

Trusts: Planning and Drafting for Divorce

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Trusts: Planning and Drafting for Divorce

Introduction



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Overview

- Trusts are one of the most powerful tools in planning to minimize the risk to assets in a future divorce. However, in order to achieve optimum results for clients, trusts must be drafted and administered in a manner that provides maximum protection.
- Traditional trust drafting often falls far short of providing the protections clients want. What provisions should be used in drafting trusts to achieve better results? What trust planning techniques can be used in different client situations to plan better?
- Consider: spendthrift clauses; discretionary versus support trusts; long term trusts versus payouts at specified ages; trust ownership of personal use assets; uses and planning implications of trust protectors, investment trustees and directed trusts, floating spouse clauses and more.

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Divorce Rates

- Over 35% of US population aged 50-70 have been divorced at least once.
- Approx. 41% of first marriages, 60% of second marriages and 73% of third marriages end in divorce.

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Planning prior to marriage

- In equitable distribution states courts divide property between marital and separate property.
- In some states separate property, including gifts and inheritances, is included in marital property.
- Property held in properly drafted trusts may not be considered for equitable distribution but may be considered for maintenance award. This varies based upon state law.

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Importance of pre-nup agreements

- Determines provisions for:
 - Equitable distribution.
 - Maintenance.
 - Post-death right of election.
 - Retirement plan benefits.
 - DSUE elections.

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Trusts and Divorce Protection - Fundamentals



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Trust Benefits

- State Income Tax Minimization.
- Estate Tax Minimization.
- GST Tax Minimization.
- Protection from Creditors/Divorce.
- Protection from Beneficiary Improvidence.

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Pfannenstiehl Case –
Lessons on Trust
Accessibility in
Divorce



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Pfannenstiehl Case – Lessons on Trust Accessibility in Divorce - 1

- Is trust to be considered as part of the marital estate?
- Mass. – Pfannenstiehl v. Pfannenstiehl considered trusts as part of marital estate if more than an expectancy and then subject to division.
- Court decided when divorce took place 11 beneficiaries, Husband, 2 siblings and grandchildren are not a closed class because other descendants would be added as born.

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Pfannenstiehl Case – Lessons on Trust Accessibility in Divorce - 2

- Ascertainable standard of sorts was included: support, etc.
- Lower court said it was part of the marital estate and said value was $1/11 \times$ full value since husband was one of 11 beneficiaries and gave wife 60% in value.
- Appealed. Court noted that it was manipulative of trustees to stop making payments on eve of divorce.

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Pfannenstiehl Case – Lessons on Trust Accessibility in Divorce - 3

- SJC decision. Found that it was a mere expectancy so it is not subject to division. Note that does not mean it cannot impact how marital assets are divided.
- Remanded to trial court to determine spouse's rights – i.e. spousal maintenance consideration.

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Self Settled Trust - Pre-Marriage



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Self-Settled Trusts and Divorce

- DAPT statutes enacted in 17 states.
- Generally protected if funded at least 30 days prior to marriage – but may only apply if divorce jurisdiction recognizes DAPTs.
- Foreign APTs may provide greater protection – but depending on funding date may be included in marital asset valuation – See, *Riechers v. Riechers*, 178 Misc. 2d 170 (1998).
- Consider self-settled trusts to hold pre-marriage separate property segregated.

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Improving Existing Irrevocable Trusts



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Modification Using Terms of Existing Trust

- Beneficiary trustee resigning.
- Relinquishing powers/rights.
- Trust Protector action.

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Decanting Existing Trusts

- Where desired to increase protection in existing trusts consider decanting, non-judicial settlements, trust division.
- Recent decision – *Ferri v. Powell* – Mass. Ct. certified that a trust that gave withdrawal power to Husband could be decanted under common law to protect it from divorce claims.

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Non-Judicial Modification

- Example: DE law provides:
- 12 Del.C.Sec. 3342(a): provides: "Notwithstanding any provision of law or a trust's governing instrument limiting or prohibiting amendment of the trust, an irrevocable trust may be modified to include any provision that could have been included in the governing instrument of a trust created upon the date of the modification upon written consent or written nonobjection of the trustor, all then serving fiduciaries and all beneficiaries even if the modification violates a material purpose of the trust."
- If the beneficiary/soon-to-be –divorced spouse consents, will that affect how a court views the modification that makes the trust more difficult to reach in a divorce? Might a decanting undertaking by the trustee be preferable?

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Trust Drafting - Clauses



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Naming Trustee to Provide Protection

- When naming a trustee the preferable approach is to, at minimum, name an independent trustee, i.e., not the beneficiary or someone the beneficiary can control (e.g., an employee of a company owned by the beneficiary), and to vest distribution decision making in that independent trustee.

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Distribution Standards – Support vs. Discretionary

- A support trust is one which provides that the trustee pay to the beneficiary as much of the trust income as is necessary for the beneficiary's health, education, maintenance and support.
- A discretionary trust leaves it to the trustees discretion to determine what, if anything, to distribute.
- Many trusts are combinations of these.
- Traditional trust drafting more often would incorporate a standard for distributions, such as pay income (even when not required such as to qualify for an estate tax marital deduction), or to provide for the beneficiary's health, education, maintenance and support ("HEMS").
- Modern trust drafting tends to more often favor giving an independent trustee the discretion as to what distributions to make. A purely discretionary distribution standard is more protective against a future ex-spouse than any other type of standard.

