

## Title

A permissible beneficiary's equitable property interest under an irrevocable discretionary trust is contingent, not vested, the divorce case of *Pfannenstiehl vs. Pfannenstiehl* notwithstanding

## Summary

A permissible beneficiary's equitable property interest under a discretionary trust is contingent, not vested. The critical condition precedent that renders the interest contingent is that the trustee must exercise his discretion in order for a portion or all of the trust estate to vest in the beneficiary. There are two important policy exceptions: (1) When the beneficiary is also the settlor such that the trust property is subject to the claims of the settlor-beneficiary's creditors and (2) when the beneficiary simultaneously possesses a non-fiduciary general inter vivos power to appoint the entrusted property. Occasionally these two policy exceptions will merge into a single exception, a topic that is covered in §4.1.3 of *Loring and Rounds: A Trustee's Handbook* [pages 278-280 of the 2015 Edition] (creditor accessibility as a general inter vivos power of appointment). Nowhere is there more confusion over what equitable property interests under trusts are vested and what are contingent than at the intersection of divorce and property law. Take the divorce case of *Pfannenstiehl vs. Pfannenstiehl*, decided August 27, 2015 (Appeals Court of Massachusetts, Norfolk). The husband was one of a number of permissible beneficiaries under an irrevocable discretionary trust established by his father. The majority characterized his equitable property interest as vested. The dissent characterized the interest as contingent. It is suggested that the dissent got it right. In Charles E. Rounds, Jr. & Charles E. Rounds, III, *Loring and Rounds: A Trustee's Handbook*, vested and contingent equitable property interests under trusts are discussed generally in §5.3.1. The section is reproduced in its entirety below.

## Text

### §5.3.1 *Nature and Extent of Property Interest* [from *Loring and Rounds: A Trustee's Handbook*]

*Trusts have been creatures of English law since the 14th Century...At the beginning..., trusts were used for dividing estates in real estate, and facilitating the donor's testamentary plans in the face of the laws of primogeniture and other restrictions imposed by the Crown on transfers of land, which*

*constituted most of the wealth of medieval society. Scholars suggest that the French Revolution ended similar efforts at dividing ownership in France, and ultimately throughout Europe and South America through the influence of the subsequent Napoleonic Code, because divided property rights came to be considered characteristic of feudalism.*<sup>13</sup>

Is the beneficiary's equitable interest itself, as distinguished from any interest the beneficiary may have in the underlying property, an interest in property, or merely a personal claim against the trustee in the nature of an equitable chose in action? "When uses were first enforced in England by the chancellors of the fifteenth century, it is clear that they looked at the use primarily as a personal relationship between the feoffee and the cestui que use."<sup>14</sup> Today, it seems reasonably settled that a beneficiary has more than mere rights against the trustee,<sup>15</sup> although Professor Maitland disagreed.<sup>16</sup> The fact that we all are obligated not to collude with a trustee in breach of trust<sup>17</sup> supports the proposition that a beneficiary's equitable rights are, for all intents and purposes, rights in rem.<sup>18</sup> In other words, the beneficiary's equitable interest no matter how ephemeral is itself an interest in property.

In addition, the beneficiary as well possesses some type of proprietary interest in the underlying trust property that is either vested or contingent.<sup>19</sup> "The result is something unique: a form of double ownership...[in the underlying property],...with the trustee holding legal title, but the beneficiary having equitable

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<sup>13</sup>Henry Christensen, III, *Foreign Trusts and Alternative Vehicles*, SH032 ALI-ABA 81, 83 (2002) (citing to Henry Hansmann & Ugo Mattei, *The Function of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. Rev. 434, 442 (1998)). See generally §8.12 of this handbook (where the trust is recognized outside the United States).

<sup>14</sup>Scott on Trusts §130. The phrase *cestui que trust* has evolved into a synonym for *beneficiary*. It is not known when this Norman-French phrase was introduced into our language, but it is believed to have been in the seventeenth century. For a discussion of such borrowings from the Norman French, see Sweet, 'Cestui Que Use': 'Cestui Que Trust,' 26 L.Q. Rev. 196 (1910). See generally §8.15 of this handbook (the doctrines ancient and modern) (discussing the "law French" phenomenon).

<sup>15</sup>See generally 3 Scott & Ascher §13.1; 2 Scott on Trusts §130.

<sup>16</sup>Maitland, *Equity* 107 (1936).

<sup>17</sup>See generally §7.2.9 of this handbook (personal liability of the trustee's agents and other third parties to the beneficiary).

<sup>18</sup>See generally 3 Scott & Ascher §13.1.

