Drafting Trusts for Maximum Asset Protection from Creditors

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In the past, it was quite common to draft estate plans so as to distribute assets outright to beneficiaries at the decedent's death. However, the increase in marital separation and dissolution, combined with a judicial system that has allowed ever-expanding theories of liability[1] and skyrocketing jury awards, calls into doubt the prudence of this type of planning. Many aspects of a traditional estate plan such as wills or revocable living trusts can provide asset protection for the surviving spouse as well as the remainder beneficiaries (typically children and grandchildren).

Drafting Revocable Living Trusts and Testamentary Trusts

State law generally provides that a creditor "steps into the shoes" of the judgment debtor. As a result, a creditor may—after obtaining a court order—generally exercise any right or power that the beneficiary has to demand income or principal from a trust for the benefit of that beneficiary.[2] Therefore, a revocable trust should contain a spendthrift provision that prevents the beneficiary from assigning his trust interest.

Spendthrift Trusts

A spendthrift trust is defined as a "trust created to provide a fund for the maintenance of a beneficiary and at the same time to secure the fund against his improvidence or incapacity."[3] Today, the validity of spendthrift trusts is recognized to varying degrees by virtually every state. A spendthrift trust is a trust with a restriction that prevents the beneficiary from voluntarily, or involuntarily, assigning his interest.

Some legislatures and courts have eroded the asset protection of spendthrift provisions over time, although other states' legislatures and courts have maintained, and even enhanced, the protections afforded by spendthrift trusts. The Restatement of Trusts and the Uniform Trust Code (UTC) provide the following exceptions to a spendthrift provision: (1) child support and alimony,[4] (2) necessaries,[5] (3) services rendered and material furnished which preserve or benefit the interest of the beneficiary,[6] and (4) claims against the beneficiary by the United States or a state.[7] Many states have adopted some or all of these exceptions.

One example of judicial erosion of spendthrift protection is *In re Marriage of Gorman*,[8] which involved a marital dissolution proceeding for Edward and Cynthia Gorman. Edward's father had died a number of years earlier, leaving assets in trust for his wife (income and discretionary principal distributions), with the remainder to go to Edward and his siblings. The trust contained a spendthrift provision. Edward's mother, age 86, also had a revocable trust with spendthrift provisions and similar distributions to Edward and his siblings at her death. Cynthia contended that the marital property subject to division in their divorce proceeding included the appreciation in the assets of Edward's parents' trusts.

The trial court held that Edward's interests in the trusts were mere expectancies because his mother—by the terms of the trust—could exhaust the principal in Edward's father's trust and could revoke her own inter vivos trust. On appeal, the Colorado Court of Appeals reversed, finding that Edward had a vested property right both in his father's trust (subject to possible exhaustion by mother's withdrawals of principal) and in his mother's trust (subject to her revocation of the trust). The court of appeals ruled that, despite each trust's spendthrift provision, a portion of Edward's interest in the trusts constituted marital property subject to division in the divorce proceeding.[9]

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1. Barry S. Engel, David L. Lockwood, and Mark Merric, Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning, ¶ 135.01 (CCH, Inc. 2000).
2. Engel, supra n. 1, at ¶ 915.02.
3. Black's Law Dictionary 1400 (6th ed., West 1990).
4. Restatement (Second) of Trusts §157(a) (2000); Restatement (Third) of Trusts (2nd tent. draft 2003) § 59(a); Uniform Trust Code (UTC) § 503(a) (2002).
5. Restatement (Second), supra n. 4, at § 157(b); Restatement (Third), supra n. 4, at § 59(2).
6. Restatement (Second), supra n. 4, at § 157(b); Restatement (Third), supra n. 4, at § 59(c); UTC, supra n. 4, at § 503(b).
7. Restatement (Second), supra n. 4, at §157(c); Restatement (Third), supra n. 4, at § 59(c); UTC, supra n. 4, at § 503(c).
8 In re Marriage of Gorman, 36 P.3d 211 (Co. App. 2001).
9. The holding in Gorman was subsequently overruled by an amendment of C.R.S. § 14-10-113 (2001) by the Colorado legislature in S.B. 02-160. For another case in which the spendthrift provision of a trust created by a third party was ignored in a divorce proceeding of a beneficiary of such trust, see Dwight v. Dwight, 774 N.E.2d 1149 (Mass. App. Ct. 2002).

