforceable right to compel the trustee to make a distribution. Under the first test, a spendthrift clause prevents the interest from being sold, therefore the interest has no property value. Under the second test, if the beneficiary can compel a distribution, for example, with mandatory and support trusts, the beneficiary would have a property interest in the trust.

In the area of “support” and “discretionary” trust cases, construction problems arose because the drafter used mixed language. For example, if a trustee \textit{may} distribute principal for a beneficiary’s \textit{support and maintenance}, is this a completely discretionary trust or a support trust? Could a beneficiary sue the trustee to compel the trustee to make distributions? Did this particular settlor intend for a certain amount of distributions to be made or did the settlor intend distributions to be completely
discretionary? Did settlor intend a result where no distributions might be made? Discretion to be exercised because of a standard imposed and the timing of such distributions seems different from other forms of discretion such as favoring one beneficiary over another or whether to invade income or principal. In every “support” trust, there seems to be an element of discretion in arriving at a correct amount needed to comply with the distribution standard.

Courts have had difficulties in determining whether a trust is “completely discretionary” or some sort of hybrid. In the latter type of trust, a beneficiary might still have an enforceable right to sue the trustee for failing to make distributions. In this group there might be a reference to the trustee’s discretion, but then perhaps other language is added such as “shall distribute” and perhaps a standard is added such as “for support and maintenance”. For example, “The trustee, within the trustee’s discretion, shall distribute to the beneficiary principal for the beneficiary’s support and maintenance.” Is such a trust completely discretionary or might a beneficiary show that some amount of distributions were intended by the settlor and sue the trustee for failing to make such distributions?

So the language used in many trusts has given the courts difficulty in trying to determine whether the beneficiary has an enforceable interest. In this group of cases, the courts have examined the entire trust, the purpose of the trust, and perhaps extrinsic evidence to determine if a beneficiary had an enforceable interest in the trust. If so, a creditor of the beneficiary can also reach that interest (in the absence of a spendthrift clause).6

The Restatement Third seeks to eliminate confusion regarding “discretionary” and “support” trusts:

“This Section departs significantly from prior Restatements, and from some lines of cases that were largely influenced by the prior Restatement positions, in that this Restatement Third does not attempt to draw a bright line between “discretionary” interests (Restatement Second Trusts sec. 155) and “support” interests (id. Sec.
The so-called “support trust,” for example, is viewed here as a discretionary trust with a support standard. This in turn requires asking and examining all the questions that follow from that view, such as how a particular standard, in context, is to be interpreted and whether a beneficiary’s other resources are to be taken into account in making a fiduciary judgment about appropriate distributions to the beneficiary.”

B. SPENDTHRIFT CLAUSE

Under the common law, if a trust was less than completely discretionary and did not contain a spendthrift clause, a creditor could reach the beneficiary’s interest in the trust to satisfy the claim.

“In the appropriate proceedings, the court will give creditor relief that is fair and reasonable under the circumstances. If the beneficiary has only the right to the trust income or a right periodically to receive ascertainable or discretionary ... payments, the court will normally direct the trustee to make the payments to the creditor until the claim, with interest, is satisfied. The court, however, may order less than all of the payments to be made to the creditor, leaving some distributions for the actual needs of the beneficiary and his family.... In some circumstances, the court may order a sale of the beneficiary’s interest and payment of the creditor’s claim from the proceeds. Sale may be appropriate when it appears unlikely that the debt can be satisfied from distribution(s) within a reasonable time ....”

Therefore in mandatory, support and many hybrid discretionary trusts a creditor could reach the trust assets to satisfy the claim. Often the courts regarded the creditor as another beneficiary of the trust and the creditor could reach trust assets as the court felt was equitable to all the beneficiaries. This changed with the recognition of the validity of spendthrift clauses in the American courts. In England spendthrift clauses were void, as creating an unlawful restraint on alienation. A few American states followed the English rule, but the majority of American states began to recognize the validity of spendthrift clauses.
The greatest single factor in the development of spendthrift trusts in America was the dictum of Mr. Justice Miller\textsuperscript{11} in the case of \textit{Nichols v. Eaton}, 91 U.S. 71 (1875) which has been often quoted in the American cases.

\begin{quote}
“Why a parent … who … wishes to use his own property in securing [his child] … from the ills of life, the vicissitudes of fortune, and even his own improvidence, or incapacity for self protection, should not be permitted to do so, is not readily perceived.”\textsuperscript{12}
\end{quote}

An example of a spendthrift clause is as follows:

\textbf{Spendthrift Provision.} No income or principal hereunder shall be pledged, assigned, transferred, sold or in any manner accelerated, anticipated or encumbered by a beneficiary other than Grantor hereunder, nor shall any income or principal hereunder in any manner be subject or liable in the hands of the Trustee for the debts, contracts or engagements of any beneficiary or be subject to any assignment or any other voluntary or involuntary alienation or disposition whatsoever. Should any beneficiary other than Grantor’s spouse attempt in any manner to anticipate, dispose of, encumber or charge his or her interest, or any part thereof, except within the limited class above, or in the event of bankruptcy, attachment, levy, garnishment or any process of whatever nature, involving any such beneficiary or his or her interest herein, then any item which would otherwise be paid over directly to such beneficiary shall in the discretion of the Trustee be applied directly for his or her support or maintenance or the support and maintenance of his or her family (excluding any separated or divorced spouse) or be allowed to accumulate in the hands of the Trustee to be held by the Trustee in trust. Nothing contained in this Section shall be construed as otherwise given effect, however, so as to restrict in any way the exercise of any power of appointment granted hereunder, or the right of Grantor’s spouse to the income from any Trust qualifying for the marital deduction.

The spendthrift clause incorporates two separate concepts. The first prohibits the beneficiary from assigning and pledging his or her interest in the trust. The second prohibits the assets from being used to satisfy the debts of the beneficiary.
The Restatement recognizes these concepts in the following sections:

**Sec. 57. Forfeiture for Voluntary or Involuntary Alienation**

Except with respect to an interest retained by the settlor, the terms of a trust may validly provide that an interest shall terminate or become discretionary upon an attempt by the beneficiary to transfer it or by the beneficiary’s creditors to reach it, or upon the bankruptcy of the beneficiary.

**Sec. 58. Spendthrift Trusts: Validity and General Effect**

(1) Except as stated in Subsection (2), and subject to the rules in Comment b (ownership equivalence) and § 59, if the terms of a trust provide that a beneficial interest shall not be transferable by the beneficiary or subject to claims of the beneficiary’s creditors, the restraint on voluntary and involuntary alienation of the interest is valid.

(2) A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid.

Comment d(2) provides: “Rights of beneficiary’s creditors. A spendthrift trust protects the income and principal interests of its beneficiaries from the claims of their creditors as long as the income or principal in question is properly held in trust. Thus, a beneficial interest that is subject to a valid spendthrift restraint cannot be attached by judgment creditors of the beneficiary, nor does it become an asset of the beneficiary’s bankruptcy estate under section 541 of the Bankruptcy Code. After the income or principal of a spendthrift trust has been distributed to a beneficiary, however, it can be reached by creditors through the same procedures and in accordance with the same rules that apply generally to property of the beneficiary.”

The case law however recognized a public policy that spendthrift clauses should not be a bar to certain claims.13

1. Alimony or child support.

2. Necessary services or supplies rendered to the beneficiary.
3. Services rendered and materials furnished that preserve or benefit the beneficial interest in the trust.

