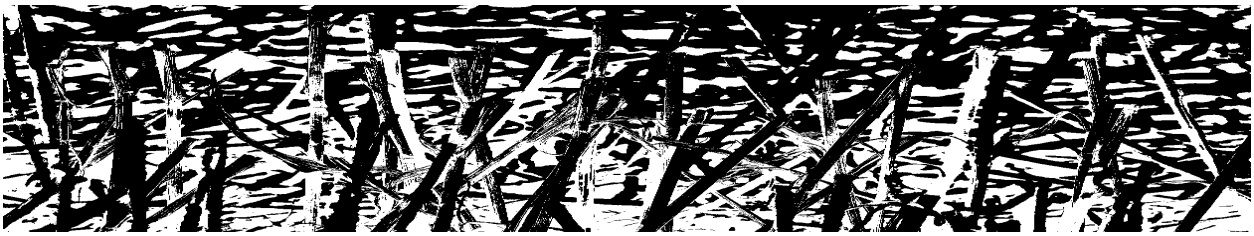

Jack Straw Fortnightly*

placeholder text

Had an interesting question come up the other day concerning the extension through 2021 of the "unlimited" charitable deduction, as part of the disaster relief measure that was tacked on to the appropriations bill at the end of December.

Whether a carryforward from 2020 could qualify.

To which the answer you want to give instinctively is "no," the carryforward would be subject to the fifty pct. limitation. But actually it takes a few hundred words to get from here to there.

Which we will undertake in a couple or three pages, but first.

when is a spouse

Taking a brief respite from tax law to talk about a couple of recent state appeals court decisions, one having to do with construing the word "spouse" in an irrevocable trust -- does this identify a specific individual? or does it describe a class, subject to open? -- and the other having to do with the circumstances under which a trustee can elect to convert an "income only" trust to a unitrust, over the objection of a contingent remainder beneficiary.

The trust construction case is *Ochse v. Ochse*, out of the 4th Texas court of appeals in San Antonio, decided November 18. The time for filing a petition for review by the state supreme court has been extended.

At issue is an irrevocable *inter vivos* trust created twelve years ago for the primary benefit of the settlor's son, with discretionary distributions of income and/or principal during his life, subject to an ascertainable standard, among a class of beneficiaries including not only the son, but also his descendants and his "spouse."

The son himself was named sole trustee,[1] and he was given both *inter vivos* and testamentary limited powers to appoint among the same class, excluding himself but again including his "spouse," in default of the exercise of which the remainder was to be distributed among his descendants, *per stirpes*.

A few years after mom set up this trust, the son divorced his spouse of

thirty years, the mother of his two adult children, and a couple of years later he remarried.

He did make some distributions along the way, but only to himself. And apparently he did not inform any of the other beneficiaries that the trust even existed, or what were its terms.[2]

At some point the two grandkids did learn about the trust,[3] and they brought suit to enjoin further distributions from the trust, to require an accounting, and to remove their father as trustee.

They joined their mother, whom we will call the "first spouse," as an interested party, on the theory that the generic references in the trust instrument to the "spouse" referred only to her, that the divorce did not have the effect of removing her from the beneficiary class, and that their father's remarriage did not have the effect of constituting the "second spouse" as a beneficiary.

The "first spouse," in turn, filed a crossclaim to enforce provisions of the divorce settlement agreement having to do with responsibility for joint tax liabilities, and for a declaratory judgment on the construction of the word "spouse."

The son and the "second spouse" jointly answered both the grandkids' petition and the crossclaim with general denials.[4]

There were cross-motions for partial summary judgment on just the declaratory judgment count, and the trial court ruled that the word "spouse" referred only to the "first spouse."

The "second spouse" then moved to sever the declaratory judgment count from the rest of the case so she could take an immediate appeal. The other parties consented.

hit pause

Jack would observe that the order granting partial summary judgment **did not say anything** about whether the "first spouse" still had a beneficial interest in the trust. Only that the word "spouse" referred specifically to her. Whether the divorce might have had the effect of **removing her from the class** of permitted distributees remains open, and may or may not be resolved when the rest of the case moves forward. Eventually.

