Current Developments, Cases, Analysis, and Practical Advice

ESTATE TAX PLANNING Advisor

Volume 1 • Issue 4 • May 2002

Planning With Spendthrift Trusts

By Gideon Rothschild and Daniel S. Rubin

The management, preservation, and distribution of wealth are the primary goals of estate planning. Since the 17th century, trusts have been viewed primarily, if not exclusively, for the purpose of tax minimization. Trusts can provide additional significant benefits, including the protection from predators and creditors.

Today, spendthrift trusts, which are practically universally accepted in the United States, provide the basis for such protection. Notwithstanding the general acceptance of spendthrift trusts, public policy exceptions have developed. One such exception relates to claims by a beneficiary's spouse or for child support. Another exception relating to tort creditors was recently addressed in *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (1999).

Sligh Litigation

On January 30, 1993 ,William B. Sligh was seriously injured in an automobile accident with Gene A. Lorance, an uninsured motorist driving under the influence of alcohol. Mr. Lorance was without any assets of his own but was a beneficiary of two spendthrift trusts established by his mother before her death earlier that year. It was alleged that Mr. Lorance's mother knew that he was a habitual drunkard who …

- Regularly drove while intoxicated,
- Had been involved in numerous automobile accidents, and
- Had been arrested and convicted on numerous prior occasions for driving under the influence.

It was further alleged that Mr. Lorance's mother established the two trusts as part of an intentional plan to enable her son to continue to lead his "... intemperate, debauched, wanton and depraved lifestyle while at the same time shielding his beneficial interest in the trusts from the claims of his involuntary tort creditors" [*Sligh v. First Nat'l Bank*, 704 So. 2d 1020 (1999).]

Notwithstanding that sympathetic background, however, the trial court dismissed Mr. and Mrs. Sligh's complaint, ruling that the assets of spendthrift trusts may not be garnished to satisfy the claims of tort judgment creditors. The Mississippi Supreme Court, in a split decision, reversed the trial court's hard-hearted but legally well-grounded decision, holding that as a matter of public policy, a beneficiary's interest in a spendthrift trust is not immune from claims arising out of a beneficiary's intentional or gross negligence [see Gideon Rothschild, Daniel S. Rubin, and Jonathan G. Blattmachr, "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?" 32 *Vand. J. Transnat'l L.* 763 (1999)].

Public Policy Exceptions

Restatement (Second) of Trusts Section 157 (1959), which sets forth the few exception that exist to spendthrift trust protections, contains no express "public policy" exception. Nevertheless, comment "a" to Section 157 does provide that "[t]he enumeration in this Section of situations in which the interest of the beneficiary of a spendthrift trust ... can be reached is not necessarily exclusive. The interest of the beneficiary of a spendthrift trust... may be reached in cases other than those herein enumerated, if considerations of public policy so require. Thus, it is possible that a person who has a claim in tort against the beneficiary of a spendthrift trust may be able to reach his interest under the trust."

As an aside, it is the authors' frequently stated contention that in the area of asset protection planning, "public policy" is often used to justify a ruling in favor of an emotionally compelling fact pattern that is not otherwise favored by the law.

Aftermath of the Sligh Case

Within six months of the decision, the Mississippi legislature negated any future implications from that decision by passing the Family Trust Preservation Act of 1998. The *Sligh* case, when considered in conjunction with its legislative aftermath, is legally significant because it demonstrates how deeply rooted spendthrift trust protections are in the United States. Although a majority of the Supreme Court of Mississippi ultimately ruled against the trustee in the *Sligh* case, it would be almost impossible to conceive of a set of facts in which the plaintiff was more worthy of our empathy or the trust beneficiary more worthy of our enmity.

Even so, the spendthrift trusts in *Sligh* came within a hairsbreadth of serving their intended purpose of protecting their assets from the beneficiary's creditors. Because of the Mississippi legislature's swift and decisive action, the next time the issue arises in Mississippi, the spendthrift trust will serve its intended purpose of protecting its assets from the beneficiary's creditors. In most other states, the issue would never even have been in doubt in the first place.