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Distribution Standards - Restatement

- The Restatement Second of Trusts provides that a purely discretionary trust will be honored as giving the trustee unfettered discretion to distribute or not distribute, regardless of the support needs of the beneficiary. In a jurisdiction whose laws follows this, a discretionary trust should not be accessible in divorce.
- The Restatement Third of Trusts states that a discretionary trust can be enforced as a support trust (based on the notion that the trustee must act in the best interests of the beneficiary). In jurisdictions that follow the newer Restatement, even a discretionary trust may not be as protective as desired.
- The answer for clients in those jurisdictions is to apply the law of another jurisdiction and preferably structure the trust to have situs in a better jurisdiction.

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Distribution Standards – Income/Sprinkling

- **Pay all Income standard:** A traditional trust often gave the beneficiary a mandatory income right. For example, the trust might mandate that income must be distributed quarterly. This income right might expose the actual income, or an estimated income stream, to the reach of an ex-spouse. Certainly, a mandatory income stream might be viewed as a resource in determining maintenance or child support.
- **Sprinkling Provision:** Ideally, the trust (excluding marital trusts which are required for tax purposes to distribute all income to the spousal beneficiary) should give the trustee the power to "sprinkle" trust income and corpus among a class of beneficiaries, not merely the spouse. Including multiple beneficiaries, each of whom has the right to receive distributions in the discretion of a trustee, makes the rights of any one beneficiary indeterminate. This should enhance the protection the trust affords in a later matrimonial action.

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Distribution Standards – Use of Property

- Traditional trusts rarely if ever addressed holding personal use assets. Modern trust drafting, in contrast, generally provides for and encourages the trust holding personal use assets.
- This could include a residence, vacation home, artwork, even jewelry.
- If the spouse is a beneficiary of such a trust he can use the assets held by the trust but he would not own them. While a court might consider the use an available resource in its analysis, the court should not be able to distribute property held in an irrevocable trust.
- Example: If a client/beneficiary wishes to buy a house (or other assets) the traditional approach is distributing cash to the beneficiary to purchase a house. Instead, the trust itself should purchase the house and permit the beneficiary to live in it. This would keep the economic value involved in the protective envelope of the trust.

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Distribution Standards – Use of Property

- Practitioners should be aware of a common twist on this planning. If the trust was created in a jurisdiction with more protective trust laws than the client's home state, the trust should not own real property in the home state. To do so would taint the trust as subject to the jurisdiction of home state courts which might negate the sought-after benefits of creating the trust in a better jurisdiction. In these instances, the house (or other tangible property) can be held in a single member limited liability company formed by the trustee and owned by the trust.

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No Distributions for Spouse of Beneficiary

- The trust instrument could expressly state that it is the settlor's intent not to allow distributions to a beneficiary's spouse.
- Limit distributions to a married beneficiary solely for immediate and direct personal needs of that descendant/beneficiary (even pursuant to a HEMS standard). Clarifies that a broader reading of a HEMS distribution standard is not intended to include the spouse.
- Caveat – this may unduly limit distributions while the beneficiary is happily married. Example: most irrevocable trusts are created for general asset protection benefits, not only for divorce protection benefits. If the child/beneficiary is being sued actual distributions, if permitted, to the spouse would enable the spouse to receive trust benefit without the child/beneficiary's claimant reaching the assets.

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Distribution Standard - Waiver

- Consider including requirement for spousal waiver prior to any distribution.

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Crummey Powers



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Crummey Powers

- Many irrevocable trusts include an annual demand or "Crummey" power to assure that gifts to the trust qualify for the annual gift tax exclusion.
- Crummey powers may provide another mechanism of attack. A Crummey power permits the beneficiary to demand a distribution of the amount given in a particular year to the trust, typically the annual gift exclusion (\$14,000 in 2017).
- During any period when an ex-spouse has the power to withdraw that amount may be exposed. New trusts might consider whether to even include such powers. With the transfer tax exemption now at \$5,490,000 (2017) most estates are not subject to an estate tax.

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Term of Trust

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Trust Termination

- Trusts were traditionally structured to end with distributions of trust principal at specified ages, for example, principal may have been directed to be distributed to the beneficiary in approximately one-third increments as follows: one-third at age 25, one-half at age 30 and the balance at age 35.
- Once distributed any protection the trust afforded terminate as to the portion of the trust distributed.
- Modern trust drafting tends to favor very long term or perpetual trusts. This coordinates with the holding of personal use assets above. If the trust, for example, can hold a house and other assets there is less need to distribute significant trust assets outright to the beneficiary at any age.

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Trust Termination (cont'd)

- Consider decanting existing trusts into new trusts that retain assets long term. While the new trust may be limited by the rule against perpetuities of the old trust incremental protection may be achieved.
- This should preferably be done well in advance of a divorce to lessen the challenges that it was "pre-divorce planning."
- New trusts should be structured to last as long as state law permits.