The order did have the effect of **excluding the "second spouse.**" And that is what the appeal is about: whether the "second spouse" might be among the class of permitted distributees --

-- as to whom the son may or may not have any **enforceable fiduciary duties**, given his limited power, exerciseable *inter vivos* in a nonfiduciary capacity, to appoint disproportionately among the beneficiary class --

-- but to whom he might have wanted to be able to appoint and/or to make discretionary distributions at the expense of his estranged children.

Which is what the rest of the lawsuit is about, pending trial.

The briefs are posted to the appeals court's website.[5] Some of the key documents from the trial court proceedings are posted to the

landing page for this newsletter, and are linked in this discussion.

where to from here

Perhaps not surprisingly, the appeals court affirmed the trial court in its determination that the word "spouse" referred specifically and only to the "first spouse," to whom it obviously did refer when the trust was created. Not a class subject to open.

Whether she has enforceable rights in the trust is a question the appeals court did not reach, see footnote [5] above.

Some of the appeals court's discussion concerning what does or does not constitute a beneficiary "class" is not entirely satisfactory, particularly the reliance on its own 2008 opinion in *Ellison Grandchildren Trust*, which was very obviously wrongly decided, for reasons well explained in a dissent to that opinion.

What we learn, in effect, is that a "class" includes or excludes who we want, based on our sympathies. Absent extrinsic evidence of the settlor's intentions. Which is not admissible unless we can establish a "latent" ambiguity.

And on cross motions for summary judgment, premised on the idea that there are no "material facts" in dispute, of course both parties are asserting that the language of the trust instrument is unambiguous.[6]

Assuming the state supreme court declines a petition for review, we go back to the trial court on the substantive claims, but with the "second spouse" no longer joined as a party in interest.

when is an encroachment

The other state appeals court decision we want to mention is *USBank v. Herbst*, out of the Eastern District of Missouri, sitting in St. Louis, involving a unitrust conversion to which a contingent remainder beneficiary had objected.

This began as a revocable trust written back in the mid 60s, which became irrevocable at the settlor's death in the late 80s. There were initially two shares, one for each of the settlor's daughters, each distributing income to the daughter for life, with discretionary encroachments on principal.

At the death of each daughter, her share was to be divided into further shares for her children, each distributing "income only," no encroachments, until the death of the grandchild, with the remainder outright to her descendants, if any, otherwise to her siblings and/or their descendants.[8]

Both daughters had since died, but we are concerned here only with descent through the younger, who had four children, all of whom are still alive, probably in their late sixties.[9] Among these, two have children and two do not.

Thus it is foreseeable that at the death of each of the two childless grandchildren, the remainder of her share will enhance the shares held in trust for any of her siblings who survive,[10] and ultimately the shares to be distributed outright among the great-grandchildren.

And that distribution will be *per capita*, rather than *per stirpes*.[11]

The corporate trustee elected to convert the "income only" trust for the benefit of one of the childless grandchildren to a unitrust paying four pct. of trust corpus, averaged over twelve quarters.

The Missouri statute authorizing this election does require notice to "qualified beneficiaries,"[12] but it does not say anything about beneficiaries consenting or objecting, and in fact expressly states that the trustee has "sole authority" to make the election and that "an action or order by any court shall not be required."[13]

Nonetheless, because one grandchild, whom we will call "Wendy,"[14] did object, the trustee petitioned the probate court for a declaratory judgment that it had authority to make the election.

Wendy counterclaimed, arguing that a unitrust conversion would erode principal the settlor had intended to be preserved for the ultimate benefit of the great grandchildren.[15]

On cross motions for partial summary judgment, the trial court ruled for the trustee, without articulating its reasoning.[16] And as noted in footnote [14], charged Wendy with a large portion of the lawyers' fees incurred by the trustee.

under what circumstances

In her opening brief on appeal, Wendy argued, among other things,[17]

(a) that the statute expressly precludes a unitrust conversion where the trust settlor has forbidden it. Obviously the settlor could not have referenced in the mid 60s a statute that was not enacted until 2001, but Wendy argued that the express limitation to distributing "income only," with no encroachment on principal, amounted to the same thing.[18]

(b) that to make the election the trustee must first make a threshold determination that it is otherwise unable to administer the trust impartially as between the income and remainder interests, but did not do so here.[19]

The trustee responded

(a) that the statutory requirement that the settlor expressly forbid the election is what it is, and maybe the settlor of a pre-2001 irrevocable trust simply cannot opt out, but in any event an "income only" limitation is the very thing a unitrust conversion is designed to address.

