

Divorce and Trusts: Dissolving or Amending Existing Trusts and Using New Trusts in Divorce Planning

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Overview of Trust Law for Family Counsel

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Trust Distribution

The key to understanding whether a trust is susceptible to claims in a family law case (divorce or child support) is understanding when and how trust assets may be distributed:

- Mandatory Trust
- Discretionary Trust
- Support Trust with Ascertainable Standards
- Discretionary Trust with Ascertainable Standards

Mandatory Trusts

- Trustee must provide / pay to the beneficiary some amount of income or corpus.
- Beneficiary has enforceable property right in the trust.
- Required / mandated payments likely are subject to claims for spousal / child support.
- The non-mandatory interest shouldn't be subject to equitable distribution in most states, unless previously distributed.

Discretionary Trusts

- As the name indicates, the trustee has the discretion to provide the beneficiary trust income or corpus
- Traditional common law: beneficiary has no enforceable property right in the trust
- Traditional common law: No trust assets or distributions considered in alimony, child support, or equitable distribution
- Key often is if there is no right to the beneficiary, the spouse or child typically has no right either.

Support Trusts with Ascertainable Standards

- Trust distributions required to be made for the beneficiary's health, education, maintenance, and support or some other standard
- Key: standards are treated as objectively determinable
- Beneficiary has property right in the objectively determinable standard that may be reached by spouse and children
- Support trusts also expand the scope of other non-beneficiary parties who have legal standing as to the trust. (Discretionary trusts are much more limited in the regard.)

Discretionary Trusts with Ascertainable Standards

- A trust that provides trustee discretion (i.e. trustee “may” rather than “shall” distribute), but stipulates that discretion can only be used for distributions for “health, education, maintenance, and support” or some other standard
- Whether spouse and children can force distribution varies greatly state by state
- Check case law in your state

Spendthrift Clauses

- Spendthrift clauses generally protect trust assets even if distributions aren't discretionary
- However, in the context of divorce / child support actions, most state spendthrift statutes allow an exception for alimony and child-support
- This is why divorce cases rely on distribution standards rather than spendthrift clauses.

Revocable Trusts

- One that a person can revoke, amend, change and/or revise
- Essentially an alter-ego for the person who has these powers
- The transfer shouldn't change status as marital vs separate property
- Argument applies even if another person is the Trustee of the spouse's revocable Trust

Irrevocable Trust

- One that a person cannot revoke or amend
- Rights and powers are set forth under the terms of the Trust in a more permanent manner than a revocable Trust
- Irrevocable trusts where a spouse is grantor require examining whether the grantor has any retained interest

Doctrine of Confidential Relationship

- Under this doctrine, one spouse arguably cannot transfer property to a trust *ex parte* outside of the marriage without informed consent

Dealing with Existing Trusts

ISSUES IN DISCOVERING TRUST ASSETS

- Finding out if a Trust Exists
- Who are the Players / Who has the Information?
- Required Disclosures in Divorce Court
- Standard Discovery Requests
- Not-so-Standard Discovery Requests

FINDING OUT IF A TRUST EXISTS

- The Easy Part:
 - Most Trust assets will be disclosed through standard disclosures (financial statements or tax returns) or by compliance with well-crafted standard discovery requests.
 - The Exception: If a trust is not disclosed but believed to exist, there are usually clues that will lead you to the trust through other assets or income. Traditional discovery techniques are generally used to determine whether a trust exists.

FINDING OUT IF A TRUST EXISTS

- The Hard Part:
 - Once you know a Trust exists, discovering its terms and assets is the next step.
 - Who are the parties?
 - Who has the information?
 - What language to use for standard discovery requests?
 - What advanced discovery techniques are available?

WHO ARE THE PLAYERS? / WHO HAS THE INFORMATION?

- Identify the Players: Grantor, Trustee, and Beneficiary are identified in the Trust Document.
 - A divorcing party could occupy one, two, or all three positions.
 - Typically the Trustee is going to have the most information relating to the current assets of the trust.
 - Although you will start with the divorcing party, you likely will need to involve the trustee in your discovery requests if they are a different person from the divorcing party.

REQUIRED DISCLOSURES IN DIVORCE COURT

- Financial Statement(s)
- Automatic Disclosure Requirements
 - e.g. Massachusetts Supplemental Probate Court Rule 410 (3 years tax returns, 3 years bank statements, etc., Local Court Rules).
- Documents already in possession of your client:
 - Income tax returns for divorcing parties may show trust income.
 - Financial and bank account statements may show deposits from trusts or trust assets.
- Trusts that hold real property will be recorded and available in the public record.

REQUIRED DISCLOSURES IN DIVORCE COURT

- Review how payments for divorcing parties' living expenses are being made. Look for usual expenses that are missing (i.e. mortgages, taxes, credit cards, utilities, vehicles, vacations, etc.).
 - In some instances, look for expenses that exceed income disclosed.

STANDARD DISCOVERY REQUESTS

- Request for Financial Statement (if not automatic in your jurisdiction)
- Request for Production of Documents:
 - All records, documents and information relating to any trusts that you, your spouse, and/or your children are a beneficiary, trustee or grantor of including, but not limited to, the documents that establish the trust, statements of the assets of the trust, fiduciary accountings, tax returns filed by or on the behalf of the trust or its beneficiaries, records of disbursements, and/or all instruments recorded by or on behalf of the trust or its beneficiaries.

STANDARD DISCOVERY REQUESTS

- Interrogatories
 - Please state the name of any trusts that you and/or your current spouse and/or your children are a beneficiary, trustee or grantor of and for each please state:
 - a. Name and contact information of all the trustees of the trust;
 - b. Name and contact information of all beneficiaries of the trust;
 - c. Name and contact information of the grantor(s) of the trust;
 - d. Whether the Trust is revocable or not;
 - e. Whether the Trust is a spendthrift trust or not;

STANDARD DISCOVERY REQUESTS (CONT.)

- f. A complete list of the assets of the trust, their location and approximate value;
- g. The date that the trust was established;
- h. The date and amount of any distributions from said trust and to whom the distributions were made;
- i. The procedure for receiving a distribution from the trust;
- j. Whether you have asked for any distributions from the trust and the date of your request;
- k. Whether you are willing to ask for a distribution from the trust to assist in the payment of your domestic obligations; and
- l. The description and location of any and all documents that support your Answer to this Interrogatory.

STANDARD DISCOVERY REQUESTS

Interrogatories Cont.

- Please list any and all financial accounts in which you have any interest, including bank accounts held individually, with another person, for management of property held in a trust which you or a third party established for your benefit or for the benefit of an ancestor or descendant of yours, regardless of whether such beneficial interest is vested or contingent, or by a business with which you and/or your current spouse have any interest whatsoever; any and all investment accounts, operating accounts, business escrow accounts, 401K's, IRA's or any other financial account, and for each, please state...

STANDARD DISCOVERY REQUESTS

- a. The type of account or investment;
- b. The name and address of the financial institution; and
- c. The name and address of each person in whose name the account is held.

STANDARD DISCOVERY REQUESTS

Interrogatories cont.

- Please describe any and all gifts in excess of one hundred dollars (\$100) made directly from or on behalf of you to any source, including but not limited to gifts to family members, and distributions from trusts during the applicable period and for each provide the...

Standard Discovery Requests

- a. The date of the gift;
- b. The name and address of the person or entity receiving the gift;
- c. Whether or not there is written evidence of the existence of a gift; and
- d A description of the written evidence.

