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ESTATE PLANNING

Planning Opportunities in 2009 Tax Law Changes

A Guide to the IRS Sample Charitable Lead Trust Forms

Drafting Discretionary Dynasty Trusts - Part 3

How to Draft Discretionary Dynasty Trusts — Part 3

This third part of a three-part article explores (1) marital property issues pertaining to a trust remainder interest, and (2) dominion and control arguments that may be made in litigation involving creditor's rights in discretionary dynasty trusts.

MARK MERRIC, ATTORNEY

Part 2 of this three-part article[2] discussed drafting the distribution interest to maximize the asset protection of a beneficiary's interest in a discretionary dynasty trust. To avoid the divorce issues regarding an estranged spouse suing through one of his or her children who were trust beneficiaries as well as possible imputation of alimony or child support, readers were advised to draft a discretionary interest where the beneficiary would not have an ability to force a distribution. Furthermore, under common law, the strong majority opinion was that a beneficiary of a discretionary trust did not have a property interest, and no creditor—not even an exception creditor—could attach such interest.[3] This third part of this three-part article examines the problems in certain states in divorce settlements when a trust interest is classified as a property interest and such property interest is also classified as marital property.

In addition to the marital property interests, if a settlor or beneficiary holds too much dominion and control over a trust, then *any* creditor may reach the assets of the beneficiary. This is where the three drafting models of a discretionary dynasty trust become important (analyzed in Part 1 of this article[4]). Model 3 allows a beneficiary to serve as the sole trustee. With very little authority to support its position, the Restatement (Third) of Trusts ("Restatement Third") states that any creditor may reach a sole trustee/beneficiary's interest in a trust. To avoid an estate tax inclusion issue, Model 3 requires an ascertainable distribution standard so that a beneficiary may serve as the sole trustee. Under the Restatement Third, any standard creates some kind of enforceable right to a distribution that generally creates a property interest in the beneficiary.

Problems with remainder interests and possibly current distribution property interests

States that classify remainder interests as marital property interests. Ten states have held that a remainder interest was marital property and part or all of a beneficiary's interest was eligible for marital division. These states (in alphabetical order) are:

MARK MERRIC is the principal in the Merric Law Firm, which is a boutique firm in Denver emphasizing activity in the areas of estate planning, international tax, and asset protection planning. He is co-author of CCH's treatise on asset protection—*The Asset Protection Planning Guide* (first edition), and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I* and *Asset Protection Strategies Volume II*. He has been quoted in *Forbes*, *Investor's News*, *On the Street*, the *Denver Business Journal*, *Oil and Gas Investor*, and the *Sioux Falls Business Journal*. For details on his monthly webinars as well as speaking events, go to www.internationalcounselor.com/HotofthePress.htm. Reprinted by permission of Mark Merric and Stephan R. Leimberg. This article is adapted from a forthcoming book, *Drafting Discretionary Dynasty Trusts, a Modular Approach to Estate Planning™*[1]*—Book I*, by Mark Merric, with Stephan R. Leimberg as the editor, to be published by Leimberg and LeClair, Inc.

1. Alaska—*Burrell v. Burrell.*[5] In 1975, the Alaska Supreme Court found a vested remainder interest is subject to division.
2. Colorado—*Balanson v. Balanson.*[6] In 2001, the Colorado Supreme Court held that any appreciation on a vested remainder interest subject to complete divestment was eligible for division as a marital asset.
3. Connecticut—*Carlisle v. Carlisle.*[7] In 1994, the Superior Court of Connecticut found that remainder interests in a credit shelter trust, marital trust, and an irrevocable trust were marital property.
4. Indiana—*Moyars v. Moyars.*[8] In 1999, the Indiana Court of Appeals distinguished *Loeb v. Loeb*,[9] which had held that a *contingent* remainder interest was too remote to be considered marital property because if the husband predeceased his mother, the entire trust property would pass to the husband's siblings. In *Moyars*, the husband owned a vested one-third remainder interest in real estate. The remainder interest was not contingent on outliving his mother's life estate. Rather, the remainder interest would pass to his estate if he predeceased his mother. Therefore, the court held that a vested remainder interest was marital property.
5. Massachusetts—*Davidson v. Davidson.*[10] In 1985, the Massachusetts Supreme Court held that neither uncertainty of value nor inalienability of a husband's vested remainder interest in a discretionary trust was sufficient to preclude division.
6. Montana—*Buxbaum v. Buxbaum.*[11] In 1984, the Montana Supreme Court held that a husband who had benefited from his future interests (vested remainder interests) by using them as collateral, could not construe them as a mere expectancy and preclude them from property division at marital dissolution.
7. New Hampshire—*Flaherty v. Flaherty.*[12] In 1994, the New Hampshire Supreme Court held that an anti-alienation clause and the circumstance that the defendant's contingent remainder interest will not have value until his last parent dies do not preclude the treatment of the interest as marital property.
8. North Dakota—*Van Ossting v. van Ossting.*[13] In 1994, the North Dakota Supreme Court held that when the present value of the husband's vested credit trust was subject to contingencies and was too speculative to calculate, the proper method of distribution was awarding the wife a percentage of future payments.
9. Oregon—*Benston v. Benston.*[14] In 1983, the Oregon Court of Appeals found that a vested, as well as a contingent, remainder interest is subject to division.
10. Vermont—*Chilkott v. Chilkott.*[15] In 1992, the Vermont Supreme Court held that techniques of actuarial valuation of pension interests were applicable to determining the present value of the husband's vested, defeasible trust interest for the purposes of property division at marital dissolution.