In light of the almost absolute protections afforded by spendthrift trusts, why are trusts frequently considered solely as a device to minimize transfer taxes? Arguably, our highly litigious society requires every planner to consider a beneficiary's potential exposure to creditor risk and, therefore, trusts should almost always be employed. The writers have seen all too many instances when the contemplated transfer of wealth is thwarted by the appearance of creditors or ex-spouses. By suggesting ways in which trusts can be structured for maximum protection,this article endeavors to promote trusts for the purpose of wealth preservation.

Planning Considerations

The very essence of a "spendthrift" trust is the inalienability of its beneficial interests; the inclusion of certain provisions within the trust agreement can maximize the protection afforded by the trust. At the very least, for example, ...

1 . The trust should be situated in a jurisdiction that recognizes the validity of spendthrift trusts without significant qualitative or quantitative exception, and

2 . The trust agreement should actually include an express spendthrift provision.

That express trust provision applies irrespective of the fact that a spendthrift trust can be created by a mere demonstration of the settlor's intent that the beneficiary's trust interest should not be subject to alienation. A declaration in a trust instrument that the interest of a beneficiary shall be held subject to a "spendthrift trust" is sufficient to restrain voluntary or involuntary alienation of the interest by a beneficiary to the maximum extent permitted [see, e.g., Texas Property Code, Title 9, Section 112.035 (2000)]. Those provisions apply even in those jurisdictions where the spendthrift nature of a trust is effected by default.

As a general matter, the right of a beneficiary of an express trust to receive the income from property and apply the income to the use of any person or pay the income to any person may not be transferred by assignment or otherwise. Nevertheless, the beneficiary of an express trust may transfer that right by assignment if that power is conferred upon such beneficiary by the instrument creating or declaring the trust [see, e.g., *New York Estates, Powers and Trusts*, § 7-1.5(a)(1) (McKinney, 1999)]. Additional factors can, however, enhance the spendthrift protection. A discussion of but a few of those additional factors follows.

Discretionary Versus Vested Interests

Where a spendthrift trust provides for the beneficiary's interest to terminate at a certain time, courts have held such interest to be a property right that is available to the beneficiary's creditors. Recently, in a divorce proceding, the Colorado Supreme Court held that a wife's remainder interest in a family trust constituted "property" and determined further that since her interest became certain during the marriage, subject only to the condition of surviving the income beneficiary, any appreciation on her interest during the marriage constituted marital property. The court distinguished such an interest from interests in discretionary trusts in which a beneficiary's mere expectancy does not rise to be a property interest [see *In re Marriage of Balanson*, 25 P.3d 28 (Colo. 2001)]. Accordingly, providing a trustee with discretion to distribute income and principal will provide significantly greater protection.

Independent Trustee

The trust should have at least one objectively independent trustee whose consent is required under the trust agreement before distributions can be made to the beneficiaries. That limitation applies because a restraint on alienation is ineffective where the same person is given both the entire legal and beneficial interest in the property. A trust generally cannot exist where there is no separation of the legal and equitable interest in property [see, e.g., Austin W. Scott and William F. Fratcher, *The Law of Trusts*, vol 2A, 4th ed (Boston: Little, Brown & Company 1989) §99].

Conversely, where the trustee is one of several beneficiaries, a valid trust is held to exist as to both the trustee's interest as well as the other beneficiaries'interests. For example, if A holds upon a spendthrift trust for A and B, A's interest, being an interest under the trust and not a legal interest, cannot be assigned to A or reached by A's creditors [see, e.g., Austin W. Scott and William F. Fratcher, *supra*, § 99.3 at 57; see also *Avera v. Avera*, 253 Ga. 16 (1984)]. An independent trustee would, nevertheless, remain advisable in order to foreclose a creditor arguing that the trust is somehow a "sham."