STANDARD DISCOVERY REQUESTS

Deposition Topics / Questions:

- Review all sources of income.
- Review all gifts, devises and bequests from family members.
- Review all bank accounts or other assets in which the party has access to, or at anytime during the marriage had access.
- Review all gifts or transfers made by the party during the marriage (or prior if relevant).

NOT-SO-STANDARD DISCOVERY REQUESTS

- Subpoena Duces Tecum of Trustee and/or Grantor
 - All records, documents and information relating to any trusts that either spouse, and/or any of their children are a beneficiary, trustee or grantor of including, but not limited to, the documents that establish the trust, statements of the assets of the trust, tax returns filed by or on the behalf of the trust or its beneficiaries, records of disbursements, and/or all instruments recorded by or on behalf of the trust or its beneficiaries.
 - Discern the purpose of the trust, and the actual management of the trust: e.g. even if the trust document states it's a spendthrift trust, has the trustee previously allowed all requests of the beneficiary?

ONCE DISCOVERY IS COMPLETE, WHAT TO LOOK FOR IN THE TRUST DOCUMENTATION

- Identify the Grantor(s):
 - Who has contributed financially to the Trust? It may be more than one person.
 - What assets were contributed to the Trust and when were they contributed?
- Who are the current and potential future beneficiaries?
 - Is a divorcing party a current beneficiary? If not, will he or she become one upon the occurrence of a future event? If so, what event?
- What is the jurisdiction whose laws apply to the trust's operation and the law for settling trust administration disputes?
 - Although seemingly a minor point, if the trust is being administered to your client's detriment the jurisdictional laws may be used to apply pressure and obtain information regarding the trust.

ONCE DISCOVERY IS COMPLETE, WHAT TO LOOK FOR IN THE TRUST DOCUMENTATION (CONT.)

- Review the management of the trust's assets to determine whether the manner in which the assets are being administered is detrimental to your client
 - Are distributions being withheld or limited in contravention of the trust agreement?
 - Is the trust being invested in a manner which diminishes the value of a divorcing party's interest in income and/or principal?

ONCE DISCOVERY IS COMPLETE, WHAT TO LOOK FOR IN THE TRUST DOCUMENTATION (CONT.)

- Has a divorcing party's interest in the trust been modified inappropriately?
- Is the divorcing party receiving hidden benefits from the trust, perhaps through inter-related transactions, investments or loans?
- If the divorcing party is a trustee, is the divorcing party receiving trustee fees or alternatively has that person stopped taking trustees fees?

ONCE DISCOVERY IS COMPLETE, WHAT TO LOOK FOR IN THE TRUST DOCUMENTATION (CONT.)

- Who are the beneficiaries, both vested and contingent and what is the nature of each class of beneficiaries' interest in the trust's income and principal?
- Are distributions made in the Trustee's discretion, subject to some type of ascertainable standard (i.e. for a beneficiary's health, support, education and maintenance), or by some other subjective or objective measurement?

ONCE DISCOVERY IS COMPLETE, WHAT TO LOOK FOR IN THE TRUST DOCUMENTATION (CONT.)

- May the beneficiary act unilaterally, or in conjunction with one or more other persons who are not trustees, to withdraw assets from the trust.
- Has a divorcing party contributed assets to the trust and also retained a beneficial interest in trust income or principal?

Issues That Impact Property Division / Settlement

WHO DO YOU REPRESENT?

- Practice Tips for Grantors
- Practice Tips for Trustees
- Practice Tips for Beneficiaries
- Practice Tips for Spouses of Beneficiaries

NON-PARTY GRANTORS: REVOCABLE TRUSTS

- As long as a Grantor retains ownership over the trust (revocable trust), a beneficiary's interest is subject to the Grantor's whim and it generally cannot be subject to division in a divorce action as the divorcing beneficiary spouse is not the actual owner of the trust.

NON-PARTY GRANTORS: REVOCABLE TRUSTS

- If a Grantor creates a revocable trust and a beneficiary spouse is in the process of a divorce, the Grantor has the power and authority to change and/or modify the terms of the trust as he or she sees fit to protect the interests of the beneficiary spouse.

NON-PARTY GRANTORS: IRREVOCABLE TRUSTS SPENDTHRIFT & TIMING

- A spendthrift provision in an irrevocable trust prevents creditors, including a divorcing spouse, from attaching the interest of the beneficiary in the trust before that interest is actually distributed to him or her. However, once those assets are distributed they are no longer protected.
- Some states will not honor a spendthrift provision against creditors or may put caps on the amount that can be placed in the trust. Additionally, there are laws that allow trust accounts to be touched for such things as child support and spousal support.

NON-PARTY GRANTORS: IRREVOCABLE TRUSTS SPENDTRHIFT & TIMING

- If the Grantor creates an irrevocable trust and is concerned about the possibility of a pending divorce of a beneficiary spouse, then the Grantor should try to ensure that the beneficiary's outright access to the trust occurs at as late a date as possible so that the beneficiary does not have immediate access to the trust whereby it does not create a present interest for the beneficiary spouse to have to divide.

GRANTORS WHO ARE ALSO PARTIES

- Trusts created by spouses themselves are generally marital property to the extent that they were created with marital contributions and therefore are typically subject to property division in a divorce.

GRANTORS: ASK THE QUESTION – WHY NOW?

- If the Grantor is aware of a pending divorce matter, should they wait to create the trust?
- Or wait to transfer any assets into the trust?

NON-PARTY TRUSTEES

- All Court Orders may not apply to a non-party Trustee:
 - Discovery on Trustee may be proper – but ask is there a proper objection to be made? Trustee must act in beneficiaries' best interest.
 - Orders against parties that are beneficiaries may require them to do things that the trustee could refuse. Trustee must consider their duties under the trust document, which may conflict with court orders.

BENEFICIARIES

- Consider what legal control and actual control/influence a beneficiary actually has.
- If a beneficiary exercises influence even in a spendthrift trust, then that actual influence may be considered to break the spendthrift clause.

COMMOLEY OVERLOOKED PITFALLS / KEY EVIDENTIARY ISSUES

Overview of Irrevocable vs. Revocable Trusts

- In order to determine whether the beneficiary's interest in the trust is marital property depends on the terms of the trust.
- When a trust is litigated/questioned, as a marital property, the following questions are considered:
 1. Is the trust revocable or irrevocable?
 2. Who (if anyone) is vested the power of appointment?
 3. Who are the beneficiaries of the trust?
 4. How and to whom does the trust provide for distributions?
 5. Is the trust a discretionary trust?
 6. Is the trust a support trust?
 7. Is the trust a non-discretionary trust?
 8. Does the trust provide for both non-discretionary and discretionary distributions?

Overview of Irrevocable vs. Revocable Trusts

- In terms of jurisdictional differences, some states, including Oregon, have a broad view on whether a beneficiary's interests constitutes property no matter whether such an interest is possessory, vested or contingent.
- Other states require that a spouse have a present right to receive the trust assets for a spouse's interests to be considered acquired property.
- Meanwhile, other states have adopted a more flexible approach based upon an examination of the type of interest held by the beneficiary spouse in the trust.

Trusts as Property v. Income

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- Other states require that a spouse have a present right to receive the trust assets for a spouse's interests to be considered acquired property.
- Meanwhile, other states have adopted a more flexible approach based upon an examination of the type of interest held by the beneficiary spouse in the trust.