One might ask why more states have not found a contingent remainder interest to be property eligible for division. First, the above issue does not apply to community property states, where inheritance and the appreciation on inheritance remain separate property. Second, in many equitable division states, neither inheritance nor the appreciation on inheritance is considered marital property. Third, a small number of states currently apply one of the following theories: (1) a contingent remainder interest is not divisible,[16] (2) a remainder interest is a mere expectancy,[17] or (3) a remainder interest is too remote to be classified as marital property.[18] Although this is currently the state of the law in Delaware, Flori-

1 "The Modular Approach to Estate Planning" is trademarked by Mark Merric.

2 See Merric, "How to Draft Distribution Standards for Discretionary Dynasty Trusts," 36 ETPL 3 (Mar. 2009).

3 For background, see Merric and Oshins, "The Effect of the UTC on the Asset Protection of Spendthrift Trusts," 31 ETPL 375 (Aug. 2004); Merric and Oshins, "UTC May Reduce the Asset Protection of Non-Self-Settled Trusts," 31 ETPL 411 (Sept. 2004); Merric and Oshins, "How Will Asset Protection of Spendthrift Trusts Be Affected by the UTC?," 31 ETPL 478 (Oct. 2004). See also Merric, Stevens, and Freeman, "The Uniform Trust Code: A Divorce Attorney's Dream," J. Prac. Est. Plan., p. 33 (Oct.-Nov. 2004); Merric, Stein, and Berger, "The Uniform Trust Code: 'A Continuum of Discretionary Trusts' or 'A Continuum of Continuing Litigation'?," J. Prac. Est. Plan. (Dec.-Jan. 2005). Many statements regarding the UTC in these articles were based on the 2003 version of the UTC, prior to the 2005 changes, many of which were made in direct response to these articles and others.

4 See Merric, "How to Draft Discretionary Dynasty Trusts — Part 1," 36 ETPL 3 (Feb. 2009).

5 537 P.2d 1 (Alaska, 1975). However, see AS 34.40.110(l), which appears to reverse the holding of this case.

6 25 P.3d 28 (Colo., 2001).

7 1994 WL 592243 (Super. Ct. Conn., 1994).

8 717 N.E. 2d 976 (Ct. App. Ind., 1999).

9 301 N.E. 2d 349 (Ind., 1973).

10 474 N.E. 2d 1137 (Mass., 1985). Also see Lauricella v. Lauricella, 565 N.E. 2d 436 (Mass., 1991), where a vested remainder interest in an irrevocable trust subject to a term of years is subject to division of marital property.

11 692 P.2d 411 (Mont., 1984).

12 638 A.2d 1254 (N.H., 1994).

13 ND Sup Ct., No 940003 (1994).

14 656 P.2d 395 (Or. App., 1983).

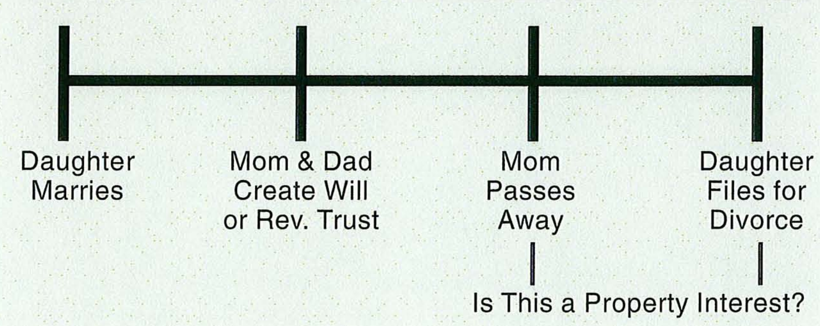
15 607 A.2d 883 (Vt., 1992).

16 Hussey v. Hussey, 312 S.E. 2d 267 (S.C., 1984); Frank G.W. v. Carol M.W., 457 A.2d 715 (Del., 1983); Khroha v. Khroha, 578 S.W. 2d 10 (Ark., 1979); Bacher v. Bacher, 520 So. 2d 299 (Fla. Dist. Ct. App., 1988).

17 Storm v. Storm, 470 P.2d 367 (Wyo., 1970).

18 Loeb v. Loeb, 301 N.E. 2d 349 (Ind., 1973).

EXHIBIT 1
Time Line



da, and Wyoming, there is no guarantee that the judicial system will not follow the trend to classify remainder interests as property.[19]

Example of the issue. In *Balanson v. Balanson*, the Colorado Supreme Court ruled that the appreciation on a vested remainder interest subject to complete divestment was marital property eligible for equitable division. *Balanson* began when the daughter married. A few years later, Mom and Dad executed a standard estate plan that created a marital trust and a credit shelter trust (i.e., family, bypass, or exemption trust) upon the death of the first spouse to die. Several years later, Mom died and the first $1 million of her assets were used to fund the credit shelter trust, with the balance funding the marital trust.

Dad is the sole trustee of both trusts. All income of the marital trust is required to be distributed to Dad. However, distributions of income of the credit shelter trust and any corpus of either trust are based on an ascertainable standard. Dad is in good health and may easily live another 15 years. Furthermore, Dad has a testamentary power of appointment over the marital share that *allows him to completely extinguish the daughter's interest* should he desire, by appointing all the trust property to his son. Several years after Mom dies, Daughter files for divorce. Son-in-law claims that the daughter's contingent remainder interest is marital property eligible for division in the divorce. Exhibit 1 shows the time line.

The daughter's remainder interest is contingent because she must outlive her father. Moreover, the daughter's interest is subject to complete divestment, because her dad may exercise his power of appointment solely in favor of his son.