4. A claim by the U.S. or a state to satisfy a claim against a beneficiary—generally these are tax liens.

C. TRUST DISTRIBUTION CLAUSES

1. MANDATORY

A mandatory distribution means a distribution of income or principal which the trust requires the trustee to make. It cannot be withheld. The beneficiary would be considered to have a property interest and could sue the trustee for failing to make the distribution. Examples of mandatory distribution trusts include marital deduction trusts, grantor retained annuity trusts, charitable remainder trusts and charitable lead trusts. The trusts in these examples require mandatory distributions in order to qualify for certain tax benefits. Some trusts are drafted with mandatory distributions even though there is no tax reason to do so. For example, staggered distributions such as ¼ of the principal at age 25, ½ the remainder at age 30 and all the remainder of the trust at age 35.

Assume a trust provides for the trustee to distribute all net income to settlor’s child not less than quarterly, and ½ the principal at 25 and the remainder at 30. With or without a spendthrift clause a judgment creditor can reach the income stream to satisfy the judgment. Further if there were no spendthrift clause a court might order the debtor’s income interest to be sold to pay the judgment.\textsuperscript{14}

2. SUPPORT

A support trust directs the trustee to apply the trust’s income and/or principal as is necessary for the support, maintenance, education, and welfare (or other standard) of a beneficiary;\textsuperscript{15}
An example of a “support” trust is:

“The Trustee shall make distributions of income or principal for the beneficiary’s health, education, maintenance and support.”

The beneficiary of a support trust can compel the trustee to make a distribution of trust income or principal merely by demonstrating that the money is necessary for the beneficiary’s support, maintenance, education, or welfare or whatever other standard is contained in the trust.\(^\text{16}\)

Much of the case law in the support trust area concerns as the actual determination as to how much money is necessary. The terms “support” and “maintenance” are normally construed as synonymous and such terms “are sometimes accompanied by a reference to the beneficiary’s accustomed standard of living or station in life. That level of intended support is normally implied from “support” or “maintenance” even without an express reference to the beneficiary’s customary lifestyle. Whether this accustomed lifestyle is expressed or implied, a lower level of distributions may be justifiable if the trust estate is modest relative to the probable future needs of the beneficiary….The accustomed manner of living for these purposes is ordinarily that enjoyed by the beneficiary at the time of settlor’s death or at the time the irrevocable trust is created.”\(^\text{17}\)

A good example of such a case in Kansas is in the 1991 case, *Godfrey v. Chandley*.\(^\text{18}\) In the trust in this case, the trustee was directed to pay as much income to the testator’s widow “as may be necessary for her support, health and maintenance.” The issue was whether the widow’s other personal income should be considered in making the determination what was “necessary.” The trial court said that other income should be considered. The Kansas Supreme Court, however, found the trust language was not ambiguous and that other income should not be considered.
Just as with mandatory trusts, the interest of a beneficiary in a support trust is subject to the claims of the beneficiary’s creditors if the trust does not contain a spendthrift clause.\textsuperscript{19} For example, Illustration 1 to Restatement Section 56, Comment d provides:

A trust provides that the trustee is to pay B all of the trust income and such amounts of principal as the trustee deems appropriate for B’s support, with the remaining principal to be paid upon B’s death to R if she is then living and if not to her issue. The trust contains no spendthrift clause. C, a judgment creditor of B, seeks to reach B’s interest in the trust through the locally appropriate proceeding. C’s claim, with interest, can be satisfied within a reasonable period of time from the income payments to which B is entitled; in fact, the claim can be satisfied sooner if principal payments are also made, with a portion of those payments directed to be paid to C, and inducement that the court finds reasonable and within the terms of the trustee’s discretionary authority (see section 60). The court may properly direct that the trust income, plus a specified portion of any principal distributions the trustee decides to make, be paid to C instead of B.

Note from the discussion above regarding spendthrift trusts, the interest of a beneficiary in a support trust was also subject to “supercreditors,” \textit{even if} it did contain a spendthrift clause.

\textbf{3. DISCRETIONARY}

If the trust is a completely discretionary trust, the common law cases have held that the trust is not subject to claims of beneficiary’s creditors. The beneficiary has no property interest in the trust and could not compel a distribution from the trust. Therefore, the trust was not subject to the beneficiary’s creditors whether or not it contained a spendthrift provision. The Second Restatement of Trusts states:

“A discretionary trust allows the trustee complete and uncontrolled discretion to make allocations of trust funds if and when it deems appropriate. Because the trustee is given such broad powers, the beneficiary can only compel the trustee to distribute funds if it can be shown that the trustee is abusing its discretion by failing to act, acting dishonestly, or acting with an improper purpose in regard to the motive in denying the beneficiary the funds sought.”
An example of a completely discretionary trust is:

“The Trustee may distribute as much or more of the net income and principal as the Trustee, in its sole and absolute discretion, deems appropriate to or among any beneficiary or beneficiaries. The Trustee, in its sole and absolute discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them.”

“Implicit in this magical discretionary language are three components: (1) a discretionary statement that the trustee “may” make a distribution, (2) the trustee has the “sole and absolute” discretion to determine whether a distribution shall be made and, if so, how much shall be distributed, and (3) the ability to exclude distributions from other beneficiaries.”

The traditional “support” trusts and the “completely discretionary” trusts have given the American courts no trouble. Trusts which have not been so straightforward have been another matter, sometimes with inconsistent results state-to-state. Kansas has had its fair share of these cases summarized as follows:

1. In re Watts, 160 Kan. 377, 162 P.2d 82 (1945)

Decedent’s will, admitted to probate in 1918, created a testamentary trust for beneficiary with a trust provision which directed the trustees to pay the beneficiary:

“at such times as to them may seem necessary such sums of money as shall in their judgment be necessary for the proper maintenance, support and education of [the beneficiary].”

The beneficiary married and had a child. Spouse brought action for divorce and received judgment for alimony and child support. She instituted action against the trustee to pay the judgment from the trust fund. The Kansas Supreme Court rules that the trust is discretionary citing the Restatement (Second) Trusts sec. 155:
“If by the terms of a trust it is provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply, a transferee or creditor of the beneficiary cannot compel the trustee to pay any part of the income or principal . . . . A trust containing such a provision as stated in this section is a ‘discretionary trust’ and is to be distinguished from a spendthrift trust, and from a trust for support. In a discretionary trust it is the nature of the beneficiary’s interest rather than the provision forbidding alienation which prevents the transfer of the beneficiary’s interest. The rule stated in this Section is not dependent upon a prohibition of alienation by the settlor; but the transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel the trustee to pay anything to himself or application for his own benefit.”

Even though the trust uses the words “maintenance, support and education,” the court concludes that the trust is discretionary and that the beneficiary did not have such an interest in the trust as could be reached to satisfy the judgment and that the trustee did not abuse his discretion in refusing to pay such judgment.


In this case the SRS brought an action to recover public assistance benefits amounting (medical assistance, food stamps and cash public assistance) against a trust beneficiary. The trust was created by the beneficiary’s grandfather and contained a spendthrift clause. The trust provision stated:

“During the lifetime of [the beneficiary], the Trustees, in their uncontrolled discretion, shall pay to [the beneficiary] the net income of the Trust. In addition, the Trustees may pay to [the beneficiary], from the principal of the Trust from time to time, such amount or amounts as the Trustees in their uncontrolled discretion, may determine is necessary for the purposes of her health, education, support and maintenance.”

The Kansas Supreme Court held that the net income generated by the trust was an available resource to the beneficiary during the time she received public assistance. However, the court ruled that the principal portion of the trust was not an available resource since that portion of the trust is
discretionary. Even though the term “in their uncontrolled discretion” was used both with the income and principal distributions its usage in the income distributions was inconsistent with the “shall pay” language.


