Discretionary Dynasty Trusts

- *Wall Street Journal, Bloomberg, Investor's News, Horse's Mouth*
- 14 years ago – HEMS & Age Vesting
- Bill Gates
- Grandma Nancy

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- Lonnie McGee's Southern California Tax and Estate Planning Forum, (2006) and (2007); and
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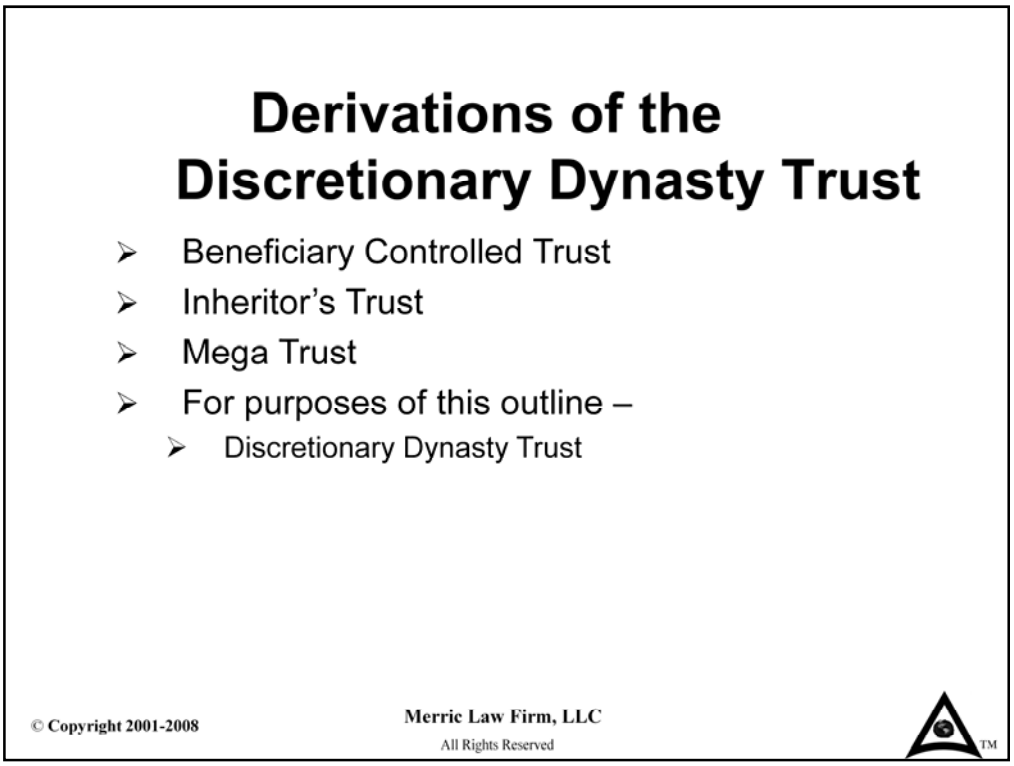
Mark Merric has been fortunate to be one of the few authors that have had three, four, and five part series published in Estate Planning Magazine, Journal of Practical Estate Planning, and Leimberg LISI. He is also a co-author of the following three treatises:

- The Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning, Commerce Clearing House (CCH) treatise, first edition;
- Asset Protection Strategies, American Bar Association (two chapters); and
- Asset Protection Strategies Volume II, American Bar Association to be published Apr. 2005 (MM responsible for 1/5 of the text).

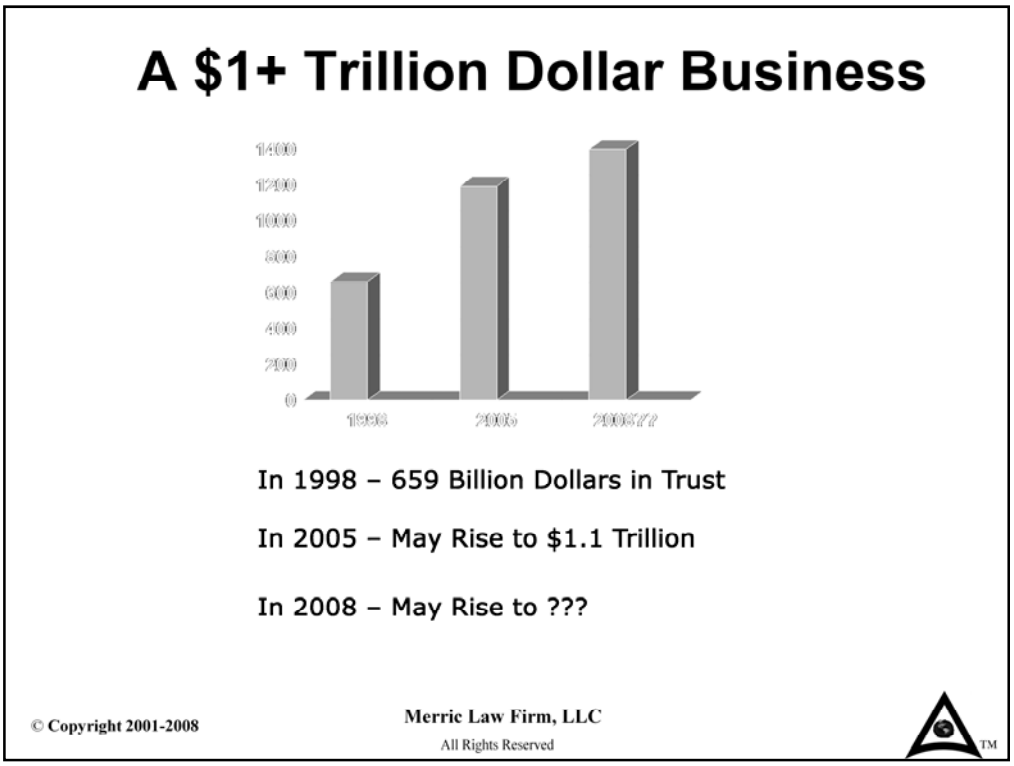
Table of Contents



A. Derivations of a Discretionary Dynasty Trust

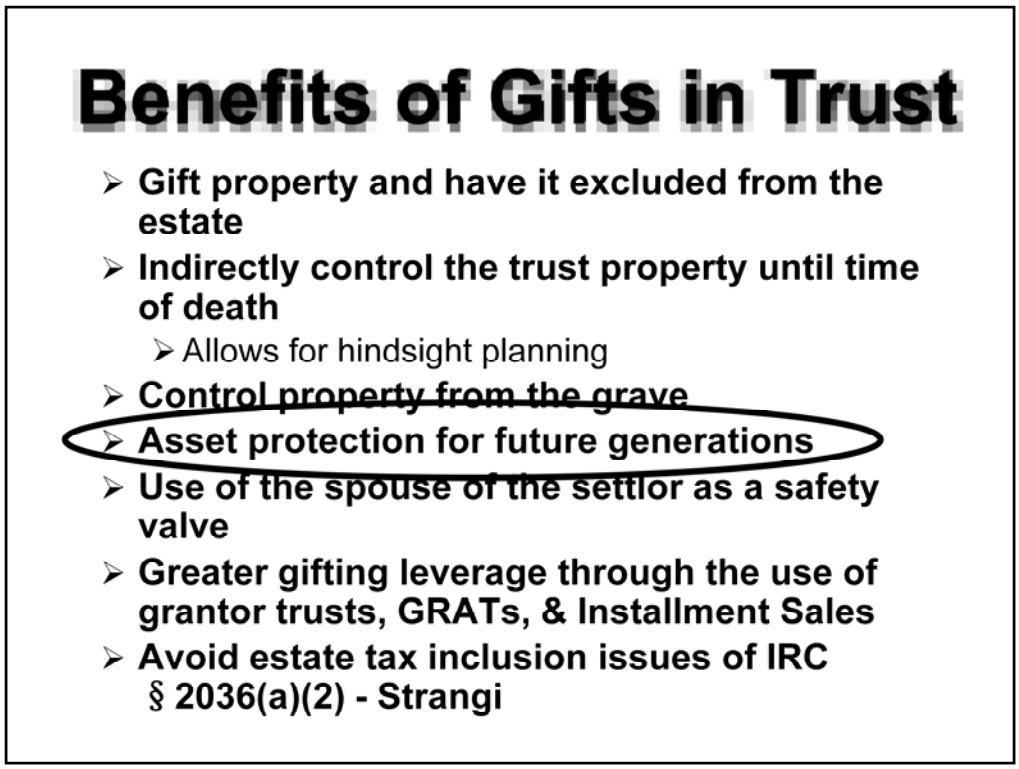
The term "beneficiary controlled trusts" and "inheritor's trusts" were coined and are trademarked by Richard Oshins, Steven Oshins, and Noel Ice. Many times these trusts are also are referred to as discretionary dynasty trusts, and have been frequently discussed by such prominent speakers as John Blatmachr and Roy Adams.

In 2005, *The Wall Street Journal* reported that 100 billion dollars in trust business had been lured away from states that had not abolished the rule against perpetuities. Rachel Emma Silverman, *Looser Trust Laws Lure $100 Billion,* Wall St. J., Feb 16, 2005 at D1.



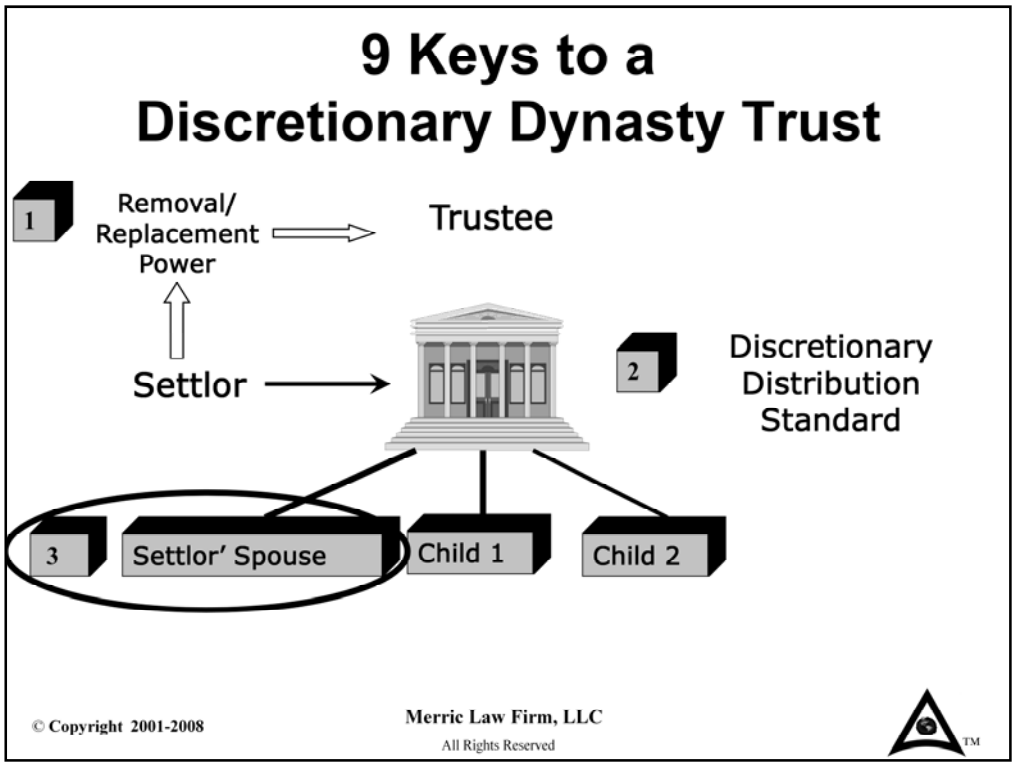
B. Over a One Trillion Dollar Business

In 2005, The Wall Street Journal reported that U.S. personal-trust assets grew to $1.19 trillion, nearly doubling from $658.71 billion in 1998 based on a study from VIP Forum, a research group. Rachel Emma Silverman, *Demystifying Trust Funds,* Wall St. J., Dec 24, 2005 at B1. In 2008, some speculate that the personal trust assets may well be close to $1.4 billion. As a side note, the Wall Street Journal reports that $100 billion in trust business has left states that failed to be competitive with the top trust jurisdictions (e.g., Alaska, Delaware, Nevada, South Dakota – listed in alphabetical order). Rachel Emma Silverman, *Looser Trust Laws Lure $100 Billion,* Wall St. J., Feb 16, 2005 at D1.



C. Benefits of Gifts and Trusts

The above slide details many key benefits of gifting property through the use of trusts. While many of the above benefits are either benefits to the settlor or the benefits save estate tax, there is one key benefit to the beneficiaries – the protection of his or her inheritance from future creditors, misfortunes, and estranged spouses.



C. Nine Keys to a Discretionary Dynasty Trust

1. Removal/Replacement Power

Until the death of the settlor (or possibly the later of the death of the settlor's spouse), the settlor retains the right to remove and replace a trustee who is independent within the meaning of IRC §672(c). However, upon the death of the settlor (or the latter death of the setlor or settlor's spouse), this removal/replacement power vests in the child (assuming the child is over a certain age such as 30 or 35).

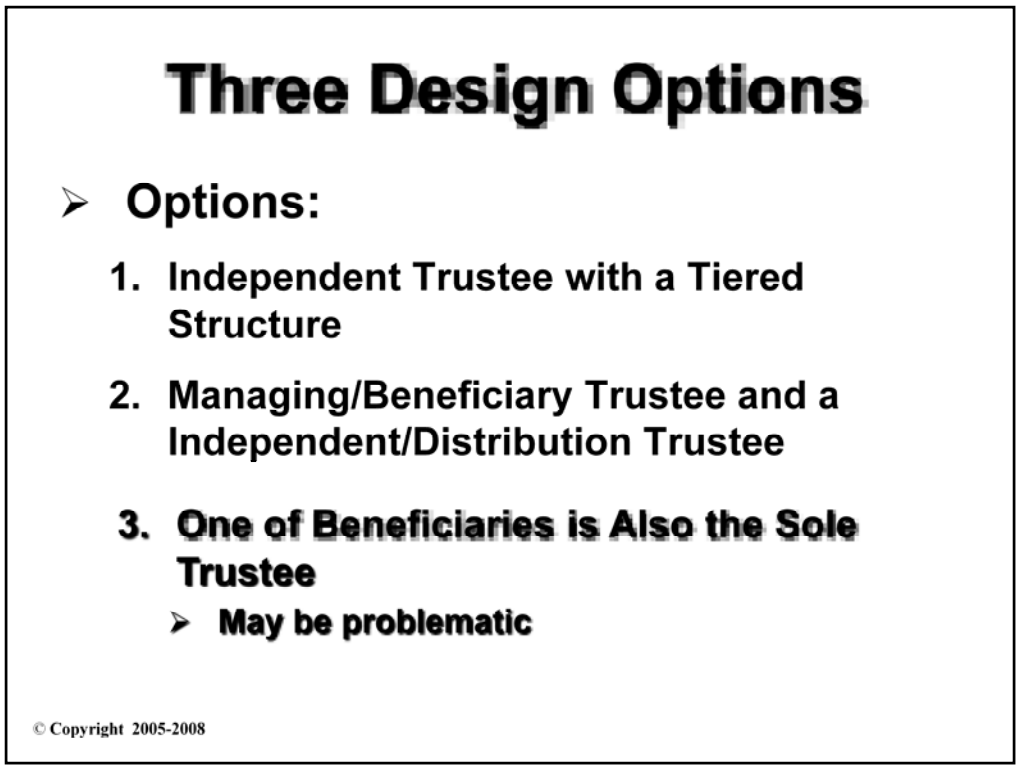
2. Discretionary Trust

The trust provides that the trustee may make distributions to anyone of the beneficiaries in the trustee's sole and absolute discretion. Further, the trustee may make unequal distributions among the beneficiaries and may distribute all of the trust to one of the beneficiaries.

3. Spousal Access Trust

The "settlor's spouse" is named as a beneficiary. The trustee may now borrow the assets from the insurance policy and make distributions to the settlor's spouse. These distributions may be used for family purposes. Naturally, if the settlor's spouse is named in the trust as a beneficiary, problems may easily arise in the event of a divorce. No client would want an estranged spouse suing for distributions from a trust that was funded with his or her assets. Therefore, rather than using the spouse's name, the spouse should be defined as a variable – "the person the settlor is currently married to." Please note that if husband and wife both settle separate trusts, due to the doctrine of reciprocal trusts only one spouse should only be a beneficiary of one trust.

There should be no estate tax inclusion issue by naming a spouse as a safety valve, because divorce is considered an "act of independent significance." PLR 88190001; PLR 9141027; Rev. Rul. 80-255; *Estate of Tully*, 528 F.2d 1401 (Ct. Cl. 1976). Also see GCM 36681 where remarriage is also an "act of independent significance."



4. Options & Problems

The issue of "who may be a trustee," becomes particularly very important with discretionary dynasty planning.

a. Safest Option

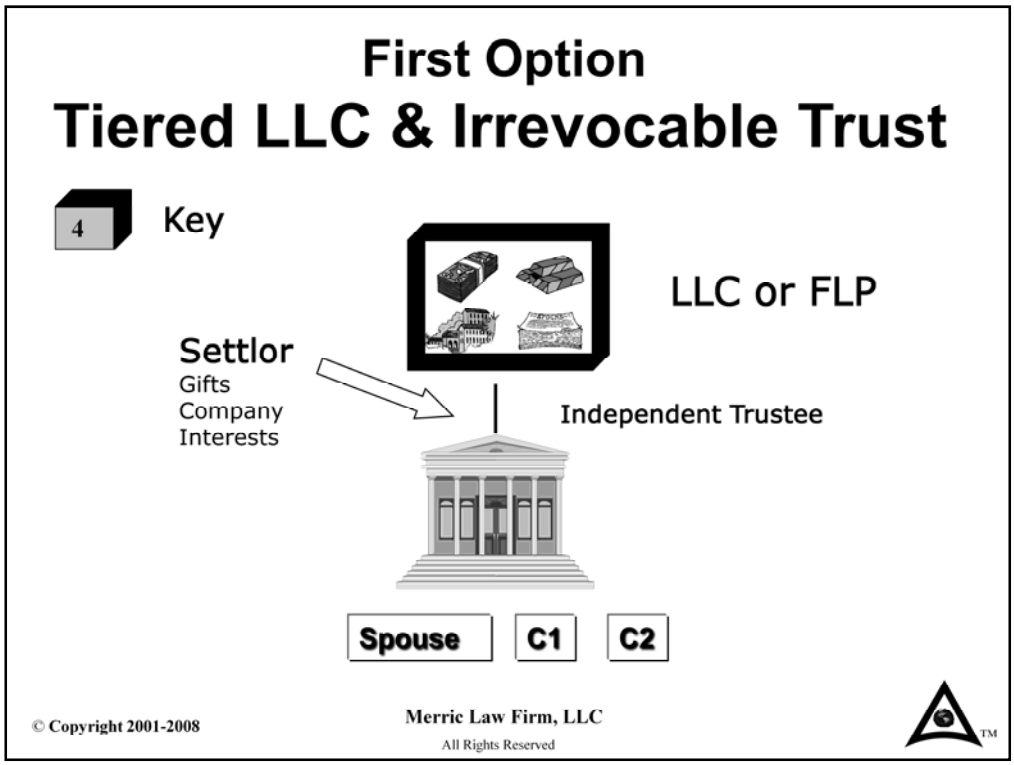
As discussed in the control and dominion portion of the detailed outline *Discretionary Dynasty Trusts*, the safest option is the use of an independent trustee. This is because courts add factors of dominion and control to determine whether a beneficiary has too much control and any creditor can reach the beneficiary's interest.

b. Toward the Grey Area of Planning

On the other hand, under current law an independent distribution trustee combined with a managing trustee should also work. However, as discussed in detailed outline, this is where courts begin to have an issue with dominion and control.

c. A Future Problem Area

Nevertheless, there are potential future problems with a beneficiary serving as a sole trustee. With little, if any, legal authority to support its position, the Restatement Third Section 60 g. takes the position that any creditor may reach a sole trustee/beneficiary's interest. There also seems to be an unreported case in Illinois that most likely can be distinguished from the Restatement Third Section 60 g. view based on several bad facts. For a detailed discussion of this case, please see the detailed outline. Also, for a discussion where some authors see this view as the wave of the future see *Beneficiary-Controlled Trusts Can Lose Asset Protection,* by Charles Harris and Tye J. Klooster, Trusts & Estates Dec 2006.



a. Independent Trustee with a Tiered FLP or LLC

i. Avoiding Dominion and Control Arguments

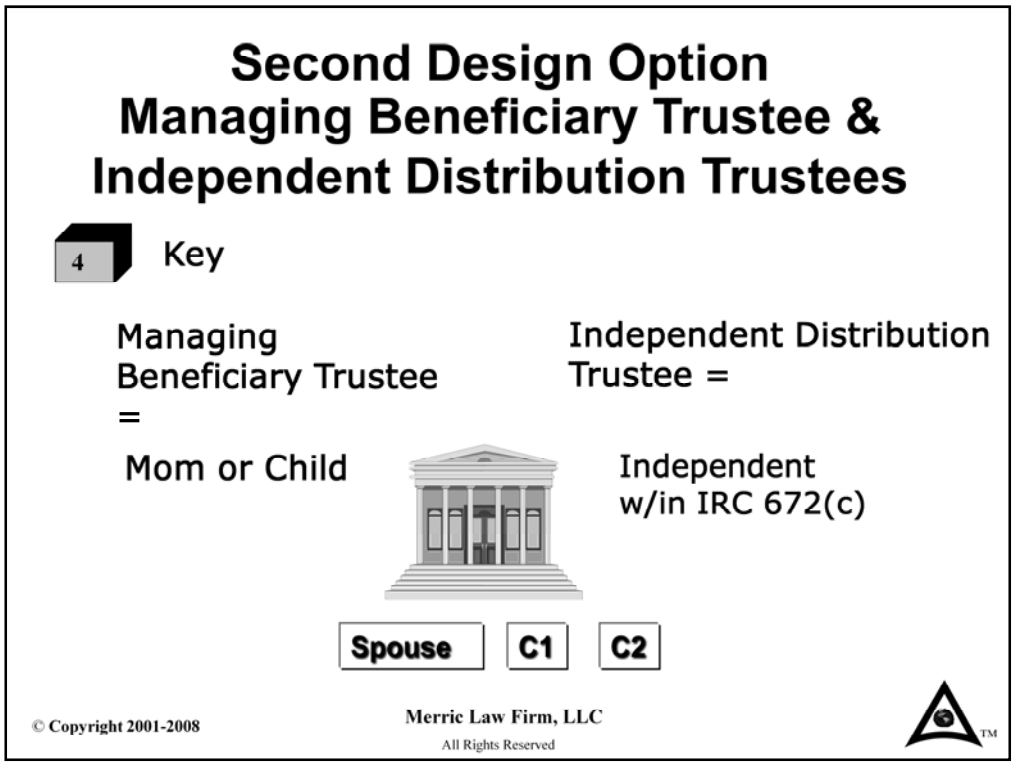
As discussed later in this outline, the independent trustee tiered FLP or LLC is the strongest design from an asset protection perspective. This design gives a greater distance between the beneficiary and the trust to help avoid dominion and control arguments.

ii. Control

The client typically retains control over the assets held by the LLC in his or her capacity as manager of the LLC or general partner of the FLP.

iii. Internal Control

Since the trustee does not have direct access to the assets of the limited liability company, the risk of misappropriation of assets is greatly reduced.



b. Managing Beneficiary Trustee &/ Independent Distribution Trustees

Some estate planners have proposed an alternative to the upper tier LLC (or FLP). These estate planners recommend using the following two co-trustees with different functions:

(1) Managing Trustee – The managing trustee typically is the settlor's spouse or child. The managing trustee has signature authority over investments and makes all investment decisions. The managing authority has absolutely no authority to make any distribution decisions. Many times the managing trustee has a removal/replacement power over the distribution trustee.