(b) that the entire purpose of the unitrust conversion statute is to overcome the difficulty of administering an "income only" trust impartially without the necessity of making adjustments, item by item. Therefore the statutory criteria for determining whether to exercise an adjustment power do not apply.[20]

The appeals court bought both these latter arguments.

The argument that an "income only" limitation itself forbids a unitrust conversion is "circular," the court said, because after the conversion

the unitrust amount itself is what we now call "income." Jack suggests this argument may itself be circular.

On the second point, the court noted that the statute as written, [21] while it does cross reference portions of the section dealing with the power to adjust, does not reference those portions requiring a threshold determination that the trust cannot otherwise be administered impartially.[22]

Bottom line, the appeals court said, the trustee of an "income only" trust can elect to convert to a unitrust just because.

where to from here

Jack says this is not satisfactory. If the statute requires notice to qualified beneficiaries, this implies that a beneficiary might object. And this in turn implies that there are criteria a court should consider in determining whether the ground of the objection is sufficient to invalidate the election.

The answer cannot be that notice and objection are inevitably an empty exercise. There must be some handful of scenarios in which the presumption, see footnote [22], that the trustee's determination to make the election is "fair and reasonable" as to all beneficiaries, can be overcome.

It may be that limiting current distributions to "income only" is not sufficient, absent other indications elsewhere in the trust instrument, or possibly extrinsic evidence, that the settlor was emphatic on this point, for whatever reasons.

But if the statute affords a beneficiary an opportunity to object, we need some criteria for reviewing the conversion election.

The most obvious criterion would be abuse of discretion, and the typical objection would probably be what we see here, that a fixed unitrust payout would favor the income beneficiary at the expense of the remainder interests, in some context in which the settlor had intended the contrary.[23]

Jack is not saying an abuse of discretion criterion would necessarily have led to a different result in the particular case. What he is saying is that the appeals court should have articulated some standard by which the trustee's action might be reviewed, and remanded for findings to support a determination that the standard had been met.

There is an application pending for transfer of this case to the Missouri supreme court.

approaching the limit

Returning to the question we planted at the top as a teaser, whether a carryforward from 2020 can qualify for an "unlimited" deduction for calendar 2021.

The question arises because the measure extending the "unlimited" deduction for cash gifts to (b)(1)(A) charities through 2021 accomplishes this by reaching into the definition of "qualified contribution" itself, as set forth in section 2205 of the Cares Act, and simply adding "or 2021" after the reference to calendar year 2020.

In other words, the querent is asking whether a cash contribution made in calendar 2020 is still a "qualified contribution" in 2021, for which you can elect to deduct up to your entire contribution base.

For example, if someone made cash contributions of 1,000x last year but had AGI of only 600x and so was able to use only that amount, can she deduct the entire remaining 400x this year, again assuming AGI of 600x.

Or would she be limited to fifty pct. of AGI, that is, 300x. And carry the remaining 100x forward yet another year.

Again, instinctively you wanna say "no," if only because the extension would to this extent not be an incentive for additional giving this year, but an after the fact tax benefit to folks who had already made whatever commitments they were going to make last year.

But let's reason through this. And let's begin with section 2205 of the Cares Act, which is what the extender amends.[24]

Subsection (a)(1) says if you make the election, the limitations of 170(b) and (d) do not apply, except as provided in (a)(2), which says

> (i) you are limited to the excess of your "contribution base," effectively AGI, over amounts subject to lower thresholds, and
>
> (ii) any excess is carried forward and "added to the excess" described in 170(b)(1)(G)(ii),

which is where we have carryforwards of cash contributions subject to the temporary sixty pct. limitation.

And note that these carryforwards are not themselves deductible up to the sixty pct. limitation, they are subject to the default fifty pct. limitation per 170(d)(1).

The point being that even though a cash contribution in either 2020 or 2021 may be "qualified" by making the election, you still have to go back to (a)(2), which says any excess over your available contribution base is carried forward. You cannot "elect" for 2021 any portion of the amount contributed during calendar 2020, because you did not make the contribution during 2021.