The decedent created a testamentary trust in his will for the benefit of his wife with the following provision:

“The main purpose of the trust is to provide for the support, health and maintenance of my wife, Peggy Chandley, during her lifetime. The trust estate shall pay, monthly or at such intervals as may be agreed upon upon by the Trustee and my Wife, during the period of the trust such portion of the net income from the trust as may be necessary for her support, health, and maintenance.”

The remainder beneficiaries contended that the wife was entitled only to trust income for support, health, and maintenance expenses which she could not pay from her own separate income. The wife contended that she was entitled to all of the net income necessary for her support, health, and maintenance and that any income not so distributed should be held by the trustee for future use should the need arise. Any undistributed income should be paid to her estate at her death. The court held that here the will did not say that the trust property was to applied to the beneficiary’s support only if the beneficiary were in actual need. Here the language is unambiguous that the settlor intended the beneficiary to receive support from the trust estate, regardless of other income.


In this case the trust in question did not contain a spendthrift clause and the trust distributive provision stated:

The trustee, in his sole discretion, may make distributions of income and principal to her or on her behalf as the trustee deems advisable after giving due consideration to all sources of funds available to her.22

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The plaintiff brought a garnishment action seeking to attach the trust assets to satisfy a judgment. The Kansas Court of Appeals ruled that the trust was discretionary and not subject to garnishment. This case is an example of the concept that creditor protection in a “discretionary” trust is not dependent upon a spendthrift clause but rather whether beneficiary has a property interest in the trust. The opinion provides a good examination of the American precedents and English counterparts.


In this case a testamentary trust was created for the son’s benefit with the trust provision:

“During my son’s lifetime, my trustee shall hold, manage, invest and reinvest, collect the income therefrom and pay over so much or all the net income and principal to my son as my trustee deems advisable for his care, support, maintenance, emergencies and welfare.”

The son applied for public medical assistance which the SRS denied contending that the trust was a support trust and ascertainable and therefore an available resource with the administrative regulations. The Kansas Supreme Court ruled that the language created a discretionary trust. “The nondiscretionary language of “shall” pertained primarily to the management functions of the trust and did not control or override the discretionary language of ‘as my trustee deems advisable,’ which pertained to whether payment of net income or principal would be made at all and, if so, the amount and purpose of any such payment. Neither the beneficiary nor any creditor could compel the trustee to pay any trust income or principal to the beneficiary, and therefore the SRS could not consider the trust assets to be resources available to the son in determining whether the son qualified for medical assistance.”23

This case involved a revocable intervivos trust which created an irrevocable trust at settlor’s death for settlor’s daughter, the daughter’s issue and the daughter’s husband. The Kansas Court of Appeals summarized the trust provision as follows:

The Trustees are required to distribute Trust income and assets to any one or more of this group of beneficiaries in such amounts as the trustees “in their absolute discretion” may determine from time to time. “[T]he Trustees shall have the absolute discretion, at any time and from time to time, to make unequal payment or distributions to or among any one or more of said group and to exclude any one or more of them from any such payment or distribution.”

The daughter sought public medical assistance which was denied by the SRS and appealed to the district court which reversed. The SRS appealed to the Kansas Court of Appeals contending that under the trust the daughter had the ability to replace the trustees and could replace them with trustees who would make distributions to her. Therefore the applicant had the legal ability to make the trust assets available to herself. The Court of Appeals disagreed that the daughter had the power to remove trustees. She had the power to select successor trustees in the event of a vacancy. The court stated that: “In Kansas, K.S.A. 59-1711 and K.S.A. 58-2411 authorize a court to remove a trustee who is not performing the duties required under the law or the trust document….In this case, the trustees have absolute discretion as to whether distributions are to be made and have specific authority to exclude any one or more of the beneficiaries from distributions. By refusing to make distributions to [the daughter], the trustees are not abusing their discretion; the are indeed performing their duties under the Trust instrument.”

In this case a grandmother established an irrevocable trust for the benefit of her grandson with the provision:

“The Trustee shall have the full power and authority at any time and from time to time to withdraw such sums and property from the principal of the trust estate as the Trustee in his absolute discretion shall deem necessary or advisable for the health, support and maintenance of Ralph E. Breeding and to pay and deliver the same to or for his benefit.”

The court held that the clause was unambiguous and the settlor intended the trustee to have as much power as possible under the law to invade the principal for the beneficiary’s benefit.


Donna Squier was injured in a motor vehicle accident in 1988 and while being treated for the injuries suffered brain damage rendering her a quadriplegic. JoAnn Williams, Squier’s mother was appointed her guardian ad litem. Williams applied for medical long-term benefits for Donna and also brought an action for damages for her injuries. Williams created an irrevocable trust with Donna and her children as beneficiaries. A settlement was reached in the civil case and the court ordered the settlement to be placed in the irrevocable trust. The SRS then discontinued the Medicaid benefits finding that the trust for Donna’s benefit was an available resource. The trial court reversed the SRS determination and the SRS appealed. The Kansas Supreme Court summarized the relevant trust provisions as follows:

[The] trust agreement provides that “the trustee shall take into consideration the applicable resources and income limitations of any public assistance program for which Donna Jo Squier is eligible when determining whether to make any discretionary distributions.” The trust goes on to state that “no part of the corpus of the trust created herein shall be used to supplant or replace public assistance benefits,” and that “for purposes of determining Donna Jo Squier’s eligibility for
such benefits, no part of the principal or income of trust shall be considered available to Donna Jo Squier.” The trustee is prohibited from knowingly exercising its discretion in a manner that would prevent Squier from receiving public assistance. The express intent is that no part of the trust income or principal be used to replace public assistance or in determining Squier’s eligibility for public assistance. The purpose of the trust is to provide goods and services in addition to those provided by public assistance.27

The court held that the trust was a Medicaid Qualifying Trust (MQT) and therefore an available resource which disqualified Donna from assistance. The court found that although the trust was established in form by Donna’s mother, it was really created by Donna and funded with Donna’s funds.28


The husband’s will was admitted to probate in 1995. The wife consented to the will in lieu of her spousal entitlements granted in K.S.A. 59-6a202. The will created a testamentary trust for wife’s benefit with the trust provision:

B. During the lifetime of my wife, the trustee shall distribute the net income of the trust in quarterly or more frequent installments to my wife.

C. In addition to the payment of the net income, my trustee may distribute to or for the benefit of my wife, from time to time, so much of the principal of the trust as the trustee, in its sole discretion, may determine is necessary to provide for my wife’s care, support, health and wellbeing, giving due regard to the standard of living she enjoyed at the time of my death, and to such other resources or sources of income which may then be available to my said wife.29

The wife applied for Medicaid nursing home assistance and SRS determined the trust was an available resource. Wife appealed to the district court which held that the portion of the trust dealing with the principal to be a discretionary trust. SRS appealed to the Kansas Supreme Court which held that because the wife did not elect to take against the will, that a portion of the trust should be deemed to have been funded by her. The wife could have taken an elective-share amount of the augmented
estate under K.S.A. 59-6a202(a)(1) and thus to that extent she in effect funded the trust with approximately $95,000. She was therefore was ineligible for Medicaid until that amount was exhausted.30


In this case the settlor created a revocable trust for the benefit of himself and his wife. At the second death, a trust was created for Settlor’s sister with the trust provision:

The testamentary trustee(s) shall pay to the beneficiaries or for their benefit, from the income or principal of that beneficiary’s trust, such sum or sums as the testamentary trustee(s) shall deem necessary or proper to provide for that beneficiary’s suitable support, health and maintenance, adding any unused income to principal at the end of each year.