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Contrast *Gorman* with *Scheffel v. Krueger.*[10] In 1985, Grandmother Krueger established an irrevocable spendthrift trust for her grandson, Kyle Krueger. The trust provided that Krueger was to receive all the net income and discretionary principal distributions for maintenance, support, and education until Krueger attained age 50,[11] at which time the trust assets would be distributed to him. In 2001, Krueger was convicted of sexually molesting a minor child, and the child's mother, Mrs. Scheffel, sued for damages on behalf of her minor daughter. The court entered a default judgment for $551,286 in damages, and Mrs. Scheffel sought to attach Krueger's beneficial interest in his grandmother's trust.

The trial court ruled that the spendthrift provisions of the trust barred attachment. Mrs. Scheffel appealed, arguing that the state (New Hampshire) spendthrift statute was not intended to bar a claim for a tort of the beneficiary, especially one for which the beneficiary had been criminally convicted. The New Hampshire Supreme Court affirmed, interpreting the spendthrift statute very strictly. The Supreme Court held that the legislature's intent in affording protection under the statute was clear, and the court was unable to create a public policy exception—even for acts as egregious as Krueger's.[12]

Doctrine of Merger

In drafting a trust for spendthrift protection, a prudent estate planner should be concerned about the doctrine of merger. Section 341(1) of the Restatement (Second) of Trusts (Restatement (Second)) provides that "[e]xcept as stated in Subsection (2), if the legal title to the trust property and the entire beneficial interest become united in one person who is not under an incapacity, the trust terminates." Subsection (2) provides an exception when a beneficiary having the entire beneficial interest in the assets of a spendthrift trust becomes the sole trustee without his consent. In that case, the beneficiary can procure the appointment of a new trustee and have the trust reconstituted. However, if a creditor of the beneficiary were to attach the trust assets before the beneficiary appointed a new trustee and reconstituted the trust, those assets would not have spendthrift protection in most states.[13]

The rights of a creditor under section 60 of the Restatement of Trusts (Third) (Tentative Draft No. 2) (Restatement (Third)) are dramatically different when it comes to a beneficiary acting as trustee. The creditor is able to reach the *maximum* amount the trustee-beneficiary can properly take. The trustee-beneficiary's rights and authority represent a limited form of ownership equivalence analogous to certain general powers under section 56, Comment b, of the Restatement (Third)—which essentially disregards the trustee-beneficiary's fiduciary position and treats the beneficiary as if he were the settlor of the trust and disregards any remainder beneficiaries.[14]

Mandatory Distributions

Mandatory income distributions. Upon the death of the first spouse to die, it is common for a revocable trust to split into a bypass (or credit shelter) trust and a marital trust. Upon the death of the surviving spouse, many estate-planning documents provide for continuing trusts for children or other beneficiaries. The terms of these sub-trusts often provide for mandatory distributions of income at least annually. Of course, in the case of a marital trust designed to qualify for QTIP treatment under IRC Section 2056(b) (7), distribution of all the net income to the surviving spouse at least annually is a prerequisite for obtaining the marital deduction.

For the other types of sub-trusts, a common reason for providing mandatory distributions is to minimize income tax. A mandatory distribution of income from a trust is taxed at the beneficiary's marginal tax rate[15] rather than the potentially higher marginal income tax rate of the trust. However, a discretionary distribution of income to a beneficiary is also taxed at the beneficiary's marginal rate,[16] as opposed to the trust's rate—but discretionary distributions offer more flexibility as well as greater asset protection possibilities.

The Restatement (Second) states that "[a]fter the income of a spendthrift trust has been paid to the beneficiary it can be transferred by him and can be reached by his creditors;" this rule is followed by the vast majority of states. [17] The approach of paying all income to the beneficiaries of the sub-trust should be rethought if one reason for creating the trust is to protect the trust income from the creditors of the surviving spouse or the remainder beneficiaries.

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10. Scheffel v. Krueger, 782 A.2d 410 (2001).
11. Kyle Krueger would not reach age 50 until 2016.
12. For another view on this case, see Steven J. Oshins and Christopher M. Riser, Scheffel v. Krueger: The Effectiveness of Statutory Spendthrift Trusts, 140 Tr. & Est. 10, 12 (Oct. 2001).
13. See George Gleason Bogert, George Taylor Bogert, and Amy Morris Hess, The Law of Trusts and Trustees, §§ 129 and 1003 (rev. 2d ed., West 1992 and Supp. 2001); Mark L. Ascher, Austin Wakeman Scott, William Franklin Fratcher, Scott on Trusts, § 341.1 (4th ed., Little, Brown & Co. 1987); Larry D. Scheafer, Trusts: Merger of Legal and Equitable Estates Where Sole Trustees Are Sole Beneficiaries, 7 A.L.R.4th 621 (1979).
14. See also Stephen E. Greer, "The Alaska Dynasty Trust," 18 Alaska L. Rev. 253, 272 (2001).
15. The required income distribution causes the sub-trust to be classified as a simple trust under Internal Revenue Code § 651. See Byrle Abbin, Income Taxation of Fiduciaries and Beneficiaries, § 403 (Aspen 2002).
16. Treas. Reg. § 1.661(a)-2(a) (2001); See also Byrle Abbin, supra n. 15, at §404.
17. Restatement (Second), supra n. 4, at § 152, cmt. j.