(2) Independent Distribution Trustee – The distribution trustee's only function is to make distribution decisions. To avoid any possible estate tax inclusion issues, almost always, the distribution trustee is independent within the meaning of IRC § 672(c).

As discussed later in the discretionary trust outline, from an asset protection perspective, this design option is weaker than the tiered structure on the proceeding page. How much weaker is in a large part determined by who serves as the independent trustee on either structure. For example, if mom's best friend serves as trustee and mom holds a removal power over such person, many estate planners argue that mom has dominion and control over the structure.

Distribution Trustee Provisions

(Complements of WealthDocs, LLC)

Definitions Section of Document

Distribution Trustee

The terms "my Distribution Trustee" or "Distribution Trustee" refer to a person or a corporate fiduciary who is qualified to serve as an Independent Trustee and is appointed as Distribution Trustee in one or more trusts under this agreement. A Distribution Trustee's authority is limited to participating in discretionary distributions specifically assigned to the Distribution Trustee, and has no other powers or responsibilities.

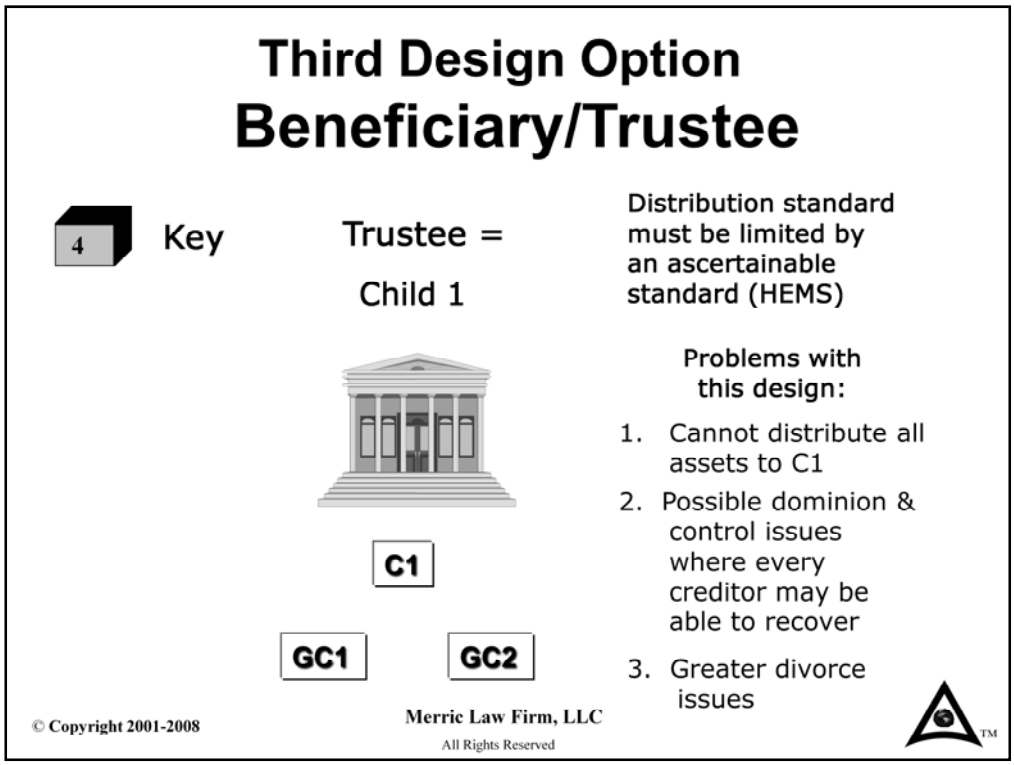
(a) Distribution Trustee Succession Upon My Death

I appoint Independent Bank Trustee to serve as the Distribution Trustee upon my death.

(b) Distributions of Income and Principal

The Distribution Trustee may distribute to the beneficiary or the beneficiary's descendants, or both, as much of the income and principal of the trust as discussed in the following distribution provisions. No other Trustee may make discretionary distributions from the beneficiary's trust. The distribution trustee has no authority to make any trustee decisions other than distribution decisions.

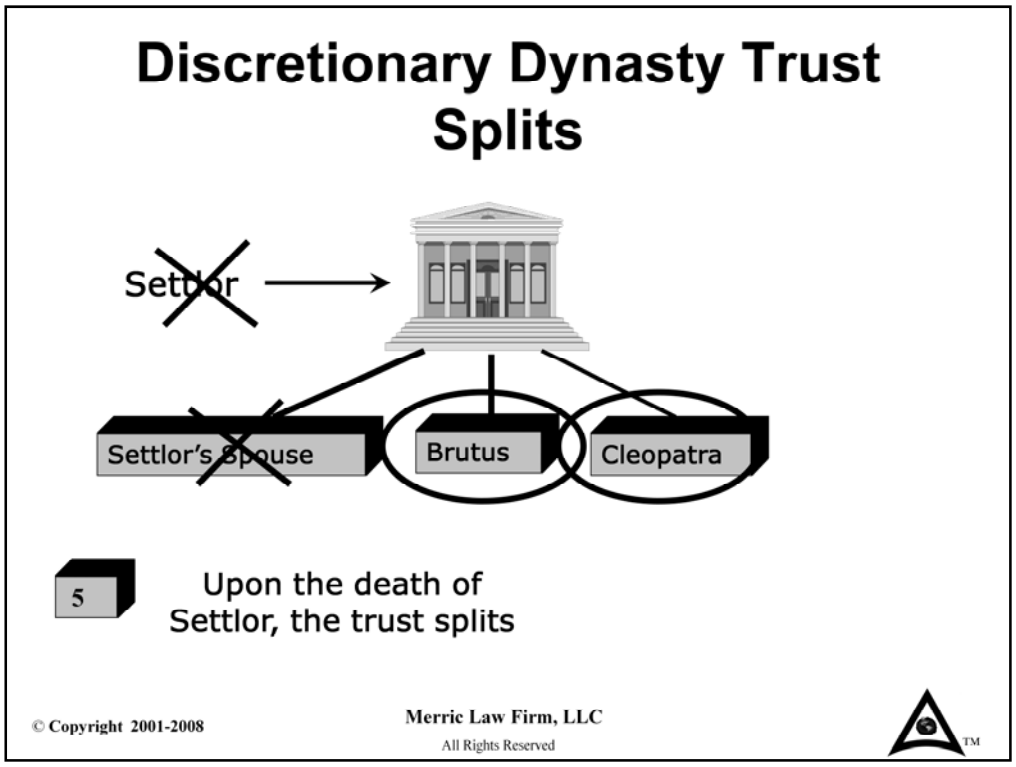
All distribution language and distribution guidelines are modified to state "the distribution trustee" instead of "my trustee."



c. One of the Beneficiaries is the Sole Trustee

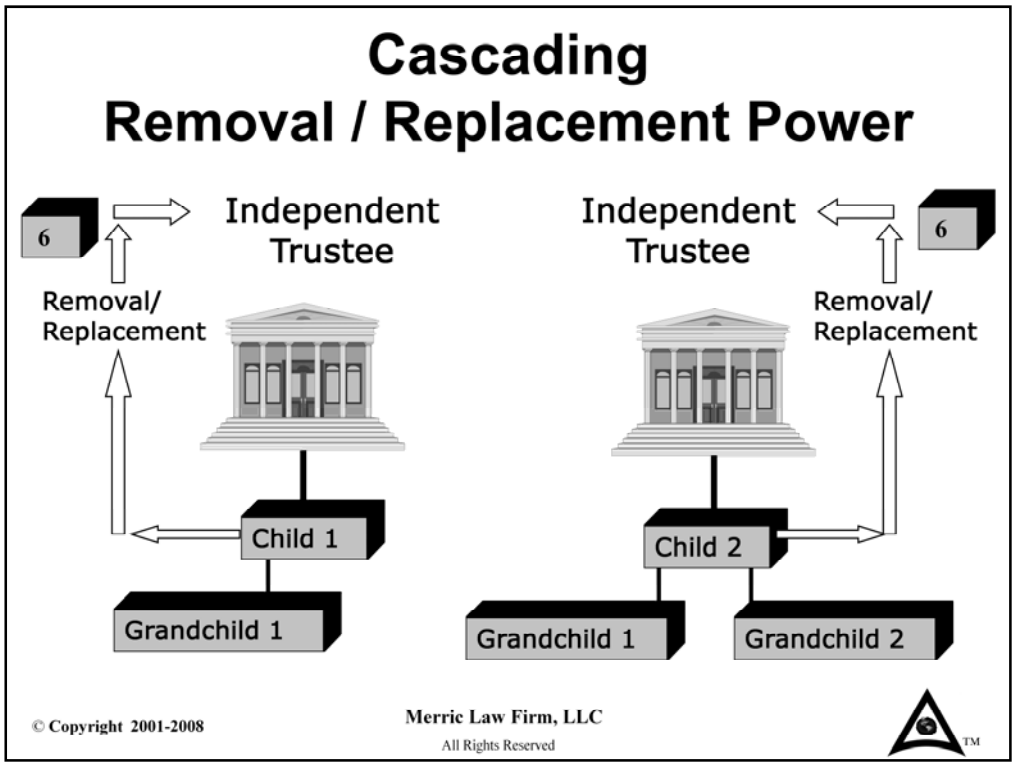
While used by some practitioners, this design option is limited when compared to the other two options. Since the distribution standard must be limited by an ascertainable standard (e.g., health, education, maintenance, and support), all of the trust assets cannot be distributed to the primary child beneficiary. Furthermore, this is the weakest model from an asset protection perspective, and may possibly fail under dominion and control arguments discussed later in this outline. Finally, there is a much greater chance of divorce issues with this design.

In general, the author would not recommend this model, if asset protection of the beneficial interest is a primary goal for the client.



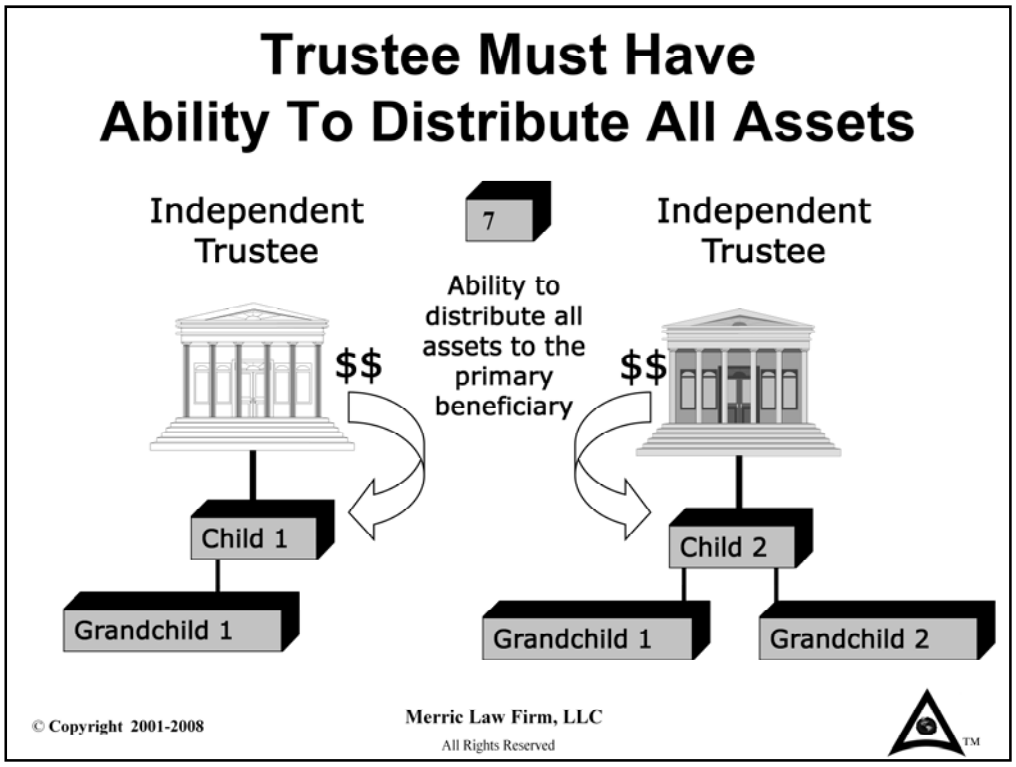
5. Trust Splits Into Separate Trusts

Upon the settlor's death (or, if a first marriage, possibly the latter of the settlor's death or the settlers spouse's death), the trust is split into separate trusts for each child. While some planners use a multiple beneficiary (i.e., a "pot trust") when they create dynasty trusts, this author recommends against such an approach. If a multiple beneficiary trust is used, the trustee of this discretionary trust will need to determine who should get what between children at the same generational level. The children will each have different opinions on what investments assets should be held by the trust. Finally, which child is going to have the removal/replacement power over the trustee? If the trust is divided into separate dynasty trusts, one for each child of the settlor, the sibling arguments are minimized.



6. Each Child Now Holds a Removal/Replacement Power

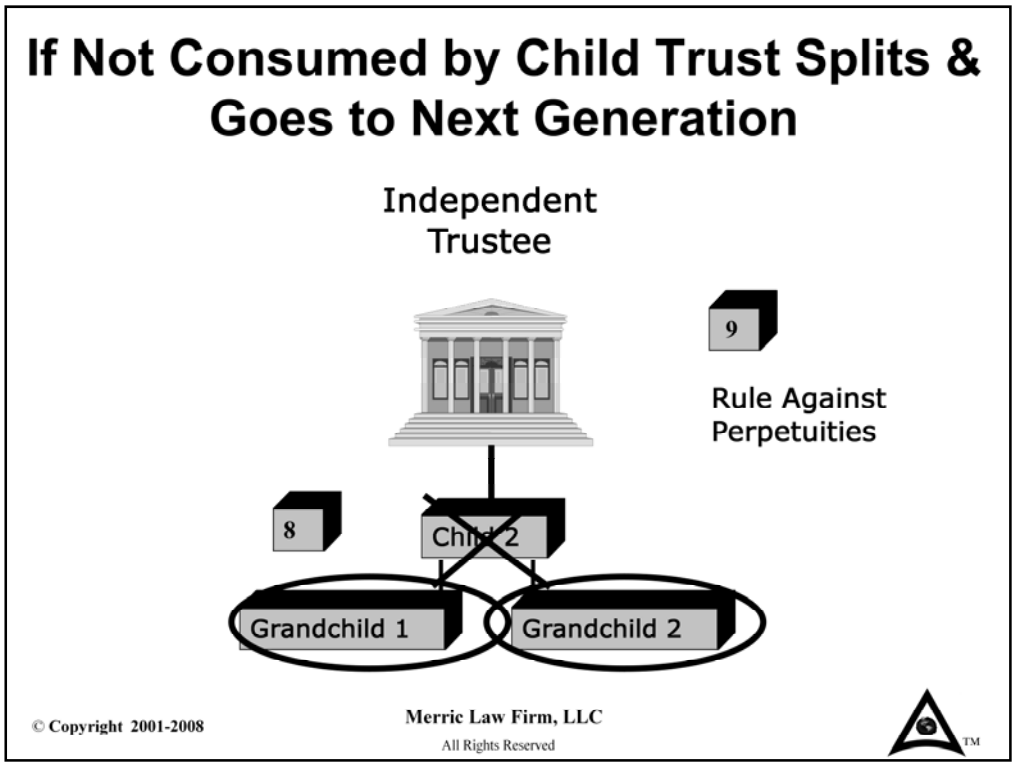
Assuming the child has reached a specified age of maturity (age 30, 35, or 40), each child receives a removal/replacement power over the trustee. Since each child has a separate trust, different trustees may serve on each separate dynasty trust, and each trustee may make investment decisions independently of the other trustee(s) on the other child trusts.



7. Trustee Must Be Able to Distribute All Assets to the Primary Beneficiary

One of the fundamental keys to a discretionary dynasty trust is that the beneficiary is willing to receive their inheritance in trust, rather than outright. During the beneficiary's life, if a beneficiary must share the trust assets with their children by the terms of the trust, then the beneficiary would must unlikely be unwilling to receive the assets in trust. Therefore, a trustee must have the power to distribute all of the assets of the trust to the primary beneficiary, should the trustee choose to do so. In addition to the asset protection benefits, this is why the trust must be drafted as a "discretionary trust" under common law, as the trustee in his or her sole and absolute discretion must have the ability to make distributions to one beneficiary and exclude all others.

Please note as discussed later in this outline, the UTC and the Third Restatement most likely destroy this feature of most discretionary dynasty trusts.

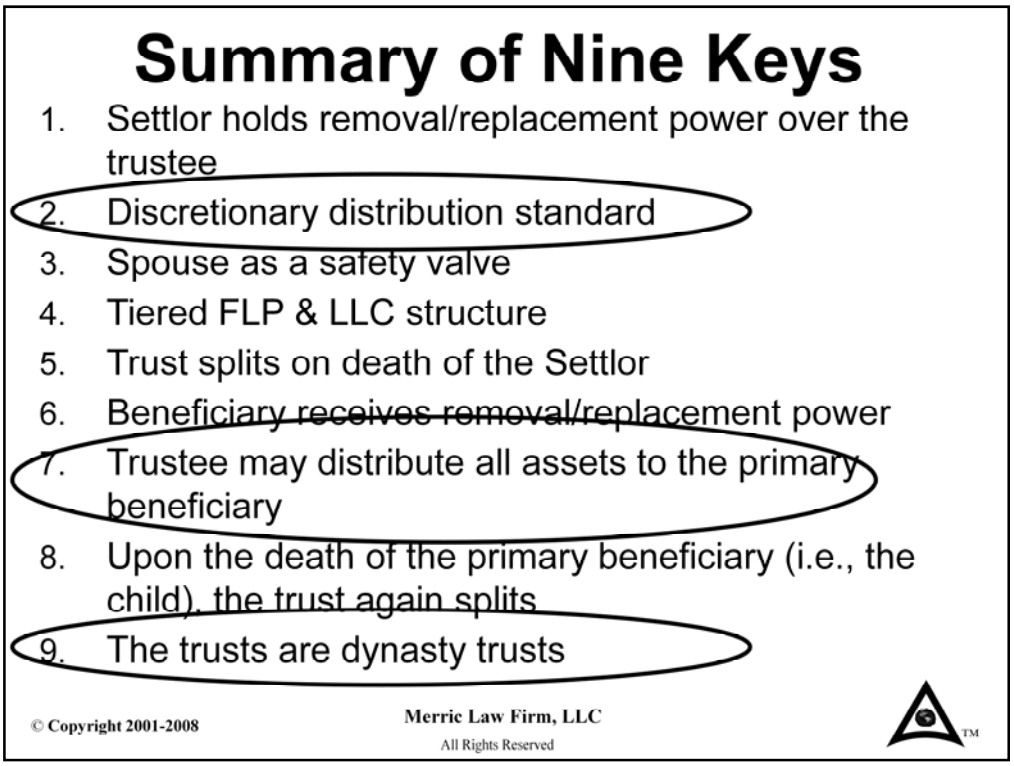


8. Upon the Death of the Child

Upon the death of the child, assuming the trust has not yet been consumed, the trust splits again so that each grandchild trust has a separate dynasty trust. If the grandchild has reached a specified age of maturity, then each grandchild holds a removal/replacement power over the trustee.

9. Dynasty Trusts and the Rule Against Perpetuities

As related to the children, it does not matter whether or not the trust is created in a jurisdiction that has abolished the rule against perpetuities. If a trust must vest twenty-one years plus a life in being, it will automatically survive to the grandchild level, maybe the next generation. In this respect, the child does not hold any vested remainder which may be considered a property interest or an enforceable right under state law.