Nevertheless, the Colorado Supreme Court ruled that even if a contingent remainder interest is subject to complete divestment, such an interest is still a property interest that can be valued for the purpose of division in a divorce. The logic behind the decision is that quite often, the court values interests such as retirement plans or business valuations that are difficult—but not impossible—to value. Once the *Balanson* court decided that a remainder interest was property, the only issue left was valuation. Thus, the solution to the remainder interest problem is relatively straightforward—create a trust where there is no remainder interest. In other words, create a dynasty trust[20] for each child and his or her descendants.

A dynasty trust is a trust where a remainder interest *never* vests in *any* beneficiary. Instead, the trust property continues to be held in one or more trusts until it is consumed, or a rule against perpetuities savings clause forces the trust to vest. A dynasty trust may be one multiple beneficiary trust (sometimes referred to as a "pot trust"), or the dynasty trust may split into separate dynasty trusts at each generation level. In a single dynasty trust for multiple beneficiaries, when the children, grandchildren, and great-grandchildren are born, they all become beneficiaries of the same dynasty trust.

Dominion and control

A dominion and control argument supersedes both spendthrift and discretionary trust protection, allowing any creditor to recover from the beneficiary's interest. Generally, a spendthrift provision is not valid if:

1. The trust settlor is also the beneficiary of the trust;
2. The beneficiary has dominion and control over the trust;
3. The beneficiary may revoke the trust; or
4. The beneficiary has powers in the trust.[21]

Beneficiary serving as a trustee

The sole beneficiary is the sole trustee. The purpose of spendthrift provisions is to protect the beneficiary from his own improvidence or incapacity for self-protection. If the sole beneficiary is the only trustee,

19 Originally, Colorado case law held that a remainder interest was indivisible. In re Marriage of Rosenblum, 602 P.2d 892 (Colo. App., 1979). However, the Colorado Supreme Court reversed this holding, finding that a remainder interest was eligible for division, 22 years later in In re Balanson, 25 P.3d 28 (Colo., 2001).

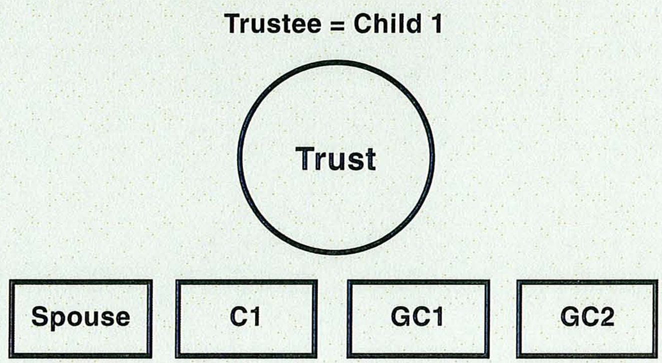
20 Restatement (Second) of Trusts, section 161; Henderson v. Collins, 267 S.E. 2d 202 (Ga., 1980) (noting that a remainder interest was future property).

21 In re Galllagher, 101 B.R. 594 (Bankr. W.D. Mo., 1989).

he cannot protect himself from his own improvidence. Using a dominion and control argument such as the court did in *In re Bottom,*[22] the spendthrift provision protection was not upheld, and the creditor was able to reach the trust assets.[23]

Beneficiary serving as sole trustee; multiple beneficiaries. Many attorneys draft trusts with an ascertainable distribution standard so that a beneficiary may serve as the sole trustee.[24] As discussed in Part 1 of this article, this is the third model or method for drafting a discretionary dynasty trust, and is illustrated in Exhibit 2.

EXHIBIT 2
Trustee/Beneficiary Is the Sole Trustee



A recent article by Charles Harris and Tye J. Klooster[25] warns of the problems of giving a beneficiary too much control when a beneficiary serves as the sole trustee. As primary authority for its conclusion that a beneficiary-controlled trust may lose asset protection, the article cites *In re McCoy,*[26] and the Restatement Third, section 60, comment g.

In *McCoy*, Mom created a trust for the benefit for her husband at her death. Husband was the sole trustee. It appears that Husband did not have a taxable estate, because the trust was drafted with discretionary distribution powers, which would result in an estate inclusion issue. The husband's discretionary distribution powers differed, depending on whether he was making distributions to his children or to himself. The husband, in his discretion, could make distributions to the children for their health, education, maintenance, and support. He could also make unequal distributions between them. When making distributions to himself as a trustee, the husband could distribute whatever was "required" or "*desirable*" for his own health, maintenance, and support. The husband also "need not consider the interests of any other beneficiary in making distributions to my spouse or for his benefit."

As to the husband making distributions to himself in his capacity as trustee, the court concluded that the word "desirable" placed no ceiling on distributions. Consequently, because the husband also did not need to consider the interests of other beneficiaries, he could distribute everything to himself. Hence, the court concluded that Husband had dominion and control over the trust, and any creditor could reach the trust assets, regardless of the spendthrift provision or discretionary nature of the trust.

Some planners will disagree with the broad interpretation that any creditor may reach a sole trustee/beneficiary's interest. They will note that the trust in *McCoy* was not drafted with an ascertainable standard, and will take the position that the poor drafting language allowing McCoy the ability to distribute anything he wished to himself (i.e., desirable) is the reason the court did not uphold the spendthrift provision.

In another case, *Morrison v. Doyle,*[27] the Minnesota Court of Appeals held that any creditor could reach a trustee/beneficiary's interest when he was the primary beneficiary (i.e., the only current beneficiary who could receive a distribution). Furthermore, the distribution language allowed the trustee to make distributions of principal and income that the trustee "in its discretion may determine for the beneficiary's education, support, health, and maintenance."