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Mandatory principal distributions. Under the Restatement (Second), a spendthrift provision is valid for a beneficiary who is entitled to have the principal conveyed to him at a future time.[18] Most states follow this rule, but a minority of states find restraints on a beneficiary's right to receive the principal of a trust to be invalid. If the "beneficiary is entitled to have the principal conveyed to him immediately, a spendthrift provision would be invalid,"[19] but a minority of states hold that, the trust principal is not reachable by creditors until the beneficiary has received it. Although the weight of authority is that no spendthrift protection is available if the beneficiary is entitled to an immediate distribution of principal, a minority of states have recognized spendthrift provisions where the beneficiary can elect whether to take the principal or leave it in trust for his benefit.[20]

As the *Scheffel* case illustrated, the payment of principal at a specified age or series of ages (e.g., one-third of the trust at age 25, one-half of the remaining trust at age 30, and the remainder at age 35) will, in a majority of states, protect the trust assets from a beneficiary's creditors until the beneficiary attains the designated age or ages. Upon reaching the designated age, however, any principal distributed to the beneficiary would then be attachable by his creditors.

Five-and-Five Powers

Because a creditor may also exercise any power of appointment a beneficiary has over a trust,[21] giving the surviving spouse a "five-and-five power" over the bypass trust should be strongly reconsidered. While a five-and-five power gives the surviving spouse added comfort that she will be able to invade the trust principal during her lifetime, it also enables creditors to reach the trust principal on a recurring basis.

For instance, suppose a bypass trust provides the surviving spouse with a five-and-five power and is funded with $1 million at the first spouse's death. Such a trust would permit the surviving spouse's creditors to access $50,000 (disregarding growth or loss in the trust assets) each year that the surviving spouse remains alive, regardless of whether the surviving spouse actually exercised the five-and-five power. Therefore, if a decedent has died leaving the surviving spouse with a five-and-five power over the bypass trust, the surviving spouse should consider a qualified disclaimer of such power if there is concern regarding future creditors of the surviving spouse (assuming the surviving spouse has no creditors pursuing her at the time of the first spouse's death).

Support Trusts

A support trust is "[a] trust which empowers the trustee to pay to the beneficiary only so much of the trust's income [and principal] as is necessary for the beneficiary's support, education and maintenance."[22] The Restatement (Second) provides that the creditors of a beneficiary of a support trust cannot reach his interest and such beneficiary cannot transfer his interest,[23] not because of any prohibition against alienation, but because the beneficiary (and thus, his creditors) cannot compel distributions from the trustee other than for the restricted purpose set forth in the trust instrument.[24]

Language that creates a support trust is typically mandatory. A support trust usually includes language specifying that the trustee "shall" make distributions.[25] In addition to mandatory language of distribution, the trustee is given a standard for making such distributions, which may be reviewed by a court for reasonableness. Typically, the drafter provides for support distributions for the beneficiary's "health, maintenance, support and education." However, on occasion, the drafting attorney includes the terms "welfare and/or comfort."[26] As one can see by the type of language used, the discretion given a trustee of a support trust for making distributions relates only to the time, manner, or size of the distributions—not to whether to make the distributions to the beneficiary.[27]

When drafting a support trust, the attorney should include a spendthrift clause. Without such a clause, any surplus income not necessary for the beneficiary's support could be subject to seizure by the beneficiary's creditors. This provision has been statutorily mandated in certain states. For instance, New York law provides that where no valid direction for the income is given in the trust document, the beneficiary's creditors can reach income in excess of what is necessary for support and educa-

