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Estate Planning

Absolute Discretion

A fully discretionary trust will shield assets from a beneficiary's creditors

By Anthony Vitiello

For years, clients have been interested in sheltering their wealth from the claims of potential creditors. Many professionals subject to malpractice liability, business owners and others in potentially high-risk endeavors seem fixated on asset-protection planning. Planning to shelter one's assets from future unforeseeable creditors can be an expensive and cumbersome process.

However, one often overlooked aspect of asset protection is the cost-effective ability to provide concrete asset and divorce protection for a client's heirs by employing established legal principles and artful drafting. Unfortunately, too many estate plans do not consider the realities of modern society: a high divorce rate, increased litigation and the accompanying jury awards. Instead, planners often focus on estate tax savings as the only true goal, with the creation of trusts for young children as a backstop to outright distributions.

The following design is recommended all too frequently. Clients create testamentary documents that establish traditional "by-pass trusts" with the spouse as the primary (if not sole) beneficiary. The spouse is the sole trustee and the trust provides for an "ascertainable standard" of distribution for income and principal, or may require all income to be paid to the primary beneficiary on an annual basis. Anything in excess of the applicable exclusion amount may pass outright to the surviving spouse. Or, there may be a marital trust to capture any additional generation skipping transfer (GST) tax exemption not allocated to the by-pass trust, with any excess assets passing outright to the surviving spouse. The marital trust has an ascertainable standard for principal distributions, with the surviving spouse also being its sole trustee. On the surviving spouse's death, the children's inheritance often passes outright at an "appropriate" age (e.g., one-third at 30, one-half of the remainder at age 35 and the remainder at 40).

An alternative tax planning technique is to divide a child's inheritance into two basic portions, one portion for which GST tax exemption has been allocated (the "GSTT Exempt Trust") and the other which has no GST tax exemption allocated to it (the "GSTT Trust"). Often the GSTT Exempt Trust contains an ascertainable standard of distribution for the benefit of the child and perhaps the child's issue. The child may be the trustee of that trust after a certain age of maturity. The portion of the inheritance constituting the GSTT Trust passes outright to the child at maturity.

So what is wrong with these very traditional estate plans? First, depending on the jurisdiction, the by-pass trust may be exposed to the creditors of the surviving spouse and the risks associated with a second marriage. Second, the amount passing outright to the surviving spouse is clearly subject to the creditors of the surviving spouse, may be subject to equitable distribution and alimony claims of a second marriage and will certainly be exposed to an elective share claim in a second marriage, absent an express written waiver.

As for a child's inheritance, the GSTT Exempt Trust may be subject to a child's creditors in certain states, given the ascertainable standard. Furthermore, all outright distributions of the GSTT Trust to a child clearly become accessible by a child's creditors and have the risk of eventually being subject to equitable distribution and alimony claims, as well as an elective share claim. If a trust provides for mandatory distributions (such as the requirement to distribute all income or a unitrust interest), those mandatory payments can be subject to a beneficiary's creditor claims and can be seen as an available income source in a divorce proceeding.

A spendthrift provision in a trust prohibits a beneficiary from transferring or assigning his interest in a trust for the benefit of his creditors. The spendthrift trust is a well-respected legal concept.

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New Jersey's spendthrift law is longstanding (see *Trust Co. of New Jersey v. Gardner*, 133 N.J. Eq. 436 (Ch.1943)) and treats any attempted beneficiary assignment to creditors as void. Other states have specifically written spendthrift protection into their statutes. See e.g. Louisiana R.S. Section 2002; Cal. Prob. Code Section 15300; McKinney's CPLR Section 5205 and McKinney's EPTL Section 7-1.5.

Depending on how a trust is designed, and depending on the governing law, spendthrift trusts have their limitations. In New Jersey, for example, at least one long-standing case provides for forced distributions to a beneficiary's creditors under an ascertainable standard. *Costanza v. Verona*, 48 N.J. Super. 355 (1958). In *Costanza*, the court held that a standard of "pleasure and comfort" permits a state institution to seek payment of a trust beneficiary's board out of the trust. The court ordered the trust distribution over the refusal of the trustee to make such payment. Such a principle is widely accepted, at least to the extent of the provision of necessaries, government benefits or alimony/support obligations. See e.g. OK ST t. 60 Section 175.25; LA R.S. 9:2005 and cases thereunder; *Bureau of Support in Dept. of Mental Hygiene & Correction v. Kreitzer*, 243 N.E. 2d 83 (Ohio, 1968).