The appellate court based its decision mainly on two factors: (1) the trustee/primary beneficiary was the only one who could receive distributions, and (2) the trustee/primary beneficiary could distribute all the property to himself. Fortunately, the Minnesota Supreme Court[28] reversed the appellate court, noting that the distributions in the trust instrument were subject to a ceiling. The trustee/primary beneficiary could not distribute more than

22 176 B.R. 950 (N.D. Fla., 1994).

23 The facts did not indicate whether there was any remainder beneficiary other than Bottom. If this is the case, the doctrine of merger would also apply. In re Wells, 259 B.R. 776 (Bkrtcy. M.D. Fla., 2001).

24 When a beneficiary serves as a trustee, an ascertainable standard—by itself—will not cure all estate inclusion issues. For a further discussion of this issue, see Merric, "Who Can Be a Trustee — Part 1," Steve Leimberg's LISI Estate Planning Newsletter # 1414 (www.leimbergservices.com) (2/8/09).

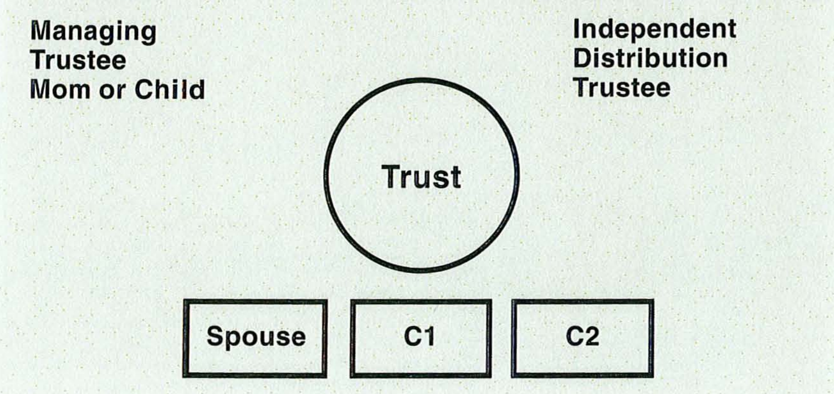
25 Harris and Klooster, "Beneficiary-Controlled Trusts Can Lose Asset Protection," 145 Tr. & Est. 37 (Dec. 2006).

26 2002 WL 1611588 (N.D. Ill., 2002).

27 570 N.W. 2d 692 (Minn. App., 1997).

28 Morrison v. Doyle, 582 N.W.2d 237 (Minn., 1998).

EXHIBIT 3
Managing/Distribution Trustee Model



for his health, education, maintenance, and support. Consequently, the ascertainable standard prevented any creditor from reaching a beneficiary/trustee's interest.

When reviewing a bankruptcy case, the Ninth Circuit in *In re Coumbe*[29] refused to allow the bankruptcy trustee to reach the assets of a trust when a sole trustee was also the primary beneficiary (i.e., the only one who could receive distributions until his death). However, the Ninth Circuit did not base its finding on a ceiling, ascertainable standard, regarding the amount the trustee/primary beneficiary could distribute to himself. Instead, the Ninth Circuit focused on the fact that Arizona had a statute that specifically stated that "A restraint on voluntary or involuntary transfer...is valid even if the beneficiary or one of the multiple beneficiaries of the trust is also one of the multiple trustees of the trust or if one of the multiple beneficiaries is the sole trustee...."

Synthesizing the above cases, the Illinois court in *McCoy* allowed recovery because the trustee/beneficiary had the power to distribute all the trust property to himself. A second case that will be discussed under removal/replacement powers below also reached a similar conclusion.[30] Conversely, the Minnesota Supreme Court in *Morrison* would not let this concept be expanded if distributions were limited to an ascertainable standard. The Ninth Circuit, following an Arizona statute, held that spendthrift provisions were valid when there is a sole beneficiary/trustee with multiple beneficiaries.

Unfortunately, the Restatement Third takes the position that *any* creditor may reach a *sole* trustee's beneficial interest, regardless of whether or not the distribution standard is limited by an ascertainable standard.[31] Again, the Restatement Third creates new law or takes an expansive view of the law that is quite detrimental to many estate plans. Not only would a creditor be able to reach a spouse/trustee's or child/trustee's beneficial interest in an inter vivos irrevocable trust, but a creditor could reach any spouse/trustee's interest in a credit shelter trust or a QTIP trust.

Fortunately, many states are enacting laws that prevent application of the sole trustee Restatement Third position.[32] It is also fortunate that no appellate court has ruled on this issue since the Restatement Third was promulgated in 2003. On the other hand, in states that do not affirmatively fix this issue by statute, many judges could follow the Restatement Third's position, not realizing the dramatic change to common law. In these states, there appear to be only three possible solutions to escape this problem: (1) forum shop to a better trust jurisdiction, (2) use co-trustees, or (3) hope that your courts affirmatively disclaim the Restatement Third's sole trustee/beneficiary's position.

Beneficiary serving as a co-trustee; multiple beneficiaries. One court has directly held that the beneficiary/trustee did not control the trust when the beneficiary was a co-trustee and there were multiple beneficiaries.[33] The court noted that the trustee/beneficiary's control was limited for two reasons: (1) as a co-trustee, a trustee/beneficiary does not have voting control; and (2) the trustee/beneficiary is also limited by her fiduciary duties to others. A second court has directly ruled that when a co-trustee/beneficiary was one of three trustees, he did not have control. This court also mentioned in dicta that the result would be the same if there were two trustees.[34] The Restatement Third takes this position as well.[35]

Model 2's method of drafting (which was created primarily by Richard Oshins) a discretionary

29 304 B.R. 378 (CA-9, 2003).