Trusts as Property v. Income

- An income interest in a trust is a provision which grants the beneficiary the right to receive periodic payments during the lifetime of the trust.
- In many jurisdictions, income earned from trusts are not considered property because the income earned via trusts cannot be assigned (one to whom property rights are transferred by another) or conveyed to another person.

Trusts as Property v. Income

- In this vein, a spouse could argue in many states (if a state statute allows it) the other spouse's income earned on separate property as marital property. For example:
 - Consider a client whose revocable trust provides that upon client's death all assets will be distributed outright to client's children in equal shares. If each child receives \$100,000, then that \$100,000 is non-marital property, as property acquired by bequest. If child invests the \$100,000 in stock that pays a \$1,000 dividend, the \$1,000 is marital property. If child purchases a home with \$100,000 and child's spouse spends weekends fixing it up to be resold, then the appreciation in the value of the home may be marital property as marital labor contributed to the increase.

Trusts as Property v. Income

- There are many cases out there in various jurisdictions that are helpful on this topic.
 - For example, in *Holte v. Holte*, during the marriage, husband's parents established an irrevocable trust, and assigned to it mineral rights with a one quarter interest to him. After filing for divorce, the trial court eventually granted his wife a one-half future interest in his trust income.
 - Husband appealed, and the North Dakota Supreme Court ultimately upheld the trial court's decision agreeing that a present valuation of the trust income was too speculative to value. Generally, marital property is valued as of the date of trial, rather than the date of distribution.

Trusts as Property v. Income

- *Holte* continued:
 - However, in certain circumstances, a property's value at trial may be too speculative to determine. Although at trial the husband had a fixed one-fourth interest in “[a]ll royalties and other income” from the trust, the value of his interest, which is based on mineral production levels, mineral values, and other factors, will fluctuate.

Trusts as Property v. Income

- In regards to a revocable trust:
 - If a child takes \$10,000, which was received from Client's revocable trust and puts it in a brokerage account containing money earned during marriage, then the inheritance has commingled with marital property. In order to avoid such problems, a lawyer should be cautious when drafting mandatory or discretionary interests in a trust.

Trusts as Property v. Income

- While the trust may not be considered property for the purposes of division of property in divorce, the income derived will have an effect on the child support and alimony / maintenance within a specific case.
- Careful analysis of income or potential income should be considered when structuring settlement agreements and in presentation to the Court at trial in cases where child support and / or alimony / maintenance are factors in play.

Case Examples

- In *Byrd v. Byrd*, the wife appealed the trial court's decision in classifying her husband's one-third interest in the trust as his separate property. The Mississippi Supreme Court affirmed concluding that the husband's one-third interest is his separate property.
- The court defined "marital assets" as assets accumulated or acquired during marriage, excluding assets attributable to one party's separate estate prior to or outside marriage. Although proceeds from the trust might have been used to purchase assets, which became marital property, at no time did any assets, proceeds, or money go into the trust from the marriage.

Case Examples

- In *Solomon v. Solomon*, the Pennsylvania Supreme Court held that only an increase in value in property actually acquired can be deemed marital property. In these instances, appreciation is to be calculated only to the degree to which the property exceeded its value at the time of acquisition.
 - However, if a beneficiary's interest does not rise to the level of a property interest in the first place, there can be no argument that the asset is subject to division in a divorce or that the appreciation is marital property.

Case Examples

- Other states also seem to focus on whether a beneficiary spouse has a present and absolute right to receive the trust assets.
 - For example, in *Mey v. Mey*, the New Jersey Supreme Court held that a beneficiary spouse's interest in a trust does not constitute property that is legally and beneficially acquired, unless the beneficiary has acquired "unimpaired control and totally free use and enjoyment" of the trust assets.

Case Examples

- In *Friebel v. Friebel*, the Wisconsin Court of Appeals held that a beneficiary spouse does not acquire an interest in a trust during the marriage unless she has a right to receive the corpus of the trust.
- Similarly, in *Lipsey v. Lipsey*, the Texas Court of Appeals held that a beneficiary spouse does not acquire an asset unless she has a right to compel distributions.

Case Examples

- Mandatory Distributions
 - In *Charles Moore*, the issue presented to the Missouri Court of Appeals was whether the income not distributed by the trust should be categorized as a marital property. The Court held that the undistributed income was marital property. The Court said, the husband had the right to terminate his trust when he attained age 35.
 - The Court held that husband constructively received the trust assets at a time during the marriage. The trial court erred in not classifying the income the trust generated from that date until the date of the dissolution of the parties' marriage as marital property.

Case Examples

- In *Linda Moore*, the Western District Court of Appeals held that “trust income which wife received as a result of corporation paying excess distributions to trusts was marital property.”
- The court treated this income as income earned on non-marital property. Furthermore, the court said trust income which wife received as a result of corporation paying excess distributions to trusts was marital property; wife, as sole trustee and sole beneficiary of each trust, held both equitable and legal title, excess distributions paid to each trust were in turn paid by wife, as trustee, to herself as beneficiary, wife reported the income on her tax returns, wife's receipt of the excess distributions payable from the trust was actual rather than constructive, and trust agreements established that her right to the income from the distributions was vested, absolute, and irrevocable.

Case Examples

Other states seem to focus on whether a trust is discretionary or non-discretionary, as well:

- For example, in *In Re Marriage of Balanson*, the beneficiary would receive the remainder interest which was subject only to her survival. In other words, she would receive the trust assets provided she did not die before her father.
 - In that case, the Colorado Supreme Court held that the beneficiary spouse's interest in a trust does not need to be subject to her present enjoyment to constitute marital property provided that the beneficiary had an enforceable contractual right to receive the trust assets in the future.
 - The court concluded that remainder interests are distinguishable from discretionary trusts in that: “[T]he value of such interests may be uncertain at the time of dissolution of marriage, they nonetheless constitute property because they are certain, fixed interests subject only to the condition of survivorship.”

Case Examples

In the Massachusetts Supreme Court, a similar decision was reached in the case of *Lauricella v. Lauricella*.

- In *Lauricella*, the beneficiary spouse had an interest in a trust subject to divestment only if husband did not survive until the trust terminated according to its terms.
 - Given husband's young age, the court concluded that the "likelihood is he will survive to receive his share..." Thus, the Massachusetts Supreme Court concluded that the fact that the valuation might be difficult, husband's interest was a divisible asset.
 - However, in a later case, *D.L. v. G.L.*, the Massachusetts Supreme Court engaged in further analysis on this topic indicating that trust documents should be examined closely in cases to determine "whether a party's interest is too remote or speculative to be so included."