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18. Restatement (Second), supra n. 4, at § 153(1).
19. Id. at § 153(2).
20. Id. at § 153, cmt. c. See also Peter Spero, Asset Protection: Legal Planning, Strategies and Forms, ¶ 6.09[4] (Warren, Gorham & Lamont 2002); Bogert, supra n. 13, at § 228; Scott, supra n. 13, at § 153; In re Arney, 35 B.R. 668 (Ill. 1983); Ober v. Dodge, 231 N.W. 444 (1930); Darling v. Dodge, 206 N.W. 266 (1925); Davis v. Harrison, 240 F. 97 (9th Cir. 1917); Cashman v. Bangs, 86 N.E. 932 (1909).
21. Engel, supra n. 1, at ¶ 915.03; Rothschild, "Protecting the Estate from In-Laws and Other Predators," 35 U. Miami Heckerling Inst. on Est. Plan., at ¶¶ 1707.13-1707.14 (2001).
22. Black's Law Dictionary, supra n. 3, at 1513.
23. Restatement (Second), supra n. 4, at § 154.
24. Id. at §154, cmt. b.; Greer, supra n. 14, at 269; Bogert, supra n. 13, at § 229; Scott, supra n. 13, at § 154; Spero, supra n. 20, at ¶ 6.04; Rothschild, supra n. 21, at ¶ 1706.
25. Lineback ex rel. Hutchens v. Stout, 339 S.E.2d 103 (1986).
26. The terms "welfare" and "comfort" are not an ascertainable standard for purposes of Internal Revenue Code § 2041, and will result in estate tax inclusion. See Treas. Reg. § 20.2041-1(c)(2) (2001).
27. Eckes v. Richland County Social Servs., 621 N.W.2d 851 (2001).

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tion.[28] California law also provides that income or principal payable to a beneficiary, in excess of the amount needed for support and education, can be used to satisfy judgments against the beneficiary.[29]

In defining support, courts tend to give deference to the settlor's intent. Consequently, the trust should be drafted to define support as broadly as possible, after taking into account the goals of the settlor. If the settlor's intent is undefined in the document, jurisdictions vary tremendously as to how they define support. Some jurisdictions define support by looking at the beneficiary's lifestyle prior to the creation of the trust ("station in life" standard).[30] Other jurisdictions review the beneficiary's circumstances without regard to lifestyle.[31] Still other states examine the beneficiary's current lifestyle without reference to any prior lifestyle, and some jurisdictions have not resolved the matter.[32]

The beneficiary of a support trust cannot assign his interest, and a trustee cannot be compelled to honor a purported assignment by the beneficiary, even if the trustee is aware of it.[33] Absent a spendthrift clause, though, it may be possible for the beneficiary to assign a vested interest in the principal of a support trust, such as where the trust provides that the beneficiary is to receive some or all of the trust assets at a given age.[34]

A support trust is a good drafting alternative either (1) in a jurisdiction that does not recognize spendthrift trust provisions, or (2) where the settlor is not comfortable with the more expansive power given the trustee of a fully discretionary trust (see discussion below).

Other Types of Trusts

Spray Trusts. A spray trust, also sometimes referred to as a blend, sprinkling or protective trust, is a trust where "the trustee has the discretion to either distribute or accumulate the ... income [and principal] of the trust and distribute it among the trust's ... beneficiaries in varying magnitudes."[35] This type of trust provides asset protection for the beneficiaries because no one beneficiary can claim a portion of the trust. The trustee has discretion to make distributions to some or all of the beneficiaries, and to exclude anyone in the class of beneficiaries.[36] Arguably, because a beneficiary cannot compel a distribution from the trustee of a discretionary spray trust, a spray trust also provides protection from claims of the Internal Revenue Service and other taxing authorities for taxes owed by a beneficiary.[37]

Discretionary trusts. Discretionary trusts offer the greatest asset protection of any planning strategy under a revocable trust. A discretionary trust is one in which the trustee has discretion "as to whether and when distributions may be made to beneficiaries."[38] This protection, which is much greater than the protection of a spendthrift trust, comes at the price of leaving the beneficiary at the mercy of the trustee's judgment to withhold or distribute trust income and principal. It is the very nature of this type of trust and the fact that the beneficiary cannot compel a trust distribution that provides the asset protection.[39] The protection is so great that in most jurisdictions it cannot be undermined to pay claims for taxes or child support.[40] A discretionary trust is most appropriate if the beneficiaries are subject to a high degree of risk and the settlor is comfortable that the trustee will act in accordance with the settlor's wishes.

Generally, a discretionary trust is drafted with permissive language. The trustee "may" (as opposed to "shall") make distributions.[41] Nevertheless, some courts have held that a mandatory distribution requirement combined with "sole and absolute discretion" of the trustee resulted in the creation of a discretionary trust.[42] Other courts have found that the explicit language permitting the trustee to exclude or discriminate among beneficiaries was a major factor in concluding that a trust was a discretionary trust.[43]