10. Summary of the Nine Keys

a. Nice Options, But Not Necessary

The following two of the nine keys are nice options that turbo charge the discretionary dynasty trust; however, they are not essential:

(1) Spouse as a beneficiary serving as a safety valve;
(2) Tiered FLP and LLC structure.

b. Helps Keep Children From Fighting

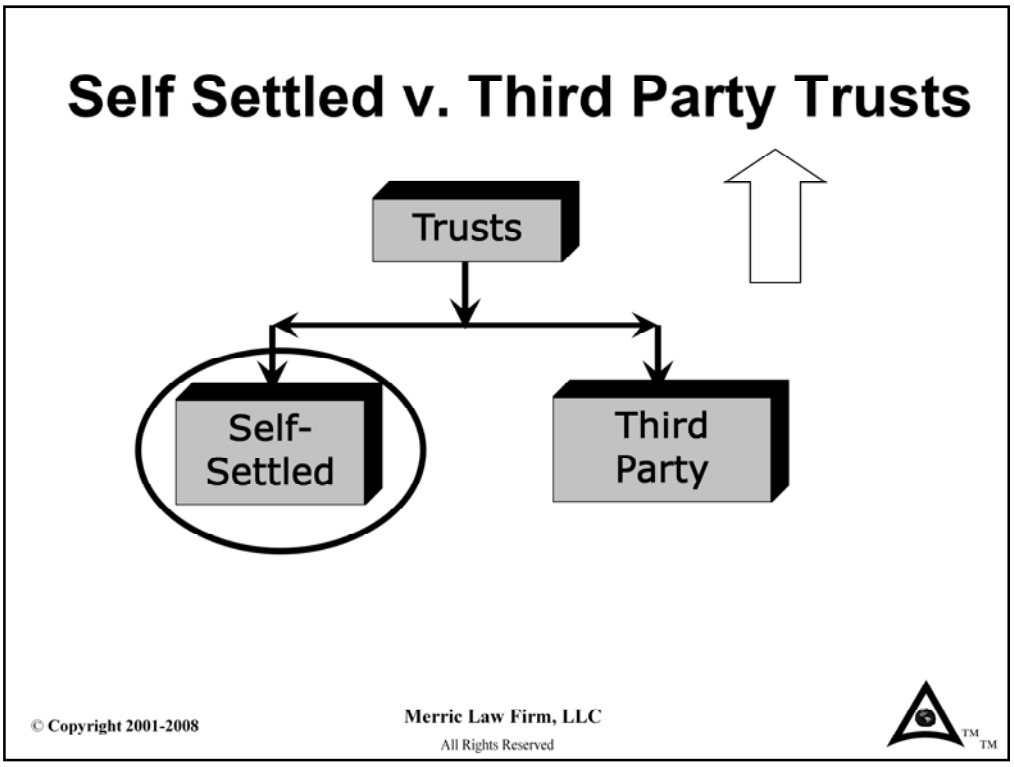
Most children would prefer not participating in a beneficiary controlled trust if such a child might possibly end up sharing part of his or her inheritance with another child. Therefore, the following elements are regarded as essential, but not absolutely necessary:

(1) Trust splits on the death of the settlor into a separate trust for each child;
(2) Upon the death of the child (i.e., primary beneficiary) of the separate child trust, the trust splits again – one separate trust for each grandchild;
(3) The settlor holds a removal/replacement power over the trust until death;
(4) After the settlor's death, each child holds a removal/replacement power over each separate trust.

c. Absolutely Essential For a Beneficiary Controlled Trust

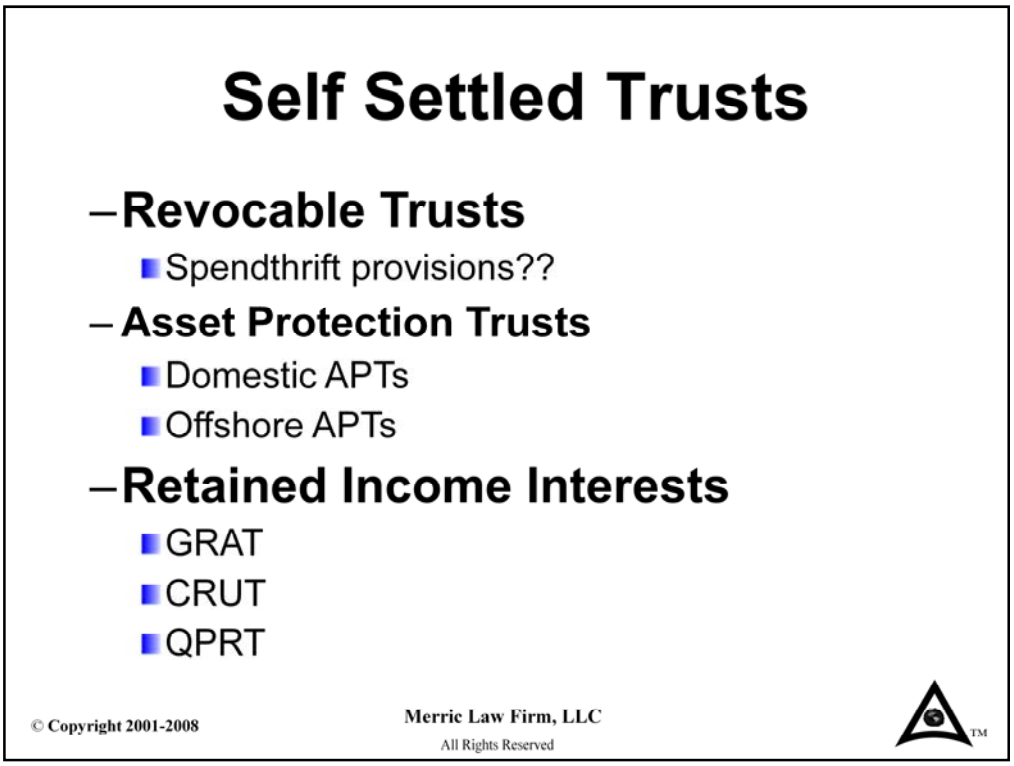
Each of the following three keys are absolutely essential for a discretionary dynasty trust:

(1) Discretionary distribution standard;
(2) Trustee may distribute all of the assets to the primary beneficiary; and
(3) Trusts are dynasty trusts.



D. Self Settled Trusts

Almost all of this outline focuses on third party trusts - generally trusts that are created for the benefit of child or grandchild. However, prior to discussing third party trusts, a brief discussion regarding the lack of asset protection for most self settled trusts follows.



The general rule for self-settled trusts is a creditor may reach the maximum amount that the trustee could distribute to the settlor.[i] With a fully discretionary trust as to income and principal, this would be the entire trust corpus.[ii] With a support trust, this may well be the entire trust corpus or possibly a lesser amount.[iii]

1. Revocable Trust

In this respect, a revocable trust (also known as a living or loving trust) provides no asset protection whatsoever – even if the trust contains spendthrift provisions.

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i Restatement *(Second) Trusts*, Section 156 (1959), and comments d. and e. *Hughes v. Commr. or Internal Revenue Service*, 104 F.2d 144 (9th Cir. 1939); *Byrnes v. Commr.*, 110 F.2d 294 (3rd Cir. 1940); *Nelson v. California Trust Company*, 202 P.2d 1021 (1949); *Greenwich Trust Co. v. Tyson*, 27 A.2d 166 (1942).

ii Restatement *(Second) Trusts*, Section 156 (2) (1959). *In Re Robbins*, 826 F.2d 293 (4th Cir. 1985); *Credit Corp. v. Chase Manhattan*, 473 N.Y.S.2d 242 (N.Y. Sup. Ct. App. Div. 1984); *Cooke Trust Co., Ltd. V. Lord*, 41 Hawaii 1993 (1955); *Crane, for Use of Niemeyer v. Illinois Merchants Trust Co.*, 238 Ill. App 257 (1925).

iii Restatement *(Second) Trusts*, Section 156 (1959), comment d. *Wolfe v. Wolfe*, 21 Mass. App. Ct. 254, 486 N.E.2d 747 (1985); *In re Spenlinhauer*, 195 B.R. 543 (D. Me. 1996); *In re Porras*, 224 B.R. 367 (W.D.Tex.Bkrtcy. Ct. 1998); *Ahern v. Thomas*, 248 Conn. 708; 733 A.2d 756 (Conn. 1999).

2. Retained Mandatory Distribution Interest

a. Attachment of a Mandatory Distribution Interest

A mandatory interest is a distribution that is required to be made by the terms of the trust. There is absolutely no discretion. Examples of retained mandatory interests by a settlor are charitable remainder unitrusts, grantor retained annuity trusts, and qualified personal residence trusts. Under the Restatement (Third) of Trusts[i] and the Uniform Trust Code[ii] any creditor may attach a mandatory interest. Naturally, this would include a settlor retaining mandatory interest in a trust. Please note that state case law may disagree with the Restatement Third and UTC position. See *Brasser v Hutchinson*, 549 P.2d 801 (Colo. App. 1976) *In re Marriage of Guinn*, 93 P.3d 568 (Colo. App. 2004).

b. Self-Settled Interest Retained

Further, it should be noted that charitable remainder trusts and grantor retained income trusts are also self-settled trusts, and a creditor should be able to reach the settlor/beneficiary's interest in such trust.[iii]

A qualified personal residence trust is also a self settled trust and a creditor would be able to attach the debtor's right to live in the residence.[iv] However, the right to live in a homestead may possibly be protected by a homestead exemption.[v]

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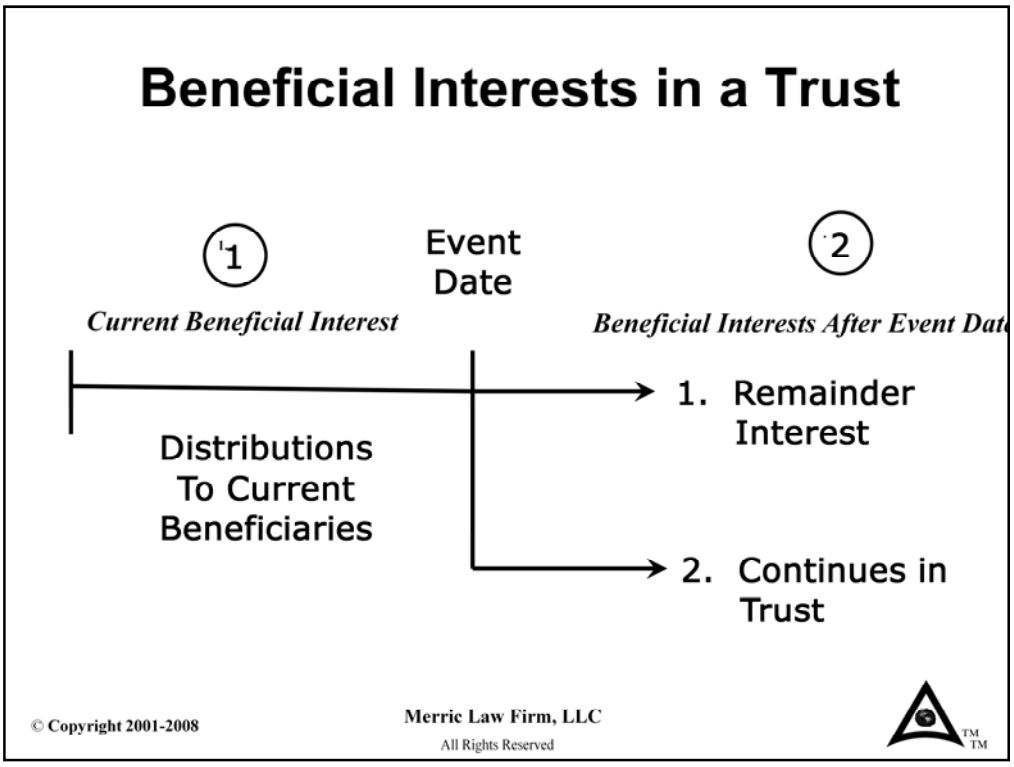
[i] *Restatement (Third) of Trusts*, Section 58 cmt d(2) third paragraph and Reporter Notes cmt d-d(2).

[ii] UTC § 506.

[iii] *In Re Mack*, 269 B.R. 392 (D. Minn. 11/2/01) and *In re Brown*, 303 F.3d 1261 (11th Cir. 2002) are both charitable remainder trust cases where the creditor reached the settlors' income interests.

[iv] In re Frangus, 132 B.R. 723 (N.D. Ohio Bkrtcy 1991) and 132 B.R. 272 (N.D. Ohio Bkrtcy 1992), the trust was not a qualified personal residence trust in conformity with the Internal Revenue Code. However, the settlors did transfer their house into trust with the life interest in the house remaining in the settlors and the remainder interest going to their children. The court held the entire residence could be reached by the creditors, rather than just the life interest.

[v] *Nolte v. White*, 784 So. 2d 493 (Fla. App. Dist. 4 2001); *Ronald v. Welbaum*, 664 So.2d 1 (Fla. App. Dist. 3 1995).



E. Beneficial Interests In Trust

1. Definitions

The time line is divided into two components for purposes of discussion: (1) distribution period to current beneficiaries; and (2) the beneficial interest after the event date.

a. Current Beneficial Interest

The distribution to current beneficiaries is the time period where a trustee may or shall make distributions to any beneficiaries until some event happens. The following is a list of examples of distributions to the current beneficiaries:

- During my spouse's life, the trustee shall make distributions of all income on a quarter-annually basis (mandatory distribution standard).
- During my life, the trustees shall make distributions to my children based on health, education, maintenance, and support (support distribution standard).
- For so long as either my spouse or I are alive, the trustee may make distributions in the trustee's sole and absolute discretion to the current beneficiaries. In determining whether a distribution shall be made and the amount of any distribution, the trustee may exclude any beneficiary from a distribution (discretionary distribution standard).

For purposes of this article, "a current period of time" is the period of time before the event date, where during this period of time, the trustee has either a mandatory distribution standard, a support distribution standard, or a discretionary distribution standard.[i] Further, for purposes of this chapter, all references to distributions means income or principal or both.

b. Event Date and the Beneficial Interest After the Event Date

The event date is where something happens on an event upon which property is either distributed to beneficiaries in the form of a remainder interest or the trust property continues in trust (e.g. a dynasty trust). Many planners may refer to the second time period of trust as the remainder interest. However, as discussed below, there are certain interests in trust that do not vest in any one or a certain class of beneficiaries.

Regarding the situations where a planner drafts a remainder interest, examples of remainder interests are detailed below.

- Upon my death, the trustee shall divide the trust property equally and distribute it to my then surviving children free and clear of trust (i.e., outright distribution).

- Upon the later of my death or my spouses death, the trustee shall distribute one-third of the trust property to my child when she reaches age 25, one-half of the balance when she reaches age 30, and the remaining trust property when she reaches age 35 (i.e., age vesting).

- At the end of ten years, the trustee shall distribute the property to my spouse free and clear of trust (i.e., term of years vesting).

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[i] As noted below, occasionally a drafter will combine some of the above distribution standards and a court may refer to this as a "hybrid distribution standard." It should be noted, for the reasons discussed later in this article, the author strongly recommends <u>not</u> drafting a trust with a hybrid distribution standard (i.e., conflicting distribution language).

In the above examples, the event dates are "upon my death," "upon the latter of my death or my spouse's death," and "at the end of ten years." After the event date, the remainder interest was distributed either outright or pursuant to an age vesting option. Before the event date, the trustee had the power to make distributions to the current beneficiaries based on the distribution standard.

On the other hand, after the event date, there may not be any immediate remainder interest. Rather, the trust property may continue to be held in trust. This is the case with either a dynasty trust or a next generation vesting trust.

- Upon my death, the trustee shall divide the trust property equally between my children. However, each share of the child's trust property shall be held in trust for his or her life. Upon my child's death, the trustee shall divide the trust property equally between my grandchildren. However, each share of the grandchild's trust property shall be held in trust for his or her life. This continues for generation to generation until the trust assets are extinguished or the rule against perpetuities is violated.[i] (dynasty trust)

- Upon my death, the trustee shall make distributions to my children for their health, education, maintenance, and support. Upon the last of my children's deaths, the trustees shall distribute the trust assets to my grandchildren by right of representation. (next generation trust)

In the first example, there is no designated remainder interest that vests in anyone. However, with the second example, the grandchildren and not the children possess a remainder interest.

From the above discussion it is easy to visualize that a beneficiary may be given a current distribution interest, a remainder interest, or both. However, the type of distribution interest and whether the beneficiary receives a remainder interest will determine whether he or she has one, two, or no property interest under state law.

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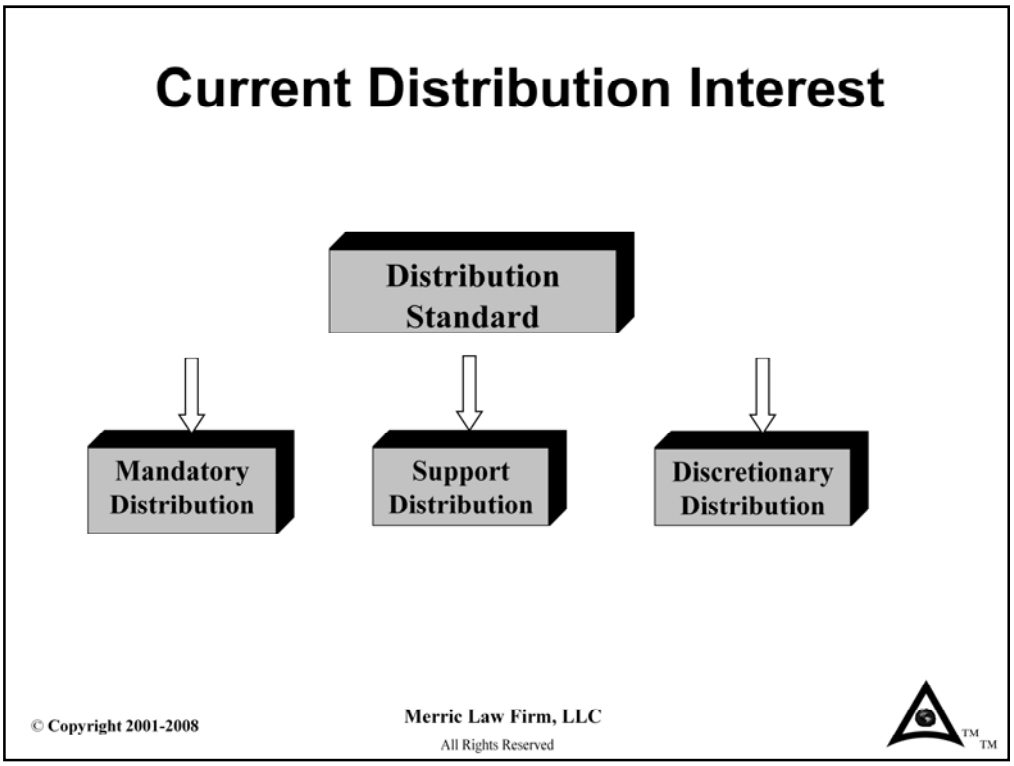
[i] The actual language of a dynasty trust is substantially different than that given in the example. This was done to conserve space and more adequately explain how a dynasty trust works.



2. Common Law Distribution Standards

a. Mandatory Distribution Standard

A mandatory distribution standard is found in the marital trust (i.e., the QTIP trust or power of appointment trust), a grantor retained annuity trust, a charitable remainder annuity trust, or a charitable lead annuity trust. With these types of trusts, the trustee must make the distribution required by the terms of the trust agreement; the trustee may not withhold or accumulate a mandatory distribution.

Typically, a mandatory distribution standard is imposed on certain trusts for them to qualify for certain benefits under the Internal Revenue Code. For example, certain marital trusts (i.e. either a QTIP or power of appointment trust) require that all income be paid at least annually to the surviving spouse in order for the trust to qualify for the marital deduction.[i] A grantor retained annuity trust (GRAT) requires that a certain amount be paid annually for the GRAT annuity term, so that the gift will be only of the remainder interest.[ii] A charitable remainder trust (CRUT) generally requires that the annuity interest be paid annually, so that the CRUT will be classified as a tax exempt entity.[iii]

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[i] IRC Sections 2056(b)(5); IRC 2056(b)(7).

[ii] IRC Section 2702(b).

[iii] IRC Section 664.

b. Support Trust

A support trust under common law was created by the settlor to support one or more beneficiaries. A support trust directs the trustee to apply the trust's income and/or principal as is necessary for the support, maintenance, education, and welfare of a beneficiary.[i] The beneficiary of a support trust can compel the trustee to make a distribution of trust income or principal merely by demonstrating that the money is necessary for his or her support, maintenance, education, or welfare.[ii]

The magical language for a support trust is something similar to:

"The Trustee shall make distributions of income or principal for the beneficiary's health, education, maintenance, and support."

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i *First National Bank of Maryland v. Dept. of Health and Mental Hygiene*, 399 A.2d 891 (Md. 1979); Restatement (Second) Trusts Section 154 (1959).

ii *Chenot v. Bordeleau*, 561 A.2d 891 (R.I. 1989), *Eckes v. Richland County Social Services*, 621 N.W. 2d 851 (ND 2001); Restatement (Second) Trusts Section 128 comments d and e (1959); *Id.*

Implicit in this support language are two components: (1) a command that the trustee "shall" make distributions; and (2) under what standard or circumstances (i.e., health, education, maintenance, and welfare) distributions are to be made.

i. Mandatory Language

A support trust typically includes mandatory language that the trustee "shall" make distributions.[i] The trustee is not given any discretion over whether a distribution is to be made. However, as pointed out below, there are few cases when a trust has been classified as a support trust even though the discretionary word "may," or the words, "discretion," and even "sole discretion" were used instead of the mandatory word, "shall."

ii. Standard For Distribution

In addition to the mandatory language of distribution, the trustee is also given a standard for making distributions, which may be reviewed by a court for reasonableness. Typically, the standard contains words such as "health, education, maintenance, and support." However, such standard may also include terms such as "comfort and welfare."[ii] Further, a support trust gives the trustee discretion only on the time, manner, or size of distributions needed to achieve a certain purpose, such as support of the beneficiary.[iii]

iii. Examples

Courts have determined the following language to create a support trust:

- "[T]he Trustee shall use a sufficient amount of the income to provide for the grandchild's support, maintenance and education" [emphasis added] was held to be a support trust.[iv]

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i *Lineback by Hutchens v. Stout*, 339 S.E.2d 103 (NC App. 1986).

ii It should be noted that for estate tax purposes, the "welfare" standard would result in the trust failing the definition of ascertainable standard. However, for the definition of a support trust, it is included within the ascertainable standard. Further, in some cases, language such as "comfort and general welfare" will also take the trust language outside that of a general support trust. *Lang v. Com., Dept of Public* Welfare, 528 A.2d 1335 (PA 1987); *Restatement (Second) Trusts, Section 154 (1959)*, and comments thereto. But see, *Bohac v. Graham*, 424 N.W.2d 144 (ND 1988).

iii *Eckes v. Richland County Social Services*, 621 N.W.2d 851 (ND 2001).

iv *McElrath v. Citizens and Southern Nat. Bank*, 189 S.E.2d 49 (GA. 1972).

- "[T]he trustee shall pay…[to the settlor's] daughters such reasonable sums as shall be needed for their care, support, maintenance, and education" [emphasis added] was determined to be a support trust.[i]

- "[T]he trustee shall administer the trust estate for the benefit of my wife and my said daughter, or the survivor of either, and the trustee shall apply the income in such proportion together with such amounts of principal as the trustee, it its discretion, deems advisable for the maintenance, care, support and education of both my wife and my said daughter" [emphasis added] created a support trust.[ii]

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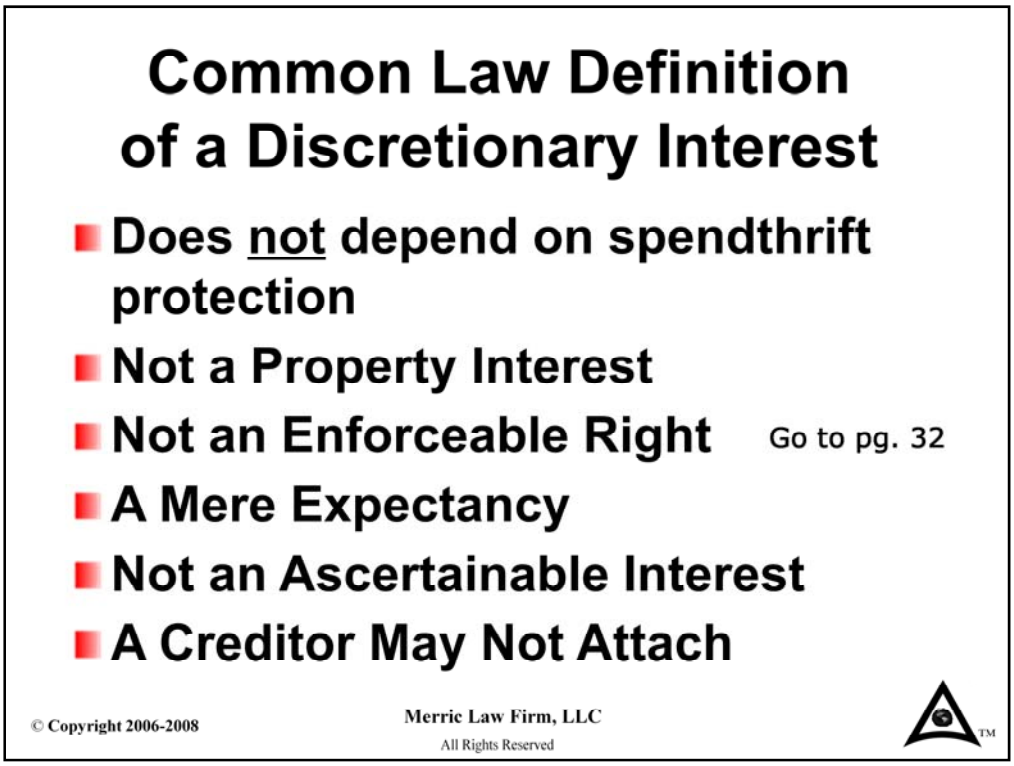
[i] *In re Carlson's Trust*, 152 N.W.2d 434 (SD 1967).