Exposure in a spendthrift trust where the trustee does not have "sole and absolute" discretion over distributions can be significant. Many states allow attachment of mandatory distributions (or distributions to which the beneficiary is entitled) to satisfy certain creditor claims, alimony and child support obligations. *Clay v. Hamilton*, 116 Ind. App 214 (1945); *In the Matter of Knauth*, 12 NY 2d 259 (1963); PA ST 20 Section 6112; VTCA Family Section 154.005; OK ST t. 60 Section 175.25; Cal. Prob. Code Section 15301(b). An ascertainable distribution standard may also allow the invasion of a trust for certain types of creditors, including alimony and support claims. See LA R.S. 9:2005; *Dwight v. Dwight*, 756 N.E. 2d 17 (Mass. Ct of App, 2001); *Ventura County Dept. of Child Support Services v. Brown*, 117 Cal. App. 4th 144 (2004). While states may exempt inheritances (such as interests in spendthrift trusts) from equitable distribution (see e.g. *Miller v Miller*, 160 NJ 408, 422 (1999)), income derived from an inheritance may be considered in an alimony award. These examples demonstrate a misconception of the common view that spendthrift trusts are protected from creditors and certainly call into question the use of any type of mandatory distribution provision or ascertainable distribution standard.

For an extreme example of a state that actually includes trust assets in the computation of an equitable distribution award, one only needs to look at Vermont's law. In *Chilkott v. Chilkott*, 607 A. 2d 883 (1992), the Supreme Court of Vermont ruled that a husband's interest in a spendthrift trust was marital property subject to distribution under Vermont law, even though it was a future contingent interest. The inter vivos irrevocable trust was established by the husband's father for the benefit of the husband's mother, with the mother to receive income for life and principal for the mother's health, maintenance and welfare. The mother was 87 at the time of trial. Upon the mother's death, the husband would have an unrestricted right to principal from the trust if he survived the mother; otherwise, his interest would pass to his children pursuant to the terms of the trust. In effect, the only trusts under Vermont law that would be protected from equitable distribution awards are trusts that do not provide for any mandatory or ascertainable standard distribution schemes and have beneficiaries other than the one in the crosshairs.

Simply put, while spendthrift trust protection in support trusts (or trusts with mandatory distribution schemes) provides protections, there is room for different results in different jurisdictions. Thus, ascertainable distribution standards and mandatory distributions must be avoided if the client wants to provide asset and divorce protection for the client's heirs.

In contrast, trusts in which the trustee has "sole and absolute" discretion to distribute or not distribute income and principal (sometimes referred to as "fully discretionary" trusts) have much more certain asset protection benefits on a national scale. See e.g. *Bacardi v. White*, 463 So. 2d 218 (Fla. 1985). In fact, some commentators view fully discretionary trusts as potentially not needing a spendthrift provision in certain jurisdictions, since a beneficiary has no right to the underlying trust property at all. See *Scott on Trusts*, Section 155 (4th Ed.). Under this theory, a creditor seeking to invade a fully discretionary trust has no right to access funds for which the debtor-beneficiary has no property right.

That is not to say that a fully discretionary trust is the perfect solution. There are jurisdictions that apparently allow a court to attach prospective distributions a trustee actually makes, regardless of whether the trust is fully discretionary; such a rule effectively terminates distributions to the beneficiary unless the trustee satisfies the creditor or support claim. See e.g. Cal. Prob. Code Section 15305 and 15305.5.

Having said that, this author has found no instances of a fully discretionary nonself-settled trust being accessed to satisfy a creditor claim in the United States, in contradiction of a spendthrift provision. It appears that in general, creditors cannot pierce a fully discretionary trust, even in those states that might be viewed as creditor friendly. See, e.g. *Reed v. U.S. ex rel. Dept of Treasury*, 169 F3d 243 (La. 1999).