The beneficiary requested $3,000 per month from the trust for her support and maintenance. The trustee requested information on the beneficiary’s assets and income. The beneficiary refused and asserted that the trustee was required to distribute the trust funds for her support without considering her assets or other income. Trial court held that the language created a discretionary trust. On appeal the beneficiary argued that the court should focus on the “words of action” such as the phrases “shall pay” and “shall deem necessary and proper.” The Court of Appeals found that such language should be viewed within the entire clause which mandated that the trustee use its discretion to determine what is necessary and proper for the beneficiary’s support, health and maintenance:

Kansas recognizes both discretionary trusts and support trusts. A discretionary trust is established when the settlor give the trustee the discretion to make distributions from the trust and the beneficiary has no legal authority to force the trustee to make a distribution from either the income or principal to the beneficiary. Miller, 275 Kan. at 354; see also Restatement (Second) Trust sec. 155, comment b (1957)(“In a discretionary trust it is the nature of the beneficiary’s interest rather than a provision forbidding alienation which prevents the transfer of the beneficiaries interest.”) In contrast, a support trust is established when the trustee “is required to inquire into the basic support needs of the beneficiary and
provide those needs. Miller, 275 Kan. at 354. In the case of a support trust, the beneficiary has the legal right to demand payment for support. 275 Kan. at 354; see Restatement (Second) Trusts sec. 154 (1957).

This is an unpublished opinion, but it is discussed here because it shows both the plaintiff as well as the trial court trying to lump the trust into one of two neat boxes. The trust language in this case is not a traditional support trust in which a beneficiary simply has to prove up an amount. But the trust is not a completely discretionary trust in which the beneficiary could never have an enforceable right. What if the plaintiff had turned over her financial information and arrived at a bona fide amount needed for support? And then the trustee declined to give it to her? Would she have no legal recourse? This seems to be exactly why the last Restatement does away with trying to lump these trusts into “support” or “discretionary” trusts. In the language of the Restatement Third, this would be a discretionary trust subject to a support standard which would require the court to examine the context of the whole document, interpret the standard used and determine whether a beneficiary’s other resources are to be taken into account in making judgment about appropriate distributions to the beneficiary.

What seems to have distilled in all the cases across the country is three categories of trusts: (1) mandatory, (2) discretionary, but the language used seems to indicate settlor intended some distributions to be made and some measurable number may still be discerned and (3) completely discretionary (subject to a trustee acting in good faith and in accordance with the purposes of the trust). This seems to be the case in the adoption of Kansas’ version of the Uniform Trust Code.

III. UNIFORM TRUST CODE IN KANSAS

The Kansas Uniform Trust Code went into effect January 1, 2003 and was a substantial adoption of the UTC drafted by the Uniform Law Commissioners. This national effort attempted to put together a uniform model for all the states regarding their trust law. The code takes precedence over
common law rules, but the common law rules and principles of equity supplement the code.\textsuperscript{33}

A ‘mandatory distribution’ is defined in the code as follows:

(a) As used in this section, “mandatory distribution” means a distribution of income or principal which the trustee is required to make to a beneficiary under the terms of the trust, including a distribution upon termination of the trust. The term excludes a distribution subject to the exercise of the trustee’s discretion whether or not the terms of the trust: (1) Include a support or other standard to guide the trustee in making distribution decisions; or (2) provide that the trust “may” or “shall” make discretionary distributions, including distributions pursuant to a support or other standard.

(b) Whether or not a trust contains a spendthrift provision, a creditor or assignee of a beneficiary may reach a mandatory distribution of income or principal, including a distribution upon termination of the trust, if the trustee has not made the distribution within a reasonable time after the mandated distribution date.\textsuperscript{34}

A judgment creditor of the beneficiary of a mandatory trust will seek an order that the trustee pay the mandatory distribution to the creditor instead of the beneficiary. If the trust contains a spendthrift clause a creditor cannot force sale of the mandatory interest to satisfy the judgment.\textsuperscript{35} Also presumably the trust might provide for the termination\textsuperscript{36} of the beneficiary’s interest or a conversion of a fixed interest (mandatory distributions) into a discretionary interest (“Protective Trust”) upon the attempt of a beneficiary to reach it.\textsuperscript{37}

The code provision regarding spendthrift trusts is found at K.S.A. 58a-502:

\textit{58a-502. Spendthrift provision.}

(a) A spendthrift provision is valid.

(b) A term of a trust providing that the interest of a beneficiary is held subject to a “spendthrift trust,” or words of similar import, is sufficient to restrain both the voluntary and involuntary transfer of a beneficiary’s interest.

(c) A beneficiary may not transfer an interest in a trust in violation of a valid
spendthrift provision and, except as otherwise provided in this article, a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.

(d) Whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee’s discretion even if: (a) the distribution is expressed in the form of a standard of distribution; or (2) the trustee has abused the discretion.

(e) This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution.

Therefore, under subsection (e) even though a beneficiary could proceed with an enforceable right in a support trust or an enforceable right in a less-than-complete discretionary trust, this would not carry over to a creditor of the beneficiary due to the language in subsection (d). This is a departure from the common law. Importantly, the provisions of (d) would to apply to “support” trusts (whether or not the word “may” or “shall” is used) and any kind of discretionary trust. Moreover, there are no exceptions in K.S.A. 58a-502 for “supercreditors.” Section 503 of the Model Uniform Trust Code sets forth such exceptions, but Kansas did not adopt that section of the uniform code.

K.S.A. 58a-814 seems to reinforce the Restatement Third position doing away with a bright-line test between support and discretionary trusts:

Discretionary powers. Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as “absolute,” “sole,” or “uncontrolled,” the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.”

Therefore in Kansas creditors of beneficiaries in mandatory trusts may attach the distribution, but could not force a sale of the interest to satisfy the judgment if the trust contains a spendthrift clause. Also generally a creditor of a beneficiary in a support trust or any kind of discretionary trust can not reach the interest if there is a spendthrift clause.
Again it is important to note here that the debtor beneficiary’s troubles are not eliminated. The judgment creditor is not going to go away and the trust is not going to be able to make distributions to the beneficiary without the creditor attaching them. If the beneficiary wants to have distributions from the trust, the beneficiary is going will have to reach a settlement with the creditor. Note that this is the same position as settlor’s face after they have established self-settled trusts in offshore jurisdictions or in U.S. states which provide asset protection for self-settled trusts. The judgment is not going to go away. Some sort of settlement of the judgment will have to occur before the trust distribution spigot can be turned on again.

Given the rules and concepts discussed above, it seems clear that an asset-protected trust can be designed in Kansas for a child or grandchild. Now the question is evolving into how much control can such a beneficiary have over such an asset-protected trust, and then how to ensure that the beneficiary is living up to the expectations of the settlor and the purposes for which the trust was created.

**IV. PROTECTOR CONTROLLED TRUSTS**

This review of the Kansas case law and statutes indicates that we can design an irrevocable trust which will not be able to be attached by a beneficiary’s creditor. Now we want to take this further and give the beneficiary more control over the assets, but make sure that the beneficiary is not out of step with the settlor's intentions and purposes of the trust.

**A. DESIGN**

**1. Child is Sole Trustee**

In its simplest form, we will name the child as the sole trustee. The trust is for the benefit of both the child and the child’s issue.\(^{39}\) No merger of equitable interest and title occurs.\(^ {40}\) The child
might be indicated as the primary beneficiary with his needs taking priority over the grandchildren. The
distribution standard will be for “health, education support and maintenance.” As trustee, the child
might wish to open an “investment management account” for investable assets with a bank trust
department or other investment manager. The PCT might be for all the assets or only certain assets
such as a family business.