[ii] *McNiff v. Olmsted County Welfare Dept.*, 176 N.W. 2d 888 (Minn. 1970).



F. Common Law Definition of a Discretionary Interest

1. Summary of the Issues

The typical or purely discretionary trust allows the trustee complete and uncontrolled discretion to make allocations of trust funds if and when it deems appropriate.[i] If the beneficiary does not have a property interest or an enforceable right,[ii] a creditor cannot stand in the shoes of the beneficiary and has no right of recovery. [iii], A beneficiary has nothing more than a mere expectancy.[iv]

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i *First National Bank of Maryland v. Dept. of Health and Mental Hygiene*, 399 A.2d 891 (Md. 1979).

ii *In re Horton*, 668 N.W. 2d 208 (Minn. App. 2003) (noting no property interest or enforceable right; *Carlisle v. Carlisle*, 194 WL 592243 (Superior Ct. Connecticut 1994); *Lauricella v. Lauricella*, 565 N.E. 2d 436 (Mass. 1991); *Baltrusis v Baltrusis*, 2002 WL 31058635 (Wash. App. 2002) unreported case.; *In Re Jones*, 812 P.2d 1152 (Colo. 1991); *State v. Rubion*, 308 S.W. 2d 4 (Texas 1957).

iii Rather than using a property analysis, some courts will find that the beneficiary's interest has no ascertainable value. *Miller v. Department of Mental Health*, 442 N.W.2d 617 (Mich. 1989); *Henderson v. Collins*, 267 S.E.2d 202 (Ga. 1980); *In re Dias*, 37 BR 584 (D. Idaho 1984); *First Northwestern Trust Company of South Dakota v. IRS*, 622 F.2d 387 (8th Cir. 1980). In essence, the analysis is the same - there is no interest or enforceable right that a creditor may attach because under this analysis the beneficial interest has no value.

iv *U.S. v. O'Shaughnessy*, 517 N.W. 2d 574 (Minn. 1994); *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991); *Medical Park Hosp. v. Bancorpsouth*, 2004 wl 965927(Ark. 2004); *In re Horton*, 668 N.W. 2d 208 (Minn. App. 2003); *Estate of Johnson*, 198 Cal. App. 2d 503 (Cal. App. 1961); *In re Canfield's Estate*, 181 P.2d 732 (Cal. App. 1947)

An "expectancy is the bare hope of succession to the property of another, such as may be entertained by an heir apparent. Such a hope is inchoate. It has no attribute of property, and the interest to which it relates is at the time nonexistent and may never exist." *Dryfoos v. Dryfoos,* 2000 WL 1196339 (Conn. Super. 2000) unreported case.

2. Erroneous Analysis By Certain Proponents of the UTC

Certain Proponents of the UTC follow the Restatement Third's new view that a discretionary interest is a property interest. They then attempt to limit the plain language of certain discretionary trust cases only to a Colorado divorce case. Moreover, a couple of these proponents even claim that if a beneficiary does not have a property interest there can be no trust.

a. Colorado Cases – Discretionary Interest Not a property Interest

All Colorado cases on point disagree with the opponent's position that a discretionary interest is a property interest. *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991); *In Re Marriage of Rosenblum***,** 602 P.2d 892 (Colo. App. 1979).

"Where the trust permits the trustees to distribute to a beneficiary or beneficiaries so much, if any, of the income and principal as they in their discretion see fit to distribute, a beneficiary **has no property interest** or rights in the undistributed funds. 2 A. Scott, Trusts 128.3 (3rd ed. 1967). Although a beneficiary of such a discretionary trust does have rights therein, those rights are merely an expectancy **and do not rise to the level of property**."

In re Marriage of Guinn, 93 P.3d 568, (Colo. App. 2004); *In re Marriage of Burford,* 26 P.3d 500 (Colo. App. 2001); *In re Marriage of Pooley,* 996 P.2d 230 (Colo. App. 1999); *In re Marriage of Balanson,* 25 P.3d 28 (Colo. 2001).

Ramey v. Rizzuto, 72 F. Supp. 2d. 1202 (D.Colo. 1999) -In discussing a Medicaid Qualifying Trust, citing *Rosenblum,* a district court held, "Under Colorado law a beneficiary of a discretionary trust **does not have a property interest** in the undistributed funds and cannot compel the trustee to distribute funds to the beneficiary."

U.S. v. Delano, 182 F.Supp.2d 10, (D. Colo. 1991). Under Colorado law, the beneficiary of a discretionary trust has a mere expectancy rather than a **property interest** in the trust. This case holds that a federal tax lien would not attach a discretionary interest.

All Colorado cases hold that a discretionary interest is not a property interest – not just divorce cases. However, some UTC proponents attempt to limit this lack of a property interest to Colorado law.

b. Other States Follow the Second Restatement

Other states following the Restatement Second that a beneficiary does not have an enforceable right to a distribution in a discretionary trust and also that a discretionary interest is **not** a property right.

- **Connecticut** – *Dryfoos v. Dryfoos,* 2000 WL 1196339 (Conn. Super. 2000) not reported; *In re Britton,* 300 B.R. 155 (Bankr. D. Conn. 2003).
- **Illinois** – *In re Pritzker,* 2004 WL 414313 (Ill. Cir. 2004) – not reported.
- **Indiana** – *U.S. v. Grim,* 865 F. Supp. 1303 (N.D.Ind. 1994).
- **Kansas** – *In re Pechanec,* 59 B.R. 899 (Bkrtcy D.Kan. 1986).
- **Massachusetts** – *D.L. v. G.L.,* 811 N.E. 2d 1013 (Mass. App. 2004).
- **Minnesota** – *U.S. v. O'Shaughnessy,* 511 N.W.2d 574 (Minn. 1994).
- **Missouri - UTC Statute Section 504.**
- **New Jersey** – *Pulizzoto v. U.S.,* 1990 WL 120670 (D. N.J. 1990) – not reported.
- **New York** – *In re Duncan's Will,* 362 N.YS.2d 788 (N.Y.Surr. 1974).
- **Ohio** – *In re Eley,* 331 B.R. 353 (Bkrtcy S.D. Ohio 2005) – Bankruptcy §541(c)(2).
- **Pennsylvania – SNT Case** – *Lang v. Comm., Dept. of Public Welfare,* 528 A.2d 1335 (PA. 1987).
- **South Dakota** – *First Northwestern Trust Co. of South Dakota, v. IRS,* 622 F.2d 387 (D Ct. 1980).
- **Texas** – *Bass v. Denney,* 171 F.3d 1016 (5th Cir. 1999); *In re Watson,* 325 B.R. 380 (Bkrtcy S.D. Tex 2005); *In re Shurley,* 171 B.R. 769 (BkrtcyW.D. Tex. 19940).
- **Tennessee** – *In re Cassada,* 86 B.R. 541 (Bkrtcy E.D. Tenn. 1988) §541(c)(2).

In addition to the areas of special needs trusts, marital dissolution, federal tax liens, and the above cases, a discretionary interest is not a property interest under bankruptcy law. See Kansas, Ohio, and Tennessee cited above.

c. Certain UTC Proponents' Argument That You Cannot Have a Trust

The author strongly disagrees with the latest proposition of certain UTC proponents that if a discretionary interest is not a property interest, there can be no trust. First, if this was true, all of the trusts in all of the cases cited above that specifically state that a discretionary interest is not a property interest would be invalid. Creditors would have recovered, because there was not trust under this latest argument. This would also lead to the erroneous conclusion that all discretionary trusts in all of the above states are invalid. This would be particularly true in Missouri, where the amended Missouri UTC Section 504 specifically states:

"A beneficiary's interest in a trust that is subject to the trustee's discretion does **not constitute an interest in property** or an enforceable right even if the discretion is expressed in the form of a standard of distribution or the beneficiary is then serving as a trustee or co-trustee."

The concern raised by these opponents is generated from failing to understand the distinction regarding a beneficiary's equitable interest in a discretionary trust when compared to a support trust.

d. Equitable Interest In a Discretionary Trust

The newest argument attempting to support the Restatement Third position weakening the asset protection behind beneficial trusts is that there can be no trust unless a beneficiary has a property interest. The nature of the disagreement arises from failing to understand the difference in a beneficiary's equitable rights under a discretionary trust when compared to a support trust.

i. Basis For Certain UTC Proponents Latest Argument

Restatement Second Section 112 states:

> A trust is not created unless there is a beneficiary who is definitely ascertained at the time of the creation of the trust or definitely ascertainable within the period of the rule against perpetuities.
>
> Comment (a) states – "Such a disposition requires that there be a person to receive the beneficial interest in the property, a person who is to have a right to enforce the trust."

ii. Summary Analysis

It is true that the beneficiary of a trust is the "equitable interest" in the trust. However, it is not true that it rises to the level of a "property interest" under state law. Nor is it true that it must be an enforceable right to a distribution.

iii. Distinguishing Equitable Interests in Trust

The trustee holds the legal interests in a trust while a beneficiary holds an equitable interest. This beginning point of analysis is well stated in *Farmers State Bank of Fosston v. Sigellingson & Co.*, 16 N.W.2d 319 (Minn. 1944).

> "An express trust, as distinguished from a resulting or a constructive one, involves the separation of the legal and beneficial interests in a thing or Res, as it is called, whereby the legal interests in the trust Res are held by a person, the trustee, for the benefit of another, the beneficiary, who has an equitable interest in the Res to receive whatever benefits he is entitled to therefrom **by the terms of the trust.**"

The key to a beneficiary's equitable interest is only to enforce the terms of the trust pursuant to its terms.

iv. Support Interest

Therefore, if a beneficiary has a support interest, the beneficiary has the power to force a distribution from the trust. The beneficiary has an enforceable right, and under Colorado law such an enforceable right would be classified as a property interest.

v. Discretionary Interest

Under common law and the Restatement Second a beneficiary of a discretionary trust does not have a right to force a distribution and likewise does not have a property interest. Therefore, the only rights that a beneficiary of a discretionary trust has is the right to enforce the remaining terms of the trust, which would include challenging a trustee's distribution decision when the trustee violated the judicial review standard (i.e., improper motive, failure to act, or dishonesty).

vi. Detailed Analysis

An excellent analysis of a beneficiary's equitable interest in a discretionary trust is quoted below from *U.S. v. O'Shaughnessy*, 517 N.W.2d 574 (Minn. 1994).

> "An express trust creates two separate interests in the subject matter of the trust--a legal interest vested in the trustee and an equitable interest vested in the beneficiary. Farmers State Bank of Fosston v. Sig Ellingson & Co., 218 Minn. 411, 16 N.W.2d 319, 322 (1944). Under a discretionary express, "a beneficiary is entitled only to so much of the income or principal as the trustee in his uncontrolled discretion shall see fit to [distribute] * * * [the beneficiary] cannot compel the trustee to pay him or to apply for his use any part of the trust property." IIA Austin W. Scott & William F. Fratcher, The Law of Trusts § 155 (4th ed. 1987) [hereinafter Scott on Trusts]. Because discretionary trusts give the trustee complete discretion to distribute all, some, or none of the trust assets, the beneficiary has a "mere expectancy" in the nondistributed income and principal until the trustee elects to make a payment. George G. Bogert & George T. Bogert, The Law of Trusts and Trustees § 228 (1992). Creditors, who stand in the shoes of the beneficiary, have no remedy against the trustee until the trustee distributes the property. Id.
>
> The parties agree that Lawrence P. O'Shaughnessy has an equitable interest in the 1951 Trusts that entitles him to bring suit to compel the trustees to perform their duties, to enjoin the trustees from committing a breach of trust, or to remove the trustees altogether. See Restatement (Second) of Trusts § 199."

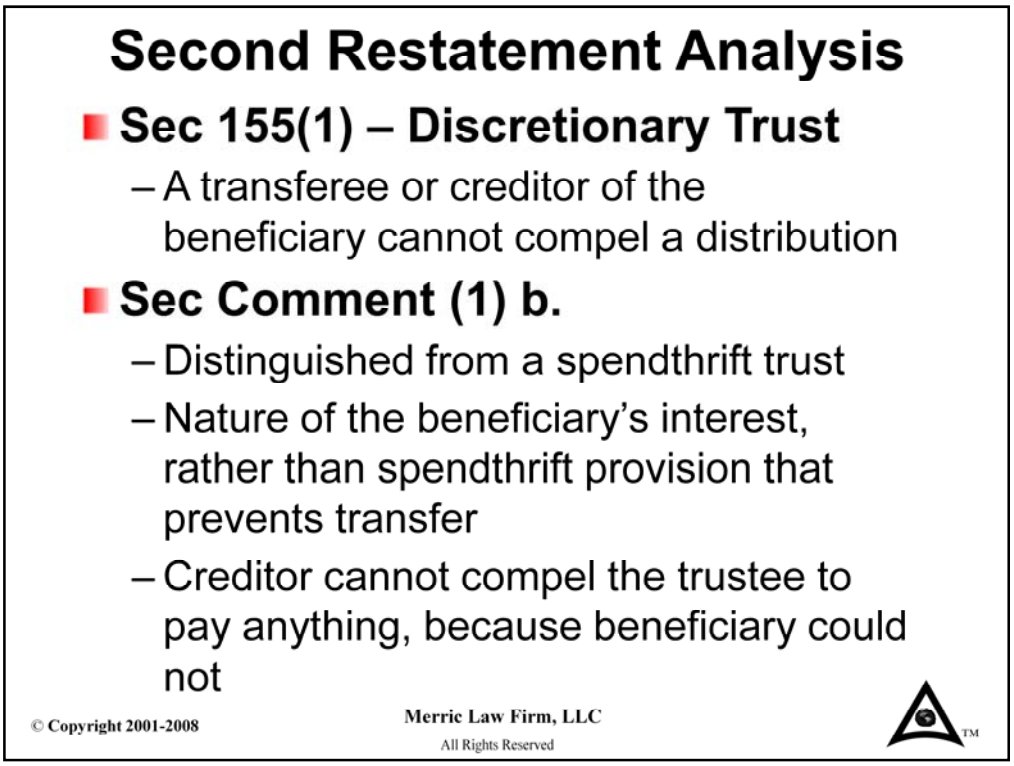
Regarding a beneficiary's equitable interests in a trust, Section 199 of the Restatement Second states that the beneficiary of a trust can maintain a suit:

(a) to compel the trustee to perform his duties as trustee;
(b) to enjoin the trustee from committing a breach of trust;
(c) to compel the trustee to redress a breach of trust;
(d) to appoint a receiver to take possession of the trust property and administer the trust;
(e) to remove the trustee.

No where within Section 199 of the *Restatement (Second) of Trusts* does it state that a discretionary beneficiary has an enforceable right to a distribution.

vii. Secondary Source Comments

One commentator has described a party's interest in a "non-self settled discretionary trust as a "contingent equitable interest." Loring, *A Trustee's Handbook at §5.3.4* at 204 (Rounds ed. 2004). *D.L. v. G.L.*, 811 N.E.2d 1013 (Mass. App. Ct. 2004). The Loring Handbook does not use the term "property," rather it is correctly titled an equitable interest.



3. Second Restatement Analysis

§ 155(1) states "[Except for a self-settled trust], if by the terms of a trust it is provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply, a transferee or creditor of the beneficiary cannot compel the trustee to pay any part of the income or principal."

Comment (1) b. ". . . a discretionary trust is to be distinguished from a spendthrift trust. In a discretionary trust, it is the nature of the beneficiary's interest rather than a provision forbidding alienation which prevents the transfer of a beneficiary's interest. The rule stated in this section is not dependent upon a prohibition of alienation which prevents the transfer of the beneficiary's interest; but the transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel payment to himself or application for his own benefit."

Also see, *Tyler v. Preston Ridge Financial Services Corp.*, 1999 WL 33744315 (Tex. App. 1999) unreported case where the trust did not include a spendthrift provision. Rather, it was the nature of the discretionary nature of the beneficiary's interest that protected the beneficial interest from creditor attachment.

4. Attachment Not Allowed Under Common Law

In an co-authored article by Richard Davis and Stan Kent, these authors incorrectly claim that common law allowed a creditor to attach a discretionary interest. These co-authors state:

> "Where a trust gives the trustee uncontrolled discretion over distributions, the beneficiary does not have an interest that is subject to a federal tax lien; however, distributions made to the beneficiary are subject to attachment." The Impact of the Uniform Trust Code on Special Needs Trusts, NAELA Journal Vol. 1, 2005.

a. Miscite

These UTC authors miscite Section 157.4 of 2A Scott & Fratcher for authority. Section 157.4 is about spendthrift trusts and support trusts. It does not apply to discretionary trusts that are covered in Section 155.

b. Incredible Minority Position

The authors do correctly cite two minority cases: one that did allow a federal tax lien to attach a discretionary trust, and another that appears it would have allowed one to attach however, the court first determined the discretionary interest was not property under bankruptcy law.

c. Majority View

i. Restatement (Second) of Trusts

Denying a creditor the ability to attach a discretionary trust at the trust level flows from Restatement (Second) § 155 that states:

> Except as stated in § 156 [i.e., self-settled trusts], if by the terms of the trust it is provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as the trustee in his uncontrolled discretion shall see fit to pay or apply, a transferee or creditor of the beneficiary cannot compel the trustee to pay any part of the income or principal.

Comment b. of Restatement (Second) Section 155 goes on to state:

> In a discretionary trust **it is the nature of the beneficiary's interest rather than a provision forbidding alienation which prevents the transfer of a beneficiary's interest.** The rule stated in this Section is not dependent upon a prohibition of alienation by the settlor; but the transferee or creditor cannot compel the trustee to pay anything to him because the beneficiary could not compel payment to himself or application of payment.

The key point in the above statement is that the beneficiary does not have an interest that they can transfer (i.e., no property interest). If a beneficiary does not have an interest that they can transfer, then a creditor cannot attach the interest.

ii. Cases on Point

- Majority Rule - *Bass v. Denney*, 171 F.3d 1016 (5th Cir. 1999) that states, "A universal canon of Anglo-American trust law proclaims that when the trustee's powers of distribution are wholly discretionary, the beneficiary has no ownership interest in the trust assets." The *Bass* court further held that a creditor could not attach a discretionary interest, nor could a trustee be required to give 72 hours notice before a distribution is made.

Extracts from other states regarding this issue are:

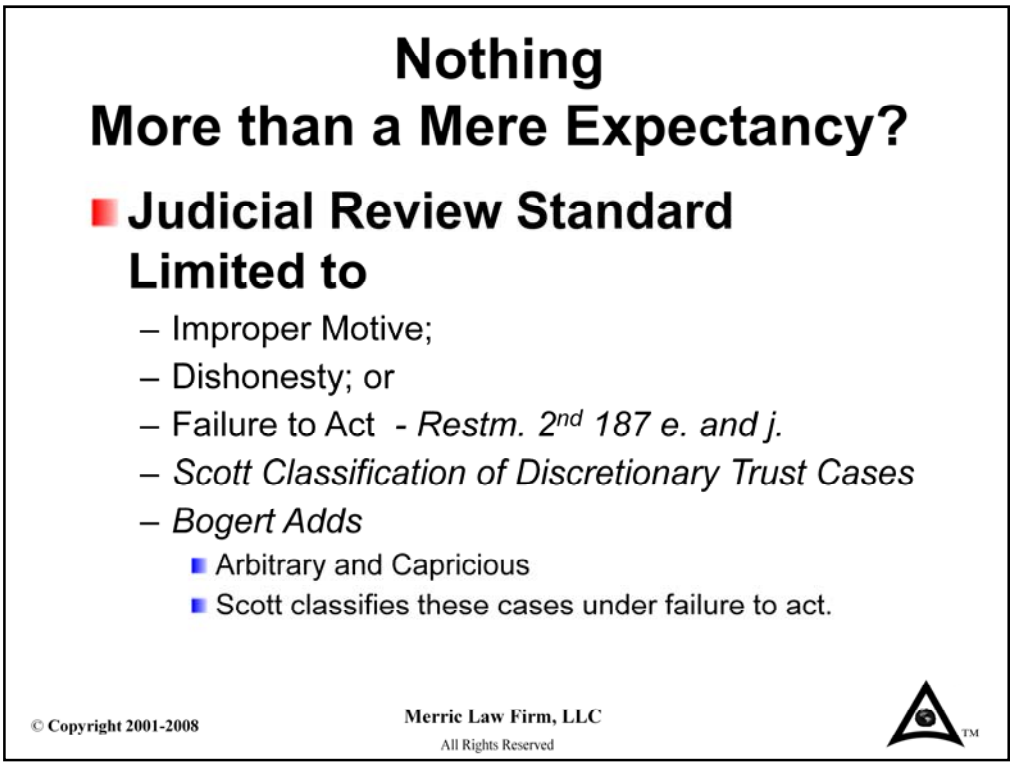
- **California:** *Estate of Canfield*, 181P.2d 732 (Cal. App. 1947).

- **Colorado** – *U.S. v. Delano*, 182 F.Supp.2d 1020 (D. Colo. 2001), "However, such a lien cannot attach to property in which the taxpayer has no "property" interest. *Aquilino v. United States*, 363 U.S. 509, 512, 80 S.Ct. 1277, 4 L.Ed.2d 1365 (1960); *Carlson*, 580 F.2d at 1369." *In re Jones*, 812 P.2d 1152 (Colo. 1991) In a discretionary trust, "neither the corpus nor the income may be reached by his [a beneficiary's creditors] until a distribution occurs." Further, the court states, "the interest in a discretionary trust is not assignable and cannot be reached by his or her creditors." Citing *G. Bogert, Trusts*, § 41 (6th ed. 1987).

