Protecting Family Inheritances From Divorce

Much can be done when clients create trusts for the benefit of their children

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hile estate planners discuss many difficult-to-address issues with clients, they often fail to mention the possibility that clients’ children may divorce. Yet, planners can help clients take measures that may prevent former daughters- and sons-in-law from intercepting the client’s children’s inheritance.

In the past, trusts typically distributed all their assets outright to children on parents’ deaths, as these trusts were used primarily to avoid probate. Then, planners began crafting trusts to prolong distributions; typical trust agreements distributed half the trust’s assets when a child reached age 30 and the remainder at age 40. Over time, trust agreements grew more sophisticated to protect assets for longer periods, even perpetually. Trustees were directed to distribute assets to provide for heirs’ health, education, maintenance and support (HEMS). Often, trusts were intended to provide not only for current beneficiaries, but also for future beneficiaries (the remaindermen).

This type of trust agreement is prevalent today—and it’s being challenged in family law courts around the country. The battle focuses on whether current and remainder beneficiaries have property rights in the trust assets; therefore, the beneficiaries’ ex-spouses might access those assets. Or, do these beneficiaries merely have an expectancy with respect to trust assets; therefore, ex-spouses have no rights? State courts offer inconsistent views, depending on both state law and trust agreements’ specifics. Generally, the more control beneficiaries have over trust assets or the more assured they are of receiving trust assets, the greater the likelihood a state court may factor those assets into the property awarded to beneficiaries’ ex-spouses.

We’ll review some trends in recent court cases and offer planning tips to help you protect trust assets for a divorcing beneficiary.

Beneficiary Control

Trust assets can be at risk when beneficiaries hold a general power to direct trust assets to be transferred to anyone, including themselves. The assets are effectively available to the beneficiaries and, as such, potentially viewed as a property right. The same argument can apply when beneficiaries are trustees of their trusts and have broad discretionary powers to distribute trust assets.

In Chilcott v. Chilcott, a Vermont court held that when a beneficiary holds an unrestricted right to access trust assets, those assets are a property right.

The result may be just the opposite when beneficiaries hold only a special power of appointment (POA). Connecticut’s Cooley v. Cooley held that such a power wasn’t a property right.

Potential Impact of POAs

In a similar vein, if a beneficiary’s right to benefit from a trust is subject to another person’s ability to redirect the assets elsewhere, such as in the exercise of a POA, the beneficiary’s interest might not be subject to division in a divorce.

A Massachusetts court held in S.L. v. R.L. that the trust in question wasn’t part of the marital estate because it was subject to complete divestment on the exercise of a general POA by the beneficiary’s mother; she could redirect the trust assets to anyone she wanted, even to herself.

The same logic might apply even when a POA is more restricted. In fact, a Massachusetts appellate court reached a similar conclusion regarding a limited POA.

A Colorado court held in In re Marriage of Balanson
that divisible property interests didn’t include a beneficiary’s interest in a trust because it was subject to another individual’s general POA. Although the decision didn’t fully explain the reasoning behind this holding, one might read Balanson as consistent with the view that a remainder interest is likely a mere expectancy because it’s uncertain how the powerholder might exercise the POA.¹⁰

Still, it’s unclear whether courts will make a distinction between general and limited POAs when a divorcing beneficiary holds the power. For federal estate tax purposes, a general POA is tantamount to the ownership of the property by the powerholder, but a limited POA isn’t. By analogy, if a third party holds a general POA over trust property, the beneficiary might not have any ownership in trust property, but may hold only a mere expectancy. Hopefully, future case law will lay this quandary to rest.

Planning Tip 1: Settlers should be advised of the risks and consider avoiding:

- making beneficiaries trustees of their trusts.
- giving beneficiaries POAs, both general and limited.

De Facto Control
It’s very important to consider how trustees and beneficiaries will interact with regard to the trust. Even a wholly discretionary trust can be subject to a determination that the beneficiary has a property right in the trust if facts show the beneficiary has been able to freely access trust funds by simply asking.