<sup>19</sup>See generally Bogert, *Trusts and Trustees* §183 (Beneficiary's Right in Personam or in Rem). But see Bogert, *Trusts and Trustees* §184 (Statutory Declarations as to the Nature of the Beneficiary's Interest); *United States v. O'Shaughnessy*, 517 N.W.2d 574, 577 (Minn. 1994) (holding that under Minnesota law, the beneficiary of a certain discretionary trust does not have "property" or any "right to property" in undistributed trust principal or income before the trustees have exercised their discretionary powers of distribution under the trust agreement).

ownership.”<sup>20</sup> Certainly the doctrine of tracing,<sup>21</sup> together with the doctrine that a non-BFP takes the underlying property of a trust subject to its terms,<sup>22</sup> supports the proposition that the beneficiary has some kind of proprietary interest in the underlying property, along with the equitable interest.<sup>23</sup> That the beneficiary possesses at least an indirect interest in the underlying trust property via the beneficiary’s equitable personal claim against the trustee is not in dispute.

Even in the case of a fully discretionary trust where one must strain to articulate a nexus between the beneficiary and the underlying property, the beneficiary still can enforce the trust against a non-BFP.<sup>24</sup> The outcome of a tax or other dispute, however, may hinge on the nature of and/or the intensity of a beneficiary’s legal relationship with the underlying trust property.<sup>25</sup> For a discussion of the doctrine of equitable conversion as it may apply to a beneficiary’s proprietary interest in entrusted real estate that the trustee is directed to liquidate, the reader is referred to Section 8.15.44 of this handbook.

The extent of the beneficiary’s equitable interest—again, not to be confused with the beneficiary’s interest in the underlying property—is usually governed by the terms of the trust. The settlor of the trust may create equitable interests that correspond to the comparable legal estates (*e.g.*, the beneficiary may be given an equitable life estate or an equitable estate for years). With respect to transmissible vested equitable interests, if the trust principal is personal property, the beneficiary’s interest is personal property, too, and follows personal property rules;

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<sup>20</sup>1 Scott & Ascher §1.1 (noting, however, that Professors Ames and Maitland objected to the characterization of a trust beneficiary’s interest as property in that legal title to the subject property is in the trustee).

<sup>21</sup>See generally §7.2.3.1 of this handbook (tracing and accounting for proceeds and profits in the trust context).

<sup>22</sup>See generally §8.15.63 of this handbook (doctrine of bona fide purchase; the BFP), §8.3.2 of this handbook (the bona fide purchase doctrine’s notice requirement), and §5.4.2 of this handbook (rights of the beneficiary as against transferees of the underlying trust property). See also §8.3.6 of this handbook (negotiable instruments and the duty of third parties to inquire into the trustee’s authority). For a comparison of the BFP, a creature of equity, with the holder in due course, a creature of law, see §8.15.68 of this handbook (holders in due course in the trust context).

<sup>23</sup>3 Scott & Ascher §13.1.

<sup>24</sup>Lewin on Trusts ¶1-06. See generally §5.4.2 of this handbook (rights of the beneficiary as against transferees, including BFPs).

<sup>25</sup>See generally 3 Scott & Ascher §13.1.1, n.1 and accompanying text. See also *United States v. O’Shaughnessy*, 517 N.W.2d 574 (Minn. 1994) (involving an unsuccessful attempt by the IRS to reach a taxpayer’s contingent equitable interest in a discretionary trust and/or the underlying property, this in order to satisfy an income tax deficiency); Cohen, *Massachusetts Estate Tax Planning for Non-Massachusetts Residents Owning Real Estate in Massachusetts*, 70 Mass. L. Rev. 124, 126 (1985) (tax); *In re Grand Jury Subpoena*, 973 F.2d 45 (1st Cir. 1992) (Fifth Amendment privilege not available to trustees of nominee trust).

if it is real estate, the beneficiary's interest is also regarded as realty.<sup>26</sup> “If, however, the trust property is real estate, but the beneficiary's interest is for a term of years, the interest is personal property.”<sup>27</sup> By statute, an equitable interest in an Illinois land trust is personal property as well.<sup>28</sup>

The equitable interest of the beneficiary may be a future interest, vested or contingent; it may rest solely in the discretion of the trustee; it may be limited to the occupation of the trust property. A trust under which the beneficiary gets the use or occupation of the underlying property but no entitlement to income or principal distributions has been referred to as a “personal trust.”<sup>29</sup>

Co-owners of a beneficial interest ordinarily hold the interest jointly unless there is a statute to the contrary.<sup>30</sup> Of course, the terms of a governing instrument may specify how the beneficial interest is to be held (jointly or as tenants in common) notwithstanding any common law or statutory presumption.<sup>31</sup>

