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Understanding the HEMS Standard in Trusts

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Four of the most commonly used words in estate planning documents are “health,” “education,” “maintenance” and “support.” Referred to as “HEMS,” this ascertainable standard is frequently used by estate planners to determine how and when a trustee may make distributions, allow a beneficiary the opportunity to serve as trustee, and create estate tax protections for the beneficiary.

Scope of the HEMS Standard

Since many trust documents reference the HEMS standard, it is important for estate planners, trustees, and beneficiaries to understand the scope of the HEMS standard. The HEMS standard is not limitless and it is therefore important to understand the types of expenses that fall within the HEMS standard.

Distributions for a beneficiary’s health are usually somewhat straightforward. Health expenses might include health insurance premiums, prescriptions, dental costs, orthodontics, vision costs, medical procedures and treatments (including routine doctor visits and medically necessary surgeries), physical therapy, home health aides, medical devices, and stays at medical facilities. However, not all expenses related to health necessarily fall within the ascertainable standard. Voluntary medical procedures such as cosmetic surgery and programs or retreats advertised to improve mental health may be beyond the scope of the ascertainable "health" standard in the trustee's discretion, depending upon the circumstances.

Distributions for a beneficiary's education are usually also relative clear. Education expenses could include daycare, tuition, graduate studies, books and supplies, tutoring, study abroad programs, uniform costs, training expenses and special education needs. As with the health standard, the education standard is not without limits. While education expenses could include study abroad programs, they do not include a blank check for use by the beneficiary for all expenses while studying abroad, such as entertainment expenses. Additionally, educational expenses for yoga classes, art classes, or a "serial" student may all fall beyond the scope of the education standard.

In comparison to distributions for health or education, distributions for a beneficiary's maintenance or support are a little less clear-cut. The Treasury Regulations interpreting Section 2041 of the Internal Revenue Code (discussed below), state that "maintenance" and "support" are to be treated as being synonymous when applying the HEMS standard. Distributions for a beneficiary's maintenance and support could include rent or mortgage payments, utilities payments, insurance premiums, property taxes, legal fees, home repairs and maintenance, food, clothing, reasonable assistance in buying a home or starting a new business, or reasonable vacation expenses. It is important to note that the maintenance and support standard is meant to maintain a family's standard of living, and is not designed to enhance or expand it. For example, if a beneficiary drives a Honda that breaks down, a distribution to the beneficiary for a new Honda would fall within the maintenance and support standard, but a distribution to the beneficiary for a Rolls Royce would most likely be beyond the scope of the maintenance and support standard.

Tax Benefits of HEMS

Limiting distributions to HEMS also permits the beneficiary of a trust to serve as a trustee without subjecting the trust assets to inclusion in the beneficiary's taxable estate. The HEMS standard is explicitly referenced in Section 2041(b) of the Internal

Revenue Code in the context of what is not a general power of appointment. Section 2041 of the Internal Revenue Code provides that the mere possession of a general power of appoint over property will cause such property to be included in the possessor's taxable estate for federal estate tax purposes. For example, if a beneficiary is serving as a trustee of a trust and the beneficiary/trustee possesses the power to make distributions from the trust to himself or herself for any reason or purpose, the trustee/beneficiary then possesses a general power of appointment over the trust, which would cause the assets to be included in the trustee/beneficiary's taxable estate for estate tax purposes. As beneficiaries often want to exert maximum power to make distributions from a trust to themselves without having to request distributions from a trustee, estate planners must thread the drafting needle between giving a trustee/beneficiary maximum power while avoiding adverse estate tax consequences.

As a safe-harbor, Section 2041 specifically provides that a "power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment." Thus, a trustee/beneficiary could make distributions to himself/herself without possessing a general power of appointment and without adverse estate tax consequences if the trust terms limit distributions for the trustee's/beneficiary's own health, education, maintenance, or support. Hence, estate planners frequently utilize HEMS provisions in trusts to provide a trustee/beneficiary with the flexibility to make distributions to himself/herself without creating adverse estate tax consequences for the trustee/beneficiary.

When to Use the HEMS Standard

The HEMS standard is most frequently used when the settlor wants to afford the beneficiary the opportunity to serve as the trustee of the beneficiary's trust. By including the HEMS standard, the beneficiary may make limited distributions to himself/herself without inadvertently causing the trust to be included in the beneficiary's estate for estate tax purposes. The HEMS standard can therefore be a powerful tool that will provide the beneficiary with enough authority to maintain his/her lifestyle.

Sometimes, however, the HEMS standard does not afford the beneficiary enough flexibility to make distributions from a trust. Because the HEMS standard is limited, if a settlor wanted to create flexibility so that the beneficiary could receive distributions beyond the HEMS standard for any reason or purpose, then the beneficiary could no longer serve as the trustee responsible for making distributions to himself/herself. Such a power as trustee would cause the trustee/beneficiary to possess a general power of appointment under Section 2041 of the Internal Revenue Code such that the trust would be included in the trustee/beneficiary's estate for estate tax purposes.

If the settlor wants the beneficiary to have greater access to the assets of the trust than afforded by the HEMS standard, yet still enable the beneficiary to be a trustee of the beneficiary's trust, a trust could be designed so that the trustee/beneficiary has the power to make distributions to himself/herself for HEMS, but another trustee (other than the beneficiary) could make distributions to the beneficiary for any reason or purpose. This type of drafting will often create the flexibility that the settlor is aiming to achieve in balancing the needs of the beneficiary with the estate tax consequences in providing greater access for the beneficiary.

Estate planners should be very careful when drafting the HEMS standard because any deviation could have adverse consequences. By simply inserting the word "comfort" into the HEMS standard and providing for the beneficiary's "health, education, maintenance, comfort or support," the language no longer falls within the scope of protection of Section 2041 of the Internal Revenue Code afforded by the HEMS standard and would cause estate tax inclusion for the trustee/beneficiary.

The HEMS standard can be a very powerful tool to balance a beneficiary's access to trust assets while avoiding adverse estate tax consequences to a beneficiary. While not an unlimited distribution standard, HEMS can usually provide a beneficiary with sufficient access to a trust that will enable the beneficiary to maintain his/her lifestyle for the duration of the trust.

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