- **Connecticut –** *Spencer v. Spencer,* 802 A.2d 215 (Conn. App. 2002). "The well-settled rule in this state is that the exercise of discretion by the trustee of a spendthrift trust is subject to the court's control only to the extent that an abuse has occurred...." *Zeoli v. Commissioner of Social Services,* supra, 179 Conn. at 89, 425 A.2d 553. Furthermore, "Connecticut bars creditors from reaching a distribution except, and until, it be in the hands of the beneficiary" Also see *Foley v. Hastings,* 139 A. 305 (Conn. 1927).
- **District of Columbia:** *Morrow v. Apple,* 26 F.2d 543 (1928).
- **Iowa:** *In re Estate of Tone,* 39 N.W. 2d 401 (1949); *Kifner v Kifner,* 171 N.W. 590 (Iowa 1919); *Roorda v. Roorda,* 300 N.W. 294 (Iowa 1941).
- **Illinois** – *First of America Trust Co. v. U.S.,* 1993 WL 327684 (C.D. Ill. 1993) – not reported, "The disbursement of the principal is subject to the sole discretion of the trustee and the beneficiary does not have a property interest therein. The levy cannot attach to the principal."
- **Kansas:** *Watts v. McKay,* 162 P.2d 82 (1945) the beneficiary of a discretionary trust "did not have an interest in corpus of the estate which could be reached to satisfy a judgment for alimony or attorney fees."
- **Kentucky:** *Calloway v. Smith,* 186 S.W. 2d 642 (1945); *Davidson's Ex'rs v. Kemper,* 79 Ky 5, 1880 WL 7269 (Ky. App. 1880) "No interest will vest in the donee until the power is exercised; and if the trustees refuse to exercise it, the gift cannot be enforced."; *Tood's Ex'rs v. Todd,* 86 S.W.2d 168 (Ky. App 1935) in a discretionary trust, "no interest is created which may be subject to the payment of his debts."
- **Maryland:** *First Natl Bank v. Department of Health & Hygiene,* 399 A.2d 891 (1979).
- **Massachusetts:** *Brown v. Lumbert,* 108 N.E. 1079 (Mass. 1915); *Iasigi v. Shaw,* 45 N.E. 627 (Mass 1897); *Morel v. Cornell,* 125 N.E. 575 (Mass. 1920) holding an interest in a discretionary trust conferred no absolute rights on the son which he could alienate in advance, or which could be taken for payment for debts.
- **Michigan.** *Miller v. Department of Mental Health,* 442 N.W. 2d 617 (Mich. 1989).
- **Minnesota.** *U.S. v. O'Shaughnessy,* 517 N.W.2d 574 (Minn. 1994) "Under Minnesota law, the beneficiary of a discretionary trust . . . does not have property or any right to property in the nondistributed principal or income before the trustees have exercised their discretionary power." Later in the opinion, "Creditors who stand in the shoes of the beneficiary, have no remedy against the trustee until the trustee distributes the property." Therefore, a federal tax lien could not attach to the discretionary trust.
- **New Hampshire:** *Anthorne v. Anthorne,* 128 A.2d 910 (1957).
- **New York:** *Matter of Duncan,* 362 N.Y.S.2d 788 (1974) held that the beneficiaries of a discretionary trust "have no absolute right to receive income or principal from the trust and there is no property or rights to property belonging to the beneficiaries, specifically Thomas W. Doran, the subject of levy."
- **Ohio:** – *Domo v. McCarthy,* 612 N.E.2d 706 (Ohio 1993), "the discretionary nature of the substituted trust prevents creditors, including Domo, from attaching James Souffer, Jr.'s interest in the James Stouffer, Sr. trust." Also, see *In re* Eley, 331 B.R. 353 (SD Ohio 2005) noting a

- **Ohio:** – *Domo v. McCarthy*, 612 N.E.2d 706 (Ohio 1993), "the discretionary nature of the substituted trust prevents creditors, including Domo, from attaching James Souffer, Jr.'s interest in the James Stouffer, Sr. trust." Also, see *In re* Eley, 331 B.R. 353 (SD Ohio 2005) noting a discretionary trust is equally effective against creditors as a spendthrift provisions.
- **Pennsylvania:** *Keyser v. Mitchell*, 67 Pa. 473 (1871) "Where the amount results from the discretion of the trustee, and that discretion is personal, no sum, economic benefit, exists to be attached."
- **Rhode Island:** *Petition of Smyth*, 139 A. 657 (1927), "If the trustees have discretion to withhold income from the beneficiary, he has no vested interest and the income can neither pass by assignment nor be reached by the creditors . . ."
- **South Carolina:** *Collins v. Collins*, 122 S.E. 2d 1 (1961).
- **Tennessee –** *In re Elsea*, 47 B.R. 142 (Bkrtcy Ten. 1985), "A debtor's interest in a discretionary trust is free from the claims of his creditors because the trustee's discretion as to whether to make payments deprives the beneficiary of any interest that can be anticipated. *Restatement (Second) Trusts §§ 154 & 155 (1959).*
- **Texas** – *Bass v. Denney* cited above as the majority rule. Some other cases are *In re Pratt*, 47 B.R. 142 (Bkrtcy. Tenn. 1985); *In re Watson*, 325 B.R. 380 (Bkrtcy S.D. Tex. 2005); *Texas Commerce Bank Nat. Assn. v. U.S.*, 908 F. Supp. 453 (S.D. Tex. 1993), "Therefore to the extent that Elly was entitled to wholly discretionary distributions from the trust in June 1993, there was no interest to which the IRS's levy could attach."

For many more cases please refer to *Scott on Trusts, Section 155 footnote 2* Fourth Edition.



5. Judicial Review Standard

a. Restatement (Second) Section 187

Restatement (Second) Section 187 – "Where discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the trustee of his discretion."

Comment e – "… the court will not interfere unless the trustee in exercising or failing to exercise the powers acts **dishonestly,** or with an **improper** even though not dishonest motive, or **fails to use his judgment,** or **acts beyond the bounds of a reasonable judgment.**

Comment j. – "The mere fact that the trustee is given discretion does not authorize him to act beyond the bounds of a reasonable judgment. **The settlor may, may however, manifest an intention that the trustee's judgment need not be exercised reasonably, even when there is a standard by which the reasonableness of the trustee's conduct can be judged.** This shall be indicated by a provision in the trust instrument that the trustee shall have "absolute" or "unlimited" or "uncontrolled" discretion. **These words are not interpreted literally but are ordinarily construed as merely dispensing with the standard of reasonableness."**

When comment e and comment j are combined, the judicial review standard for a discretionary trust becomes (1) dishonesty; (2) improper motive; or (3) failure to act. In fact, this is the classification system used by *Scott on Trusts.*

b. Scott & Bogerts on Discretionary Judicial Review Standard

Also see the detailed analysis of *Scott on Trusts*, Section 187 at Page 15 where it is noted that if the distribution standard includes enlarged or qualifying adjectives such as "sole and absolute discretion" combined with "no fixed standard by which the trustee can be determined is abusing his discretion…the trustee's discretion would generally be deemed final." Furthermore, Section 187.2 provides, "[e]ven though there is no standard by which it can be judged whether the trustee is acting reasonably or not, or though by the terms of the trust he is not required to act reasonably, the court will interfere where he acts dishonestly or in bad faith, or where he acts from an improper motive." This analysis by *Scott on Trusts* remains consistent through the 2003 supplemental volume.

George Taylor Bogert also seems to hold relatively the same definitional analysis as *Scott* in *The Law of Trusts and Trustees*, 2nd Edition 1980, Supplement through 2003. Section 560 of the Supplement at Page 183 provides that if a settlor has given a discretionary power (without qualification), the court is reluctant to interfere with the trustee's use of the power…Hence, in the absence of one or more of the special circumstances mentioned hereinafter, the court will not upset the decision of the trustee. These special circumstances (at Page 196) are (1) a trustee fails to use his judgment; (2) an abuse of discretion; (3) bad faith; (4 dishonesty; (5) an arbitrary action. Regarding the issue of "arbitrary action," *Bogert* provides, "[i]f the trustee has gone through the formality of using his discretion, but has not deliberately considered the arguments pro and con, and thus has made a decision for no reason at all, his conduct may be characterized as arbitrary and capricious, as amounting to a failure to use his discretion. In this respect, *Bogert* suggests that the "arbitrary" action is a subset of a trustee failing to act.

The Restatement (Second) of Trusts three tier classification that was followed by *Scott* of (1) dishonesty; (2) improper motive; and (3) failure to act is also supported by many cases.[i]

c. Most Cited Judicial Review Standard For A Discretionary Trust

Certain UTC proponents who apparently wish to follow the Restatement Third's new view of law and create an enforceable right to a distribution in almost all discretionary trusts generally ignore the dual judicial review standard under common law or imply it is only a Colorado case. However, as detailed on the next page, the discretionary judicial review standard from the Restatement (Second) of Trusts, cited by Scott on Trusts is by far the most common judicial review standard for a discretionary trust.

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[i] *In Re Jones*, 812 P.2d 1152 (Colo. 1991); *Ridgell v. Ridgell,* 960 S. W. 2d 144 (Tex. App. 1997); *Kansas Dept. of Social and Rehabilitation Services*, 866 P.2d 1052 (KS 1994); *Simpson v. State, Dept. of Social and Rehabilitation Services*, 906 P.2d 174 (Kan.App.,1995); *Wright v. Wright*, 2002 WL 1071934 (Iowa App. 2002) – not cited for publication. (However this is an excellent case of a psychotic child attempting to sue the parent trustees on a discretionary trust. Had the psychotic child had an enforceable right, the result would be more than problematic); *First Nat. Bank of Maryland v. Department of Health and Mental Hygiene*, 399 A.2d 891 (Md. 1979); In re Tone's Estates**,** , 39 N.W.2d 401, (Iowa 1949); *Town of Randolph v. Roberts*, 195 N.E.2d 72 (Mass. 1964).

Colorado	*In re Jones*, 812 P.2d 1152 (Colo. 1991); *In re Guinn*, 93 P.2d 568 (Colo. App. 2004)
Connecticut	*Auchincloss v. City Bank Farmers Trust Co.*, 70 A.2d 105 (Conn. 1946)
Iowa	In re Tone's Estates**,** , 39 N.W.2d 401, (Iowa 1949); *Wright v. Wright*, 2002 WL 1071934 (Iowa App. 2002) – not cited for publication
Illinois	*Croslow v. Croslow*, 347 N.E. 2d 800 (Ill. App. 1976)
Kansas	*Simpson v. State, Dept. of Social and Rehabilitation Services*, 906 P.2d 174 (Kan.App. 1995); *Kansas Dept. of Social and Rehabilitation Services*, 866 P.2d 1052 (KS 1994)
Maryland	*First Natl. Bank v. Dept. of Health & Mental Hygiene*, 399 A.2d 891(Md. 1979).
Massachusetts	*Town of Randolph v. Roberts*, 195 N.E.2d 72 (Mass. 1964)
New York	*Vanderbilt Credit Corp. v. Chase Manhattan Bank, Natl. Assocn.* 473 N.Y.S.2d 242 (N.Y. 1984).
Ohio	*In re Ternansky's Estate*, 141 N.E. 2d 189 (1957); *Culver v. Culver*, 169 N.E. 486 (1960); *Thomas v. Harrison*, 191 N.E.2d 862 (1962)
Oregon	*Barnard v. U.S. Natl. Bank*, 495 P.2d 766 (Or. App. 1972).
Pennsylvania	*Lang v. Commonwealth, Dept. of Public Welfare*, 528 A.2d 1335 (Pa. 1987)
Rhode Island	*Chenot v. Bordeleau*, 561 A.2d 891 (R.I. 1989)
South Dakota	SB 98
Texas	*Ridgell v. Ridgell*, 960 S. W. 2d 144 (Tex. App. 1997)
England	*Re Trafford's Settlement: Moore v. Inland Revenue Commissioners*, 1 All E.R. 1108 (Ch. D.) 1984
Canada	*Minister of Community & Social Services v. Henson*, C.C.L. 3069 (Ont. C.A.) – because trustees have unfettered discretion as to whether to pay income or principal to handicapped beneficiary, beneficiary cannot compel payment, so beneficiary has no "liquid assets" that disqualify him for an allowance as a disabled.
	In re Maw, 1 D.L.R. 365 (Man.) 1953

G. Elements of a Common Law Discretionary Trust

Courts have emphasized four factors when classifying a trust as a "discretionary trust" under common law.

1. Uncontrolled Discretion

The Restatement (Second) and most court holdings agree that the most important of these factors is granting the trustee uncontrolled discretion. *Restatement (Second) Sec. 187 comment j*.

2. Permissive Language

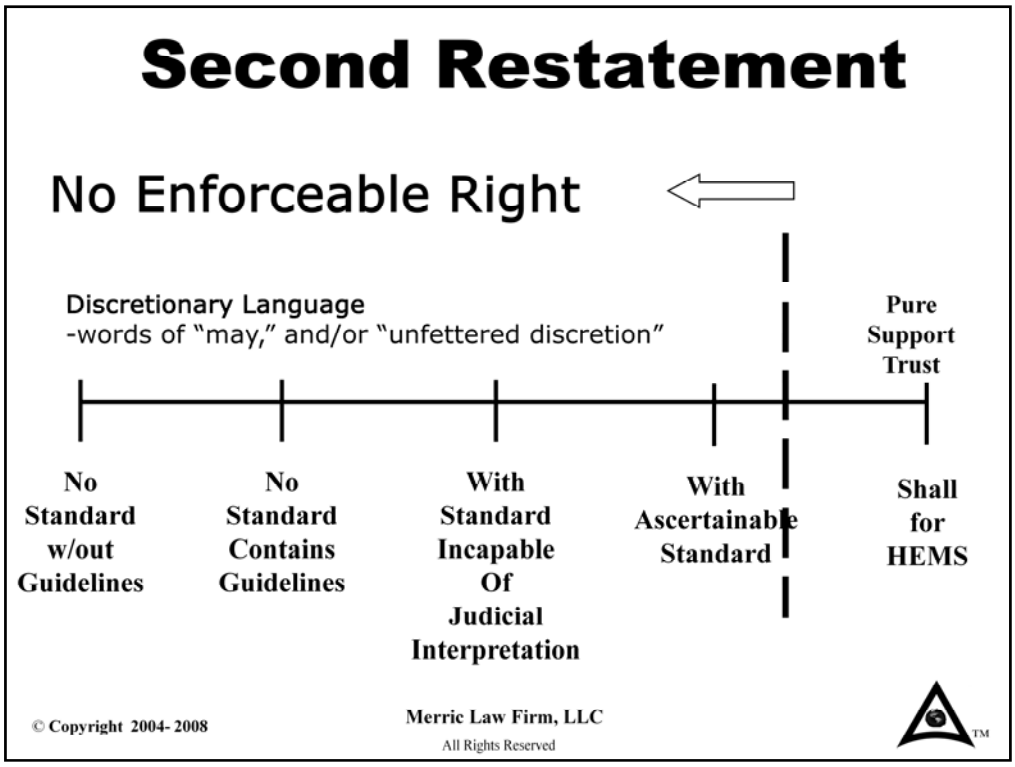
Generally, a discretionary trust uses permissive language: the word "may" instead of the word "shall." *State ex. rel. Secretary of SRS v. Jackson*, 822 P2d 1033 (KS 1991). Some courts have placed greater emphasis on the discretionary nature of the trust with words such as "may" v. "shall." *Tidrow v. Director, Division of Family Services*, 668 S.W. 2d 912 (Mo. Ct. App. 1985); *Matter of Henry's Estate*, 565 P.2d 1166 (Wash 1977); *Lineback by Hutchens v. Stout*, 339 S.E.2d 103 (N.C. App. 1986); *LaSalle National Bank v. U.S.*, 636 F.Supp. 874 (Dist Ct. Ill. 1986); *Delano v. U.S.*, 182 F.Supp.2d 1020 (D. Colo. 2001).

3. No Requirement of Equality

Other courts have noted that when the uncontrolled discretion is combined with the ability to discriminate among beneficiaries, there is little if any question that the settlor intended to create a discretionary trust. *Dryfoos v. Dryfoos*, 2000 WL 1196339 (Conn. Super. 2000) unreported case; *McNiff v. Olhstead County Welfare Dept.*, 176 N.W.2d 888 (Minn. 1970); *First NorthWestern Trust Company of South Dakota v. IRS*, 622 F.2d 387 (8th Cir. 1980); *Matter of Brooks' Estate*, 596 P.2d 1220 (Colo. App. 1979); *Hamilton v. Drogo*, 150 N.E. 496 (Ct. App. NY 1926).

4. Standard is Not Ascertainable

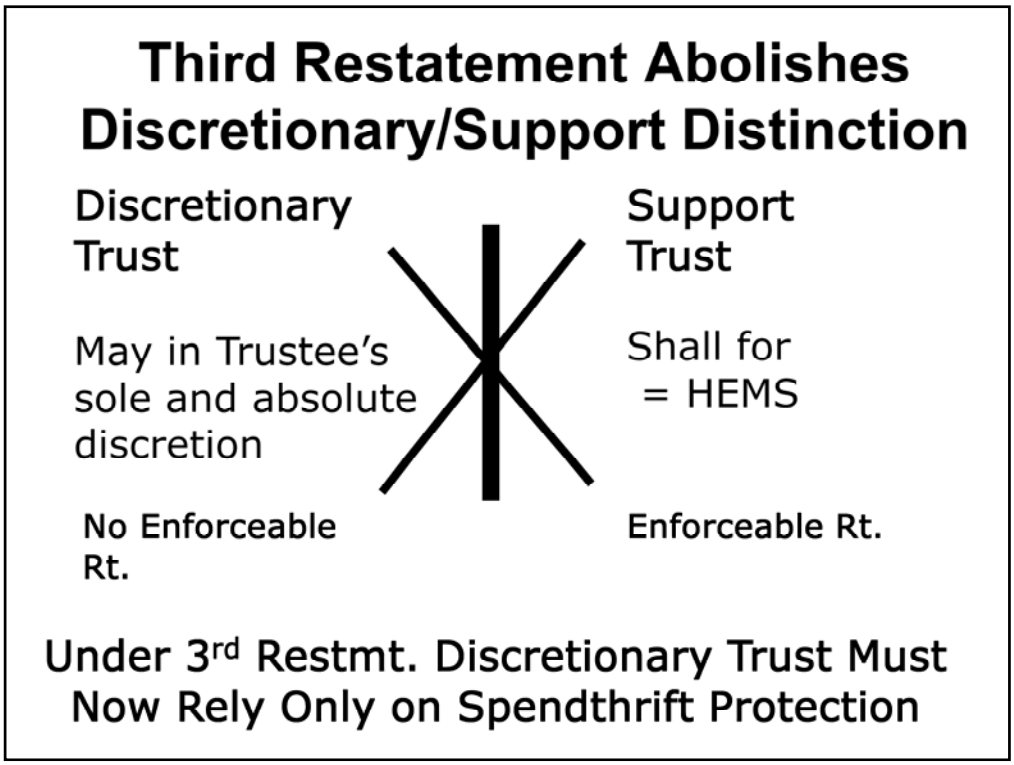
Some courts have noted that words such as "comfort and general welfare" may not be capable of judicial determination, and that this language may remove a trust from being classified as a support trust. *Bohac v. Graham*, 424 NW 2d. 144 (ND 1988). New York requires that no ascertainable distribution standard be used. *Estate of Escher*, 420 N.E. 91 (Ct. App. NY 1981).



H. Comparison of Second and Third Restatement of Trusts

1. Second Restatement of Trusts

The Second Restatement of Trusts focuses on the grant of extended discretion to determine whether a beneficiary has an enforceable right. Absent clear settlor intent to the contrary, the use of the words "sole," "absolute," or "unfettered" discretion will almost always result in the classification of the trust as a discretionary trust. In this respect, regardless of whether a trust contained a standard capable of judicial interpretation or incapable of judicial interpretation, the trust would be classified as a discretionary trust, and a beneficiary would not have an enforceable right.



2. Restatement Third Position

a. Abolishes the Discretionary-Support Distinction

The traditional trust analysis has explained in detail the difference in asset protection with a discretionary dynasty trust, where neither the current distribution interest is an enforceable right nor the interest after the event date is a property interest. The asset protection afforded by a discretionary dynasty trust is based on a property or enforceable right analysis. On the other hand, for support trusts the asset protection is based on spendthrift protection, subject to the four exception creditors.

b. Claims 125 Year Court Distinction is Arbitrary and Artificial

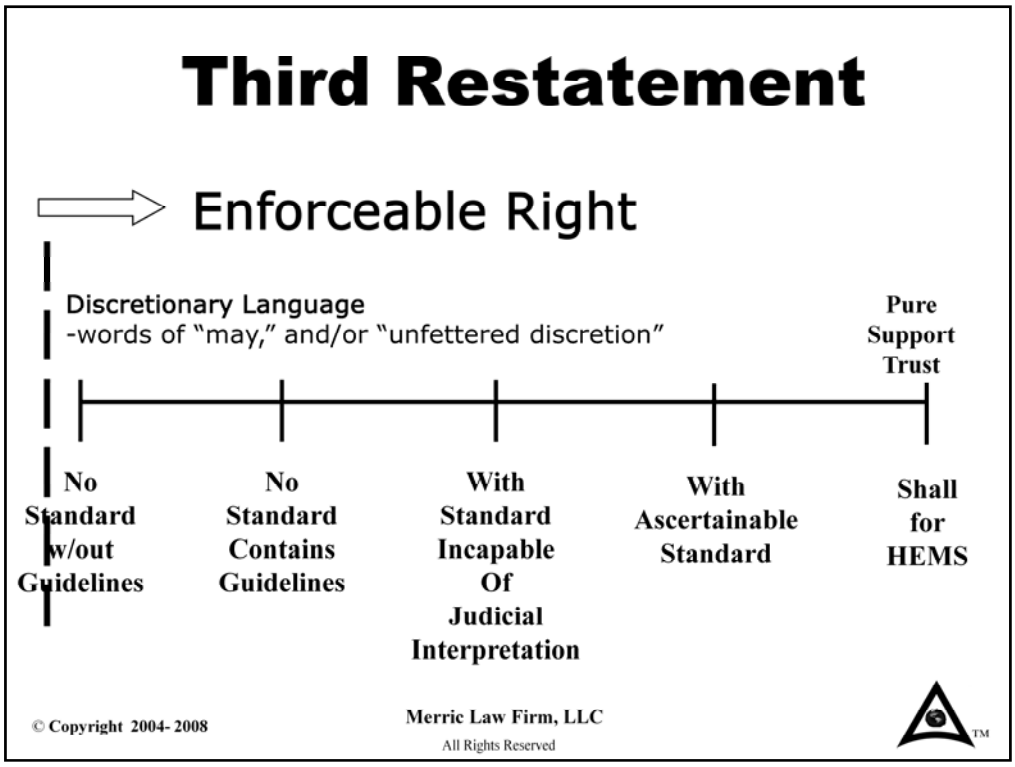
"Not only is the supposed distinction between support and discretionary trusts arbitrary and artificial, but the lines are also difficult – and costly – to attempt to draw. Attempting to do so produces dubious categorizations and almost inevitably different results (based on fortuitious differences in wording or maybe a "fireside" sense of equity) from case to case for beneficiaries who appear, realistically, to be similarly situated as objects of similar settlor intentions." § 60 Rept Note to cmt. a.

c. Continuum of Discretionary Trusts

The Restatement Third specifically states that there should be no discretionary/support trust dichotomy. Rather, the Restatement Third creates new law when it defines a continuum of discretionary trusts, from the most discretionary to a support trust.

d. Only Spendthrift Protection Remains For a Discretionary Trust

The result of equating a discretionary trust to a support trust for asset protection purpose is now both trusts only enjoy spendthrift protection.



e. Creation of an Enforceable Right in Almost All Trusts

As detailed in the following quotations it appears the Restatement Third takes almost the opposite position than the Second Restatement of Trusts:

- At first blush, it appears the Restatement Third follows the common law discretionary trust view when it states, "A transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so."[i] However, the sentence immediately following the above sentence, for almost all purposes negates the above sentence. It states, "It is rare, however, that the beneficiary's circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless."[ii]

- "Reasonably definite or objective standards serve to assure a beneficiary some minimum level of benefits, even when other standards are included to grant broad latitude with respect to additional benefits."[iii] In other words, similar to the aberrational line of discretionary-support trust cases in Ohio, Connecticut and to a lesser extent Pennsylvania, the Restatement Third adopts this distinct minority position.

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i *Restatement (Third) of Trusts,* Section 60, comment e.

ii Id.

iii *Restatement (Third) of Trusts,* Section 50, comment on Subsection (2): d. first paragraph.