A “protector” will be named, for example the drafting law firm, an accountant or a trusted friend. The protector is given various duties including the right to fire the trustee and appoint a new trustee. Upon acceptance of the position of protector an agreement would be executed listing the duties and responsibilities of the protector, as well as a fee agreement. The protector could not appoint himself as trustee. The child could not fire the protector. The child could replace a protector in the event of resignation or for any reason the protector ceased to serve. In the event of a threat of litigation, the child might resign as trustee or not. If the child resigned as trustee, the protector would name a new trustee. If the litigation threat goes away, the protector could re-appoint the child as trustee again. The PCT is not for everybody. The protector will add expense to the trust administration, but for settlors with substantial assets, the PCT gives the beneficiary more control over the assets, protects the assets from creditor claims, and helps to ensure that the beneficiary does not fall out of step with the settlor's expectations.

In such a PCT trust, why wouldn’t the distribution standard for the trustee simply be complete discretion over distributions? Moreover, why would the child consider resigning as sole trustee when K.S.A. 58a-502(d) provides that a creditor of a beneficiary may not compel a distribution that is subject to the trustee’s discretion and K.S.A. 58a-502(c) provides that if there is a spendthrift clause a creditor of the beneficiary may not reach the interest before its receipt by the beneficiary (mandatory or support trust for example)?
A creditor might argue that 58a-502(c) and (d) should not be read literally (or that this statute is trumped by K.S.A. 58a-505(b)(1)) where the trustee and the beneficiary are one in the same. Here the irrevocable trust was created by the parent for the child, so this is not a self-settled trust. Or is it? If the child is the sole trustee and the trustee has complete discretion to distribute property to himself, might not such a trust be deemed to be funded by the child? Might not a creditor argue that since the child could have removed all the trust assets on day one, in effect this makes the trust a self-settled trust, settled by the child? K.S.A. 58a-505(b)(1) provides the holder of a “power of withdrawal” is treated the same as the settlor of a revocable trust to the extent of the property subject to the power. A “power of withdrawal” is defined in K.S.A. 58a-103(10)(a) as a presently exercisable general power of appointment. If the trust distribution power exercisable by a trustee is limited by an ascertainable standard relating to an individual’s health, education, support or maintenance within the meaning of IRC sec. 2041(b)(1)(A) it would not be considered a general power of appointment.

Also the judgment creditor would seek to have the court order the child to do whatever were in his power to satisfy the judgment. Therefore, the child-trustee with complete discretion to distribute to himself would immediately resign. Could a creditor then raise a fraudulent conveyance argument? The creditor would argue that the act of resigning in favor of a different trustee is in-effect a fraudulent transfer? The resignation now definitely puts the assets beyond the creditor’s reach due to K.S.A. 58a-502(d) and this should be treated as a transfer if occurring within the applicable statute of frauds period. The resignation might well open a four-year window for the creditor to reach the entire trust estate. K.S.A. 58a-505(b)(2) provides that upon the lapse, release or waiver of the power, the holder is treated as the settlor of the property, but only to the extent the value of the property exceeds the greater
of the amount specified in section 2041(b)(2), in other words “health, education, support and maintenance.” Therefore, the act of resigning as trustee should not be deemed to be a fraudulent transfer if HESM was the distribution standard used, but it might if a broader distribution standard was used. Also if a protector fired and replaced the child-beneficiary-trustee, this would also appear not to be a fraudulent transfer.

Senate Bill 404, presently under consideration in the Kansas Legislature, would amend K.S.A. 58a-502(d) to provide that if a beneficiary were serving as sole trustee and the distribution standard were not in the form of an ascertainable standard, the beneficiary's creditor would have the right to compel any present distribution the trustee is authorized to make to himself.

Therefore the best design for the protector-controlled trust is to limit the distribution standard to the ascertainable standard “health, education, support and maintenance.” Such distribution clause might provide that “the trustee, in the trustee’s absolute discretion may distribute income or principal to the beneficiaries for their health, education, support and maintenance.” Such a PCT fund presumably would not be considered to be “marital property” in a divorce situation even if the child continued as trustee and did not resign. The child would continue to use the property (e.g., vacation home), manage the property (e.g., family owned business) and would be able to sell the property and reinvest the proceeds just as with outright ownership. With regard to judgment creditors, note again that a debtor-beneficiary would have to reach an accommodation with the creditor in order for the beneficiary to be able to again receive distributions from the trust, otherwise the creditor would take them.

2. Child is Co-Trustee

In this structure, the child would be a co-trustee to serve with a second independent trustee, for example a trusted friend or advisor or a friendly corporate trustee. The independent trustee could be
given authority over trust distributions and the beneficiary-trustee given responsibility to manage and invest the assets of the trust. Again a protector ensures that the purposes of the trust are being followed. The beneficiary would have no power to remove the protector.

**B. ROLE OF A PROTECTOR**

Protectors have been used for many years in offshore trusts and domestic self-settled asset protection trusts to maintain control over a trustee. In such self-settled irrevocable trusts, a settlor would name both a trustee and a protector. The protector is given various duties including the power to fire and replace the trustee. The settlor would have no power to fire either the trustee or the protector. A protector can be toggled into existence by triggering events similar to agents under springing powers of attorney.

As previously discussed, if the PCT distribution standard is limited to an ascertainable standard of health, education support and maintenance, it is probable that a Kansas court would not consider such a trust to be self-settled and the beneficiary would not need to resign as trustee. However, if it did appear that it would be advisable for the beneficiary to resign, a protector’s ability to appoint, fire and replace trustees allows the beneficiary to become trustee again, assuming the beneficiary and the protector are still on the same page.

The use of protectors in domestic trusts has dramatically increased in the last 15 years or so, partly due to so-called Domestic Asset Protection Trusts which are self-settled, creditor-protected, irrevocable trusts established for the benefit of the settlor himself and established in one of the states which has a state statute allowing them.47 Trust attorneys have been adding “trust advisors” or “special trustees” to various trusts for many years. A protector may turn out to be a slightly different concept,48 one in which the agent has more powers than a traditional trustee and is seen an embodiment
of the settlor to represent the settlor’s interests, even after the settlor is gone. One writer has suggested that the emergence of trust protectors is one of the most significant recent developments in American trust law. In the next few years another writer suggests that we may see an even more dramatic increase in the use of protectors in domestic trusts in general. It seems certain that settlors and drafters will be authorizing the use of powers not generally seen before, except in the asset-protection trust world. Whether such powers are given to “special trustees” or “protectors” time will tell.

The problem is that the trust protector is so new to the world of domestic trusts, there is very little case law on their use and only a few state statutes which address trust protectors. In other words there is no black letter law as yet, not even a light gray. The subject is addressed directly in the Restatement (Third) of Trusts: “Unfortunately, trust law in this country shows virtually no appellate experience with [trust protector] questions and negligible legal development of the protector concept and principles for similar roles. No consensus has been drawn regarding the role of the trust protector as it relates to the duties of a fiduciary.”