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How to Define Spouse



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Floating Spouse Clause

- Traditional trust drafting would either include or exclude the client's spouse. Modern trust drafting sometimes uses a more flexible variant by naming a spouse as beneficiary but then defining that spouse to be whomsoever the client happens to be married to at any point in time.
- The divorce may by the terms of the trust terminate the ex-spouse's interests. This might provide an opportunity to use trust assets to benefit the spouse prior to but not after the divorce.
- Practitioners should consider the ability to use this technique to make a trust safer from future divorce. Consideration should be given to the existence of potential floating spouse rights in pre and post-nuptial agreements.

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Spendthrift Provision



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Spendthrift Provision

- Both traditional and modern trust drafting tend to include spendthrift provisions in many (not all) irrevocable trusts. This type of provision prevents a beneficiary from assigning his interests in a trust to creditors, which should include an ex-spouse.
- Matrimonial practitioners should encourage clients planning for future matrimonial issues to incorporate spendthrift protections in new trusts.
- Spendthrift Trust – UTC § 502:
 - Public Policy Exceptions – Child support/spousal maintenance/tort creditors/ tax obligations/creditors providing services for protection of beneficiary.

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Trust Protectors



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Trust Protector

- A trust protector is a position that is being used more frequently in trust drafting, but likely is still rather uncommon.
- The roles which a trust protector can play can differ based on state law and the provisions of the governing instrument.
- A protector can have certain specified powers, typically including the right to remove a trustee, replace a trustee, change the situs and governing law of the trust, and in some instances other powers.

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Trust Protector (cont'd)

- **Example:** Mom sets up a trust for daughter and names daughter as trustee. Daughter's powers to distribute to herself must be limited to an ascertainable standard to avoid having trust assets reachable by daughter's creditors and to avoid having trust assets included in daughter's estate.
- Depending on state law this distribution standard might expose trust assets to daughter's later divorce. Daughter perceives her marriage as becoming uncertain. She resigns as trustee and her brother who is named successor, takes over. If this was done one month prior to the divorce how might the court view the resignation?
- What if instead of daughter divorcing, an independent trust protector removed her? It would no longer be daughter's action which might be viewed as pre-divorce planning?

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Trust Protector (cont'd)

- **Power to Change Trust Situs:** Traditionally trusts were created in, and governed by the law of, the client's home state. But there is no reason to restrict trust administration to the settlor's home state. While more practitioners are considering state income tax impact of trust situs, the matrimonial implications could be significant.
- **Example:** The protector's actions in the preceding example might be taken further. Perhaps the protector may opt to name a trustee based in Nevada, and use her authority as protector to change governing law and situs from an East coast state to Nevada, and name a trust company in Nevada. How might that raise the cost and difficulty of the ex-husband pursuing the trust? If the home state law where the mother/settlor created the trust makes the trust accessible in divorce as a support trust, will moving the trust to a state whose laws do not make a support trust reachable suffice to mitigate that risk?

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Swap Power

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Swap Power - 1

- Another common power that has been used to cause trusts to be characterized as grantor trusts for tax purposes and to provide planning flexibility is the swap or substitution power. This gives the settlor the right to swap assets of equivalent value for assets in the trust.
- **Example:** Wife started a widget manufacturing company and gifted 20% of the stock to an irrevocable trust for the children. Husband was named trustee. The business grew substantially. In the maelstrom of the divorce the status of the trust was overlooked. Post-divorce, wife wanted to reclaim her stock, since a 20% minority interest in the business out of her control would be an impediment to her selling the company. So she attempted to swap a personal note to the trust in exchange for the stock. The now ex-husband, who remained the trustee, refused to honor the transaction. So while a swap power could have been an important tool for flexibility had the issues been addressed during the pendency of the divorce it may prove elusive.

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Swap Power - 2

- A similar fact pattern arose in a recent case. The trustee was the wife and mother of the daughter of the marriage who was the beneficiary of trust. The couple divorced. The ex-husband tried to exercise swap power and now ex-wife trustee refused. He tried to swap in a note and the ex-wife/trustee objected saying it was not of equivalent value as required by the trust instrument. *Schirazi v. Eden* 2016 WL 5867215. In the divorce the issue of trustee and trust actions should have been addressed. It may have been preferable for all involved to have had the wife/ex-wife resign as trustee in favor of an independent and ideally an institutional trustee.
- If a swap power is added to a trust consider naming an independent trustee to make the swap. If a spouse is trustee for a trust with a swap power, as part of the divorce consider naming an independent trustee to prevent the ex-spouses from feuding over the exercise of a swap or other powers.
- Even better, provide that upon a divorce any interest a spouse has should be terminated (i.e. Spouse deemed to be predeceased).

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Conclusion

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Conclusion

- Practitioners should exercise care in tailoring trusts and other estate planning of their clients. The increased flexibility and complexity of modern trusts will require special care and provisions in marital agreements.
- Both matrimonial and estate practitioners must address the new flexibility in trust drafting and planning to obtain optimal results for clients.

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