In the Massachusetts case of Caruso v. Caruso,⁷ the court found the beneficiary’s accountant, acting as trustee, amounted to a “yes man” for the beneficiary and was, therefore, in too close a relationship to exercise independent judgment. The court held that even though a trust is purely discretionary, when the beneficiary appears to hold de facto control of the trust, its property becomes subject to division.⁸

Planning Tip 2: Help settlors think through how independent the trustees they select will be in fulfilling their duties.

Surety of Income
When a trust mandates that all its income (as opposed to trust assets in general, per HEMS standards) be paid currently to a beneficiary, there’s a greater chance a court might value the income stream, concluding that because the beneficiary is guaranteed income, it’s a marital asset. Indeed, some courts, such as the North Dakota Supreme Court, have held that a mandatory income interest and limited withdrawal rights can be included as marital property subject to division.⁹

Other courts disagree. The Delaware Supreme Court ruled that a mandatory income interest wasn’t divisible property because it couldn’t be reduced to constructive or actual possession.¹⁰

Some courts have held that a mandatory income interest isn’t property subject to division.

A Colorado court held, in In re Marriage of Guinn,¹¹ that a mandatory income interest wasn’t property subject to division. Some helpful facts in that case were:

1) the trustees could use their reasonable discretion in determining what was allocable to income versus to principal;
2) the beneficiary had no ultimate right to the principal; and
3) the beneficiary couldn’t direct how the trust assets were to be invested.

Note, however, that another Colorado court, in In re the Marriage of Tondeleyo L. Dale,¹² found that a vested remainder in an irrevocable trust was a property interest, even as it decided that a remainder interest in a revocable or amendable trust was a mere expectancy. Unfortunately, this case didn’t focus on whether any third-party POA would be tantamount to a revocable or amendable trust.

Beneficiaries’ ex-spouses may even (but not always) have greater rights to trust assets if trustees are required to make distributions of income and/or principal to the beneficiaries according to a certain standard (such as HEMS).¹³ In contrast, when trustees have pure discretion to make distributions, beneficiaries’ rights are more uncertain, which provides greater protection for the assets in divorce proceedings.

Planning Tip 3: Have grantors consider giving trustees the authority to withhold distributions in their sole and absolute discretion, so as to reduce the risk that the beneficiary’s interest will be deemed a property right.
Age and Remainder Interests

Beneficiaries can be granted current rights to trust assets. For example, a trust can mandate that its current income be distributed to the beneficiary. In contrast, a beneficiary can be prohibited from receiving any financial benefit from the trust until the beneficiary reaches a certain age or survives another individual (the remainder interest).

A recurring issue in a divorce is whether a remainder interest constitutes property subject to division. Many states recognize trust assets as separate property that isn't subject to division upon divorce.

However, other states have treated as marital property subject to division:

1) the income; and/or
2) any appreciation on trust assets that accrued during the marriage.

The Supreme Court of Pennsylvania took a combination of these stances when it ruled that receiving trust assets on attaining a certain age was a mere expectancy. However, voluntarily leaving those assets in the trust after attaining the age left the appreciation of those assets vulnerable to division as marital property.14

Property to be held for a fixed period of years and then distributed equally to beneficiaries also might be an expectancy and not be divisible in divorce proceedings.15 For example, in Indiana, trust assets were found not to be includible in divisible assets when the spouse would receive trust property outright only on the death of the income beneficiary. Here, the Indiana court concluded the future interest was too remote and was merely an expectancy.16

In contrast, a similar remainder interest was held to be divisible in Trowbridge v. Trowbridge as part of the remainder beneficiary’s estate under Wisconsin law.7 The court in Davidson v. Davidson also found such a remainder to be vulnerable to division under Massachusetts law because it was fixed at the time of divorce, irrespective of the spendthrift provision in the trust document.18 Courts in Montana, New Hampshire and North Dakota have held that a remainder interest contingent on the prior death of the income beneficiary was property subject to division because the remainder interest had “vested.”