- Even if a trust does not include a standard, under the Restatement Third the beneficiary is <u>not</u> safe. "It is not necessary, however, that the terms of the trust provide specific standards in order for the trustee's good-faith decision to be found unreasonable and thus constitute an abuse of discretion."[i] The Restatement Third goes further to the most likely imputation of a distribution standard if there is no standard or guideline when it states, " "Sometimes trust terms express no standards or other clear guidance concerning the purpose of a discretionary power, or about the relative priority intended among the various beneficiaries. Even then a general standard of reasonableness or at least good-faith judgment will apply to the trustee (Comment b), based on the extent of the trustee's discretion, the various beneficial interests created, the beneficiaries' circumstances and relationships to the setttlor, and the general purposes of the trust."[ii]

- Reporter Comment under Section 60(a) that states, "The fact of the matter is that there is a continuum of discretionary trusts, with the terms of the distributive powers ranging from the most objective (or "ascertainable," IRC 2041 of standards (pure "support") to the most open ended (e.g. "happiness") or vague ("benefit") of standards, or even with no standards manifested (*for which a court will probably apply "a general standard of reasonableness."*{Emphasis added}. In other words, it is the Third Restatement view that a "reasonableness standard" of review should be applied to most discretionary trusts, regardless of whether or not the trustee is granted "sole," "absolute," or "unfettered" discretion.

- Regarding rights between remainder beneficiaries, the Restatement Third takes issue with common law that all (or none) of the trust could be distributed to a discretionary beneficiary. Referring to common law, "This "one-sided" liberalization of the discretionary authority, where a court finds the settlor's language was intended to assure generosity in favor of a life beneficiary, would thus tend to encumber the efforts of remainder beneficiaries who see to challenge what might otherwise be excessively generous decisions by a trustee."[iii]

After reviewing the above quotations as well as reading Sections 50 and 60 (including comments and reporter comments), it becomes quite apparent that "It is rare, however, that the beneficiary's circumstances, the terms of the discretionary power, and the purposes of the trust leave the beneficiary so powerless" that such beneficiary cannot force a minimal distribution. Remember, as demonstrated by the minority line of discretionary-support cases, such minimal distribution disqualified the beneficiary from governmental assistance.

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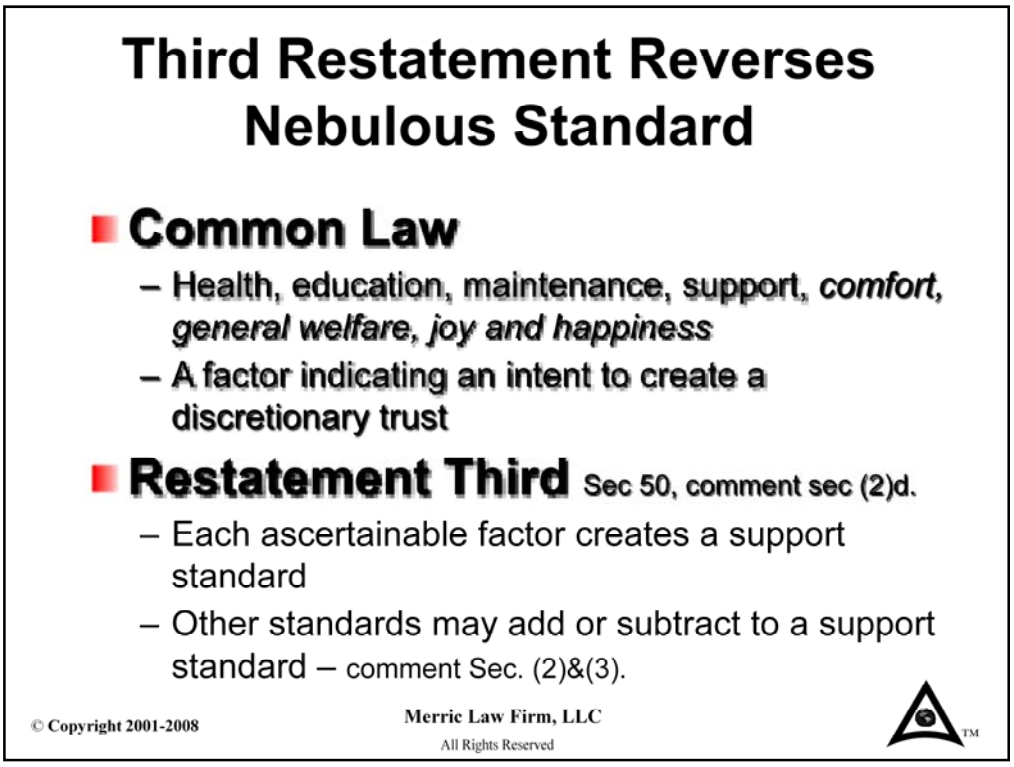
[i] *Restatement (Third) of Trusts,* Section 50, comment on Subsection (1): b., third paragraph last line.



f. Reverses Common Law Element of a Discretionary Trust

- "Reasonably definite or objective standards serve to assure a beneficiary some minimum level of benefits, even when other standards are included to grant broad latitude with respect to additional benefits."[i]

- "Other standards and supplementary language. . . . These provisions may permit or even entitle beneficiaries to receive greater or lesser, or different, benefits than would have been authorized under a support provision standing alone. [ii]

- The terms of a discretionary standard occasionally include stronger language, such as the word "happiness." Such language suggests an intention that trustee's judgment be exercised generously and without relatively objective limitation. Although "happiness"" alone expresses no objective minimum of entitlements (which to some extent may nevertheless be readily implied), the primary effect of such a term is to immunize from challenge by remainder beneficiaries almost any reasonable affordable distribution. [iii]

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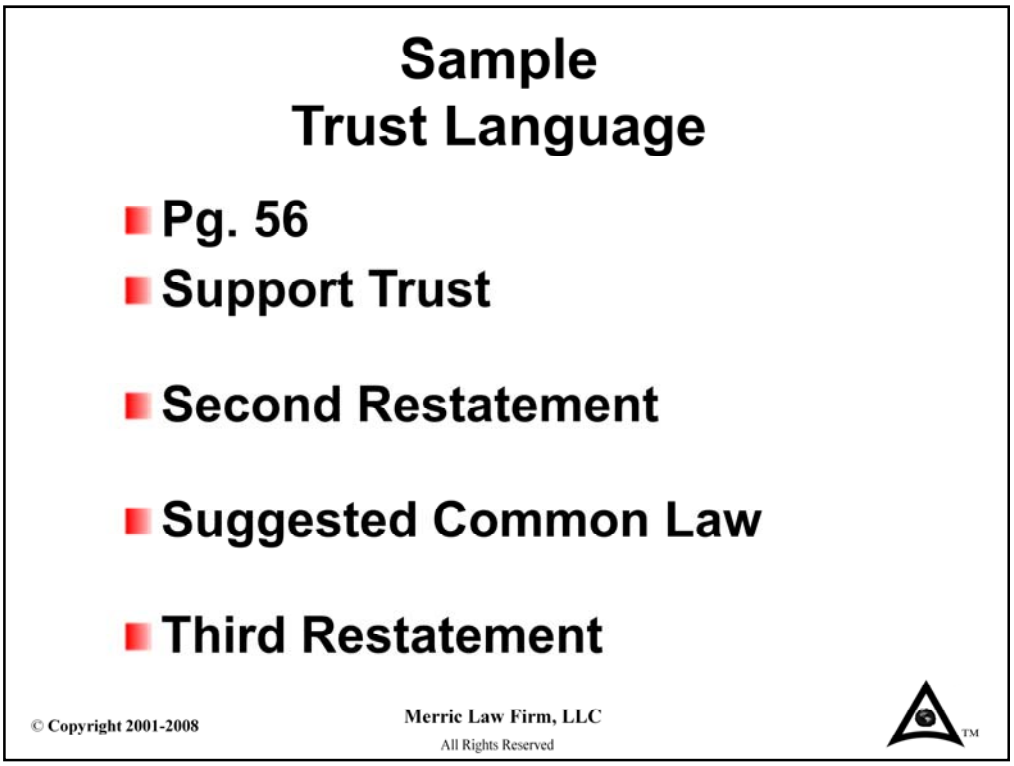
i *Restatement (Third) of Trusts,* Section 50, comment on Subsection (2): d. first paragraph.

ii *Restatement (Third) of Trusts,* Section 50, comment on Subsection (2): d(3). first paragraph.

iii *Restatement (Third) of Trusts,* Section 50, comment on Subsection (2): d(3). Page 268 second paragraph.



3. Sample Trust Language

The language on the following page gives examples under the Restatement (Second) and Restatement (Third).

How Does One Draft After the Restatement Third & UTC?

- Which state are you in?
- Where will your trust end up?
- Conservative Approach

- Run to South Dakota or Delaware
- Prop. Mich.; Missouri; Fla.
- Ohio's problems

Go to pg. 51

Support Trust

My Trustee shall make distributions to the beneficiaries listed in Section 1.07 for health, education, maintenance, and support.

Discretionary Distribution Standard – Restatement (Second) of Trusts

My Trustee may pay to or apply for the benefit of any one or more of the beneficiaries listed in Section 1.07 as much of the net income and principal as the trustee determines in his sole and absolute discretion for his or her health, education, maintenance, support, comfort, general welfare, an emergency, or happiness.

Discretionary Distribution Standard – Common Law

My Trustee may pay to or apply for the benefit of any one or more of the beneficiaries listed in Section 1.07 as much of the net income and principal as the trustee determines in his sole and absolute discretion for his or her health, education, maintenance, support, comfort, general welfare, an emergency, or happiness. The Trustees, in their sole and absolute discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them.

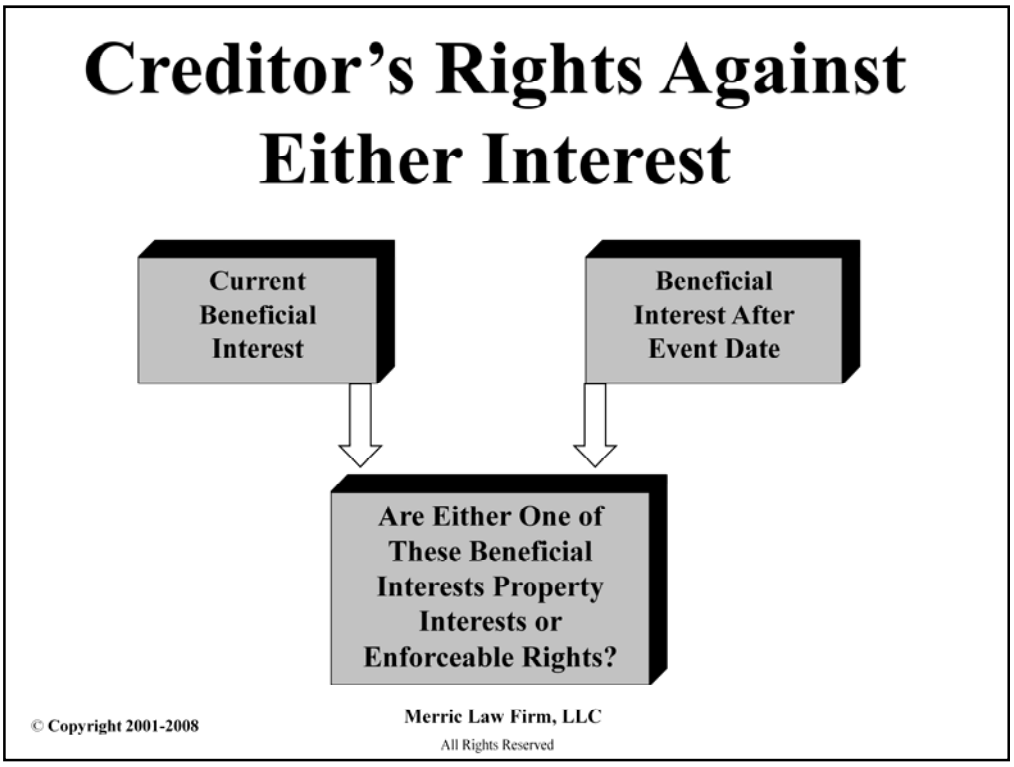
Discretionary Distribution Language After the Restatement (Third) of Trusts

My Trustee may distribute as much of the net income and principal as my Trustee, in its sole, absolute, and unfettered discretion, determine to any beneficiary listed in Section 1.07. My Trustee, in its sole, absolute, and unfettered discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them. Also, my Trustee, in its sole discretion may distribute all of the income and principal of this Trust to one of the beneficiaries and exclude all other beneficiaries from any of the Trust Property. When making distributions, my Trustee may, in its sole, absolute, and unfettered discretion may, but need not, consider a beneficiary's income or other resources that are available to the beneficiary outside of the trust and are known to the Trustee. The power to make a distribution in my Trustee's sole, absolute, and unfettered discretion includes the power to withhold making a distribution to any beneficiary in my Trustee's sole, absolute, and unfettered discretion.

In keeping with the wholly discretionary nature of this trust and all separate trusts created hereunder, no beneficiary, except as regards to any irrevocable vesting in the beneficiary's favor, shall have any ascertainable, proportionate, actuarial or otherwise fixed or definable right to or interest in all or any portion of any trust or its property. It is my intent that the trustee have all of the discretion of a natural person, and that a distribution beneficiary holds nothing more than a mere expectancy. It is also my intention that the above language be interpreted as to provide my Trustee with the greatest discretion allowed under law.

Distributions made to a beneficiary under this Article shall not be considered advances and shall not be charged against the share of such beneficiary that may be distributable under other provisions of this agreement. Any undistributed net income shall be accumulated and added to the principal of the trust."

Note: Many trust companies will have problems accepting the above language.



I. Creditor's Rights Against a Current Distribution Interest

A creditor may seek to attach the current distribution interest, the interest after the event date or both. Meaning, whether a creditor will be able to attach either interest (or both) first depends on whether the interest in trust is classified as a property interest under state law.

As previously noted most courts determine whether a beneficiary has a property interest or enforceable right under state law.[i] Rather than using a property analysis, some courts will find that the beneficiary's interest has no ascertainable value.[ii] In essence, the analysis is the same - there is no interest or enforceable right that a creditor may attach, because under this analysis there is no value to the beneficial interest. For purposes of this outline, the property analysis shall be used. Therefore, the beginning step in determining whether a creditor may recover against a beneficial interest in trust is to determine whether the current beneficial interest or the beneficial interest after the event date (e.g., the remainder interest) is a property interest or an enforceable right under state law.

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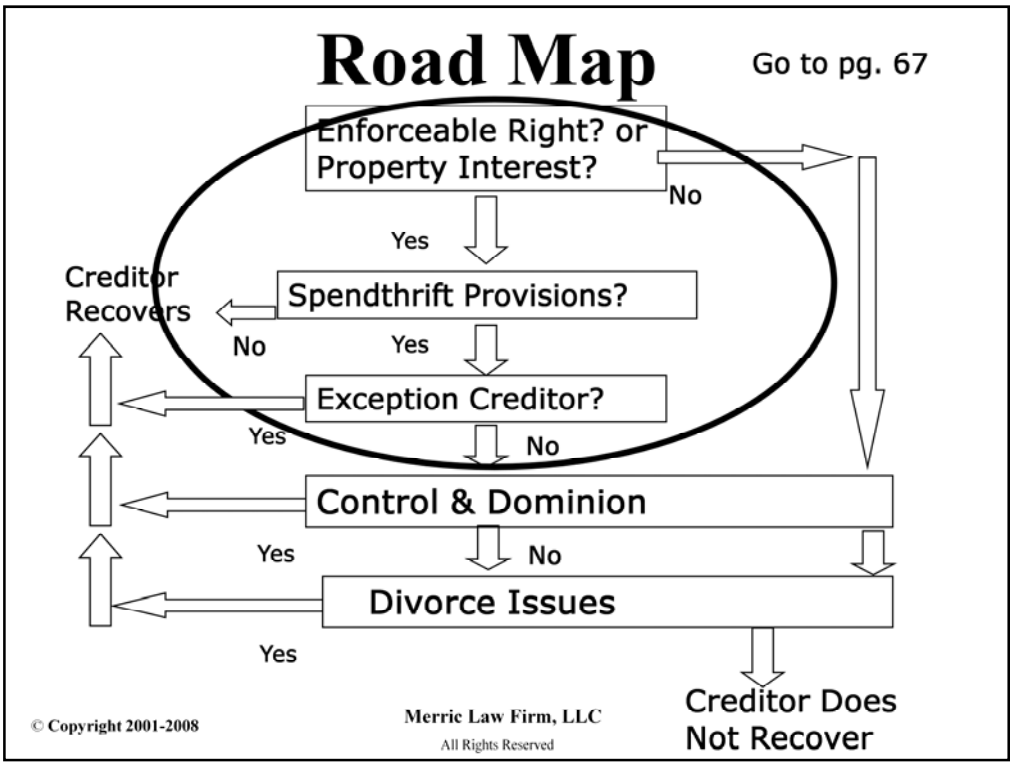
i *Carlisle v. Carlisle*, 194 WL 592243 (Superior Ct. Connecticut 1994); *Lauricella v. Lauricella*, 565 N.E. 2d 436 (Mass. 1991);

ii *Miller v. Department of Mental Health*, 442 N.W.2d 617 (Mich. 1989); *Henderson v. Collins*, 267 S.E.2d 202 (Ga. 1980); *In re Dias*, 37 BR 584 (D. Idaho 1984).



1. Road Map

The above roadmap depicts all of the issues that need to be addressed to determine whether a creditor may recover against a beneficial interest. This outline will first discuss the property interest issue and then follow with the spendthrift provision and exception creditor analysis. Even if a trust is designed to avoid the exception creditors to a spendthrift trust, if a beneficiary retains too much control, a creditor may reach the beneficial interest. Furthermore, in some states, an estranged spouse actually may receive more rights than a normal creditor.

2. Creditor's Rights Against A Current Distribution Interest

As previously noted most courts determine whether a beneficiary has a property interest or enforceable right under state law. Rather than using a property analysis, some courts will find that the beneficiary's interest has no ascertainable value. In essence, the analysis is the same - there is no interest or enforceable right that a creditor may attach, because under this analysis there is no value to the beneficial interest. For purposes of this article, the property/enforceable right analysis shall be used. Therefore, the beginning step in determining whether a creditor may recover against a beneficial interest in trust is to determine whether the current beneficial interest or the beneficial interest after the event date (e.g., the remainder interest) is an enforceable right under state law.

3. What Constitutes a Property Right

What constitutes a property interest in many cases depends on state law.[i] While state law may vary from the following definition a bit, generally property is defined as "everything that has an exchangeable value or which goes to make up wealth or estate."[ii] An equitable interest in trust property is regarded as a property interest of he same kind as a trust res and is more than a mere chose in action.[iii] At first, this definition of a property interest seems too complex to understand. However, the analysis may be simplified. Generally, there are two methods for determining whether something constitutes property: (1) something that may be sold or exchanged, or (2) an enforceable right. [iv]

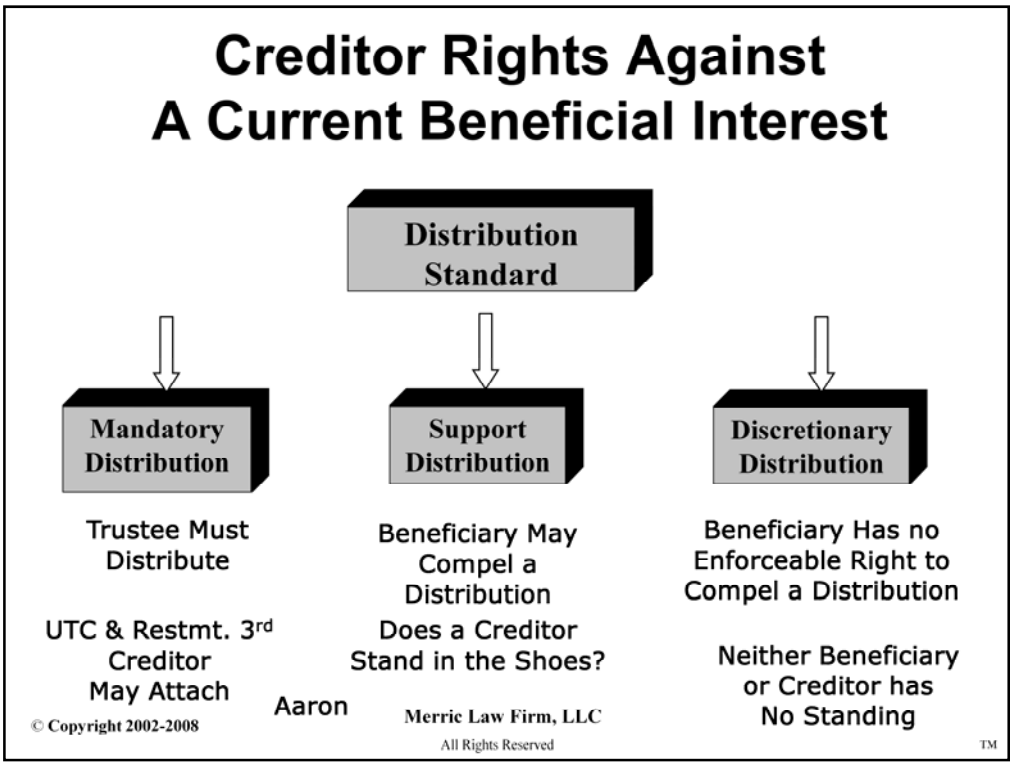
With regard to the first type of property, such property is freely alienable, and as such has a fair market value that may be determined by a market price. However, beneficial interests in trusts are generally restricted by spendthrift provisions (discussed in Section E. below), which prevent the transfer of any beneficiary's interest. In this respect, there is no fair market value, because the property cannot be sold. On the other hand, under the second test, in many situations, a beneficiary has an enforceable right (i.e., a property interest). For example, with certain trusts a current beneficiary has a right to sue the trustee to force a distribution pursuant to a standard in the trust. Also, if a beneficiary has a vested remainder interest, a beneficiary will most likely receive property at some time in the future.

i. As previously noted in this outline, some courts will hold that the beneficiary interest of a discretionary trust has no ascertainable value. Hence, the analysis is the same.

ii. *Graham v. Graham*, 194 Colo. 429; 574 P.2d 75, 76 (Colo. 1978) (citing *Black's Law Dictionary*, 1382 [4th Ed.]).

iii *Senior v. Braden*, 295 U.S. 422 (1935); *Brown v. Fletcher*, 235 U.S. 589 (1915); *II W. Fratcher Scott on Trusts*, Section 130 at 406 (1987).

iv. *In re Balanson*, 25 P.3d 28 (Colo. 2001); *Dryfoos v. Dryfoos*, 2000 WL 1196339 (Conn. Super. 2000) unreported case



4. Rights Against A Current Beneficial Interest

a. Mandatory Distribution

When the terms of a trust require a mandatory distribution to be made, there is no question that the beneficiary has an enforceable right to a distribution. The beneficiary may unquestionably sue the trustee to force a distribution. Therefore, a fixed interest, which is an interest that creates an enforceable right in the beneficiary, is a property interest. For example, *In re Question Submitted by the United States Court of Appeals for the Tenth Circuit*, the Tenth Circuit held that the future right to receive $1,000 a month by a beneficiary was a property interest.[i] In this respect, the mandatory distribution right may be analogized to an annuity for a period of time.