But let's look more closely at the scenario our querent is proposing. Cash gifts during calendar 2020 of 1,000x, adjusted gross income in each of 2020 and 2021 of 600x.

There are at least four ways you could approach this:

> (a) If you made no election, you would deduct 360x for 2020 under the temporary sixty pct. limitation and carry 640x forward up to five years, subject each year to the fifty pct. limitation.
>
> Any amounts subject to lower percentage limits would be forced into carryforward.[25]
>
> (b) If you elected the entire amount, your limitation for calendar 2020 would be 600x, including any amounts subject to lower percentage limitations, which would not be forced into carryforward, and the excess, which might therefore be more than 400x, would again be carried forward up

to five years, again subject each year to the fifty pct. limitation.

But you might want to elect less than the entire amount in order to preserve the marginal value of the deduction, as the last dollar is coming from the lowest rate bracket. How would this work.

(c) If you elected only the excess of your contribution base over amounts subject to lower limitations, you might achieve the same result as in alternative (b). But maybe not.

Maybe the fact that you made cash contributions that would be subject to the temporary sixty pct. limitation would force you back into alternative (a), "wasting" a carryforward year for items subject to lower limitations.

(d) Unless you were able to preclude this result by electing everything over fifty pct. of your contribution base. But this does not solve the problem of taking some portion of your deduction against the lowest rate bracket.

Of course, much of the preceding discussion assumes we have items subject to lower limitations for which we do not want to "waste" a carryforward year.

If we are looking only at cash, we could select some middle ground between 360x and 600x, balancing the marginal rate against the time value of money, etc.

tangents and skews

[1]

The son's then spouse was designated, by name and not by the signifier "spouse," as the immediate successor trustee in the event he ceased to serve. Each of the children was to become trustee of his or her separate share upon attaining age thirty-five.

[2]

The existence of the trust did come up in the divorce proceeding. The settlement agreement recited that the former spouse would "continue to enjoy" whatever might have been her interest in the trust.

Without expressly conceding that she had any enforceable interest.

The settlor has since deceased, but as a practical matter what this means is that she is unavailable to testify as to her intentions, assuming extrinsic evidence were even admissible.

In the course of the litigation we are about to describe, the former spouse sought to subpoena records from the settlor's lawyers to clarify.

The trial court determined these were privileged, and not subject to an exception for communications "relevant to an issue between parties claiming through the same deceased client."

The appeals court denied a writ of mandamus in a summary opinion.

[3]

Among other things, the kids learned that the trust had been funded with stock in C.H. Guenther & Sons, the parent of Pioneer Flour, that the company was about to be sold to a private equity firm out of Chicago, and that their father was likely to distribute large amounts of the proceeds to himself to clear some personal debt.

The trust had initially been funded with 850 shares of Guenther stock, and the kids' amended petition alleged that the settlor had later transferred additional shares to the trust. This would place the value of the trust corpus somewhere well north of seven million.

The trust instrument did extend "Crummey" withdrawal rights to the entire class of permitted distributees, including the son's "spouse." If as does appear to be the case the son as trustee did not inform the "Crummey" power holders of the later transfer, there may still be hanging powers out there.

Unless the settlor notified the trustee that the transfer was not subject to the withdrawal rights, as she apparently had done with the initial transfer.

[4]

Your correspondent is not familiar with the manner of pleading exemplified here, which he would characterize as "narrative."

The answer to the crossclaim is literally a one-sentence general denial. The answer to the amended petition, after a brief general denial, sets forth a series of recitations, most of which your correspondent would call affirmative defenses, though these are not identified as such, and at least one of which looks like a counterclaim for damages resulting from a temporary restraining order the court had imposed at the outset of the litigation.

And a fair amount of material that looks like a trial brief.

Several of the affirmative defenses take the position that the trust beneficiaries have no enforceable rights, which is as may be, and literally no right to information concerning the administration of the trust.

Note: although the docket entries are somewhat cryptic, it appears the temporary restraining order was replaced at some point by a more narrowly crafted temporary injunction agreed to by the parties.

[5]

The response brief on behalf of the "first spouse" is a study in disingenuous overstatement of the significance of some of the underlying facts, notably the fact that the divorce settlement agreement said she would "continue to enjoy" whatever might have been her interest in the trust, see footnote [2] above.