Again, the issue of the beneficiary's relationship to the underlying property is separate from the issue of whether a particular equitable interest is vested or contingent. “[The equitable]...[i]nterests of beneficiaries of private express trusts run the gamut from valuable substantialities to evanescent hopes. Such a beneficiary may have any one of an almost infinite variety of the possible aggregates of rights, privileges, powers, and immunities.”<sup>32</sup> Equitable interests in trustee individual retirement accounts (IRAs) and realty or nominee trusts tend to crowd the substantial end of the rights spectrum,<sup>33</sup> and to the extent they are transferable may themselves constitute the underlying properties of other trusts.<sup>34</sup> One who unconditionally possesses the *entire* equitable interest in a parcel of real

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<sup>26</sup>See generally Scott & Ascher §13.1.1.

<sup>27</sup>3 Scott & Ascher §13.1.1 (citing to Restatement (Second) of Trusts §130(b) cmt. c, & illus. 6).

<sup>28</sup>3 Scott & Ascher §13.1.1, n.3.

<sup>29</sup>3 Scott & Ascher §13.2.6.

<sup>30</sup>In many states, such statutes have been enacted. See generally 2A Scott on Trusts §143. Many states' statutes impose a presumption of tenancy in common. See, e.g., N.Y. Est. Powers & Trusts Law §6-2.2 (Consol. 1979); Ill. Ann. Stat. ch. 76, §1-1a, 2 (Smith-Hurd 1987); Cal. Civ. Code §683 (West 1982); Mass. Gen. Laws Ann. ch. 184, §7 (West 1987).

<sup>31</sup>See, e.g., *Anderson v. Bean*, 220 Mass. 360, 107 N.E. 964 (1915).

<sup>32</sup>*Farkas v. Williams*, 5 Ill. 2d 417, 422-423, 125 N.E.2d 600, 603 (1955) (citing 4 Powell, *The Law of Real Property*, at 87).

<sup>33</sup>See §§9.5.2 of this handbook (the IRA trust) and 9.6 of this handbook (trusts that resemble corporations or agencies); Charles E. Rounds, Jr., *State Common Law Aspects of the Global Unwindings of the Madoff Ponzi Scheme and the Sub-Prime Mortgage Securitization Debacle*, 27 Wis. Int'l L.J. 99 (2009).

<sup>34</sup>See generally §2.1 of this handbook (the property requirement); Charles E. Rounds, Jr., *State Common Law Aspects of the Global Unwindings of the Madoff Ponzi Scheme and the Sub-Prime Mortgage Securitization Debacle*, 27 Wis. Int'l L.J. 99 (2009).

estate is even said to possess an equitable fee simple.<sup>35</sup> At the opposite extreme are the contingent equitable interests in charitable trusts.<sup>36</sup> At least from the perspective of any member of the public selected at random, such interests tend to be little more than evanescent hopes. A beneficiary's interest in a trust associated with a qualified employee benefit plan tends to move over time from the contingent end to the vested end of the rights spectrum.<sup>37</sup> “[A]...discretionary beneficiary, who is merely a member of a class to whom the trustees have a discretion to apply trust capital or income,...has a mere right to require the trustees to consider from time to time how to exercise their power.”<sup>38</sup> The interest is contingent because it is subject to the condition precedent of the trustee exercising discretion. Nonetheless, the equitable interest is an interest in property; it is not merely a hope or expectancy.<sup>39</sup>

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<sup>35</sup>See generally 3 Scott & Ascher §13.2.1 (noting also that words of inheritance such as “to X and his heirs” are no longer necessary to create an equitable fee simple). To possess the entire equitable interest is to be the sole beneficiary. “If the terms of a trust require payment to one person of both the income for a period of time, and, thereafter, the principal, that person is the trust's sole beneficiary, unless there is a contingent gift to another or a resulting trust upon the designated person's failure to survive the stated period.” 3 Scott & Ascher §13.2.2. Generally for someone to qualify as the sole beneficiary of a trust, the underlying property must pass to that person's probate estate in the event of his or her death before final distribution.

<sup>36</sup>See §9.1 of this handbook (the grantor trust).

<sup>37</sup>I.R.C. §§401(a)(7), 411; ERISA §203 (ERISA vesting standards).

<sup>38</sup>Lewin on Trusts ¶1-08 (England). See generally §3.5.3.2(a) of this handbook (the discretionary trust).

<sup>39</sup>See Kevin D. Millard, *Rights of a Trust Beneficiary's Creditors Under the Uniform Trust Code*, 34 ACTEC L.J. 58, 72 (2008) (the equitable interest of a beneficiary of a discretionary trust is more than a mere expectancy, it is an interest in property).