Depending on the jurisdiction, a discretionary trust subject to a distri-

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28. N.Y. EPTL § 7-3.4 (2003).
29. Cal. Prob. Code § 15307 (2003).
30. California adopted this standard at Cal. Prob. Code § 15307 (2003) (comment by California Law Revision Commission).
31. N.Y. CPLR §§5226 and 5226.2 (2003).
32. Spero, supra n. 20, at ¶ 6.04; C. R. McCorkle, Surplus Income of Trust in Excess of Amount Required for Support and Education of Beneficiary; as Subject to Claims of Creditors, 36 A.L.R.2d 1215 §4 (1954).
33. Restatement (Second), supra n. 4, at § 154, cmt.c; Bogert, supra n. 13, at § 229; Scott, supra n. 13, at § 155; Spero, supra n. 20, at ¶ 6.04; Rothschild, supra n. 21, at ¶ 1706.1.
34. In re McLoughlin, 507 F.2d 177 (1975); Seattle First Nat'l Bank v. Crosby, 254 P.2d 732 (1953); Epstein v. Corning, 22 A.2d 410 (1941).
35. Black's Law Dictionary, supra n. 3, at 1513.
36. Restatement (Second), supra n. 4, at §§ 161, 162 cmt. a; Bogert, supra n. 13, at § 230; Spero, supra n. 20, at ¶¶ 6.05, 6.10(6)(b); Rothschild, supra n. 21, at ¶ 1707.3.
37. Magavern v. U.S., 550 F.2d 797 (1977), 39 A.F.T.R.2d 77-968, 77-1 USTC ¶ 9249.
38. Black's Law Dictionary, supra n. 3, at 1510.
39. Restatement (Second), supra n. 4, at §155 cmt. b; Bogert, supra n. 13, at § 228; Scott, supra n. 13, at § 155; Spero, supra n. 20, at ¶ 6.03(1); Rothschild, supra n. 21, at ¶ 1705.1.
40. Spero, supra n. 20, at ¶6.03(1).
41. State ex rel. Secretary of Social and Rehabilitative Servs., v. Jackson, 822 P.2d 1033 (1991).
42. Myers v. Kansas Dept. of Social and Rehabilitative Servs., 866 P.2d 1052 (Kan. App. 1994).
43. McNiff v. Olhstead County Welfare Dept., 176 N.W.2d 888 (Minn. App. 1970).

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bution standard may or may not provide protection from the beneficiary's creditors. In some jurisdictions, the inclusion of a standard is fatal. For instance, in *Martin v. Martin*,[44] the court held that a trustee could be compelled to make distributions that were subject to the beneficiary's creditors' claims. The trust instrument in *Martin* required that the trustee exercise his discretion after taking into account the beneficiary's needs for education, care, and support.[45] Similarly, in *Taylor*,[46] the court noted that the trust instrument stated that the trustee "shall pay" so much of the trust income as the trustees deem necessary for the health care, maintenance, and support of the beneficiary. The court ruled that this provision showed the settlor's intent for mandatory distributions, and the trust was held not to be a discretionary trust.[47]

There is a trend toward eliminating the distinction among support trusts, discretionary trusts, and discretionary trusts with distribution standards.[48] The UTC provides that "whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to a trustee's discretion, even if: (1) the discretion is expressed in the form of a standard of distribution; or (2) the trustee has abused the discretion.[49] To the extent a trustee has not complied with a standard of distribution or has abused his discretion: (1) a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse; and (2) the court shall direct the trustee to pay the child, spouse, or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion."[50]

Thus, the general rule under the UTC is that a creditor cannot compel the trustee to distribute from a discretionary trust, even if the trustee has failed to comply with the distribution standard or has abused his discretion. The one exception is for support claims of a child, spouse, or ex-spouse. Otherwise, the power to force a distribution lies solely with the beneficiary.[51]

The asset protection of a discretionary trust is not available "where the trustee has discretion merely as to the time [and manner] of payment, and where the beneficiary is ultimately entitled to the whole or to a part of the trust property."[52] Accordingly, to achieve maximum protection from a discretionary trust, the trust should provide that the trust assets can be held in trust indefinitely, and the trust should contain a spendthrift provision.

For example, in *McDonald v. Evatt,*[53] the court found that a trust was not discretionary because the trustee could pay something or nothing, so the trustee's discretion related merely to the time of payment. The testamentary trust in question provided that the trustees could pay from net income "such sums of money as they may deem best fit and proper," if in their opinion it was fit and proper to do so. Similarly, in *In re Nicholson's Estate*,[54] the court held that language keeping all moneys and other things of value in trust for two boys, to be distributed at the trustee's discretion, afforded discretion only as to the time and manner of payment. Finally, in *Kammholtz v. Allen*[55] and *In re Neumeister's Estate,*[56] the courts found differences between (1) a discretionary trust in which the trustee has unlimited discretion as to whether the beneficiary should receive anything, and (2) a trust in which distributions to beneficiaries by the trustee were conditioned merely upon the occurrence of an event.