30 In re Baldwin, 142 B.R. 210 (Bkrtcy. S. D. Ohio, 1992).

31 Restatement Third, section 60, comment g.

32 Lead trust jurisdictions of Delaware, South Dakota, and Texas have all passed statutes to address this issue. After concerns were expressed regarding the Uniform Trust Code's ("UTC's") integration with the Restatement Third, the national UTC's 2005 amendment addressed this concern. UTC states have made this correction.

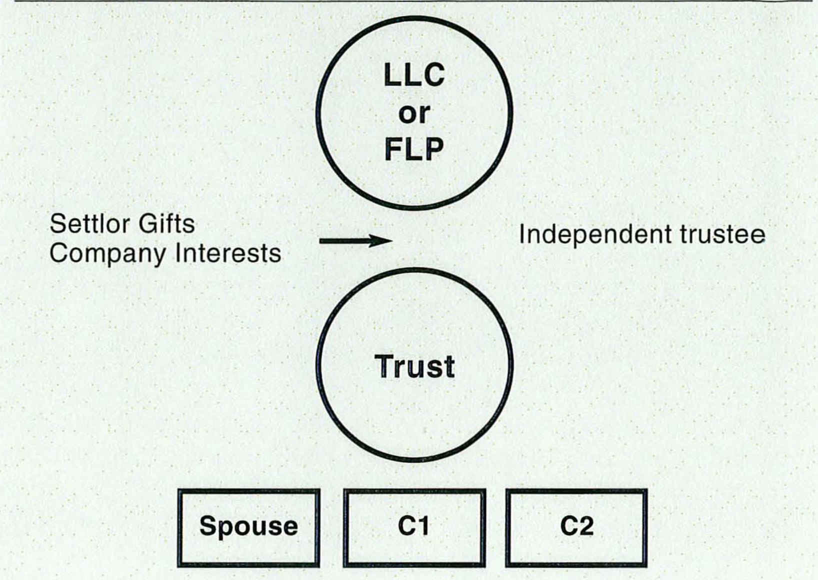
33 In re Schwen, 240 B.R. 754 (D. Minn., 1999).

34 In re Hersloff, 147 B.R. 262 (M.D. Fla., 1992).

35 Restatement Third, section 60, comment g, states that a creditor can reach a trustee/beneficiary's interest, regardless of whether the distributions are limited by an ascertainable standard. But it also states, "The rule does not apply, however, if the discretionary power is held jointly with another person who, in exercising the discretionary authority, has fiduciary duties to other beneficiaries of the trust."

dynasty trust uses co-trustees.[36] Conversely, unlike the co-trustee cases discussed above, it bifurcates the trustee powers by using both a managing trustee and a distribution trustee. The managing trustee, who has no vote regarding distributions, is the beneficiary/managing trustee. The distribution trustee is someone who is independent within the meaning of IRC Section 672(c). In this respect, from a dominion and control attack, Model 2 has further distanced itself than co-trustees with equal voting power, because the managing trustee has absolutely no voting power. However, at present, there are no asset protection cases directly on point using this model. A diagram of Model 2 appears in Exhibit 3.

EXHIBIT 4
Independent Trustee Model



Independent trustee; trust owns interest in an FLP or LLC. Further distancing oneself from a dominion and control attack, many estate planners use only one independent trustee. Typically, the trust assets are held by a limited liability company ("LLC") or family limited partnership ("FLP"), and the trust owns a substantial interest in the LLC or FLP. Many times, the FLP and LLC are also used for estate planning purposes. Generally, the settlor serves as the manager or general partner of the LLC or FLP, respectively.[37] A diagram of this Model 1 appears in Exhibit 4.

In Model 3, the child trustee/beneficiary will most likely hold, but is not required to hold, a removal/replacement power over the trustee. The reason is that the child is serving as a trustee. In Model 2, after the death of the settlor, the managing trustee/beneficiary has a removal/replacement power to replace the distribution trustee with someone who is independent within the meaning of IRC Section 672(c). In Model 1, after the death of the settlor or the settlor's spouse, the trust splits into a separate trust for each child: one for Brutus, and one for Cleopatra. Now Brutus holds a removal/replacement power over the independent trustee for the benefit of him and his descendants. The same is true for Cleopatra.

From an estate tax inclusion perspective, Rev. Rul. 95-58[38] holds that the trustee's powers with a discretionary trust are not attributed to the settlor of a *common law discretionary trust.* The reason is that the settlor held a power to remove/replace the trustee with a person who is independent within the meaning of IRC Section 672(c). Regarding a *common law discretionary* trust, *Estate of Vak*[39] and *Estate of Wall*[40] hold that the trustee's powers are not attributed to the settlor or attributed to a beneficiary who holds a power to remove/replace a trustee with an independent corporate trustee. In a common law discretionary trust, if the trustee powers were attributed to a beneficiary by holding a removal/replacement power, he or she would have the ability to make distributions to himself or herself that would not be limited by an ascertainable standard, and this would create an estate inclusion issue.

While tax principles may have some analogy to asset protection issues, it is important to note that they are not dispositive in creditor courts. At this time, there appears to be only one case directly on point regarding trustee removal/replacement powers.[41] In *Baldwin v. Bank One Trust Company*,[42] the wife was the beneficiary of a discretionary

[36] See Part 1 of this article, *supra* note 4.

[37] One still needs to make sure to design the structure to avoid any estate inclusion issues under IRC Section 2036.

[38] 1995-2 CB 191.