With a mandatory distribution, the creditor is not attaching the trust's assets. Rather, the creditor is attempting to attach to the mandatory distribution stream.[ii] Since such interest is a property right, the only question is whether spendthrift provisions provide some type of protection for a mandatory distribution received by a trust. This is analyzed in Section VII of this outline.

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i *In re Question Submitted by the United States Court of Appeals for the Tenth Circuit*, 191 Colo. 406, 411; 553 P.2d 382, 386 (1976).

ii *Restatement (Third) of Trusts*, Section 56, comment a; *Uniform Trust Code*, Section 501.

b. A Support Distribution or Ascertainable Standards

The common law purpose of a support trust is to provide support for a beneficiary based on a "standard." The most common standard used is to provide support for a beneficiary's health, education, maintenance, and support. Such a support standard must be definite enough for a court to be able to determine whether a trustee is following the support standard. In this respect, magical words such as health, education, maintenance, and support have been determined to be definite. Words such as comfort and welfare may or may not be definite enough depending on state law. On the other hand, words such as joy and happiness are not capable of interpretation on a reasonable basis, and these words may easily result in a trust not being classified as a support trust.

As previously noted, if a trust is classified as a support trust, a beneficiary of a support trust can compel the trustee to make a distribution of trust income or principal merely by demonstrating that the money is necessary for his or her support, maintenance, education, or welfare.[i] In other words, a beneficiary has a right to sue the trustee from failing to make a distribution from a support trust. If a beneficiary has the right to sue the trustee, the beneficiary most likely has a property interest under state law.[ii] If this is the case, does the creditor stand in the beneficiary's shoes and may be also sue the trustee to force the payment of the beneficiary's debt? Absent spendthrift provisions, this would definitely be the case. Therefore, whether a creditor (including an estranged spouse) may recover must be discussed in the spendthrift portion of this article.

c. Discretionary Interest

Under the Restatement of Trusts (Second) and almost all of the case law to date, a discretionary beneficiary has no contractual or enforceable right to any income or principal from the trust, and the beneficiary cannot force any action by the trustee.[iii] This is because a court may only review a discretionary trust for abuse and bad faith. There is no reasonableness standard of review by a court for a discretionary trust. Further, the discretionary interest is not assignable.[iv] In this respect, a discretionary beneficiary's interest is generally not classified as a property interest; rather, it is nothing more than a mere expectancy.[v] If a beneficiary has no right to force a distribution from a trust, then the same rule applies to the beneficiary's creditor – he or she may not force a distribution.

Through this aspect, the protection of the trust assets of a discretionary trust does not depend on spendthrift provisions with respect to the current beneficial interest. As will be seen in the discussion of the spendthrift provisions, the asset protection features of a discretionary trust is much stronger than that of a support trust or a mandatory distribution trust that must rely on spendthrift protection.

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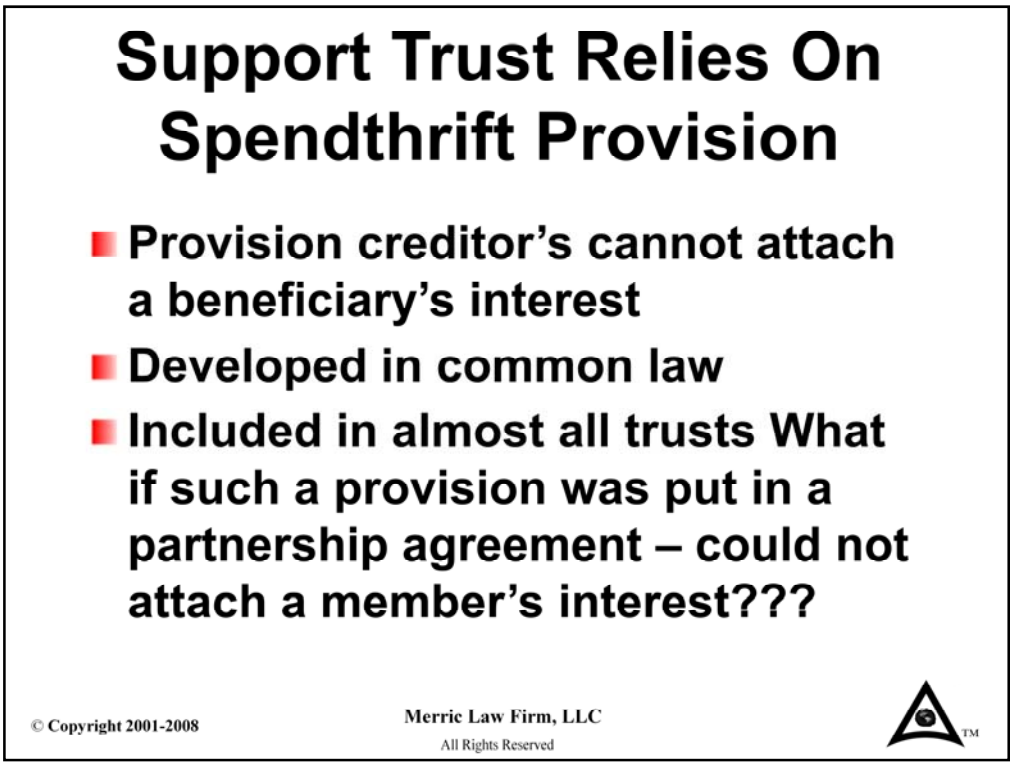
i *Chenot v. Bordeleau*, 561 A.2d 891 (R.I. 1989), *Chenot v. Bordeleau*, 561 A.2d 891 (R.I. 1989), *Eckes v. Richland County Social Services*, 621 N.W. 2d 851 (ND 2001); Restatement (Second) Trusts Section 128 comments d and e (1959); *Id.*

ii Each state law must be analyzed in this respect. However, the author is unaware of a case where state law held that a beneficiary of a support trust did not have a property right (i.e., an enforceable right) to force the trust to make a distribution pursuant to the support standard.

iii *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991); G. Bogert, *Trusts and Trustees*, Section 228 (2nd Ed. 1979).

iv *Id.*

v *U.S. v. O'Shaughnessy*, 517 N.W. 2d 574 (Minn. 1994); *In re Marriage of Jones*, 812 P.2d 1152 (Colo 1991).



5. Spendthrift Provisions

A spendthrift provision is a provision in a trust that states that the beneficiary cannot sell, pledge or encumber his or her beneficial interest. Further, the provision states that a creditor cannot attach a beneficiary's interest. At common law, the purpose of a "spendthrift trust" was to protect a beneficiary (other than the settlor of the trust) from his or her own spending habits. The idea was to provide for someone who could not provide for himself or herself, and to keep such beneficiary from becoming dependent on public assistance. Therefore, if a "spendthrift clause or provision" was added to a trust, the common law developed a legal principle that a creditor could not recover from the beneficiary's interest.[i] If the mere insertion of such a clause could protect a beneficiary's interest, why not include such a provision in almost all trusts? Today, this is in fact the case, and almost all trusts include a spendthrift clause.[ii] Assuming, as will almost always be the case, the drafter includes a standard spendthrift clause, then whether a creditor may recover against the assets of a support trust[iii] depends on the type of creditor who seeks recovery.

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i The U.S. Supreme Court followed the common law view of spendthrift protection in *Nichols v. Eaton*, 91 U.S. 716 (1875).

ii Even though almost all drafters include a spendthrift provision in a trust, the trust instrument must still be examined to make sure that this is indeed the case. If a spendthrift clause is not included, a creditor stands in the shoes of the beneficiary and may enforce any right that he or she has: mandatory distribution; ascertainable standard distribution; or a remainder interest. *In re Katz*, 203 B.R. 227 (E.D. Pa. 1996); *Chandler v. Hale*, 377 A.2d 318 (Conn. 1977).

iii As noted above, a creditor generally has no right of recovery against a discretionary interest, because the beneficiary does not have a property interest. Therefore, the analysis of spendthrift provisions is unnecessary for a discretionary trust. However, with a support trust, the beneficiary has an enforceable right and may force the trustee to make a distribution.

6. Exceptions Under the Restatement (Second) of Trusts

However, the same analysis is not true for a trust that is classified as a support trust. In this case, the beneficiary may force a distribution from the trust pursuant to the standard provided in the trust instrument. So the question becomes, can a creditor stand in the shoes of the beneficiary and force such a distribution? By the language of the spendthrift provisions it prohibits a creditor from doing so. However, under which circumstances will courts make exceptions to spendthrift protection?

Except for certain types of creditors, a spendthrift provision protects the trust's assets from attachment.[i] The Restatement (Second) of Trusts, Section 157, (1959) carves out the following four key exceptions to spendthrift protection, where a creditor may attach the assets of a support trust:

1. alimony or child support;
2. necessary services or supplies rendered to the beneficiary;
3. services rendered and materials furnished that preserve or benefit the beneficial interest in the trust; and
4. a claim by the U.S. or a State to satisfy a claim against a beneficiary.[ii]

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i *In Re Graham* 726 F.2d 1268 (C.A.8. Iowa 1984); *In re Stephens*, 47 B.R. 85 (Bkrtcy. D. Vt. 1985).

ii *Restatement (Second) of Trusts*, Section 157 (1959).

a. Alimony or Child Support

Almost all, if not all, recent cases hold that a spouse may reach a beneficiary's interest for alimony or child support.[i] Therefore, if a trust is classified as a support trust, almost always an estranged spouse may reach the assets of the trust to satisfy a maintenance or child support claim. However, this exception does not apply to a division of marital property pursuant to a divorce.

b. Necessary Services or Supplies Rendered to the Beneficiary

Most cases in this area arise when a federal or state institution is attempting to attach a beneficiary's interest for medical services rendered on behalf of the beneficiary.[ii] Further, in almost all of these cases the drafting attorney conflicted the magical words of a discretionary trust with those of a support trust.

c. Services Rendered and Materials Furnished That Preserve or Benefit the Beneficial Interest in the Trust

These are generally claims by attorneys for fees incurred to either sue the trust or protect a beneficial interest. Unfortunately, while the other three exceptions of the Second Restatement are almost universally applied by the states, this one is not. In other words, frequently attorneys are not allowed to recover their fees from the trust.

d. A Claim by the United States or State to Satisfy a Claim Against a Beneficiary

Generally, these are tax liens. The Internal Revenue Service may generally reach a beneficiary's interest in a support trust for payment of a tax lien.[iii] *First Northern Trust Co. v. Internal Revenue Service*, 622 F.2d 387 (8th Cir. 1980) exemplified that it is a well established legal principle that the income from a spendthrift trust is not immune from federal tax liens, notwithstanding any state laws or recognized exemptions to the contrary.[iv]

In summary, there are four exception creditors that can reach a support trust's assets to satisfy their claim. These creditors are referred to as "exception creditors" for the purpose of this outline. It should be noted that in a non-UTC state, these exception creditors (including the federal government) would have no claim against the trust assets if it had been drafted as a discretionary dynasty trust.

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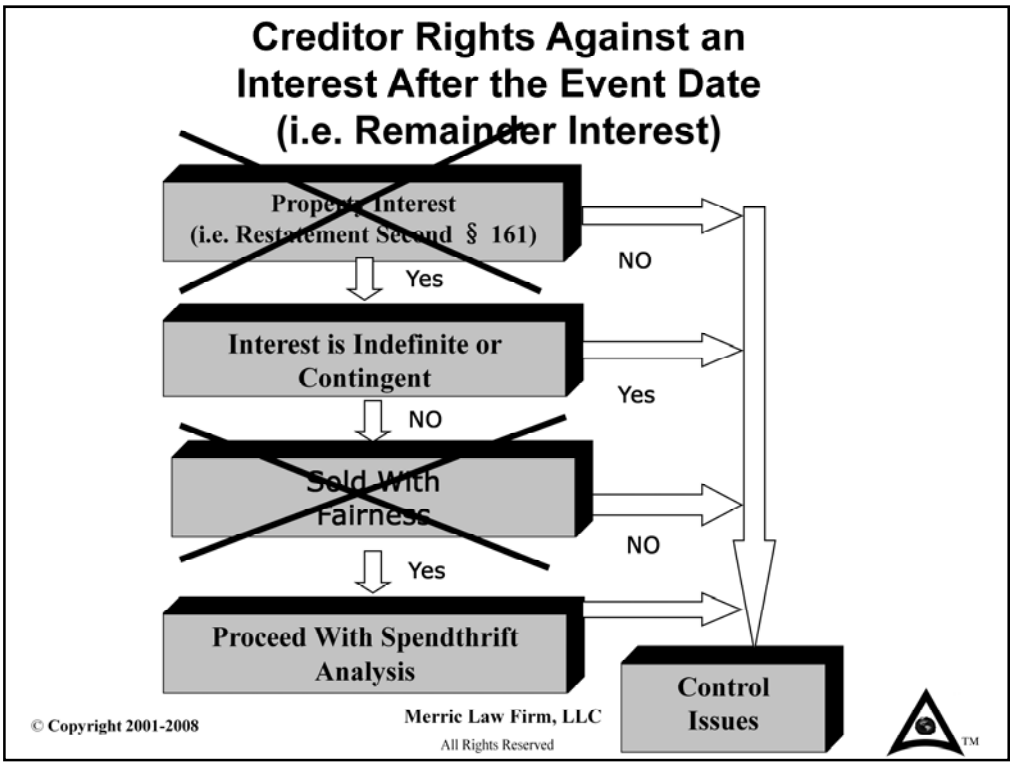
i *In re Threewitt*, 20.B.R. 434 (Bkrtcy. D. Kan. 1982); *Payer v. Orgill*, 191 N.E.2d 373 (Ohio 1963).

ii *Department of Mental Health and Development Disabilities v. First Nat. Bank of Chicago*, 432 N.E. 2d 1086 (Ill. App. 1 Dist., 1982); *Department of Mental Health and Developmental Disabilities v. First National Bank of Chicago*, 432 N.E. 2d 1086 (Ill. App. Dist. 1982); *State v. Rubion*, 308 S.W. 2d 4 (Tex. 1957); *Lang v. Com., Dept of Public Welfare*, 528 A.2d 1335 (Pa. 1987); *Sisters of Mercy Health Corp. v. First Bank of Whiting*, 624 N.E. 2d 520 (Ind. App. 3 Dist. 1993).

iii *Bank One Ohio Trust & Co.*, 80 F.3d 173 (6th Cir. 1996).

iv But see, *U.S. v. Riggs Nat. Bank*, 636 F. Supp 172 (D.D.C. 1986).



J. Creditor's Rights Against an Interest After the Event Date

(1) Not an Inseparable Interest

A remainder interest is definitely a property interest. However, as noted before, the Restatement (Second) of Trusts, Section 160 addresses this issue as an "inseparable interest." A remainder by definition is separable. At some time, someone will receive the remainder interest based on the terms of the trust. Therefore, the analysis moves to the next step, the "indefinite" or "contingent" rule.

(2) Indefinite or Contingent

The Restatement (Second) of Trusts further provides, if a beneficial trust interest is "so indefinite or contingent that it cannot be sold with fairness to both the creditors and the beneficiary, it cannot be reached by creditors."[i] There are two constituents to this rule, (i) is the remainder interests "indefinite?;" and (ii) can it be sold with fairness to both the creditors and the beneficiary?

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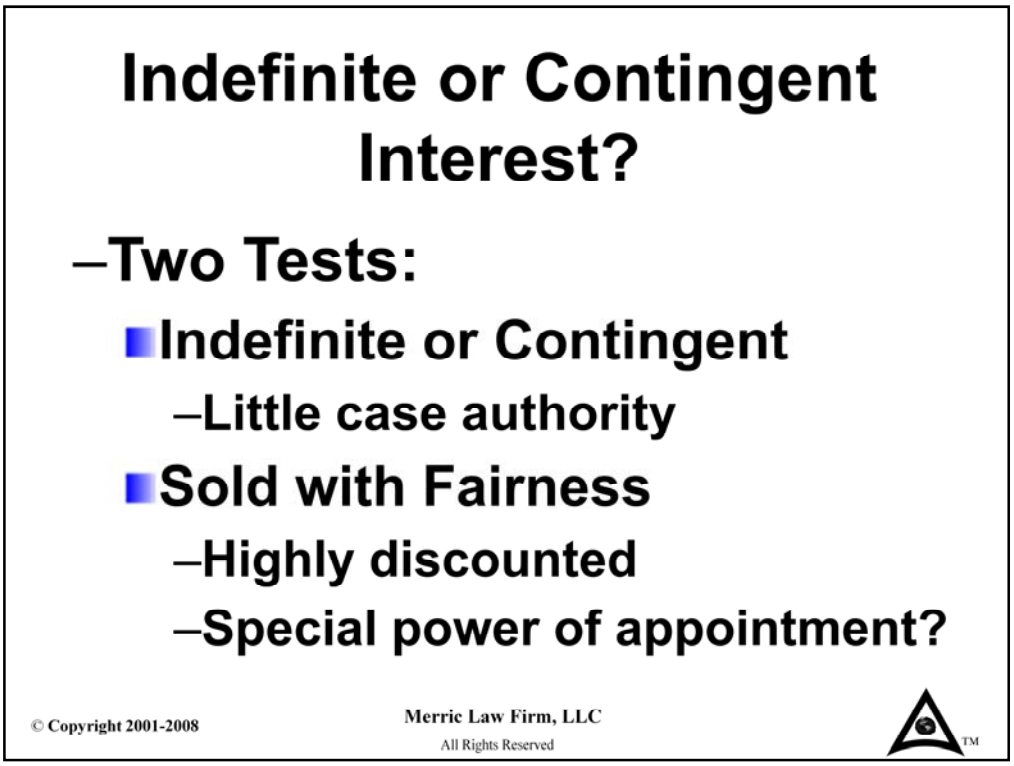
i *Restatement (Second) of Trusts*, Section 161 (1959).



1. Two Tests

a. Indefinite and Contingent Interests

A vested interest is not a contingent interest. A vested interest is one where the debtor/beneficiary or the debtor beneficiary's estate will take at some point of time in the future. The clear majority rule appears to be that a vested remainder interest may be sold at a judicial foreclosure sale, unless b. below applies discussed below or the trust contains spendthrift provisions (which is analyzed separately in Section B. below).[i] These cases follow the general property rule, that a remainder interest in property, even though it is a future interest may be sold.[ii]

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[i] *Henderson v. Collins*, 267 S.E.2d 202 (Ga. 1980) [vested remainder interest in a discretionary trust may be sold at judicial foreclosure sale.] *Also See, Burrell v. Burrell*, 537 P.2d 1 (Alaska 1975); *Moyars v. Moyars*, 717 N.E. 2d 976 (Ct. App. Ind. 1999); *Benston v. Benston*, 656 P.2d 395 (Or. App. 1983); *Lauricella v. Lauricella*, 565 N.E. 2d 436 (Mass. 1991) [under all of these cases, a vested remainder interest was considered marital property for division purposes.]

[ii] *Mid American Corp. v. Geisman*, 380 P.2d 85 (Okla. 1963) [where a debtor received a remainder interest under a will. Once the death of the willmaker had occurred, the remainder interest was vested. It was not in trust, and a simple future property analysis provided for the property to be received under the will to be sold at a judicial foreclosure sale.]

Regarding most estate planning trusts, some estate planners might consider a remainder interest as a contingent interest an (1) either one party must outlive the other party in order to take; (2) or the trust property is subject to complete divestment due to a special power of appointment usually held by the surviving spouse. However, Restatement (Second) of Trusts, Section 162, Illustration 1 as well as the cases cited in the footnote indicate that the mere fact that a child must survive a parent in order to take the trust property, this fact is not too contingent; and therefore, unless b. below applies, absent spendthrift protection, a creditor would be able to judicially foreclose on the remainder interest.[i] Further, in the bankruptcy context, when the bankrupt was to receive her interest in trust when she attained the age of 25 one year later, the Bankruptcy Court held that the debtor/beneficiary's interest was not too remote (i.e., contingent) to be included in the Bankruptcy estate.[ii]

b. Sold With Fairness

Would a willing buyer or willing seller pay much for an interest in trust that was contingent on a child outliving his parent? Most likely, it would be highly discounted. However, what if the interest was subject to a special power of appointment in the surviving spouse what could divest the entire remainder interest? In this case, a purchaser at a judicial foreclosure sale most likely would pay little for the interest when compared to the amount that would ultimately be received by the remainder beneficiary.

First, the author would like to note that there are very few reported cases where anyone other than a former spouse attaches the remainder interest.[iii] It is the author's opinion that most creditors do not attempt to judicially foreclose on a remainder interest, because in almost all cases the "sold with fairness rule" would apply. Even if the "sold with fairness rule" did not apply, several states have passed statutes preventing the forced sale of remainder interests.[iv]

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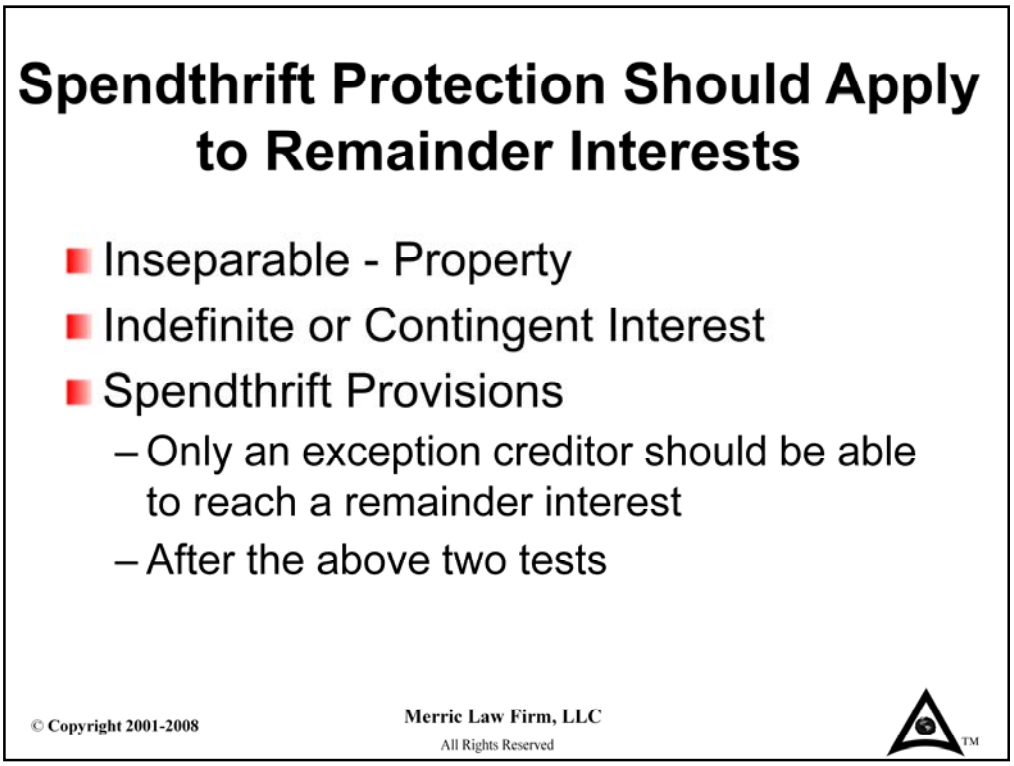
i *In Re Neuton*, 922 F.2d 1379 (9th Cir. 1990) [Where the fact that the debtor would need to outlive his mother in order to take the trust property was not so contingent as to prevent the judicial foreclosure sale of a 25% of the debtor's interest by a bankruptcy trustee. See further discussion of this case under spendthrift provisions.] *Also See, Balanson v. Balanson*, 25 P.3d 28 (Colo. 2001); *Davidson v. Davidson*, 474 N.E. 2d 1137 (Mass. 1985); *Benston v. Benston*, 656 P.2d 359 (Or. App. 1983); *Trowbridge v. Trowbridge*, 114 N.W. 2d 129 (Wis. 1962) [under all of these cases, vested remainder interests were not too indefinite to be classified as marital property for purposes of division]. *But See, Loeb v. Loeb*, 301 N.E. 2d 349 (Ind. 1973), where the contingency of outliving the debtor's mother was considered too indefinite for purposes of equitable division in a divorce.

ii *In re Dias*, 37 B.R. 584 (D. Idaho 1984).

iii *Mid America Corp. v. Geisman*, 380 P.2d 85 (Okla. 1963) [In a one paragraph holding, the Supreme Court of Oklahoma reverses the appellate court decision to sell the remainder interest – noting the proper remedy was a lien. The Supreme Court thought the remedy was too drastic a measure as related to the beneficiary.]

iv *Restatement (Third) of Trusts*, Section 56, Reporter comment e.