In describing that interest, the brief throws the word "vested" around as though it meant something more than that the "first spouse" was a permissible distributee, subject to the impartial exercise of the trustee's discretion, limited by an ascertainable standard, but also

subject to defeasance by her former spouse's exercise of a limited power, exerciseable in a nonfiduciary capacity, to appoint disproportionately among other beneficiaries.

The appeals court, to its credit, did clarify in a footnote on the last page of its opinion that it did not subscribe to this use of the word "vested."

[6]

As discussed in footnote [2], the "first spouse" was prevented from developing extrinsic evidence of the settlor's intentions here, and so was compelled as a practical matter to go with the idea that the word "spouse" unambiguously referred only to her.

Jack suggests it is unlikely extrinsic evidence would have helped the "second spouse."

Jack also suggests the scrivener of this trust instrument did the settlor no favors by using such abstract language. If she had intended to protect her daughter-in-law in the event of a divorce, or to the contrary protect her son against the daughter-in-law, it would not have been difficult to make these objectives explicit.

[7]

Disclosure: your correspondent was trust counsel at what was then called Mercantile Trust in St. Louis in 1987, when this trust would have become irrevocable at the settlor's death, and probably participated in the intake, though he has no independent memory of this.

[8]

Literally the trust instrument says "amongst his or her then heirs at law who are direct descendants of [the settlor.]" The statute governing intestate succession in Missouri would share the remainder equally among surviving siblings and descendants of predeceased siblings, rather than creating per stirpital shares at the first degree at which there are survivors.

See footnote [11] below.

[9]

The other daughter may also have had children, but those are not our concern here.

[10]

Longtime readers of the Jack Straw will have noticed that we use the feminine rather than the masculine for the indefinite personal pronoun, rather than for example alternating, and we eschew altogether the awkward construction "his or her."

In the particular case in fact one of the childless grandchildren is male.

[11]

One sibling had three children and another had one. Regardless who might survive whom, each of those four will end up with an equal share of the remainder after all four siblings have deceased. See footnote [8] above.

The appellant here was of course the sibling who had three children.

[12]

The quoted phrase is a term of art in the uniform trust code meaning anyone who is currently a permissible distributee, anyone who is an immediate successor to that status, and anyone who would take if the trust terminated.

As applied here, not only the siblings but also the four great grandchildren, all of whom are almost certainly adults.

Perhaps not surprisingly, the appellant and her three children were represented by the same lawyer. Interestingly, the lawyer who represented the sibling whose trust share was at issue also represented the other two siblings and the remaining great grandchild.

So those four somehow saw their interests as essentially aligned.

[13]

It might be noted that the trust for one of the other siblings had already been converted to a unitrust sometime previously and that an election to convert was pending as to the other.

[14]

Not her given name, but actually a nickname that does appear in some of the documents submitted on the cross motions for summary judgment.

We are using the name here as a convenience, no disrespect, rather than repeating descriptors like "the granddaughter who had objected," etc.

See footnote [10] above.

[15]

Not technically her fight, except that if she survives her childless sibling, the remainder of that trust will enhance the corpus of her trust, marginally increasing the income payable to her.

In asserting her objection to the conversion at hand, Wendy also sought to revoke the conversion that had already occurred and to rescind her consent to the other pending election, see footnote [13] above.

She withdrew those pleadings, together with her constitutional claim, nominally without prejudice, in order to allow the judgment here to become final and appealable.

But the trial court found that merely by raising these additional claims, Wendy had "added a divisive element" to the proceedings and assessed a large portion of the lawyers' fees incurred by the trustee against her. Something north of $135k, representing several hundred hours even at top rates, and apparently still leaving some fees on the table. Jack would like to see the billing records.

The appeals court affirmed this assessment on the ostensibly limited ground that it was "not clearly arbitrary or unreasonable," but then remanded to the trial court to make a further assessment for fees incurred by the trustee on appeal, expressly embracing the logic that by "widen[ing] the scope of the litigation" to include the unitrust conversions affecting the other two trusts, Wendy had "added a divisive element," etc.

And in effect characterizing her objectives as mercenary: to limit the amounts distributable to each of her siblings from their separate trusts in order to enhance the remainder ultimately distributable to her children. As if this were somehow a bad thing.