A settlor may authorize, and a protector may theoretically exercise, an almost unlimited range of powers. Professor Ausness identifies a whole range of powers which might be given a protector:

(1) advise trustees in general,
(2) supervise the actions (or certain actions) of trustees,
(3) direct, veto or suspend distributions of trust income or principal,
(4) arbitrate disputes among beneficiaries or between beneficiaries and the trustee,
(5) modify the provisions of the trust instrument in response to changing external conditions
(6) interpret the trust in case of an ambiguity which saves the expense of requesting instructions from the court,
(7) advise a trustee about financial matters,
advise a trustee about investment decisions,
advise a trustee about discretionary distributions,
give advise to a trustee where an educational, support or special needs trust is involved
provide direction to a trustee regarding notification of qualified beneficiaries as required by statute
review trust accountings potentially protecting trust beneficiaries against negligence or misfeasance,
eliminate or delete beneficiaries or increase or decrease their interest in the trust,
grant a power of appointment to one or more beneficiaries
terminate or amend an existing power of appointment to prevent an inappropriate appointment of trust property if the donee is elderly or otherwise susceptible to undue influence.
power to prevent a donee (such as a doting parent or grandparent) from appointing property to improvident children or grandchildren.
terminate a trust prior to its expected date of termination under certain circumstances
power to decant property into another trust, providing the beneficiaries are the same,
power to move the situs of the trust.

Separate and apart from asset protection, the use of protectors in trusts in the future is sure to prove interesting. One can certainly envisage a line of cases concerning “ambiguous powers” given to a protector, whether a protector exercised powers in good faith, or whether a protector failed to exercise a power, that is failed to “protect.” With the adoption of the Uniform Trust Code in Kansas, it is clear that if a protector has the power to direct the actions of the trustee or a modification of the trust such person would be presumed to be a fiduciary and must act in good faith in accordance with the interest of the beneficiaries and the trust purpose.
Eighteen states have adopted the Uniform Trust Code including Kansas. K.S.A. 58a-808 provides:

(b) If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust of the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust.

(c) The terms of a trust may confer upon a trustee or other person a power to direct the modification or termination of the trust.

(d) A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty.

Although trust protectors are not mentioned by name in the statute, the comments to the Uniform Code section make it clear that the subsections (b)-(d) ratify the use of trust advisers and trust protectors.

What about a situation where a protector has the power to direct the actions of a trustee, but fails to direct, fails to monitor, etc. In other words inaction. In 2009 the Missouri Court of Appeals was called upon to consider such a case of inaction in Robert T. McLean Irrevocable Trust v. Davis. In McLean, the court considered whether a protector could be sued for failing to supervise a trustee who may have spent trust funds improperly (to the tune of $500,000). The trial court dismissed the suit against the protector finding that the protector had no legal duty to supervise the trustees.

On appeal both parties acknowledged that the protector was a fiduciary and both acknowledged that there was no Missouri case law dealing with the function or duties of a trust protector. Although Missouri adopted UTC section 808 in MRS 456.8-808, the court only refers to it in a footnote, and rightly so because it is useless in this fact pattern.
The protector argued that he owed no legal duty to the beneficiary. The power to fire a trustee is not the same thing as a duty to fire the trustee. Such a duty cannot be implied as a matter of law. The beneficiary himself could have gone to court to remove the trustee. Under the trust terms the protector would only be liable for actions taken in bad faith.

The appellant argued that a legal duty to the beneficiary was owed as a matter of law. Why was a protector even injected into this document with a power to fire the trustee if the protector was not going to monitor the situation? Failure to do so would amount to bad faith.

The court states: “A legal duty owed by one to another may arise from at least three sources: (1) it may be proscribed by the legislative branch; (2) it may arise because the law imposes a duty based on the relationship between the parties or because under a particular set of circumstances an actor must exercise due care to avoid foreseeable injury; or (3) it may arise because a party has assumed a duty by contract (agreement) whether oral or written. The court then held that here the trust agreement created the fiduciary position of protector and legal duties to be exercised in a fiduciary capacity. What those duties were supposed to be is not a matter of law but a matter of fact. Therefore the trial court needed to make a (1) determination as to the exact nature of the protector duties and responsibilities, (2) whether the protector breached those duties and (3) whether he acted in bad faith. Since these are questions of fact never determined at the trial level, the case was reversed and remanded to the trial division for that determination.

Two concurring opinions in McLean give food for thought. In the first, the judge writes:

“I concur in the result reached in the principal opinion. I do so … reluctantly. My reluctance results from the trust’s designation of a “trust protector” when that term has not been previously accepted or otherwise defined by statute or court opinions of this state. Trusts are, in my opinion,
dangerous devices when they undertake to break new ground insofar as designating obligations or rights of a nature not theretofore established by statute or prior judicial determination….If a problem or dispute arises with respect to a trust’s administration, it is not unusual for lengthy, expensive litigation to follow or for an interested party to conclude that, because of time and expense constraints, it is impractical to pursue judicial determination of a controversy. For that reason I suggest that breaking new ground by using procedures other than those time-proven in the law is something that should not be encouraged.”

In the second concurring opinion, the judge writes:

“I agree that there is no duty as a matter of law as a “trust protector” …. I do not believe it is appropriate for this Court to make up the duties of a trust protector out of whole cloth….The [document] was prepared by a law firm; whatever the reason to add a trust protector to this trust has not been fleshed out in the summary judgment motions. When these issues are fleshed out by a more complete record a determination can be made…."

In the fall of 2011, the case was tried. At the end of the beneficiary’s case, the court granted the protector’s motion for a directed verdict on the basis that there was no evidence of any bad faith by the trust protector. The case is now on appeal again.

The McLean case offers food for thought about using a “trust protector” in everyday trusts. In Kansas, trust advisors and special trustees have been used for years to address special concerns. K.S.A. 58a-815(a)(1) indicates that a trustee, without authorization by the court, may exercise powers conferred by the terms of the trust. Presumably a settlor and drafter could give a “special trustee” any of the powers (for example those identified above by Professor Ausness) and eliminate any concerns about using an unknown entity not “time-proven in the law.”
In Kansas it would be helpful if K.S.A.58a-808 were amended to provide more guidance regarding protectors. Jurisdiction over the protector would be clearly spelled out in the statute and there would be no doubt that the protector would be accountable for not living up to the duties while the trust had situs in Kansas. Settlors who incorporate a PCT design should spell out duties and responsibilities for a protector and approve a fee agreement for same (in domestic asset protection trusts and offshore trusts a separate schedule is attached). Hopefully, this would eliminate the issues in the McLean case, because there would be a bundle of duties associated with acceptance of the role of protector and the role would not be entered into lightly.

C. BENEFICIARY’S DEATH-FEDERAL ESTATE TAXATION

Under the protector-controlled-trust designs, will the assets of the trust be includable in the child’s estate?

1. Inclusion because of Distribution Standard Used

A. Child is Sole Trustee

Under IRC §§ 2031(a) and 2033, a decedent’s “gross estate” includes the value of all property owned by the decedent at death. This definition is very broad. Specific types of property are thereafter addressed in the Code. Code section 2041 concerns property which is controlled by a decedent under what is termed a “power of appointment.”

A “general power of appointment” is a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that a power to consume, invade or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of
appointment. IRC sec. 2041 applies only to powers donated to the decedent by some third party, not to powers that the decedent retained or reacquired in connection with property formerly owned. If a parent establishes an irrevocable trust for a child and names the child as trustee with power to make distributions to himself, this is deemed to be a power of appointment.

In a protector controlled trust where the child is the sole trustee, the distribution standard used can determine whether the assets are includible in the child’s estate at death. For example assume the child is sole trustee in the following trusts:

a. The trust provides that the trustee has discretion to distribute the property to himself. The property is included in his estate because his unlimited power of withdrawal is considered a general power of appointment. IRC sec. 2041(b)(1). It doesn’t matter whether he actually withdraws the property or not.

b. A trust provides that the trustee has a power to distribute any or all of the principal for his own health. None of the trust property is included in the trustee’s estate because his power to withdraw principal for himself was limited to an ascertainable standard (health). In the PCT structure, if the distributions are limited to an ascertainable standard, the trust assets would not be includible in the child’s estate because of the distribution standard (they might be includible for other reasons).

