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Asset protection for heirs

By Anthony F. Vitiello

In the last 10 years, clients have increasingly sought to shelter their own assets from the claims of potential creditors. Professionals, individuals in potentially high-risk businesses and even those contemplating marriage — and subsequent divorce — seem focused on asset protection and divorce protection planning.

As is commonly known, planning to shelter one's assets from future unknown creditors can be an expensive, cumbersome and prying process. In fact, in those cases where the planning is actually challenged, both the client and the planner are put to the test by creditors and the courts, with fraudulent transfer and bankruptcy laws being used as the proverbial club against both.

One often overlooked aspect of asset protection is the cost-effective ability to provide significant asset and divorce protection for a client's heirs utilizing accepted legal principles and thoughtful drafting, in addition to more cutting-edge techniques. Unfortunately, too many estate plans do not consider the realities of modern society: a high divorce rate, increased frequency of litigation and mushrooming size of verdicts. Instead, planners often focus on estate tax avoidance — a worthy cause in and of itself — and the creation of trusts for young children, solely to shepherd them through their tender years.

Typical plan

A plan implemented all too frequently is as follows.

Clients create testamentary documents which 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 (health, support, maintenance, etc. — sometimes called a "support trust"), or may even require all income to be paid to the primary beneficiary. Anything in excess of the applicable exclusion amount may pass outright to the surviving spouse.

Alternatively, there may be a marital trust to capture any excess generation skipping transfer tax (GSTT) exemption not allocated to the by-pass trust. 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 is either left to them outright at an appropriate age or is divided into two basic portions for each child, one portion for which GST tax exemption has been allocated (GSTT Exempt Part) and the other which has no GST tax exemption allocated to it (GSTT Part).

Often the GSTT Exempt Part trusts contain an ascertainable standard of distribution for the benefit of the child and perhaps the child's children. The child may be the trustee of that trust after a certain age of maturity and often serves alone after that age. The portion of the inheritance constituting the GSTT Part passes outright to the child at maturity (e.g., one-third at 25, one-half of the remainder at age 30 and the remainder at 35).

And what's wrong with it

So what is wrong with this very traditional estate plan?

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 Part trust may be subject to a child's creditors in certain states, given the ascertainable standard. Furthermore, all outright distributions of the GSTT Part 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 any trusts provide 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 in many instances and can be seen as an available income source in a divorce proceeding. Is that a dark enough picture?

Use of spendthrift trusts

A spendthrift provision in a trust prohibits a beneficiary from transferring or assigning his interest in a trust for the benefit of that beneficiary's creditors. The most common iteration of the spendthrift provision treats beneficiary attempts to assign trust interests to creditors as void.

The spendthrift trust is a well-respected legal concept. New Jersey's spendthrift law is long-standing (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 statute. See Louisiana R.S. Section 2002; California Probate Code Section 15300; McKinney's CPLR Section 5205 and McKinney's EPTL Section 7-1.5.

A state's acceptance of spendthrift trust protection is not a panacea, however. Depending on how a trust is designed, and depending on the governing law, such trusts may have limitations. New Jersey has a case on the books that provides for

Anthony F. Vitiello is chairman of the Taxation and Estate Planning Group at Connell Foley. His practice is limited to estate, tax and asset protection planning, estate administration and estate controversies.

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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).

Danger of discretionary distributions

The exposure present in a spendthrift trust where the trustee does not have "sole and absolute" discretion over distributions can be significant. Many states have statutes and cases on the books allowing 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. An ascertainable distribution standard may also allow the invasion of a trust for certain types of creditors, including alimony and support claims. Finally, while states may exempt inheritances (such as spendthrift trust interests) from equitable distribution (*Miller v. Miller,* 160 NJ 408 (1999)), income derived from an inheritance may be considered in an alimony award.

These types of cases and legal developments that may chip away at the protected nature of spendthrift trusts call into question the use of any type of mandatory distribution provision or ascertainable distribution standard in trust design. Simply put, while spendthrift trust protection in support trusts, or trusts with mandatory distribution schemes, provides protection, there is clearly room for different results in different jurisdictions. Thus, ascertainable distribution standards and mandatory distributions should be avoided if the client wants to provide asset and divorce protection for the client's heirs.

Sole and absolute discretion

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 *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; this is in contrast to a trust having an ascertainable standard of distribution. 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. Of course, why take the risk of not having a spendthrift provision?

That is not to say that a fully discretionary trust is the perfect solution in creditor-friendly states. 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 provision effectively terminates distributions to the beneficiary unless the trustee satisfies the creditor or support claim. See e.g., CA Prob Code Section 15305 and 15305.5.

Having said that, this author has found no instances of a fully discretionary trust being accessed to satisfy a creditor claim in the United States, in contradiction to 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 with respect to trust access.

Interaction with federal bankruptcy law

Spendthrift trusts and fully discretionary trusts are respected under federal bankruptcy law as an "exclusion" from the bankruptcy estate, to the extent such types of trusts would prohibit a creditor's claim under state law. 11 U.S.C. Section 541(c)(2) states a "restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy 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 on spendthrift protection 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 a mobile society. Can you predict where your descendants will be living after you are gone and if the state law governing your trust will change in the future?

Rule against perpetuities

If the case has been made for implementing fully discretionary trusts and there are important non-tax reasons for keeping inherited assets in a fully discretionary trust to the extent feasible under relevant tax law, how long could the structure be kept in-tact? New Jersey has repealed its rule against perpetuities. Thus, trusts created under New Jersey law can be perpetual. But we are not alone. At least sixteen 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. In the author's experience, the most popular of these states are Alaska and Delaware, which provide strong asset protection and an income tax-free environment for trusts, as well as perpetual existence of trusts. Our neighboring states of New York and Pennsylvania have not repealed the rule, although Pennsylvania has proposed legislation to do so. Maryland allows a trust creator to "opt out" while Connecticut retains the rule.

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In any event, for those of us with clients in states like New York, it is possible to take advantage of another state's substantive laws in certain trusts, thus allowing for the creation of perpetual trusts even by New York domiciles.

Enormous benefits

So what is the benefit of creating a fully discretionary perpetual trust, other than the asset protection and divorce protection it provides for its many generations of beneficiaries? Well, married couples can pass $4 million in trust and such trusts will never be subject to estate or GST tax again. An example will demonstrate the significance of this point.

Dad age 85, has a son age 50, and a grandson, 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 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, regardless of investments in the trust. 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 non-exempt trust. If the growth rate was 7 percent, the non-exempt 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 non-exempt trust during the 125-year period.

The planning opportunities and tax ramifications can be staggering on a $540,000 trust, let alone a $4 million trust.

Given the significant differences in trust laws from state to state, the generally accepted protective nature of a fully discretionary trust and the ability to choose applicable state law, the "typical" trust model is outdated; the

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standard of care has changed. If a child will receive an inheritance anywhere near or exceeding $1 million the non-tax 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, the extent of beneficiary participation in trust management, etc.); 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 makes its creation worthwhile. I know many doctors who wish their parents had created such trusts for their inheritance. Think of how fondly you will be viewed by the successful professional children of your clients.

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