Spendthrift trusts and fully discretionary trusts are given specific protection under federal bankruptcy law as an "exclusion" from the bankruptcy estate, to the extent such trusts prohibit a creditor's claim under state law. See 11 U.S.C. Section 541(c)(2), which states a "restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." Thus, spendthrift protection under bankruptcy law may only be as

extensive as it is under applicable state law. In that case, the state law governing the trust is important since the state's legal parameters affect a bankruptcy court's ability to access a trust.

In sum, drafting a trust that gives the trustee anything less than sole and absolute discretion to distribute, or not distribute, income and principal to any beneficiary of the trust effectively reduces the ability of a trustee to shield trust assets from a beneficiary's creditors and divorcing spouse in modern society where the population is mobile.

If there are significant nontax reasons for keeping inherited assets in a fully discretionary trust, to the extent feasible under relevant tax law, then for how long could the structure be kept in tact? New Jersey has repealed its rule against perpetuities. N.J.S.A. Section 46:2F-9. Thus, trusts created under New Jersey law can be perpetual. At least 16 other states have effectively repealed their rule against perpetuities, allowed the creator of a trust to "opt out" of the rule against perpetuities or extended the effective time period in which the rule would terminate a trust. New York and Pennsylvania have not repealed the rule. McKinney's EPTL Section 9-1.1; 20 Pa.C.S.A. Section 6104. Maryland allows a trust creator to "opt out" while Connecticut retains the rule. MD Code, Estates & Trusts Section 11-102; C.G.S.A. Section 45a-491. Delaware, of course, has effectively repealed the rule DE ST TI 25 Section 501. In any event, for those of us who have clients in states that retain the rule, taking advantage of another state's substantive laws presents the opportunity for creating perpetual trusts.

So does it make financial sense to create these multigenerational trusts? An example will demonstrate the significance of this point. Dad, age 85, has a son at age 50, and a grandson, currently age 20, who eventually has a son at age 30 (the great-grandson) who also eventually has a son at age 30. Assume life expectancy is always 85 years and that the net death (estate and GST) tax rate at each generational level is always 46 percent. Dad dies and leaves $540,000 in trust (with any applicable estate tax being paid out of other assets). Dad's executor allocates $540,000 of his GSTT exemption to that trust. Alternatively for this example, Dad's executor allocates no GSTT exemption to that trust and thus the trust is subject to GST tax at the son's death and at the end of each subsequent generational level. Assume an annual five percent after-tax growth rate. After the great-great-grandchild dies (125 years), the trust not exempt from GST taxes has grown to approximately $20.5 million. The trust exempt from all estate and GST taxes has grown to approximately $240.5 million — almost 12 times greater than the nonexempt trust. If the growth rate was 7 percent, the nonexempt trust would be worth $216 million after 125 years, while the GST tax exempt trust grows to over $2.5 billion (yes, billion). Why? Because there have been four levels of GST tax in the nonexempt trust during the 125 year period. The planning opportunities and tax ramifications can be staggering on a $540,000 trust, let alone a $2 million trust fully utilizing the GST tax exemption.

In sum, given the significant jurisdictional differences in trust laws, the generally accepted protective nature of a fully discretionary trust and the ability to choose applicable state law, the "typical" trust design is outdated. If a child will receive an inheritance exceeding $1 million, the nontax benefits alone outweigh any additional administrative costs of implementing a fully discretionary perpetual trust. Of course, other details must be carefully weighed and balanced (trustee selection and succession issues, inclusion of other discretionary powers, etc.). In addition, a beneficiary obviously cannot be the trustee with distribution authority to himself in a fully discretionary trust. However, all these interests can be balanced and satisfied. Moreover, even if a trust is not exempt from GST (and/or estate) taxes and even if the trust will be exhausted by the child at some time later in life, the asset protection and divorce protection available in a fully discretionary trust may make its creation worthwhile. Many doctors wish their parents had created such trusts for their inheritance. ■