[39] 973 F.2d 1409, 70 AFTR2d 92-6239 (CA-8, 1992).

[40] 101 TC 300 (1993).

[41] The author is aware of an offshore trust case where the settlor initially was held in contempt because she was not able to exercise her removal and replacement powers to repatriate the trust assets. Grant, 2005 WL 2671479 (S.D. Fla., 2005) unreported case. However, the holding of this case was reversed in Grant, 2008 WL 2894826, 101 AFTR2d 2008-2676, 2008 U.S. Dist. Lexis 51332 (S.D. Fla., 2008), and the defendant was not held in contempt for not being able to comply with the court order to remove and replace the trustee.

[42] 142 B.R. 210 (Bkrtcy. S.D. Ohio, 1992).

trust. The distribution language provided, "If, in the judgment of the Trustee, the circumstances of said wife make it necessary or desirable, the Trustee may pay to or use for her benefit from time to time such amounts of the income or principal of Trust No. 2 as the trustee may determine . . . ."

Furthermore, the wife was the only beneficiary who could receive a distribution during her life and, as used in this article, the term "primary beneficiary" would apply. Finally, the wife had the ability to remove and replace the current bank trustee with any other corporate trustee. Unfortunately, the trust agreement did not define corporate trustee. Therefore, the Ohio District Court found that the wife had the ability to create her own corporation which she could control, remove the existing trustee, substitute her corporate trustee, and force a distribution of all the trust assets to herself by her controlled corporate trustee. Naturally, this was all speculation; the wife never removed the bank trustee or appointed her own trustee.

Regardless, the Ohio court concluded, "the Court must analyze the terms of the Trust not only for the actual exercise of dominion and control by the Debtor but also for the ability to exercise dominion and control." Therefore, the court held the removal/replacement power constituted dominion and control over the trust.

Model 3 and Model 2 typically limit the removal/replacement power to someone who is independent within the meaning of IRC Section 672(c). Consequently, Models 3 and 2 do *not* allow someone to create his own controlled corporation and replace the trustee with his controlled corporation.

If a settlor or beneficiary holds too much control and dominion over a trust, then *any* creditor may reach the assets of the beneficiary.

Other dominion and control issues

In addition to trustee/beneficiary and possibly removal and replacement powers, there are other areas where a court may hold or trial attorneys may seek to expand the dominion and control issues so that any creditor may reach a beneficiary's interest, regardless of spendthrift or discretionary trust protection.

Model 2 Example—Management and distribution trustees. Using Model 2, assume that upon Dad's death, he created a credit shelter trust for the benefit of Mom and her three children. Mom is the managing trustee. Mom has an unconditional removal/replacement power over the trustee for so long as the replacement trustee is independent within the meaning of IRC Section 672(c). Mom's best friend is the distribution trustee.

Mom is the primary beneficiary—that is, the only beneficiary who may receive distributions during her life. The reason for limiting distributions just to Mom is that one child does not get along with Mom, and the estate planner did not wish to risk the problematic child attempting to sue Mom and force a distribution during Mom's life. Remember, the Restatement Third almost always gives a beneficiary an enforceable right to a distribution, and provides no guidance on how to draft a distribution standard that would not be an enforceable right.

The distribution language is purely discretionary, and all trust assets may be distributed to Mom. The hope is that under the Restatement Third, the problematic child will not sue, claiming that the trustee distributed too much money to Mom. The trust is also a dynasty trust. Mom has a special power of appointment and may appoint property among her children.

During the last seven years, Mom has made repetitive requests for distributions from the trustee, and the trustee has never denied any of Mom's requests. The trust was funded with all of Dad's assets of $2 million. The trust has made a 5% rate of return on its investments of $100,000 per year, and Mom's distributions have been $150,000 per year. Prior to Dad's death, Mom's standard of living was $125,000 a year. The trust contains a spendthrift provision. Mom has a car accident, and all of a sudden has a major creditor claim.

Is Mom's trust protected from the tort creditor? Fortunately, the only state that allows a tort creditor to attach trust assets by statute is Georgia. This is why common law estate planners draft discretionary trusts in Georgia, so that no creditor—not even a Georgia tort exception creditor—may attach or reach the trust assets.[43] In the

[43] Ga. Code § 53-12-28. The Mississippi Supreme Court adopted a tort creditor exception. Sligh v. First Nat'l Bank, 704 So.2d 1020 (Miss., 1997). Due to the anticipated loss of trust business, Mississippi's tort creditor exception was repealed by the Family Trust Act, Miss. Code § 91-9-5003. Wyoming also experienced a temporary scare when the trial attorneys attached a tort creditor exception to its proposed qualified disposition act in 2007. Because the qualified disposition act is integrated with Wyoming's UTC, this proposed tort exception creditor would have applied to all Wyoming trusts. Fortunately, Doug McLaughlin, the lead drafter of the Wyoming UTC, and others negotiated with the trial attorneys for the removal of the proposed tort exception creditor in exchange for a requirement that the settlor of a qualified disposition must carry $1 million in liability insurance. Oklahoma has also had a few scares with the proposed introduction of the UTC. Under Oklahoma law, any creditor may reach the assets of only an Oklahoma *support trust*, to the extent that the income per beneficiary exceeds $25,000. Because the UTC reduces the asset protection of a discretionary trust by allowing any creditor to attach a discretionary interest, had the Oklahoma UTC ever become law, this exception creditor would have applied to all trusts.

above example, the trust is discretionary, there is a spendthrift provision, and Mom does not reside in Georgia. Accordingly, the issue has nothing to do with possible exception creditor status to a support trust, or that under common law a discretionary trust has no exception creditors and no one may attach the trust. The real issue is whether any creditor may pierce the trust and reach the underlying assets under a dominion and control argument. Therefore, let's analyze each of these powers.