The following are all discretionary trusts not limited by an ascertainable standard.

c. A trust provides that the trustee has the power to distribute principal for his “health and welfare.” All of the trust property would be included in the trustee’s estate because “welfare” is not an ascertainable standard.

d. A trust provides the trustee, in the trustee’s sole and absolute discretion, “may make distributions to the beneficiaries [including himself].” All of the trust property is included in the
trustee’s estate.

e. A trust provides the trustee, in the trustee’s sole and absolute discretion, may make distributions for “comfort, welfare and happiness.” All of the trust property is included in the trustee’s estate.

f. A trust provides the trustee, in the trustee’s sole and absolute discretion, may make distributions for “health, education, maintenance, support, comfort, general welfare, and happiness.” All of the trust property is included in the trustee’s estate.

B. Child is Sole Trustee but Resigns

Assume that trust gives the child-beneficiary-trustee a special power of appointment at death and discretion over distributions to himself limited by an ascertainable standard. If the child continued to act as trustee right up to the time of his death, none of the property would be included in his estate because his power of withdrawal was limited by an ascertainable standard. Assume a creditor threat appeared and the beneficiary stepped down as trustee. Two months later, the beneficiary died. The trust assets would not be includible in the beneficiary’s estate.

Assume that trust gives the child-beneficiary-trustee a special power of appointment at death and complete discretion over distributions from the trust to himself, or assume any other discretionary trust for his benefit not limited by an ascertainable standard. If the child continued to act as trustee right up to the time of his death, the property would be included in his estate because of the distribution standard i.e., his power of withdrawal is not limited by an ascertainable standard. Assume a creditor threat appeared and the beneficiary resigned as trustee or was removed by the protector. Two months later, the beneficiary died. Would the trust assets be includible in the beneficiary’s estate or would the act of resigning be deemed a completed gift to the remaindermen? The assets would not be in the
estate because of the distribution standard, and it would not be a completed gift to the remaindermen assuming the beneficiary has a testamentary power of appointment. In other words, the beneficiary would still have the power to alter the remaindermen’s beneficial interests. The act of resigning has not affected that ability. Under the Treasury Regulations: “A gift is … incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard.”⁶² Since the beneficiary has not given up power to change the respective interests of the remaindermen, the gift would not be complete.

Nevertheless a very good reason for limiting the distribution standard to an ascertainable standard is a creditor’s fraudulent conveyance argument resulting from the resignation of a trustee also holding unlimited power over distributions, and opening a four-year window to reach the entire trust estate. Moreover, again a court will order a judgment debtor to do whatever is in his or her power to satisfy a judgment. The child-trustee-beneficiary-debtor might argue that under K.S.A. 58a-502(d) he cannot as trustee be compelled to make a distribution that is subject to the trustee’s discretion. Don’t count on it. Also recall that the change presently under consideration by the Kansas Legislature to K.S.A. 58a-502(d) will remove any doubt about it.

C. Child is Co-Trustee.

Under the second PCT design above, if the child is a co-trustee with no power over the distributions, the distribution standard would not cause inclusion in the child’s estate. However, the power of appointment rules would still come into play, whether the child is sole trustee or co-trustee.

2. Inclusion because of Lifetime or Testamentary Power of Appointment

If the terms of the trust established by the beneficiary’s parent gives the child a general power of
appointment over the trust assets during the child’s lifetime, the assets would be includible in the child’s estate. One would never see this in a protector-controlled trust because the judgment creditor would request that the court force the debtor-trustee to exercise the power in favor of the creditor, that is pay off the judgment. If the child is given a testamentary general power of appointment, from an asset protection point of view, the creditor would request the court to order the child to appoint the appropriate portion of the trust estate to the creditor at the child’s death to satisfy the judgment.

The settlor of the trust can give the beneficiary a testamentary, and perhaps lifetime, special power of appointment, one that is not exercisable in favor of the holder, the holder’s estate, the holder’s creditors or the creditor’s of the holder’s estate. Special powers of appointment are not includible in the holder’s gross estate. A special power of appointment often is used when the donor wants to give the holder the flexibility to control the disposition of trust property but still limit the group benefiting from the holder’s exercise of the power. For example:

1. The trust gives the child beneficiary the testamentary power to appoint trust principal in favor of anyone other than child, the child’s estate or the creditors of either. None of the trust property will be included in the child’s estate because the power is a special power of appointment.

2. The trust gives the child a testamentary power to appoint trust principal in favor of the child’s descendants. The child’s power of appointment is a special limited power of appointment limited to the class of the beneficiary’s descendants. None of the trust property will be includible in the child’s estate.

3. The trust gives the child a testamentary power to appoint trust principal in favor of anyone in the entire universe, on such terms and conditions as he may state, in further trust or not, except the child, the child’s estate or the creditors of either. None of the trust property will be included in the child’s estate because the power is a special power of appointment.
If the trust limits the distributions the child-trustee might make to himself to health, education, support and maintenance, the asset would not be includible in the child’s estate at death because of the distribution standard. If the trust gave the child-beneficiary a testamentary special power of appointment, the trust assets would not be included in the child’s estate in the following situations:

1. Child does not exercise the testamentary power.

2. Child exercises the testamentary special power but does not create further trusts.

3. Child exercises the testamentary special power and creates a further trust for benefit of grandchild and gives the grandchild a testamentary general power of appointment.

4. Child exercises the testamentary special power and creates a further trust for the benefit of grandchild and gives the grandchild a testamentary special power which cannot be exercised in a manner that would postpone the vesting of any interest in the property for a period ascertainable without regard to the date of the creation of the child’s power.

Example: Upon the death of the primary beneficiary, the Trustee shall distribute any remaining balance, including principal and accrued, accumulated and undistributed income, to any one or more said beneficiary’s descendants, either outright or in trust upon such terms and conditions and in such amounts or proportions as said beneficiary shall appoint by said beneficiary’s last unrevoked Will specifically referring to this power of appointment; provided however, that if said beneficiary shall appoint in trust, such trust must terminate within 21 years after the death of the last survivor of Dagnabit Bootsbob’s grandparents’ descendants living on the date of Settlor’s death.

In each of these situations, the settlor’s trust would be deemed a generation-skipping trust with a “taxable termination” occurring at the child’s death.

In the event a child beneficiary exercises the special testamentary power of appointment to create further trust a grandchild in the same PCT format, that is, a distribution standard limited to HESM and the grandchild is given a testamentary special power of appointment which could postpone
the vesting for a period ascertainable without regard to the date of the creation of the child’s power, the trust assets would be includible in the child’s estate under IRC §2041(a)(3). In Kansas the grant of another power that could postpone the vesting either has to be exercised or terminate within 90 years after its creation to be valid.\textsuperscript{64} So the child \textit{legally} has the power to grant another power that would postpone the vesting only if such second power complies with state law. It is unknown whether the grandchild will exercise the second power. Therefore, the grant of the second power must have a qualification or \textit{other provisions in the trust document must compel the same result}.

\textbf{Example:} Upon the death of the primary beneficiary, the Trustee shall distribute any remaining balance, including principal and accrued, accumulated and undistributed income, to any one or more said beneficiary’s descendants, either outright or in trust upon such terms and conditions and in such amounts or proportions as said beneficiary shall appoint by said beneficiary’s last unrevoked Will specifically referring to this power of appointment; provided however, that if said beneficiary shall appoint in trust, any further trust which owes its existence to an unexercised nongeneral power of appointment must terminate within 90 years of the creation of the power.