Shifting trusts. To give the beneficiary greater flexibility, it is sometimes possible to draft a trust to allow a shift in its purpose, terms, and beneficiaries. Whether a shifting provision in a trust prevents attachment by a beneficiary's creditors depends on the nature of the creditor's claim and the interest, if any, that the beneficiary retains after the shift occurs. The higher the priority of the claim, the less interest in the trust property the beneficiary can retain if absolute

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44. Martin v. Martin, 374 N.E.2d 1384 (Oh. App. 1978).
45. Cf. Lineback, supra n. 25; Chenot v. Bordeleau, 561 A.2d 891 (1989); Myers, supra n. 42 (where language referencing a distribution standard was not found to cause the trust to be classified other than as a discretionary trust).
46. U.S. v. Taylor, 254 F.Supp 752 (1966), 18 A.F.T.R.2d 5179, 66-2 USTC ¶ 9522.
47. See also TAM 200017665. Cf. First of America Trust Co., 72 AFTR 2d 93-5296, 93-2 USTC ¶ 50507.
48. Greer, supra n. 14, at p. 263.
49. UTC, supra n. 4, at §504(b); Restatement (Third), supra n. 4, at §60. If the settlor's purpose in establishing the trust is to provide for a beneficiary's needs, and if it is acceptable social policy that the beneficiary should not be left without support, then the trustee is subject to a standard of reasonableness in determining whether a distribution should be made to a beneficiary. See Greer, supra n. 14, at p. 263; Clifton B. Kruse, Jr., Third Party and Self Created Trusts: Planning for the Elderly and Disabled Client, at 61, and fn. 112 at 98-99 (3rd ed., ABA Real Property, Probate and Trust Law Section 2002).
50. UTC, supra n. 4, at § 504(c).
51. Id. at §504(d); cmt. to §504. See also UTC, supra n. 4, at §814(a).
52. Restatement (Second), supra n. 4, at §155(c); Bogert, supra n. 13, at §228; Spero, supra n. 20, at ¶6.03(1)(b); Rothschild, supra n. 21, at ¶ 1705.2.
53. McDonald v. Evatt, 62 N.E.2d 164 (1945).
54. In re Nicholson's Estate, 50 A.2d 283 (1947).
55. Kammholtz v. Allen, 256 F.2d 437 (Cal. App. 1958), 155 F.Supp 511 (1957).
56. In re Neumeister's Estate, 304 P.2d 67 (Cal. App. 1957).

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protection of trust property is desired. A shifting trust that terminates a beneficiary's interest on the occurrence of a specified event gives the greatest assurance for asset protection from a beneficiary's creditors.[57] The basis for this rule lies not in protecting the beneficiary—but rather in implementing the settlor's intent and protecting the settlor's right to choose the objects of his bounty.[58]

Although the termination of a beneficiary's interest offers the greatest protection from a beneficiary's creditors, a shifting trust that does not completely terminate the beneficiary's interest is effective against creditors in many jurisdictions. The retained interest must be such that the beneficiary cannot force a distribution from the trust.[59] For instance, in *Miller v. Miller*,[60] the court upheld a trust in which the beneficiary's interest—upon his filing for bankruptcy—shifted so that distributions were solely at the discretion of the trustee.[61]

Suspension of distributions to beneficiary. As an alternative to terminating or changing the character of a beneficiary's interest, some drafters have suspended the right of a beneficiary to receive distributions upon the occurrence of a specified event(s); the beneficiary's interest is reinstated after the disqualifying event has passed or has been resolved. This suspension protects against creditors' claims, if the trustee's power to suspend distributions is absolute and not just a condition limiting the time or manner of payment. The breadth of the trustee's discretion is critical to achieve protection from creditors.[62]

For example, the trust could provide that distributions could be suspended in the event that the trustee determines that such distributions would not benefit the beneficiary—such as when the beneficiary has separated from his spouse or is going through a divorce, is afflicted with a drug, alcohol or gambling addiction, has a proven inability to manage his finances, or is subject to the undue influence of others. This type of broad discretion would thwart a public policy argument that the suspension of benefits provision is being misused to allow a beneficiary to avoid his creditors.[63]

Drafting a Revocable Living Trust for Maximum Asset Protection

It is important that a revocable trust that provides for a continuing trust for the surviving spouse or descendants and other beneficiaries include a spendthrift clause.