A dominion and control argument supercedes both spendthrift and discretionary trust protection, allowing any creditor to recover from the beneficiary's interest.

1. Being a managing trustee allows Mom to control investments. Conversely, this is less power than being a sole trustee with distribution power. In *Baldwin*, the creditor made two dominion and control arguments: (1) the beneficiary had the power to veto certain investment decisions; and (2) the beneficiary had an unconditional removal/replacement power, and there was a discretionary distribution standard. The *Baldwin* court summarily dismissed the argument regarding the investment powers held by the trustee.
2. On the other hand, the *Baldwin* court did have problems that Mom could remove/and replace the corporate trustee with a corporation controlled by Mom, and in essence through the corporation, could be making discretionary distributions to herself. However, in the above example, Mom must replace any trustee with a trustee that is independent within the meaning of IRC Section 672(c).
3. Appointing Mom's best friend as a trustee of a discretionary trust does not create a tax problem, because a best friend is independent within the meaning of Section 672(c). Yet, for most trial judges whose background is as a trial attorney, using a best friend as a trustee may appear to be suspicious. Conversely, there is no case law on this issue at this time, and Mom's best friend is bound by fiduciary principles similar to any other trustee.
4. Mom is the primary beneficiary. In *Morrision v. Doyle*, the court of appeals held that any creditor could reach a trustee/beneficiary's interest when distributions could be made only to a primary beneficiary, and the trustee had discretion to distribute pursuant to an ascertainable standard. Fortunately, the Minnesota Supreme Court reversed this position. Also, *In re Baldwin* was concerned with discretionary distribution language as well as a primary beneficiary fact pattern.
5. Mom has a special power of appointment empowering her to disinherit her children. In elder law circles, some of the state departments reviewing five-year Medicaid trusts are claiming that this is a way for the grantor to get money back from her children. The donor gifts property to a five-year trust with the right to receive only the income from the trust. However, if the donor needs principal, the trustee makes a distribution to the children, with a high likelihood that they will turn around and give it back to the donor (since the donor could possibly disinherit the kids if they do not give this money back to the parents). While this may be an elder law issue, in our fact pattern Mom is a beneficiary and the possible extortion use of a limited power of appointment does not appear to be applicable.
6. Mom made repetitive requests from the trusts for distributions during the last seven years, and all of them were granted. The court held in *In re McCullough*[44] that if the trustee does nothing more than follow the settlor's instructions regarding investments and signing checks for distributions, the settlor controls the activities of the trust. The trustee is nothing more than an instrument of the settlor. The same principle should also apply if a beneficiary is dictating all the trustee's actions. As applied to the facts of the example, a court has the ability to possibly find a dominion and control argument.

At this point in the analysis, courts may well reach different conclusions. Other than possibly the sixth factor above, the first five factors by themselves do not appear to have violated a dominion and control issue. Nevertheless, when the above six factors are combined, a court may possibly hold that

[44] 259 B.R. 509 (DC R.I., 2001). Also see In re Pugh, 274 B.R. 883 (Bkrtcy. D. Ariz., 2002), where the managing trustee performed all the acts of a distribution trustee, without the distribution trustee's knowledge.

Mom has dominion and control over the trust. In this respect, as a general rule, the greater the beneficiary distances himself or herself from the trust, the greater the asset protection will be. Similarly, if a CPA, attorney, or corporate trustee was serving as a managing trustee, this fact pattern would improve greatly. Furthermore, if there were instances when Mom was denied a distribution request, this would also help. In many situations, the special power of appointment is probably unnecessary. Finally, one may wish to limit the removal/replacement power of the distribution trustee to independent corporate trustees, CPAs, and attorneys.

Model 3 Example—Sole trustee who is also a beneficiary. Using Model 3, assume that upon Dad's death, he created a credit shelter trust for the benefit of Mom and three children. Assume the following facts. Mom is the sole trustee. Distributions are pursuant to an ascertainable standard. Mom is the primary beneficiary who is the only beneficiary that may receive distributions during her life. After Mom's death, the trust will split into one dynasty trust for each child, and each child will become the primary beneficiary of his or her trust. The trust was drafted this way to avoid the first divorce issue discussed in Part 1 of this article where an estranged spouse could sue through a beneficiary's children and force a distribution to him or her as a guardian.

Mom has a special power of appointment and may appoint property among her children. While not stated in the trust or in any written documentation, this power gives Mom the veiled threat of being able to disinherit any child from his or her share of the trust should the child become a problem to Mom. For example, if a child challenges the amount of a distribution to Mom in court, Mom could exercise the power against such child in retribution.

During the last seven years, Mom has made repetitive requests for distributions from the trustee, and Mom as trustee has never denied herself any such request. The trust was funded with all of Dad's assets of $2 million. The trust has made a 5% rate of return, or $100,000 per year, and Mom's distributions have been $150,000 per year. Prior to Dad's death, Mom's standard of living was $125,000 a year. There is no documentation regarding Mom reviewing her own requests for distributions. The trust contains a spendthrift provision.

Many states are enacting laws that prevent application of the sole trustee Restatement Third position.

Again the issue is whether any creditor may succeed under a dominion and control argument. Each one of Mom's powers is analyzed below.