TRUSTS AND DIVORCE

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Agenda

- Irrevocable Life Insurance Trust
- Qualified Terminable Interest Property (QTIP) Trust
- Qualified Personal Residence Trust (QPRT)
- Charitable Remainder Trust – Division on Divorce
- Decanting to Protect Trust Assets
- Section 682 - Alimony Trusts
- Domestic Asset Protection Trusts

THE MAJOR TAKEAWAY

In high net worth divorces, get a T&E attorney or a CPA with a solid tax background involved because this stuff is complicated

TRUSTS EXISTING AT TIME OF DIVORCE

IRREVOCABLE LIFE INSURANCE (ILIT) TRUST

Irrevocable Life Insurance (ILIT)

- Unless provided otherwise in the ILIT, the grantor-insured is not able to change the beneficial interests in the trust
- ILIT may provide that spouse's interest in trust terminates on divorce
 - May require another policy be purchased to satisfy the ex-spouse
- Another issue: former spouse may still be entitled to benefits if he/she survives the insured or may be a trustee or beneficiary of the ILIT
 - State law (e.g., UPC §2-804) may not revoke a former spouse's interest in an ILIT, unlike a revocable trust, where the spouse's interest terminates under UPC §2-804

Irrevocable Life Insurance (ILIT – Options)

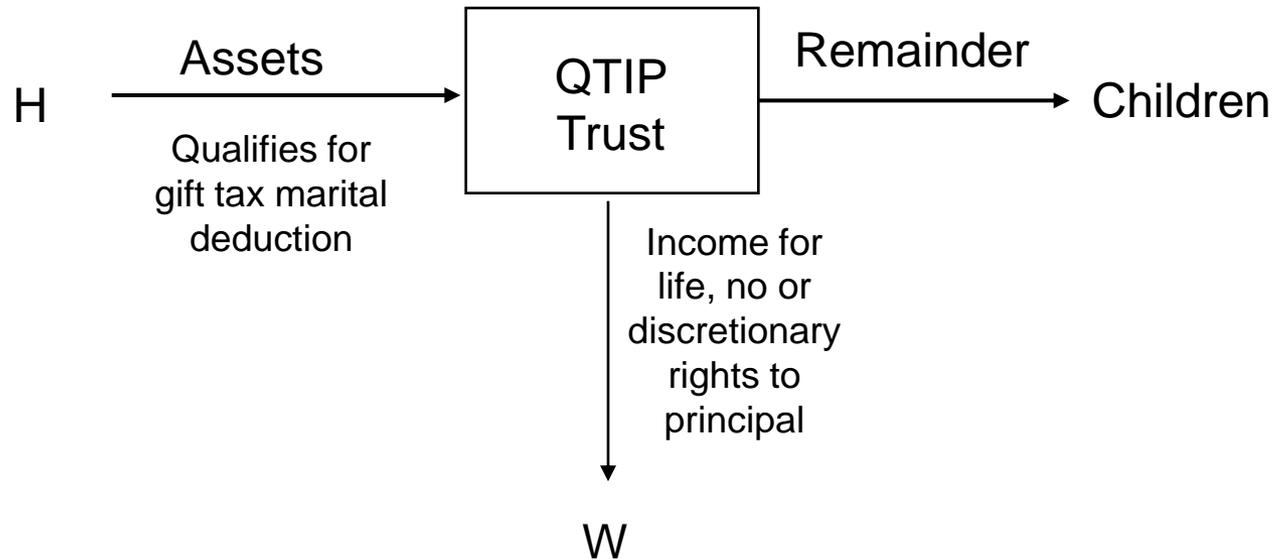
- Grantor's spouse could agree to disclaim or renounce his/her interests in the ILIT as part of the marital settlement agreement
- Grantor could request court to amend the ILIT to remove the ex-spouse as a beneficiary
 - Also, could modify the terms of the trust by means of a non-judicial settlement agreement. See, for example, Pennsylvania Uniform Trust Act
 - If permissible under state law, decant to a new trust
- Grantor can create a new ILIT and have it purchase the policy from the old ILIT for its interpolated terminal reserve value, thereby leaving just the sales proceeds in the old ILIT
 - Could be a breach of trustee's fiduciary duty if spouse is excluded as beneficiary of the new trust
- If grantor is still insurable, grantor could purchase a new policy (owned by a new ILIT) and have the trustee of the old ILIT surrender the old policy (leaving the cash surrender value in the old ILIT)

TRUSTS EXISTING AT TIME OF DIVORCE

QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUSTS

Inter Vivos QTIP

- Transfer assets to trust, income payable to spouse for life, remainder to children
- Qualifies for gift tax marital deduction
- Allows one spouse to give assets to the other spouse while retaining control over the remainder interest



Benefit: H retains control over principal

Inter Vivos QTIP – Tax Ramifications

- Under Section 672(e)(1)(A), inter vivos QTIP trust is a grantor trust
 - Grantor is treated as holding any power or interest granted to his/her spouse

- In the event of divorce, Section 682(a) provides that the income of the trust is thereafter includible in the beneficiary spouse's income

- Inter vivos QTIP is not terminated by divorce
 - Former spouse will retain his/her income interest for the remainder of his/her life, even if he/she remarries

 - Trust may be drafted so that a trustee's discretionary right to invade principal for the benefit of the spouse is contingent upon being married to the grantor

 - Trust may be drafted so that if parties divorce and trustee has right to distribute principal to ex-spouse, the discretionary principal distributions reduce amounts owed as alimony.

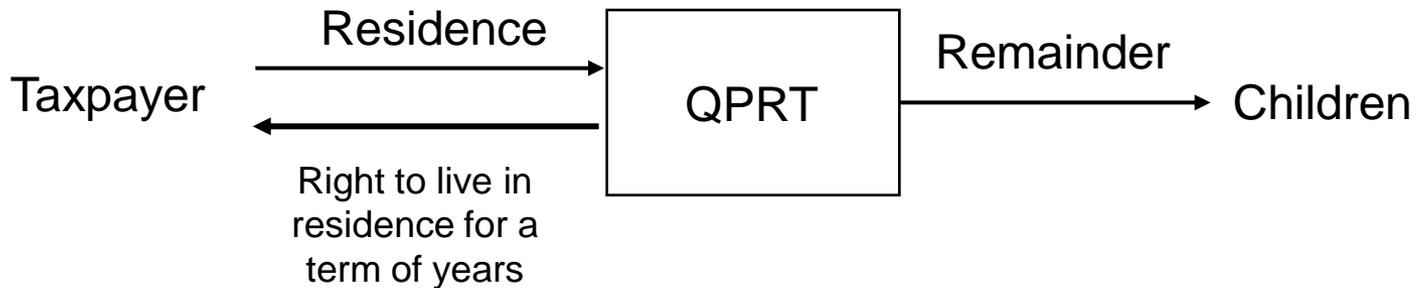
TRUSTS EXISTING AT TIME OF DIVORCE

QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRTs)

QPRTs

DEFINED

- Personal residence is transferred to an irrevocable trust, donor retains right to use the residence for a term of years after which the ownership passes to selected remainder beneficiaries (kids or a trust for the benefit of the kids)
- Result: residence transferred to children at reduced gift tax rate
- Lots of complicated statutory requirements



Benefit: Taxpayer gets residence out of his taxable estate at a reduced gift tax value

QPRTs

GOVERNING INSTRUMENT REQUIREMENTS

- Must prohibit commutation (prepayment) of the term holder's interest
- Must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term of the trust

QPRTs

RESIDENCE CEASES TO BE PERSONAL RESIDENCE OF GRANTOR

- Trust must terminate and all trust property must be distributed outright to the grantor within 30 days
- If governing instrument permits the trustee to hold the sale proceeds, the sale of the personal residence is not considered a cessation of use until the earliest of two years, the expiration of the term interest or the date a new residence is acquired

QPRTs

OPTION FOR HANDLING QPRT IN A DIVORCE

- Alternative #1: Unwind the QPRT – very difficult
 - QPRT is an irrevocable trust
 - If unwound, transfer tax savings are forfeited
 - Issue: do you get back any unified credit used to make the transfer
 - Children could disclaim their remainder interest
 - Difficult if minors or unborn descendants are involved
 - Disclaimer constitutes a taxable gift by the remaindermen