Eliminating the Rule Against Perpetuities

The trust agreement should provide that the trust property remain in trust for the longest possible period so as to continue the spendthrift trust protections. Where an extended term is desired, the settlor should create the trust in a jurisdiction that allows the perpetual existence of trusts. Fourteen domestic jurisdictions, to date, have repealed the Rule Against Perpetuities as it applies to trusts:

- Alaska
- Arizona
- Delaware
- Florida (allowing trusts created after December 31, 2000, to continue for a maximum period of 360 years)
- Idaho
- Illinois
- Maine
- Maryland
- New Jersey
- Ohio
- Rhode Island
- South Dakota
- Virginia
- Wisconsin

In that regard, it is notable that a grantor's designation of controlling law will govern the administration of the trust provided that certain minimum contacts exist between the trust and the designated jurisdiction. A settlor domiciled in one state may create an *inter vivos* trust by conveying property to a trust company of another state as trustee and delivering the property to the trustee to be administered in that state [see, e.g. , Austin W. Scott and William F. Fratcher, *supra*, § 626 at 419; see also Restatement (Second) of Conflict of Law § 270]. In conjunction with continuing the trust for the maximum possible period, the trust agreement should encourage the trustee to acquire assets for the use of the beneficiary in lieu of making distributions to the beneficiary. Similarly, the trustee should be empowered to make loans to the beneficiary (whether those loans are secured or unsecured) or equity investments in the beneficiary 's business entities.

For some clients, it is not desirable to continue the trust, in perpetuity or otherwise. For example, the client may wish to give the beneficiary the right to withdraw principal upon attaining a certain age. Where the beneficiary allows property to which the beneficiary is entitled to remain in trust , the beneficiary has most likely thereby created a "self - settled" trust, which would be ineffective to protect the beneficiary's beneficial interest from the beneficiary's creditors [see, e.g., *In re Doris L. Morris*, 151 B.R. 900 (C.D. Ill. 1993); *Hartsfield v. Lescher*, 721 F. Supp. 1052 (E . D. A rk. 1989)]. In that event, the trustee or another independent party can be granted the right to extend the term of the trust where a creditor problem exists at a time the trust would otherwise terminate. A slight variation on that concept is a "hold back" provision, allowing the trustee to withhold an otherwise mandatory distribution in the event that a creditor issue exists at the time of distribution.

Termination

In more extreme cases, the trust agreement can provide for the termination of the beneficiary's trust interest upon the occurrence of an event that calls into question the protection of the trust fund. For example, the trust agreement may provide that the beneficiary's interest terminates in favor of another beneficiary in the event that the first beneficiary is at any time deemed insolvent. The trust agreement may provide that an attempted alienation by the trust beneficiary or an attempted attachment by the beneficiary's creditors will cause the beneficiary's beneficial trust interest to be forfeited in favor of another beneficiary.

The Ninth Circuit has held such a termination provision effective to withstand even a federal tax claim on the basis that such provision left no property interest remaining that could be attached by the beneficiary's creditors [see *In re Fitzsimmons*, 896 F.2d 373 (9th Cir. 1990)]. A less drastic alternative might involve the conversion of an absolute spendthrift trust interest into a discretionary trust interest. The court in *Domo v. McCarthy*, 66 Ohio St. 3d 312, 317 (1993), determined, "It is obvious to us that when appellant filed his original creditor's bill in 1988, he triggered the spendthrift provision, converting James, Jr.'s interest from an absolute right in income and principal to an interest in which the trustee must administer the trust as a purely discretionary trust for James, Jr., James, Jr.'s dependents, and the settlor's lineal descendants. As such, the newly created discretionary trust cannot be reached by appellant as a creditor of James, Jr." Alternatively, the trustee can be given the power to exclude beneficiaries at the trustee's discretion by revising the trust's beneficial interests.