If the exercise of the second power can legally suspend the absolute ownership of the property for a period ascertainable without regard to the date of the creation of the first power, the property is includible in the estate of the holder of the first power.\textsuperscript{65} This is often referred to as the “Delaware Tax Trap,” described by Alexander Bove, Jr. as follows:

\textbf{One state, however, (Delaware) had a law that, though the exercise of successive special powers of appointment, would allow the vesting of a non-charitable interest to be postponed beyond the rule against perpetuities. Viewing this as a means of indefinitely deferring the imposition of a transfer tax, congress enacted sections 2514(d) and 2041(a)(3), which impose a transfer tax on the exercise of a special power of appointment used to create another special power, the subsequent exercise of which could postpone the vesting of ownership without reference to the creation of the first power (which would ordinarily start the running of the [rule against perpetuities]). If the donee of a special power exercised the power in the manner contemplated by sections 2514(d) and 2041(a) (3) the power would be treated as a general power, the exercise of which would of course be a gift, or if the powerholder deceased, the property subject to the}
exercise would be includable in his estate. Since the effect of this law would be to impose a gift or estate tax on an individual who never actually owned the property because he only possessed a special power of appointment, it is viewed as a tax trap, and, because of its original relation to Delaware, it is called the “Delaware Tax Trap”.

D. GENERATION-SKIPPING

When the settlor creates the irrevocable trust for the benefit of the child, he may have done so through his Last Will & Testament. More or less at the end of the probate administration, the judge will order the establishment of the testamentary trust as set forth in the testator’s will. The settlor could also have created the irrevocable trust in his revocable trust which, at his death, or perhaps the second death of the spouse or some other triggering event, a new irrevocable trust is funded for the benefit of the child. The settlor’s form 706 may affirmatively allocate the generation skipping tax exemption to the trust or a deemed allocation will be made under IRC 2632.

In the four situations discussed above, the trust created for the child would be a generation-skipping trust. During the child’s lifetime, if distributions were made to the grandchild, these would be “taxable distributions.” The recipient is responsible for filing form 706 GS (D-1) and paying any generation skipping tax due (not required if the inclusion ratio of all distributions is zero). At the child’s death, a “taxable termination” occurs and the trustee is responsible for filing form 706 GS (T) and paying any generation skipping tax due. The trustee is liable for the GST tax on taxable terminations so if (1) the trustee has not recognized the implications of the trust when the trust was accepted, (2) the settlor has previously used up all his GST exemption, (3) the trustee distributes all the trust assets at the child’s death and (4) the trustee is informed by the tax preparer of the GST tax consequences--the trustee is going to have a real bad day.
The American Law Institute, founded in 1923, publishes Restatements of the Law - treatises on case law (judge-made law, i.e., decisions in cases, as opposed to statutory law). The Restatements reflect the legal community’s thinking regarding general rules and trends regarding particular areas of the law. These distillations are often referred to as the common law or “black letter” law. Although the principles are not binding they are very valuable in helping judges decide new cases. In 2003 the ALI published the Restatement Third of Trusts (current through 2012).


Restatement (Third)Trusts §§56,60.

Restatement (Third) Trusts §60, Comment a. Emphasis added. The problem appears eliminated in Kansas. K.S.A. 58a-502(d) provides: “Whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee’s discretion even if: (a) the distribution is expressed in the form of a standard of distribution”

Restatement (Third) Trusts §§56, 60.

Restatement (Third) Trusts §56, comment e.

Codified in Kansas in K.S.A. 58a-501.

Erwin N. Griswald, Spendthrift Trusts §29 (2d ed. 1947): The philosophy behind Mr. Justice Miller’s opinion made it attractive to judges whose youth had been spent in the forties and fifties of the nineteenth century. That had been a pioneer period. Mr. Justice Miller was himself a self-made man. The spirit of the times was of individualism for the man of property. What a man owned was his own; with it he could do as he liked. If he desired to give his property to another in such a way that the donee could not transfer it and his creditors could not reach it, that was a matter which concerned the donor alone.”


Restatement (Third) Trusts §59

Restatement (Third) Trusts §56, Comment d

Restatement (Second)Trusts, §154 (1959).

Restatement (Second) Trusts, §128 comments d and e.

Restatement (Third) Trusts §50, Comment on Subsection (2):d(2).


Restatement (Third) Trusts §56, Comment d.

Restatement (Second) Trusts, §187, comment e.

160 Kan. at 378

853 P.2d at 76.

866 P.2d at 1059

21 Kan.App.2d at 682

Citing Kansas Administrative Regulations 30-6-106(c)(1993 Supp.)
Wife received personal injury settlement and funded an irrevocable trust in which she was the beneficiary and her parents were the trustee. Distributions to her were within the trustee’s sole and absolute discretion. The court acknowledged that although assets from a personal injury settlement would normally be marital property, here the controlling factor was the wife’s interest in the trust rather than the source of the funding that determined whether the trust was marital property.

See also Estate v. Cross, 75 Ohio St.3d 530, 664 N.E.2d 905 (1996); Tannler v. DHSS, 211 Wisc.2d 179, 564 N.W.2d 735 (1997); Since the legislation in OBRA ’93 the cases have focused on whether the trust provides for only the benefits allowed by a special or supplemental needs trust and whether the discretionary-beneficiary applicant was in fact if not form the settlor of the trust.


Reg. §20.2041-1(b): The term “power of appointment” includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume is a power of appointment.

For example, see §60, Comment g of the Restatement Third provides that if a beneficiary is serving as trustee, a beneficiary’s creditors can reach the maximum trust assets that the trustee could legally distribute to himself.

For example, see §60, Comment g of the Restatement Third provides that a beneficiary may resign as trustee or release a discretionary withdrawal power and thereby cut off creditors except that the resignation or release of discretionary power may constitute a transfer in fraud of creditors in which case, it will be available to creditors.

K.S.A. 33-209.

Alaska, Delaware, Missouri, Nevada, New Hampshire, Rhode Island, South Dakota, Tennessee, Utah, Wyoming and Hawaii

This may depend on whether broader powers are given and whether state statutes define and regulate protectors the same as trustees.

Alexander A. Bove, Jr., The Trust Protector, Are they friends or fiduciaries? And should every trust have one? Asset
Protection Strategies Vol. II, American Bar Association, 2005


[53] Restatement (Third) of Trusts §64 reporter’s notes (2003); See also See Professor Ausness n49, p15: “Although a trust is often thought of as relationships among and between the grantor, beneficiaries, and trustee, Scott and Ascher on Trusts suggests that the trust is also something in of itself. ‘It seems proper, therefore, to define the trust as either a relationship with certain characteristics or perhaps as a legal institution involving such a relationship.’” 1 AUSTIN W. SCOTT, WILLIAM F. FRATCHER & MARK L. ASCHER, SCOTT AND ASCHER ON TRUSTS, sec. 2.1.4 (5th ed. 2006)

[54] See McLean below n56


[57] 283 S.W.3d at 795

[58] 283 S.W.3d at 796

[59] IRC §2041(b)(1)

[60] Reg. §20.2041-1(b): The term “power of appointment” includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume is a power of appointment.

[61] Not a taxable termination for GST purposes because the non-skip person still has an interest in the trust. IRC §2612(a)(1)(A).


[63] But see discussion below regarding the exercise of certain “successive powers.”

[64] K.S.A. 59-3401(c)(2)

[65] Reg.§20.2041-3(e)