QPRTs

OPTION FOR HANDLING QPRT IN A DIVORCE

- Alternative #2: Let the QPRT run its course
 - Eventually the residence will pass to the remaindermen e.g., the children
 - Arrangements could be made to compensate the vacating spouse with other marital property equal to the value of the residency interest for his/her lost occupancy rights
 - One alternative as part of a property settlement may be to transfer one spouse's interest to the other spouse as part of a §1041 tax-free property transfer
 - Transfer should happen after the divorce is final to avoid Reg. 25.2702-5(c)(9) which prevents a transfer to a spouse during the retained term of the trust

QPRTs

OPTION FOR HANDLING QPRT IN A DIVORCE

- Alternative #2: Let the QPRT run its course (cont.)
 - If grantor spouse holds the residency interest and a reversionary interest (on his death before the expiration of the term), both the residency interest and the reversionary interest should be transferred to the transferee spouse.
 - *Transfer* reversionary interest to the transferee spouse. *Relinquishing* the reversionary interest would cause a taxable gift to the remaindermen e.g., children
 - In addition to the residency interest and the reversionary interest, the grantor spouse may have retained other rights which should be surrendered. Those rights may include:
 - Right to continue to use the home after the expiration of the residency interest for fair market rent
 - Right to remove and appoint trustees
 - Other “administrative” rights

QPRTs

OPTION FOR HANDLING QPRT IN A DIVORCE

- Alternative #2: Let the QPRT run its course (cont.)
 - Tax consequences of transfer of residency interest to transfer spouse
 - Income tax- tax-free under §1041
 - Gift and estate tax
 - Should be no problem as long as the interests transferred to transferee spouse are used by that spouse as a personal residence
 - IRS regulations do not require that the residency and reversionary interests be held by the original transferor, nor do they preclude the transfer of those rights. The only requirement is that the person holding those rights use the home as his or her personal residence.

QPRTs

RESIDENCE CEASES TO BE PERSONAL RESIDENCE OF GRANTOR

- Alternative #3: Sell the house on the open market and convert to an annuity
- Rather than have the QPRT terminate when there has been a cessation of use, the regulations provide that the governing instrument may either require, or give the trustee the option of, converting the trust into a GRAT for the balance of the term. Reg. 25.2702-5(c)(8).
 - Conversion to a GRAT must occur within 30 days after the date on which the trust ceases to be a QPRT
 - The annuity amount must be paid from the cessation date with interest at a rate not less than the Section 7520 rate in effect on the cessation date
 - Annuity cannot be paid unless the property (or some portion) is sold because the property typically is the only asset of the trust and the annuity cannot be paid with a promissory note or with the property itself.
 - If property is sold, QPRT is a grantor trust and each H and W must include half the gain as income on their individual income tax returns.
 - If sold to third parties, home no longer remains in the family

RESIDENCE CEASES TO BE PERSONAL RESIDENCE OF GRANTOR

- Alternative #4: Sell the property before the divorce and buy separate substitute properties
 - If only one spouse has a retained interest, the trustee may sell the residence and purchase a replacement residence for the grantor with a fraction of the proceeds
 - The non-reinvested proceeds would convert to an annuity payable to the grantor spouse satisfying the requirements of Reg. 25.2702-5(c)(8)
 - The annuity could, pursuant to the divorce agreement, be for the benefit of the non-grantor spouse.

RESIDENCE CEASES TO BE PERSONAL RESIDENCE OF GRANTOR

- Alternative #5: Sell to the non-grantor spouse
 - Reg. 25.2702-5(c)(9) says the governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor or the grantor's spouse during the retained term
 - Also, can't substitute non-grantor spouse for the grantor spouse for the duration of the term
 - Query – could the non-grantor spouse agree to purchase the residence from the trust after the divorce at FMV when he/she is no longer a spouse?
 - If so, should be income tax-free under §1041

QPRTs

CO-TENANCY OWNERSHIP

- Typically, spouses transfer title to residence to a T/C, each owning an undivided one-half interest, and then transfer the undivided interest in the residence into separate QPRTs, one for each spouse
- IRS takes the position that co-tenancy ownership with anyone other than a spouse or dependent child disqualifies a QPRT
- Thus, if both H and W establish separate QPRTs and then divorce, both trusts are disqualified
- Property would then have to convert to GRATs

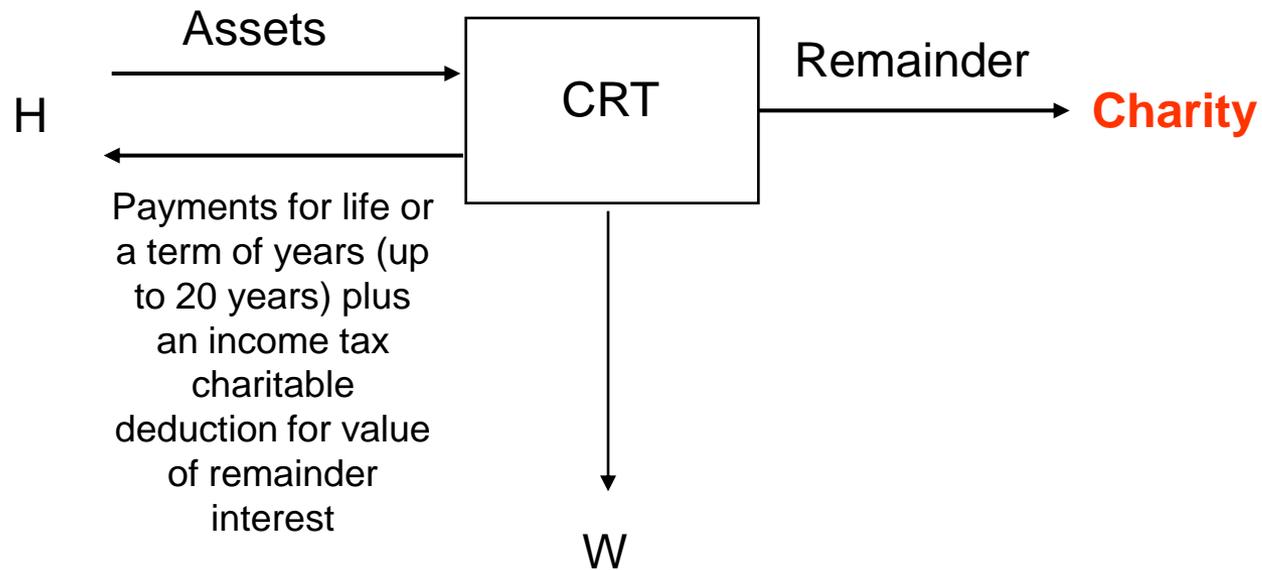
TRUSTS EXISTING AT TIME OF DIVORCE

CHARITABLE REMAINDER TRUST

Charitable Remainder Trust

DEFINED

- Irrevocable trust
- Payments to grantor for life or term of years (up to 20 years)
- Remainder interest payable to charity
- Benefit to grantor: payments for life or term of years (up to 20 years) plus income tax charitable deduction for value of remainder interest