Finally, consideration might be given to including the beneficiary 's spouse (or significant other) as an additional discretionary beneficiary of the trust. There may exist a creditor issue that prevents distributions from being made directly to the beneficiary. In that event, distributions can instead be made to the beneficiary 's spouse, which can benefit that individual as well as the beneficiary (e.g., the distributions can be used for a family vacation or rental payments on the family residence).

Where it may be desirable to include the beneficiary 's spouse as a beneficiary of the trust, consider naming the beneficiary's spouse by reference to a defined term rather than by name. For example, "Spouse of the Settlor shall refer to the person to whom the Settlor is married at the time a distribution is made." In that manner, the beneficiary 's spouse will be automatically excluded as a beneficiary upon a divorce, and the benefi-

Spendthrift Trust Background Information

By Gideon Rothschild and Daniel S. Rubin

What exactly is a spendthrift trust? The Restatement (Second) of Trusts (1959) provides that a spendthrift trust is "[a] trust in which by the terms of the trust or by statute a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed" [Section 152(2)].

The maxim "*cujus est dare, ejus est disponere,*" or "[w]hose it is to give, his it is to dispose" is frequently cited as the underlying legal justification for spendthrift trusts. In 1875, the U.S. Supreme Court, in establishing the modern rule validating spendthrift trust protections, stated that "[w]e concede that there are limitations which public policy or general statutes impose upon all dispositions of property, such as those designed to prevent perpetuities and accumulations of real estate .... We also admit that there is a just and sound policy ... to protect creditors against frauds upon their rights .... But the doctrine, that the owner of property ... cannot so dispose of it, but that the object of his bounty ... must hold it subject to the debts due his creditors ... is one which we are not prepared to announce as the doctrine of this court" [*Nichols v. Eaton*, 91 U.S. 716, 725 (1875); see also, *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (1999) at 1028 ("Perhaps the most important policy consideration in favor of enforcing spendthrift trust provisions is the right of donors to dispose of their property as they wish.")]. Exceptions nevertheless do exist to the protections afforded by a spendthrift trust. According to the Restatement (Second) of Trusts, for example, although a trust is a spendthrift trust, the interest of the beneficiary can nevertheless be reached in satisfaction of an enforceable claim against the beneficiary ...

1. By the wife or child of the beneficiary for support, or by the wife for alimony;
2. For necessary services rendered to the beneficiary or necessary supplies furnished to the beneficiary;
3. For services rendered and materials furnished which preserve or benefit the interest of the beneficiary;
4. By the United States or a State to satisfy a claim against the beneficiary.
[Restatement (Second) of Trusts, Section 157 (1959)]

As a general matter, however, those excepted creditor claims are usually not of significant concern to most clients.

Additionally, the self-settled trust rul e, followed in all states except Alaska, Delaware, Nevada , and Rhode Island, denies spendthrift protection where the settlor retains a beneficial interest in the trust. A detailed discussion of self-settled trusts is beyond the scope of this article and will be presented in a future issue. ■

ciary 's new spouse will be automatically included upon the beneficiary 's remarriage.

Conclusion

For as long as estate plans are developed under a regime that imposes transfer tax at rates as high as 50 or 55 percent, the use of trusts to minimize those taxes will remain undeniably important. Those same estate plans are developed in a society where the adage "love thy neighbor" often seems to have been supplanted by the adage "sue thy neighbor." The judicious use of those same trusts must also look to first obtaining, and then enhancing, the spendthrift trust protections that they can also provide. The law surrounding spendthrift trust protections is, however, an iceberg, and this article exposes merely the tip. Therefore, the diligent estate planner will dig further to discover the myriad creative ways that exist to protect his clients' intersts through the use of spendthrift trusts.

For more information, see Gideon Rothschild's presentation to the 35th Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Protecting the Estate From In-Laws and Other Predators *(Matthew Bender).*

Gideon Rothschild is a partner in the New York law firm of Moses & Singer LLP and the Chair of the Committee on Asset Protection Planning of the American Bar Association's Real Property Probate and Trust Section. Daniel S. Rubin is a partner at Moses & Singer LLP. ■