The next consideration in drafting a revocable trust for maximum asset protection is to avoid the application of (1) the doctrine of merger or (2) section 60(g) of the Restatement (Third) (dealing with a beneficiary-trustee). This can be done in several ways. The first is to have an independent third party serve as trustee over the beneficiary's trust. Creditor protection for the beneficiary is not sacrificed by giving the beneficiary the right to remove and replace the independent trustee with another independent trustee.[64] A beneficiary's power to remove and replace the trustee should be limited to "reasonable cause."[65] A better strategy from an asset protection, as well as estate tax, perspective is to draft the trust to provide for an independent trust protector who can remove and replace the trustee with a new independent trustee.[66]

While an independent trustee provides the greatest assurance of asset protection, such a trustee is often not acceptable if the settlor wants the surviving spouse or the remainder beneficiary to participate in the administration and distribution decisions of the trust created for the spouse or remainderman. In that case, the spouse or beneficiary can serve as co-trustee with another trustee who has fiduciary duties to other beneficiaries of the trust.[67]

A third alternative is to appoint the spouse or beneficiary as trustee of the trust created for his or her benefit, and name an independent trustee as the successor trustee. If the beneficiary-trustee anticipates a challenge by a creditor, he or she could resign as trustee, and the independent trustee would assume the administrative duties over the trust. However, if the creditor attached the beneficiary-trustee's interest before the beneficiary-trustee's resignation, the beneficiary's interest may be reached to the same extent as if the beneficiary had remained as trustee.

The doctrine of merger can also be avoided by drafting the beneficial interest as a fully discretionary spray trust that allows the trustee to distribute income and/or principal among a class of beneficiaries—such as the surviving spouse and descendants of the deceased spouse or a child of the settlor and that child's descendants.[68] This type of trust contains no provisions for distributions for

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57. Spero, supra n. 20, at ¶¶ 6.07-6.07(2)(a); Rothschild, supra n. 21, at ¶ 1707.11; Annot., Validity of Provisions of Instrument Creating Legal Estate Attempting to Exempt It From Claims of Creditors, 80 A.L.R. 1000 (ALI, 1932); In re Fitzsimmons, 896 F.2d 373 (Cal. App. 1990); Security-First Nat'l Bank v. Rogers, 330 P.2d 811 (1958); Meade v. Rowe's Executor and Trustee, 182 S.W.2d 30 (1944); Nichols v. Aton, 91 U.S. 716 (1875); Cf. Bank One Trust Co., N.A., 77 A.F.T.R.2d 96-1579, 80 F.3d 173 (Oh. App. 1996), 96-1 USTC ¶ 50188.
58. Am. Jur.2d Trusts §126 (Lawyers Cooperative Publishing 1995); In re Reuss' Estate, 91 N.Y.S2d 479 (1949); Miller v. Miller, 31 S.E.2d 844 (W.Va. App. 1944).
59. Spero, supra n. 20, at ¶ 6.07(2); Rothschild, supra n. 21, at ¶ 1707.12.
60. *Miller v. Miller*, 31 S.E.2d 844 (W.Va. App. 1944).
61. See also Industrial Nat'l Bank v. Budlong, 264 A.2d 18 (1970); Jones v. Coon, 295 N.W. 162 (1940). Cf. Riggs Nat'l Bank, 636 F.Supp 172 (1986), 57 A.F.T.R.2d 86-1358, 86-1 USTC ¶ 9398.
62. Spero, supra n. 20, at ¶¶ 6.03(1)(b), 6.07(2)(b); Rothschild, supra n. 21, at ¶ 1707.16.
63. Spero, supra n. 20, at ¶ 6.07(2)(b). See also Domo v. McCarthy, 580 N.E.2d 788 (Oh. App. 1989); Landmark First Nat'l Bank v. Haves, 467 S.2d 839 (Fla. App. 1985); Roorda v. Roorda, 300 N.W. 294 (1941); Okla. Dept. of Human Services v. Tr. Co. of Okla., 825 P.2d 1295 (1991) cert. den.; McGrath v. Ward, 91 F.Supp 636 (1950).64. Rev. Rul. 95-58, 1995-2 CB 191, and P.L.R. 9746007; but Cf. P.L.Rs 200031008, 200020010, and 200024011.
64. Rev. Rul. 95-58, 1995-2 CB 191, and P.L.R. 9746007; but Cf. P.L.Rs 200031008, 200020010, and 200024011.
65. See P.L.R. 9303018 for a discussion of "reasonable cause."
66. Greer, supra n. 14, at p. 268.
67. Restatement (Third), supra n. 4, at §60, cmt. g; Greer, supra n. 14, at 273-274; Spero, supra n. 20, at ¶ 6.09.
68. Spero, supra n. 20, at ¶ 6.05.

Drafting Trusts for Maximum Asset Protection from Creditors

(continued from page 10)

support or for health, education, maintenance, and support. In addition to avoiding the doctrine of merger, a fully discretionary spray trust should bar a claim for spousal support and alimony, as well as claims from state and federal taxing authorities.