Benefit: Payments to H plus income tax charitable deduction

CRT – Division on Divorce

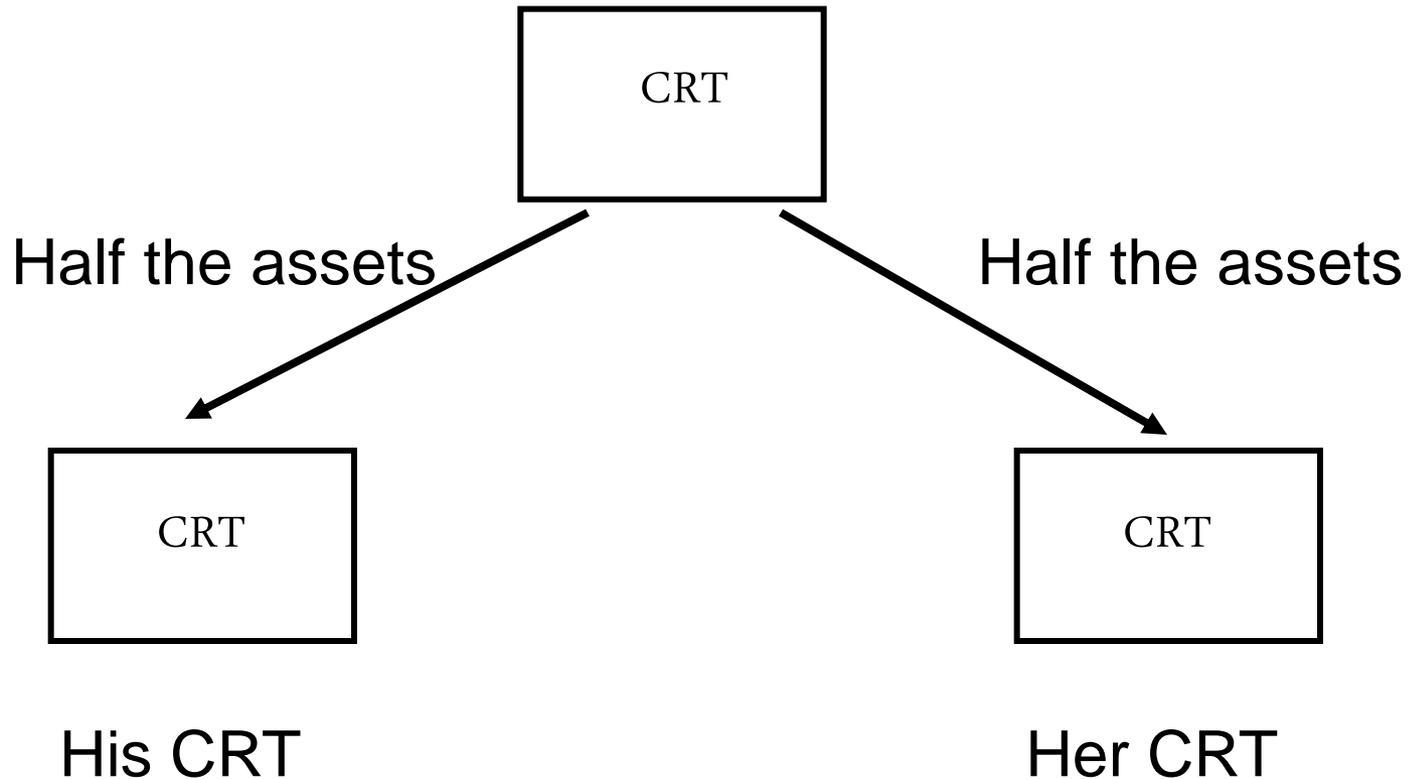
CRT MAY BE SPLIT INTO TWO CRTS TAX-FREE UPON DIVORCE

- One spouse gets a life interest in one CRT and the other spouse gets a life interest in the other CRT with the remainder interest in the trust going to the same charity as in the original CRT

BASIS AND HOLDING PERIOD OF ASSETS IN THE CRT WILL BE THE SAME AS BEFORE THE DIVISION

AUTHORITY: Rev. Rul. 2008-41; PLRs 201029002, 200824022, 200814003, 200744019, 200728026, 200616008, 200539008, 200524014, 200524013, 200502037, 200143028, PLR 200109006, PLR 200045038, PLR 200333013, PLR 200310120, PLR 200219012, PLR 200120016, PLR 200143028, PLR PLR 200035014

Division of CRT on Divorce



Same provisions as original CRT

CRT – Division on Divorce

IF CRT NOT SPLIT AT DIVORCE AND FORMER SPOUSE BECOMES THE LIFE BENEFICIARY AFTER THE DEATH OF THE GRANTOR/SPOUSE OF THE CRT, THE FORMER SPOUSE'S INTEREST NO LONGER QUALIFIES FOR THE ESTATE TAX MARITAL DEDUCTION

- Value of CRT will be includible in the estate of the deceased grantor
- Actuarial value of ex-spouse's interest will be subject to estate tax
- CRT will most likely have language suggested by Rev. Rul. 82-128 i..e. the surviving ex-spouse's right to become the income beneficiary of the CRT is contingent on the ex-spouse being responsible for the estate tax attributable to the inclusion of his/her interest in the deceased CRT grantor's estate.

CRT – Termination on Divorce

ALTERNATIVE TO DIVIDING A CRT – TERMINATE IT

- Determine present value of non-charitable beneficiary's income interest and the charitable beneficiary's remainder interest
 - Use methodology under Reg. 1.664-4 for valuing interests in CRT
 - Pay each the non-charitable income beneficiary and the charitable remainderman their actuarial value of the CRT
- Use discount rate under Section 7520 on date of termination
- Comply with state law i.e. get blessing of state attorney general
- Non-charitable income beneficiary and his physician must sign affidavit that non-charitable income beneficiary has no medical condition that is expected to result in a shorter life expectancy than set forth in the actuarial tables for a person of the non-charitable income beneficiary's age
- All beneficiaries must consent to the early termination
- Authority: numerous private letter rulings

CRT – Termination on Divorce

ALTERNATIVE TO DIVIDING A CRT – SELL INCOME INTEREST TO CHARITY

- Grantor can sell his income interest in the CRT to the charitable remainderman.
- Authority: PLR 200310024 and other private letter rulings

DECANTING TO PROTECT TRUST ASSETS

Decanting To Protect Trust Assets

Ferri v. Powell-Ferri, Case No. SJC-12070, 2017 Mass. LEXIS 198 (March 20, 2017)

- In March, 2011, following the filing of a divorce action in CT between the beneficiary and his wife, the trustees of the 1983 trust (under which the beneficiary had rights of withdrawal at stated ages) decanted its assets to a new (2011) spendthrift trust (under which the trustee had complete discretion as to distributions and which eliminated the beneficiary's withdrawal rights) without informing the beneficiary and without his consent.
- The trustees decanted the 1983 trust out of concern that the wife would reach the assets of the 1983 trust as a result of the divorce action.

Decanting To Protect Trust Assets

Ferri v. Powell-Ferri, Case No. SJC-12070, 2017 Mass. LEXIS 198 (March 20, 2017)

- Court held if trustee has the discretionary power to distribute property to or for the benefit of the beneficiaries, then the trustee likewise has the authority to distribute the property to another trust for the benefit of the those same beneficiaries.

