Folks:

Take-Away: Often it is unfortunate that a Trust's distribution provisions obfuscate if the Trust is intended to be a *discretionary trust* or a *support trust*.

Background: Many Trust instruments use *health, education, support, and maintenance,* or HEMS, as a distribution standard. Sometimes the HEMS standard is mixed with words that provide a trustee with discretion. Such a mix of standards often creates the question if that distribution is a *support provision,* under the Michigan Trust Code (MTC) or a *discretionary trust*. That is a big distinction since with a *support provision* the trust beneficiary's 'exception creditors' can access the assets held in the Trust, in contrast to a *discretionary trust* where there are no rights granted to exception creditors, since the *discretionary trust* beneficiary only possesses an expectancy, i.e., no property rights in the Trust.

Support Provision: The MTC defines a *support provision* as follows:

> "*Support provision means a provision in a trust that provides the trustee <u>shall distribute income or principal or both for the health, education, support, or maintenance of a trust beneficiary, or language of similar import.</u> A provision in a trust that provides the trustee has discretion whether to distribute income or principal or both for these purposes or to select from among a class of beneficiaries to receive distributions under the trust provisions is not a support provision, but rather is a discretionary trust provision*. [MCL 700.7103(k).]

This definition is unique to the MTC. The definition is not based on the Uniform Trust Code (UTC.) With a *support trust* the interest of the trust

beneficiary may not be transferred and the trust property is not subject to the enforcement of a judgment until the income or principal, or both, is distributed directly to the trust beneficiary [MCL 700.7503] unless an exception creditor is involved.

Exception Creditors: With a *support* trust the trust beneficiary's creditors, e.g., a spouse entitled to spousal support; a child support recipient; or the state or federal government, can access the assets that are held in the *support trust* created for the benefit of the trust beneficiary. [MCL 700.7504.] *In re Darrell V. Wright Trust Agreement, Michigan Court of Appeals, Nos 319834, 319834 (March 17, 2015)* the Michigan Department of Treasury was permitted to reach assets held in a third-party Trust.

Discretionary Trust: The MTC uses a definition of a *discretionary trust* that protects against the claims of a beneficiary's creditors. A *discretionary trust* is defined as:

> *"..a provision in a trust, regardless of whether the terms of the trust provide a standard for the exercise of the trustee's discretion and regardless of whether the trust contains a spendthrift provision, that provides the trustee has discretion, or words of similar import, to determine 1 or more of the following:*
>
> *(i) Whether to distribute to or for the benefit of an individual or a class of beneficiaries the income or principal or both of the trust;*
> *(ii) The amount, if any, of the income or principal or both of the trust to distribute to or for the benefit of an individual or a class of beneficiaries;*
> *(iii) Who, if any, among a class of beneficiaries will receive income or principal or both of the trust;*
> *(iv) Whether the distribution of trust property is from income or principal or both of the trust; and*
> *(v) When to pay income or principal, except that a power to determine when to distribute income or principal within or with*

> *respect to a calendar or taxable year of the trust is not a discretionary trust provision if the distribution must be made.* [MCL 700.7103(d).]

Again, this definition of a *discretionary trust* is unique to Michigan and is not based on the UTC. The Reporter Comments to a *discretionary trust* provide the following guidance and warning:

"In addition, even if the trust provision establishes a standard for exercise of a trustee's discretion, such as an ascertainable standard, the provision remains a discretionary trust provision if the terms of the trust grant the trustee the kinds of discretion described in paragraphs (d)(i) through (v). Although trusts that contain discretionary trust provisions confer considerable protection to the trust from the claims of a creditor of a beneficiary, the use of a discretionary trust provision also means the beneficiary's interest is that of an expectancy only and gives a trustee considerable latitude in the exercise of its judgment. See MCL 700.7815. For this reason, practitioners should be careful in their drafting to ensure that if the settlor does not intend to create a discretionary trust provision, the language of the trust is not phrased permissively or in some other manner that inadvertently frustrates the settlor's intent by creating one."

A recent example of a *discretionary trust* that prevented trust assets from being reached to satisfy child and alimony support arrearages is *In re Antonia Gualtieri Living Trust, Michigan Court of Appeals, March 19, 2019*. In this case, the Trust instrument provided that the trustee 'in its sole and absolute discretion, shall apply to or for the benefit of' the beneficiary as much of the net income and principal from the trust as the trustee deems advisable for the beneficiary's education, health, maintenance, and support. The Court found that the Trust was a *discretionary trust* because the word 'shall' was preceded by the words 'sole and absolute discretion.' Consequently, even though the HEMS standard was used in the distribution standard, it was treated as a *discretionary trust*.

Comments: A couple of random observations follow:

HEMS Origins: Of course, we need to recognize that the HEMS standard comes from the Tax Code, and thus is automatically found in almost software programs that lawyers use. HEMS deals with transfer tax implications, not how the settlor intends the Trust to benefit the trust beneficiary. It deals with if a trust beneficiary has the power as trustee to distribute to himself or herself, to avoid estate inclusion under IRC 2041.

Exception Creditors: Sometimes you must wonder if, someday in the future, a Michigan appellate court will hold that Michigan's public policy is such that a divorcing spouse, or a child who are entitled to support, should be a common law exception creditor, especially if the HEMS standard is mixed with words of trustee discretion. Probably not the way MCL 700.7504 is currently written, but I can foresee a judge getting angry when the beneficiary enjoys the support of a Trust while ignoring his/her financial obligations to a former spouse or minor children.

State Income Tax: The presence of a HEMS standard in a Trust could expose the Trust to state income tax on undistributed taxable income if any beneficiaries are residents of California, (or maybe Georgia or North Carolina) which have drafted their state income tax statutes to reach HEMS Trusts.

Conclusion: When you review a Trust instrument and see HEMS language, be sure to ask the settlor if he/she understands that possible exposure of the Trust's assets to creditor claims against the beneficiary.

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