1. Mom has both investment powers as a trustee and distribution powers as a trustee. The *Baldwin* court summarily dismissed the investment powers as an issue.
2. Mom's distribution powers are limited by an ascertainable standard. Absent a statute protecting Mom in this capacity, the Restatement Third takes the position that any creditor may reach Mom's interest.
3. As noted in the Model 2 example above, the use of the term "primary beneficiary" has been viewed by a couple of courts with a little suspicion. Still, by no means should this factor be close to fatal by itself.
4. The issues with "veiled threats" and special powers of appointment are currently being challenged by a few regulatory agencies regarding the eligibility for governmental benefits. Therefore, this factor alone should not result in a dominion and control type of argument.
5. The fact that Mom made distributions to herself for a bit more than her customary standard of living with no documentation as to the reason why may prove to be a bit problematic when combined with some of the other factors.

If a state does not have a statute that affirmatively rejects the Restatement Third position, one must rely on the assumption that a court will realize that the Restatement Third's position is a creation of or expansion of trust law and hope the court will reject it. So let's assume that the state has adopted a statute to address this issue so that we may proceed with the analysis. The term "primary beneficiary," plus the sole trustee making distributions to himself or herself as a "primary beneficiary," combined with a veiled threat through the special power of appointment as well as undocumented distributions in excess of Mom's customary standard of living do create a situation where courts could hold that any creditor could attach the assets of the trust under a dominion and control argument. Addressing all these items would require a statutory fix.

Furthermore, as many a seminar presenter will tell you, someone in the audience always asks what is there to stop a result-oriented court from ignoring most of the law on point, and looking only at very limited factors in drawing its own conclusion. As discussed in Part 2 of this article, the court in *Dwight v. Dwight*[45] imputed income from a discretionary trust to the beneficiary based on the following three facts:

1. The court found that Dad left the son's share of the inheritance, but not the daughters' share, in a discretionary trust to avoid an alimony claim;
2. The son told the trustee he did not need any money; and
3. The broad discretionary powers of the trustee.

Absent statutory protection, a result-oriented court may attempt to find a combination of factors as constituting dominion and control.

South Dakota's discretionary-support classification trust statute. In addition to addressing the enforceable right issues created by the Restatement Third,[46] South Dakota's discretionary-support classification trust statute is the only statute that also addresses many dominion and control issues. SDCL § 55-1-32 provides:

> In the event that a party challenges a settlor or a beneficiary's influence over a trust, none of the following factors, alone or in combination, may be considered dominion and control over a trust:
>
> (1) A beneficiary serving as a trustee or a co-trustee as described in § 55-1-28;
>
> (2) The settlor or a beneficiary holds an unrestricted power to remove or replace a trustee;
>
> (3) The settlor or a beneficiary is a trust administrator, a general partner of a partnership, a manager of a limited liability company, an officer of a corporation, or any other managerial function of any other type of entity, and part or all of the trust property consists of an interest in the entity;
>
> (4) A person related by blood or adoption to a settlor or a beneficiary is appointed as trustee;
>
> (5) A settlor's or a beneficiary's agent, accountant, attorney, financial advisor, or friend is appointed as trustee; or
>
> (6) A business associate is appointed as a trustee.

SDCL § 55-1-33 provides:

> Absent clear and convincing evidence, no settlor of an irrevocable trust may be deemed to be the alter ego of a trustee. The following factors by themselves or in combination are not sufficient evidence for a court to conclude that the settlor controls a trustee or is the alter ego of a trustee:
>
> (1) Any combination of the factors listed in § 55-1-32;
>
> (2) Isolated occurrences where the settlor has signed checks, made disbursements, or executed other documents related to the trust as a trustee, when in fact the settlor was not a trustee;
>
> (3) Making any requests for distributions on behalf of beneficiaries; or
>
> (4) Making any requests to the trustee to hold, purchase, or sell any trust property.

Like any other statute, South Dakota's statute is not perfect. Yet, as other states look to lead trust jurisdictions to improve certain aspects of their trust law, more states will adopt anti-dominion and control statutes.

Conclusion

Part 1 of this article began with the nine keys to drafting a discretionary dynasty trust. It noted that there were primarily three models for drafting a discretionary dynasty trust. Part 2 of this article discussed estranged spouses being able to force a distribution on behalf of a grandchild as well as the possible imputation of income for child support and alimony if a beneficiary has an enforceable right to a distribution. Part 2 also touched on estate inclusion issues with respect to spousal lifetime access trusts as well as self-settled estate planning trusts. Part 2 concluded that absent a statute codifying the Restatement (Second) of Trusts in this area, drafters would want to use very broad discretionary language in an attempt to avoid a beneficiary of a discretionary trust holding an enforceable right to a distribution.

This third part of the article began with marital property issues in certain equitable division states, and in these states dynasty trusts solve this issue. Finally, there is another great horizon for future trust litigation regarding creditor's rights. This is the dominion and control type of argument. States have begun enacting statutes to remedy the sole trustee/beneficiary issue created under the Restatement Third. However, there are many more dominion and control issues. One lead trust jurisdiction, South Dakota, has begun addressing these dominion and control issues, and other states will follow.

Once a drafter is aware of the advantages of using discretionary dynasty trusts, he or she may decide whether Model 1, Model 2, Model 3, or some variation of the three models is appropriate for a client. The author's experience is that once explained to the client, clients greatly prefer the discretionary dynasty trust over the traditional age vesting, ascertainable standard trusts. ■

> **Practice Notes**
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> **The Restatement Third takes the position that *any* creditor may reach a *sole* trustee's beneficial interest, regardless of whether or not the distribution standard is limited by an ascertainable standard.**

[45] 756 N.E. 2d 17 (Mass. Ct. of App., 2001).

[46] As noted in Part 2 of this article, many practitioners believe that these issues have spilled over into the national version of the UTC.