- Concurring opinion of 3 judges made clear that SJC was not deciding whether Massachusetts law will permit trustees to decant for the sole purpose of removing the trust's assets from the marital estate that might be distributed to the beneficiary's spouse in a divorce action.
 - Court could find that decanting for such a purpose violates public policy
 - Trial court found decanting was done without beneficiary's knowledge or consent
 - Case answered question certified to it by Connecticut Supreme Court – opinion on public policy issue was not requested

STRUCTURING TRUSTS AS PART OF THE DIVORCE PROCESS

ALIMONY TRUSTS

Alimony Trusts

- Transfers in trust are frequently utilized in the context of divorce and separation.
- A trust provides the recipient spouse with a regular source of funds, rather than the payor spouse's unfunded promise to make alimony payments.
- Most transfers in trust fall under the rules of §1041(a) and do not result in the recognition of gain or loss to the transferor.
 - The transfer is treated as if the transferee spouse received the beneficial interest in the trust as a gift from the transferor spouse.
 - The trust obtains a carryover basis in the transferred property.
 - The transferor's transfer to the trust is generally protected from gift tax liability by §2516.

Alimony Trusts

- For income tax purposes, §682 applies to trusts involved in a divorce or separation, not §71.
 - §682 applies if the transferor and transferee are divorced, have a written separation agreement, or are legally separated.
 - §682 provides that the transferee spouse is taxed as a trust beneficiary, and not as the recipient of alimony, on the amount of any trust income that the transferee spouse is entitled to receive.
 - But for this provision, such trust income would otherwise have been taxable to the transferor spouse under the grantor trust rules of §§671-679 as payment used to satisfy the grantor's support obligation).

Alimony Trusts

- Since the recipient spouse is not receiving alimony, the transferor spouse is not entitled to an income tax deduction when the trust is created
- §682 does not apply to the portion of any income of a trust fixed as child support payments under a divorce decree, written separation agreement or the trust instrument.
 - Child support payments, made from a trust are considered payments for support, and the income attributable to them is taxed to the transferor spouse.
 - Thus, the rules of §682 tax the grantor spouse on trust income fixed for child support, and the beneficiary spouse is taxed on the balance of the trust income payable to him or her.
 - If the trust income in a given year is insufficient to make the required distributions for support of the spouse and for child support, income distributions are deemed to be applied first to child support. §682(a).

Alimony Trusts – Income Tax Issues

SECTION 682 TRUSTS – 3 CONDITIONS:

- The parties are divorced or separated under a decree of divorce or separate maintenance or under written separation agreement;
- The spouse/beneficiary is entitled to receive the “income” under the terms of the trust; and
- The income would otherwise have been taxable to the grantor spouse

Alimony Trusts

GOVERNED BY §682 of IRC

- Used to protect recipient spouse's interest in alimony where assets of obligor spouse could be jeopardized in the future or the alimony recipient is financially unsophisticated
- Obligor spouse transfers cash or assets to trust
- Managed by neutral third party trustee
- Trust provides that income from trust is payable to obligee spouse in satisfaction of alimony and/or support obligations
- Absent §682, obligor spouse taxable on trust income
- §682 taxes obligee/recipient spouse on trust income (except income for child support)
- Trust generally governed by rules of Subchapter J

Alimony Trusts

ADVANTAGE OF ALIMONY TRUST

- Minimizes or eliminates post-divorce interaction between spouses
 - Transferee spouse would prefer to look to trustee for payment

- Guarantees that payments will be made
 - Ex-spouse could otherwise refuse to pay
 - Ex-spouse could die
 - Ex-spouse could have financial problems or lose assets to creditors

- Opportunity for professional money management

- Benefit of third party (trustee) oversight

- Provides transferor spouse with a way of protecting assets used to fund the settlement e.g., a closely held business interest

Alimony Trusts

ADVANTAGE OF ALIMONY TRUST

- ❑ Payments can continue after the death of the payee spouse (unlike alimony)
- ❑ Payments can be frontloaded without fear of recapture (unlike alimony)
- ❑ Payments may be reduced for contingencies related to the child (unlike alimony).
- ❑ May avoid estate tax
- ❑ Gives transferor spouse assurance that assets not consumed by the transferee spouse will ultimately pass according to transferor's wishes at transferee's death

Alimony Trusts

PLR 200408015

- Couple gets divorced
- As part of settlement, H sets up a trust to pay a fixed monthly amount to W for life
- On death of W balance of trust payable to children
- Trust required to be invested in munis so there is no taxable income
 - If invested in other assets, W would have been taxable on income payable to her under §682, and since trust was set up as a grantor trust, H would have been taxable on balance of the income

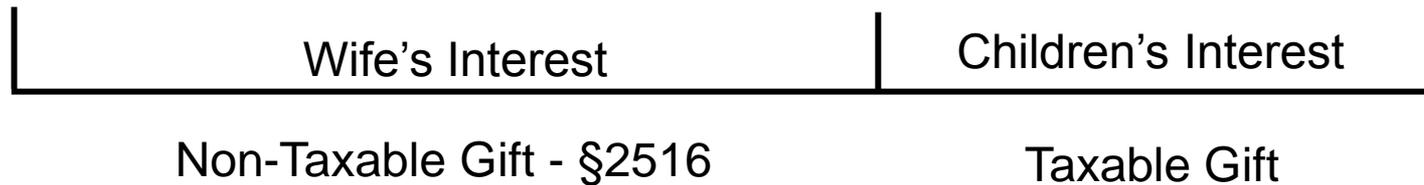
Alimony Trusts

PLR 200408015

- Gift tax – W received interest pursuant to a divorce so her interest not a taxable gift pursuant to §2516.
 - Only taxable gift was the gift of the remainder interest to the children
 - The spouse’s “annuity” interest and the children’s remainder interest valued under §7520
 - Low interest rate environment results in higher value for the spouse’s “annuity” and a lower value for the children’s remainder interest. Thus, it is possible to zero out the value of the remainder interest.

- Estate tax – H didn’t retain any interest in the trust so the trust assets are not included in his estate
 - Since the trust is not a QTIP trust, the trust assets not included in W’s estate either

Trust: Fixed monthly amount to Wife, remainder to children



Alimony Trusts

PLR 200408015

- Bottom line: if the trust's investment performance exceeds §7520 rate used in valuing annuities, the excess will pass to the children free of estate or gift tax.
- This is better than giving the assets to W outright because any assets remaining at W's death will be included in W's estate