The Colorado court in Balanson7 also found that if a beneficiary (the spouse in question) has a remainder interest and only has to survive the income beneficiary to receive it without further trustee discretion, this interest is a divisible property interest. Thus, the appreciation on that property during the marriage also could be factored into the marital property equation.20 This was the result even though the income beneficiary (that is, the spouse’s father) had the right to income and to invade principal subject to an ascertainable standard.

However, in another Colorado case,21 the trustee had total discretion to distribute trust assets to a beneficiary who might be the spouse in question. Specifically, distributions of any or all of the trust assets in that case could have been made in the trustee’s total discretion to other beneficiaries, to the exclusion of the divorcing spouse. There, the court held that the ex-spouse of the beneficiary wasn’t able to include the trust assets as a property interest of the beneficiary.

Planning Tip 4: Consider having the grantor give the trustee total discretionary power to distribute among multiple beneficiaries, so as to shield trust assets from inclusion in marital property.

Spendthrift Clauses

A spendthrift clause may be helpful in preventing creditors from obtaining trust assets. Some states, however, disregard spendthrift clauses for both alimony and child support.22 These states, typically, have adopted the Uniform Trust Code. Others except only child support. Still others deny both or are undecided on the issue.

Planning Tip 5: Check the applicable state law for the level of protection that a spendthrift clause will provide to trust assets in a future divorce.

Additional Vulnerabilities

Even when trust assets are successfully kept out of a divorce’s property division, some courts still take them into consideration and assign more of the beneficiary’s non-trust marital assets to the other spouse than the court otherwise might have.

For example, in In re Marriage of Rhinehart,23 an Iowa court concluded that a trust wasn’t divisible property because the settlor (the beneficiary’s father) retained the power to amend the trust. Yet, the court considered the value of those trust assets in its equitable division of the beneficiary’s other marital assets in the divorce. Similar results occurred in Montana’s In re Marriage of Harris.24

In Dwight v. Dwight,25 a trust wasn’t factored in as part of the divisible marital estate. Nevertheless, the court viewed the trust as a resource to the child and awarded higher alimony to make up for the fact that the trust assets were rendered unavailable as marital assets subject to division.

Planning Tip 6: There are a variety of strategies that might help reduce the exposure of non-trust assets
to the equitable distribution remedy. For instance, the trust could be designed as a grantor trust to the beneficiary, meaning that the beneficiary would be liable for all income taxes on the trust’s earnings, leaving fewer assets available for equitable distribution.26

Planning Tip 7: The beneficiary could create a trust of his own in a state that has self-settled asset protection trust law that protects trust assets from divorce-related claims.

Informed Clients
Clients may feel their circumstances don’t warrant taking precautions against their children’s potential divorces. However, it’s essential that we discuss the possibility of beneficiaries’ divorcing and the measures that might be employed to protect their assets. And, if clients are interested in adding such protections to their trust instruments, we’ve listed specific provisions for you, as practitioners, to consider. (See “Battle of the Trust Provisions,” this page.)

Endnotes
8. For yet another “bad facts” case concluding the trust was marital property when the beneficiary was the sole trustee and sole beneficiary, see Moore v. Moore, 189 S.W.3d 627 (Mo. Ct. App. 2006).
13. A health, education, maintenance and support (HEMS) standard doesn’t always expose the trust assets when the beneficiary divorces. The New Jersey Supreme Court concluded that a HEMS standard can’t be factored into an alimony award against a trust beneficiary; Tannen v. Tannen, New Jersey Supreme Court (Dec. 8, 2011) (A-53-10) (066951).
17. Towbridge v. Towbridge, 114 N.W.2d 129 (Wis. 1962).
26. Under Internal Revenue Code Section 678(a)(1), the beneficiary is considered the grantor only if he has the power to vest trust assets in himself—which would create greater risk to the trust assets under the case law discussed in this article. However, a lesser known provision, IRC Section 678(a)(2), says that if the beneficiary partially released a Section 678(a)(1) power, that beneficiary will always expose the trust assets when the beneficiary divorces. The New Jersey Supreme Court concluded that a HEMS standard can’t be factored into an alimony award against a trust beneficiary; Tannen v. Tannen, New Jersey Supreme Court (Dec. 8, 2011) (A-53-10) (066951).