If asset protection for a beneficiary is an issue, a trust should never be drafted to provide for outright distribution of income or principal to a beneficiary. Instead, the income should be accumulated and added to principal, and held in trust for the lifetime of the beneficiary. If protection of the deceased spouse's assets from the creditors (or new paramour) of the surviving spouse is desired, a QTIP marital trust, which provides for the distribution of income only, should be used instead of a general power of appointment marital trust. If distributions of only income would prove inadequate for the support of the surviving spouse, discretionary support distributions can be added, although this would subject a portion of the principal in the QTIP trust to potential attachment by the surviving spouse's creditors.

Specific Drafting Issues

Irrevocable life insurance trusts and intentionally defective grantor trusts. Considerations in drafting an irrevocable life insurance trust (ILIT) or an intentionally defective grantor trust (IDGT) for maximum asset protection are much the same as the considerations applicable to a revocable trust. With regard to an ILIT, though, there is the added problem of Crummey[69] powerholders, who have a general power of appointment subject to attachment by their creditors.[70]

To deal with this, a properly drafted ILIT should include a provision allowing the settlor—on a contribution-by-contribution or ongoing basis—to exclude a Crummey powerholder from receiving a withdrawal power over a current, as well as future, contributions to the ILIT.[71] The result is that if a Crummey powerholder has creditors who may attach his withdrawal right or the amount withdrawn when the Crummey powerholder exercises his withdrawal right, such powerholder can be excluded from the beneficiaries eligible to make withdrawals from current and/or future contributions to the ILIT.

Supplemental needs trusts. "Discretionary supplemental care trusts providing for the needs of beneficiaries not supplied by way of public benefit programs, created by non-beneficiary [trustors], appear to be legal, appropriate and encouraged by both state common law and statutes. These trusts are sensitive responses by caring family members or others to make available to the chronically ill and disabled community the extra needs, beyond basic support, that such beneficiaries reasonably require or from which greater comfort can be achieved."[72] A supplemental needs trust is simply a variation of a discretionary trust. Its purpose is to set aside assets, which, at the trustee's discretion, can be used to pay for the "supplemental" needs of the beneficiary not covered by governmental assistance programs (such as Medicaid or SSI), while at the same time not causing the beneficiary to be disqualified for valuable government aid. A supplemental needs trust can be created either as a sub-trust of a revocable trust or as a stand-alone trust.

Split-interest trusts. Many estate planners have drafted split-interest trusts (such as qualified personal residence trusts (QPRTs), grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs)) to distribute assets outright to children. The reason is that the existence of an estate tax inclusion period (ETIP) prevents the allocation of generation-skipping transfer (GST) tax exemption upon the execution of the trust, thereby precluding the leveraging that is available with other planning strategies. Instead, the planner should consider using continuing trusts for beneficiaries after the expiration of the settlor's term interest in a split-interest trust. These continuing trusts can be structured with the same provisions discussed above for revocable trusts, which will protect the trust assets from the beneficiaries' creditors. The continuing trusts can also be structured to include a testamentary general power of appointment over non-GST tax-exempt assets in order to avoid imposition of GST tax.

Furthermore, in states that do not have strong bankruptcy protection for the home, a QPRT may offer substantial asset protection for the settlor's residence.[73] Upon transfer of the house to a QPRT, the settlor converts his interest in the residence from a fee simple to a right to occupy the property for a term of years. Even if a creditor of the settlor could force the sale of the residence within the trust, the creditor would be able to attach only an income stream—because the sale of the residence in a properly drafted QPRT would convert the trust to a GRAT for the balance of the QPRT term.[74]

Conclusion

Many drafting techniques will increase the asset protection available to trust beneficiaries. A prudent estate planner should be knowledgeable about these techniques, and take advantage of them when drafting a trust for a client who is concerned about creditors, a divorcing spouse of a child or descendant, or others who might attempt to reach the trust interests of a surviving spouse or descendant.

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69. See Crummey v. C.I.R. , 397 F.2d 82 (1968), 22 A.F.T.R.2d 6023, 68-2 USTC ¶ 12541.
70. But see UTC, supra n. 4, at §505(b)(2), and Tex. R.S. §112.035(e), which appear to limit the ability of a creditor of a Crummey powerholder to attach the powerholder's withdrawal rights.
71. See Rothschild, supra n. 21, at ¶ 1707.14.
72. Kruse, supra n. 49, at 82.
73. Rothschild, supra n. 21, at ¶ 1703.3.
74. Treas. Reg. § 25.2702-5(c)(8)(i)(B) (2003).