Alimony Trust – Avoiding a Taxable Gift - §2516

HOW TO AVOID TAXABLE GIFT WHEN ESTABLISHING AN ALIMONY TRUST

- Generally, comply with Section 2516

Alimony Trust – Avoiding a Taxable Gift - §2516

GIFT TAX CONSEQUENCES - §2516

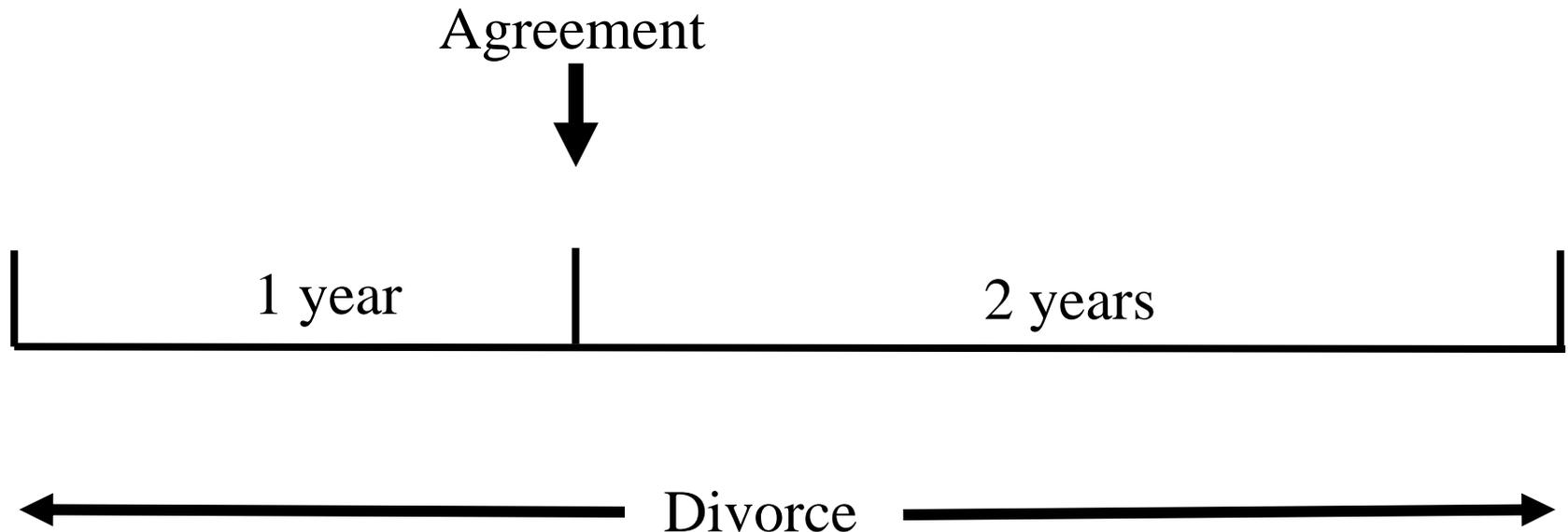
- Payments of alimony, support for minor child and property settlements made under agreement meeting requirements of §2516 are deemed made for adequate consideration i.e. no gift

- §2516 requirements:
 - Must be a written agreement
 - Regarding spouse's marital or property rights or to provide support for *minor* children
 - §2516 does not apply to transfers to adult children
 - Final decree of divorce required for §2516 to apply
 - Decree of separation, separate maintenance or annulment will not suffice
 - Not necessary for agreement to be adopted, approved or even submitted to court
 - Only payments designated and required by the agreement qualify as non-gifts
 - Divorce must be final either one year prior to or two years after the written agreement

- Transferee takes transferor's basis and holding period

- Note: a divorce transfer not exempt under §2516 may escape tax under general gift tax principles

Alimony Trusts – Avoiding a Taxable Gift - §2516



Note: the property transfer can be made at any time

DOMESTIC ASSET PROTECTION TRUSTS

Domestic Asset Protection Trusts

IRREVOCABLE TRUST – SELF-SETTLED TRUSTS

- Created by party who is also a beneficiary
- Common law rule: assets in self-settled trust are subject to donor's creditors e.g. spouse for support
 - Restatement (Third) of Trusts and UTC in accord

Domestic Asset Protection Trusts

IRREVOCABLE TRUST – DAPT

- Designed to protect self-settled trusts from creditors
- Alaska, Colorado, Delaware, Hawaii, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia and Wyoming have enacted self-settled trust legislation
- Creditors not permitted to reach assets of trust
 - ❑ In most cases (except Alaska, Nevada, Virginia and Wyoming) spouses excluded from list of creditors who cannot reach trust assets
 - ❑ In a number of DAPT states the spouse must be married to the grantor at the time of the transfer to the DAPT to be an exception creditor
 - ❑ Otherwise, spouse has to sue with the S/L claiming a fraudulent transfer and prove an actual intent to defraud – not easy
 - ❑ UTC has rejected approach taken in DAPT states

Domestic Asset Protection Trusts

PROBLEM WITH PRE-NUPTIALS

- As a contract, must be free from fraud, duress, undue influence, overreaching and unconscionability
- A self-settled trust may be an alternative to a pre-nuptial agreement
 - Doesn't require the consent of a future spouse

Domestic Asset Protection Trusts

SEMINAL CASE – NICHOLS V. EATON (USSC 1875)

- USSC says people have the right to dispose of their assets in whatever manner they wish
- There is almost no potential as a creditor for accessing property that is held in a spendthrift trust
- However, there are certain creditors where public policy dictates that their claims be enforceable even against spendthrift trusts e.g. spouse and children
 - These creditors are called exception creditors
 - The public policy of seeing exception creditors being paid on their claims outweighs the public policy of enforcing the terms of a spendthrift trust

Domestic Asset Protection Trusts

BACKGROUND

- Historically, self-settled trust have been against public policy
 - That is the position of Uniform Trust Code. See comment to Section 502 of the UTC.

- Since 1997 in the United States a number of states have enacted domestic asset protection trust statutes

- Currently there are 15 states: AK, CO, DE, HI, MO, MS, NV, NH, OH, RI, SD, TN, UT, VA and WY. OK also has an ineffective DAPT statute.

Domestic Asset Protection Trusts

DELAWARE

- There are limited circumstances where a creditor will be able to enforce a claim against the trust property
 - First situation: There was a fraudulent transfer into the trust
 - If claim arose after the transfer to the trust, creditor must prove the transfer was made with actual intent to defraud.
 - S/L for fraudulent transfer depends on whether the claim arose before or after the funding of the trust
 - If claim arose before funding of the trust, S/L is 4 years from the date of the trust funding or 1 year from the discovery of the funding of the trust
 - If claim arose after the funding of the trust, S/L is a fixed 4 years from date of trust funding

Domestic Asset Protection Trusts

DELAWARE

- There are limited circumstances where a creditor will be able to enforce a claim against the trust property
 - Second situation: if the creditor is an exception creditor
 - 2 classes of exception creditors: (1) certain tort claims and (2) spousal and child support claims
 - However, DE statute defines a spouse or former spouse as persons married to transferor before the trust was funded.

Domestic Asset Protection Trusts

DELAWARE

- There are limited circumstances where a creditor will be able to enforce a claim against the trust property
 - If person funds a DE DAPT and later gets married and then gets divorced, his spouse or former spouse is not an exception creditor
 - Spouse would have to proceed against the trust like any other creditor i.e. argue within the S/L that the transfer was done with intent to defraud
 - Even if there was an intent to defraud, spouse would have to sue within the 4 year S/L
 - If trust was established 4 years before marriage, off the hook
 - If parties marry before 4 years from the date the trust was established, stay married for 4 years and you're off the hook

Domestic Asset Protection Trusts

NEVADA

- There is no provision for making a spouse or former spouse an exception creditor
- Creditor must prove that transfer was fraudulent by clear and convincing evidence
- S/L for transfers made before the marriage is 2 years from the date of funding of the trust
- There are 4 states where a spouse is not an exception creditor: AK, NV, VA, WY

Domestic Asset Protection Trusts

CAN A PERSON ALREADY MARRIED WHO WANTS TO PROTECT ASSETS GO TO A STATE LIKE AK, NV, VA OR WY AND SET ASIDE PROEPTY IN A DAPT AND PROTECT IT IN A DIVORCE?

- Yes
- But better to establish self-settled trust before one gets married in a DAPT state

Domestic Asset Protection Trusts

THREE SIGNIFICANT CHALLENGES TO DAPT

- Must be separate property – can't be marital property
- Funding was a fraudulent transfer
- Conflict of laws issue – can settlor domiciled in one state create a trust governed by the law in another state?
 - Restatement 2d of Conflict of Laws Section 273 – validity of trust determined by law of the state where settlor has manifested an intention that the trust is to be administered
 - Scott and Ascher on Trusts – law of the state of administration governs

Thank You!