Jack asks how a beneficiary is supposed to raise these issues without incurring penalties for being "divisive."

Or should she just shut up.

[16]

Your correspondent does not (yet) have access to the briefs on the cross motions for partial summary judgment, but one imagines many of the same arguments were presented there as in the briefing on appeal.

[17]

She also argued that much of the evidence on which the trial court based its ruling was inadmissible hearsay, not within the business records exception, which is beyond our immediate scope. And of course that the award of lawyers' fees was arbitrary and unreasonable, see footnote [14] above.

[18]

In her answer to the trustee's petition, Wendy also argued that the retroactive application of the statute to an existing, irrevocable trust was unconstitutional.

She abandoned this claim in order to finalize the judgment on the cross motions for summary judgment and pursue the present appeal.

[19]

The cross reference is to the second paragraph of section 103 of the uniform principal and income act of 2000, as enacted in Missouri in 2001 pretty much verbatim.

An interesting wrinkle here, that for some reason was not mentioned in the briefs or in the appeals court's opinion, is that the requirement of impartiality itself includes an exception where "the terms of the trust clearly manifest an intent that the fiduciary shall or may favor one or more of the beneficiaries."

Which Jack says the "income only" requirement arguably does, shifting capital appreciation to the remainderman at the expense of the income beneficiary.

[20]

In an affidavit supporting the trustee's motion for summary judgment, a trust officer who had not himself been involved in the decisionmaking identified records that were said to document a process that did involve something like this determination.

Whether those records were inadmissible was a key point of contention in this litigation, beyond the scope of our analysis here.

But in the end the appeals court determined in effect that the statute permitted a unitrust conversion without reference to whether the trust could otherwise not be administered impartially.

[21]

Further disclosure: your correspondent was a member of the state bar committee that drafted the 2001 revision to the Missouri trust code adopting the then most recent version of the uniform principal and income act. But at the time his energies were focused on waging a failing rearguard action against the abrogation of the common law rule against perpetuities.

Section 104 of the uniform act extended to the trustee a power to adjust receipts and disbursements as between the income and principal accounts if it had determined that it was otherwise not possible to administer the trust impartially.

It did not yet include provision for a unitrust conversion, but the conversation was out there, and there were drafts floating around.

Delaware was first out of the gate. Missouri was actually second, and New York a close third.

Both the Delaware and the Missouri statutes require notice to qualified beneficiaries, and the Delaware statute mentions the possibility that a beneficiary might object to the conversion, but neither provides any express mechanism for dealing with an objection. The New York statute literally requires the consent of "all persons interested in the trust."

The California statute, enacted shortly thereafter, does require the trustee to make a threshold determination that the trust cannot otherwise be administered impartially. The Pennsylvania statute, enacted several years later, requires a threshold determination that a unitrust conversion would enable the trustee "to better carry out the intent of the settlor."

[22]

Plus, the appeals court noted, there is language in yet another section to the effect that any decision made "in accordance with" any of the provisions of the principal and income statute is "presumed to be fair and reasonable to all of the beneficiaries." Speaking of circular arguments.

[23]

And this is in fact the criterion the drafters settled on in the 2018 revision to the uniform principal and income act, which does finally include a unitrust conversion feature, albeit without an ordering rule.

Elsewhere, your correspondent has argued that an ordering rule taxing realized gains to the "income" beneficiary also has the effect of shifting a benefit to the remainderman. But that is beyond our immediate scope here.

As it happens, the Missouri state bar committee that drafts proposed trust law revisions does appear to be considering a version of the 2018 uniform act, and it may be that within a few years the *Ayers Trust* decision will be obsoleted.

Yet further disclosure: your correspondent does still (or again) sit on that committee, although it has been years since he left Missouri.

[24]

As is typical of temporary measures allowing "unlimited" deductions for contributions to disaster relief efforts, from which it was cribbed, section 2205 does not directly amend Code section 170, but says "qualified contributions" are to be "disregarded" in applying the percentage limitations.

[25]

We mentioned this anomaly in Jack Straw three comma five last May, noting that the Joint Committee had said this was a drafting error, but also noting that there has been no effort to enact a technical correction.

Jack says, it's another blue day in a nowhere place