2. Spendthrift Protection & Remainder Interests

Absent spendthrift provisions, a beneficiary may transfer the remainder interest, and a creditor may attach such interest. [i]

On the other hand, if spendthrift provisions are present, ordinary creditors may not attach a remainder interest, even in Bankruptcy Court. The Federal Bankruptcy Court is required to look to state law to apply property rules.[ii] For example, *In Re Neuton*, a California state statute provided that spendthrift provisions protected 75% of the remainder interest.[iii] The debtor's ordinary creditor could not recover against the amount protected by state law. However, if the creditor is one of the four exception creditors, the creditor may attach and/or judicially foreclose and sell the remainder interest. [iv]

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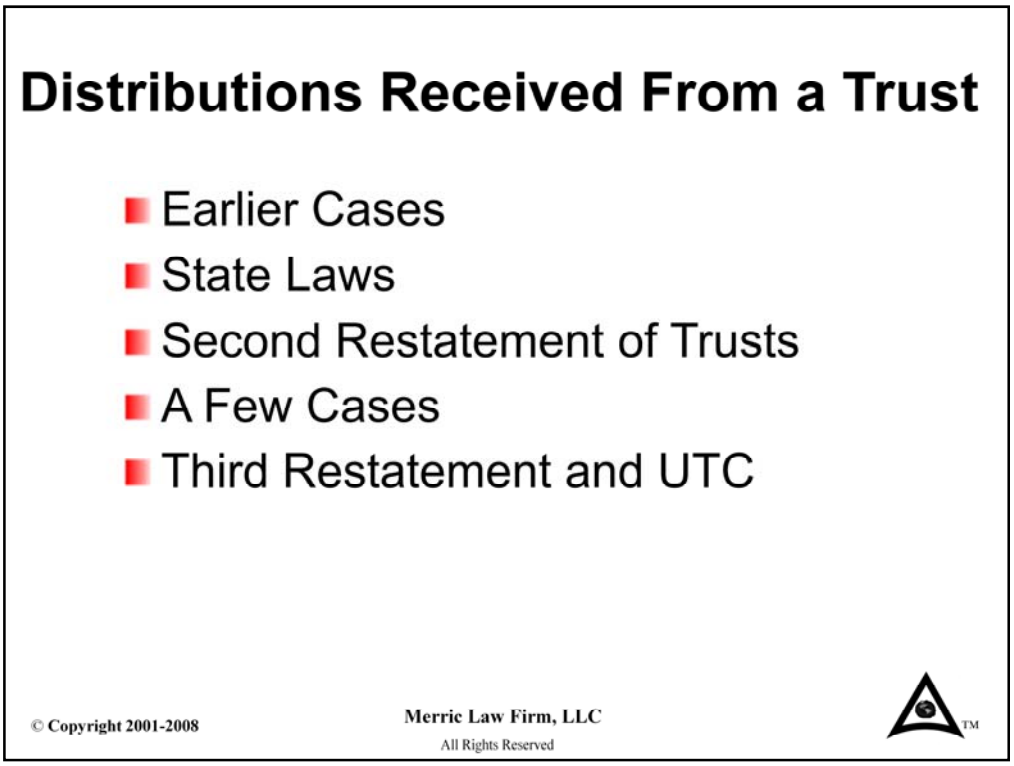
i *Restatement (Second) of Trusts*, Section 161 (1959); *Henderson v. Collins*, 267 S.E.2d 202 (Ga. 1980) [noting that in this case a remainder interest was a future property interest]; *Martin v. Martin*, 374 N.E.2d 1384 (Ohio 1978); *Miller v. Department of Mental Health*, 442 N.W. 2d 617 (Mich. 1989)..

ii However, in the highly controversial case of *U.S. v. Craft*, 122 S. Ct. 1414 (2002), the Supreme Court overturned 50 years of well established property law when it stated that federal common law determined property rights.

iii *In Re Neuton*, 922 F.2d 1379 (9th Cir. 1990).

iv *Miller v. Department of Mental Health*, 442 N.W. 2d 617 (Mich. 1989).



K. Distributions Received From a Trust

1. Earlier Cases

Early common law held that a spendthrift provision generally protects a distribution received by a beneficiary from attachment. *Bucknam v. Bucknam*, 200 N.E. 918 (Mass. 1936); *Jackson Square Loan & Sav.l Ass'n v. Bartlett*, 53 A. 426 (Md. 1902); *Boston Safe Deposit & Trust Co. v. Collier*, 111 N.E. 163 (Mass. 1916). The distribution would be protected regardless of whether the trust had a mandatory distribution standard, discretionary distribution standard or one based on an ascertainable standard.

The purpose of a spendthrift trust was to protect a person who could not either adequately care for him or herself or could not control his or her spending habits. The public policy reason behind a spendthrift clause was to allow a trust to provide for the needs of a spendthrift so that such person did not become part of the welfare roles. If a creditor could attach a trust distribution once received by a beneficiary, the objective of spendthrift protection would be defeated.

2. State Statutes

Some state legislatures did not think that a spendthrift should be able to lead a life of luxury while they had outstanding obligations. Therefore, they limited the amount of protection to a formula of the reasonable needs of the beneficiary. For example, New York State Statute allowed a creditor to reach ten percent of the amount distributed to a beneficiary as well as the amount of principal held by the trust that was "unnecessary for the reasonable requirements of the judgment debtor."[i] California (Section 15307 of the California Probate Code) as well as Pennsylvania also appear to have this type of a state statute.

3. Restatement (Second) of Trusts

The Restatement (Second) of Trusts took the exact opposite position. Under Section 152 comment j, it held that a distribution was not protected once it was received by the beneficiary. The Restatement (Second) of Trusts omitted the earlier case law above and cited three cases to support its position.[ii] When the author reviewed these cases, he was unable to see how the facts of these cases strongly supported the position taken in the Restatement (Second) of Trusts. Further, if the position in the Restatement (Second) of Trusts is correct, as noted above, the original purpose behind creating the judicial exception allowing spendthrift protection would be defeated.

Further, since the three mid 1940 cases, the author is aware of two appellate cases on point. Without any supporting authority from any court or even citing the Restatement (Second) of Trusts and without any analysis in the opinion, the Montana Supreme court held that a creditor could execute on trust income once it was paid to the beneficiary.[iii] In a different case, the Tenth Circuit Court also reached the same conclusion. Unfortunately, the Tenth Circuit also did not cite any supporting authority for its holding or provide any analysis.[iv]

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i *In re Vogel*, 16 B.R. 670 (Bkrtcy S.D. Fla. 1981).

ii *Commir. v. IRS*, 148 F.2d 566 (5th Cir. 1945); *Minot v. Minot*, 66 N.E. 2d 5 (Mass. 1946); and *Commonwealth v. Berfield*, 51 A.2d 523 (1947).

iii *Lundgren v. Hoglund*, 711 P.2d. 809 (Mont. 1985).

iv *Guidry v. Sheet Metal Workers, Int'l Ass'n*, 10 F.3d 700 (10th Cir. 1993), might be cited as one of those "bad facts make bad law" cases. Guidry misappropriated funds from his employer. The U.S. Supreme Court reversed and remanded the case back to the 10th Circuit and held the creditor could not reach the assets in Guidry's pension plan. A pension plan is a spendthrift trust protected from attachment under ERISA. Upon being reversed, the 10th Circuit held once a distribution was made to a beneficiary (even if held in a segregated account), it was subject to attachment.

4. Uniform Trust Code and Restatement (Third) of Trusts

As noted above, earlier cases held that distributions from trust were protected when received by a beneficiary. Some states by statute limited this to the reasonable needs of a beneficiary. The Restatement (Second) of Trusts, Section 152 comment j took the position that a distribution may be attached after it was received by a beneficiary. After promulgation of the Restatement (Second) of Trusts, a couple of court cases appear to follow the Restatement, but make no mention of the Restatement in their findings. The Restatement (Third) of Trusts, Section 58 comment d. also takes the position that spendthrift protection does not extend beyond the point of distribution. However, both the Uniform Trust Code and the Restatement (Third) of Trusts make allowance for the reasonable needs of a beneficiary, by giving the court discretion to determine the reasonable needs of the beneficiary.[i] In this respect, although it is not mandatory for a court to provide for the reasonable needs of a beneficiary, it is permitted under both the Uniform Trust Code and the Restatement (Third) of Trusts.

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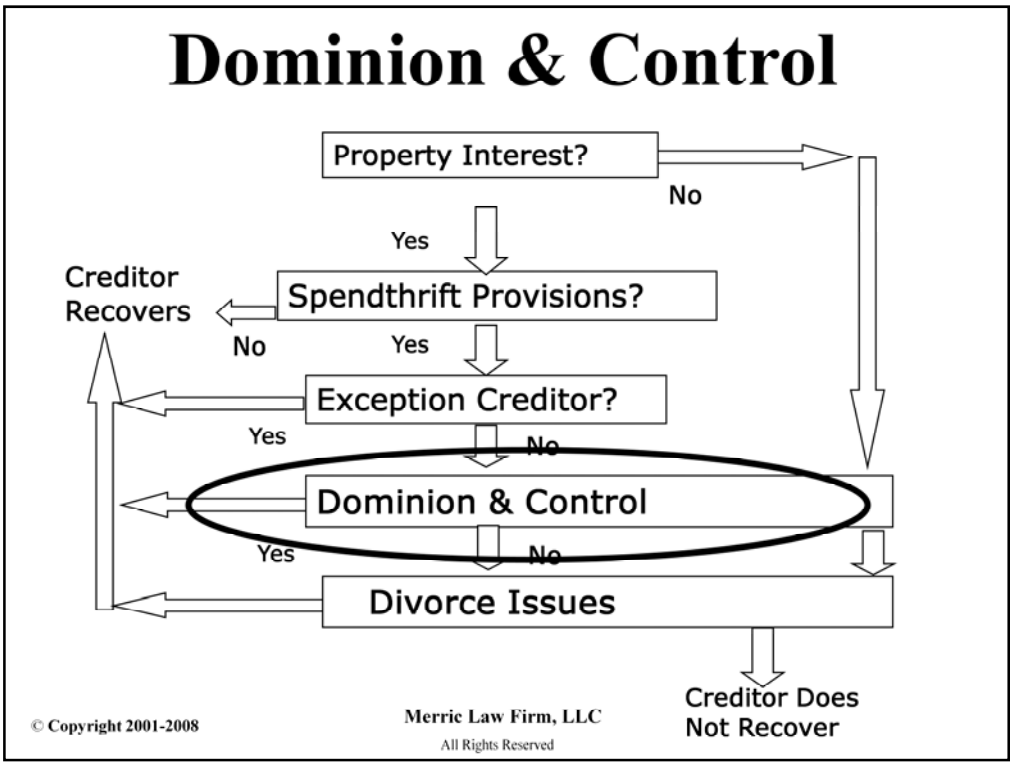
[i] *Uniform Trust Code,* Section 501 comment; *Restatement (Third) of Trusts,* Section 56, comment e.



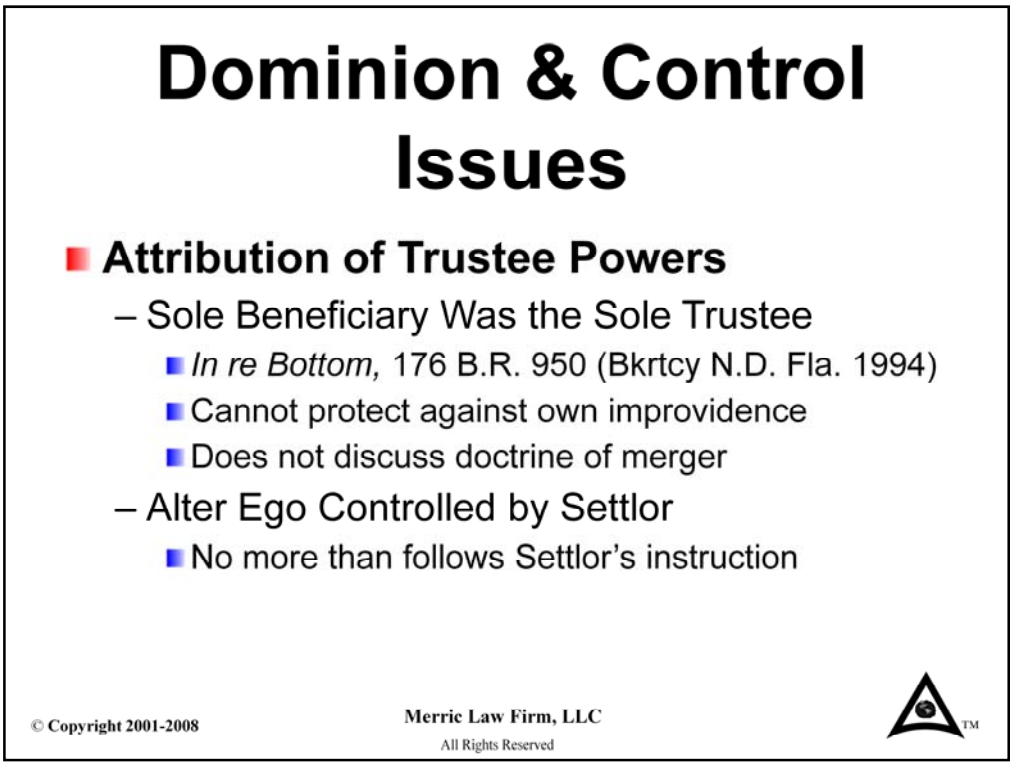
L. Dominion and Control

1. Road Map

As previously noted, if a beneficial interest is not considered a property interest, under common law, the asset protection does not depend on spendthrift protection. In this case, unless a dominion or control issue or a divorce nuance is present, then no creditor may attach the beneficial interest in a discretionary/dynasty trust.

In the case of a support trust, an exception creditor may attach a current beneficial interest. However, unless a dominion or control issue or a divorce nuance is present, no other creditor may attach the current beneficial interest.

Generally, not even an exception creditor, may recover against a remainder interest. However, as noted in the following pages, a divorce nuance may well be an exception to this general rule.



2. Attribution of Trustee's Powers

Several states require that in order for spendthrift provisions to be enforceable, not only must the settlor not be a beneficiary, but the beneficiary must not have control or dominion over the assets of the trust. The concept of dominion and control is an attribution concept where most of the powers of the trustee are attributed to the beneficiary.

a. The Sole Beneficiary Was 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, he cannot protect himself from his own improvidence. Using a control and dominion argument, the court *In re Bottom,* the spendthrift provision protection was not upheld,[i] and the creditor was able to reach the assets of the trust. The doctrine of merger should also apply in a *Bottom* fact pattern.

b. Alter Ego Trustee

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.[ii] The trustee is nothing more than an instrument of the settlor. The same principal should also apply if a beneficiary is dictating all of the trustee's actions.

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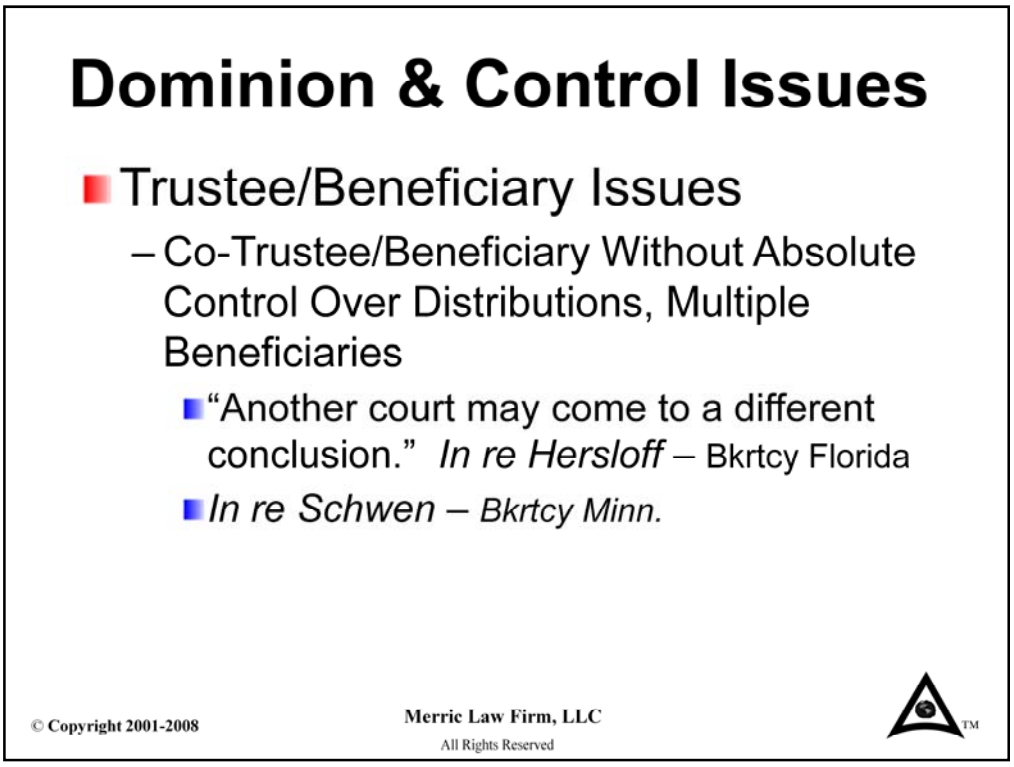
i *In re Bottom,* 176 B.R. 950 (N.D. Fla. 1994).

ii *In re McCullough,* 259 B.R. 509, (D. Rhode Isl 2001).



3 Beneficiary Serving as a Trustee

a. Beneficiary Serving as a Co-Trustee; Multiple Beneficiaries

On the other hand, two courts have held that the beneficiary/trustee did not control the trust when the beneficiary was a co-trustee and there were multiple beneficiaries.[i] While these two courts indicated that the consent of at least one other person was sufficient to negate a dominion and control issue, another court may come to a different conclusion. In this respect, two cases may not be a representative sample on which to base one's planning. Therefore, the author prefers not to use co-trustees where a beneficiary is also one of the trustees for asset protection planning purposes.

b. *Beneficiary Serving as Sole Trustee; Multiple Beneficiaries*

Some attorneys draft so that trusts (with an ascertainable standard distribution standard) and then have the primary beneficiary (i.e., the child) as the sole trustee of the trust. The trust has both the primary beneficiary and the primary beneficiary's children as beneficiaries. To date, the author is aware of only one case which addressed the issue directly and another case that mentions the issue as dicta.

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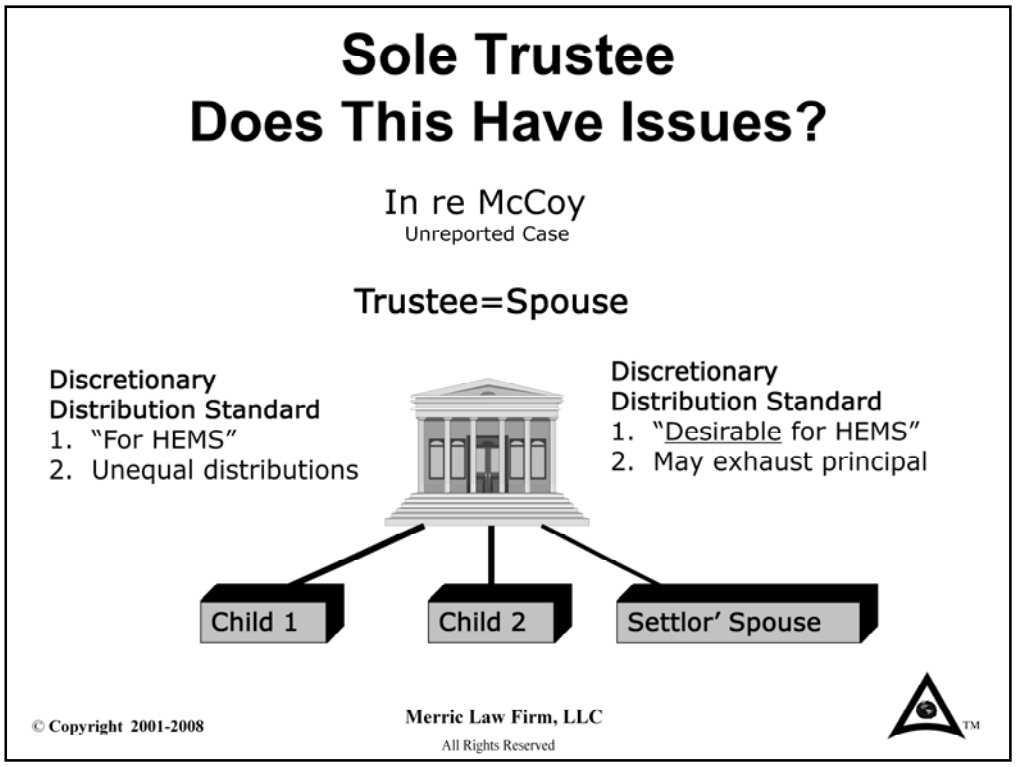
[i] *In re Hersloff*, 147 B.R. 262 (M.D. Fla. 1992); *In re Schwen*, 43 Collier Bankr. Cas. 2d 255 (D. Minn. 1999).



b. *Beneficiary Serving as Sole Trustee; Multiple Beneficiaries*

A recently published article in Trusts and Estates Dec. 2006 titled, *Beneficiary-Controlled Trusts Can Lose Asset Protection,* by Charles Harris and Tye J. Klooster warns of the problems of giving a beneficiary too much control – in particular where a beneficiary serves as the sole trustee. As primary authority for its conclusions, the article cites, *In re McCoy,* 2002 WL 161588 (ND. Ill. 2002) unreported case and the Restatement Third of Trusts, Section 60 comment g.

Some planners will disagree with the limited authority from which the authors base their conclusions. However, while the cases in this area are sparse, it is sufficient to infer that the article serves as a warning of that which may well become future planning issues. Particularly, in view of the unsupported position of law taken by *Restatement (Third) of Trusts,* Section 60 comment g.

i. *In re McCoy*

The primary issue discussed in *McCoy* was the dual discretionary distribution standards between the spouse/trustee and the children.

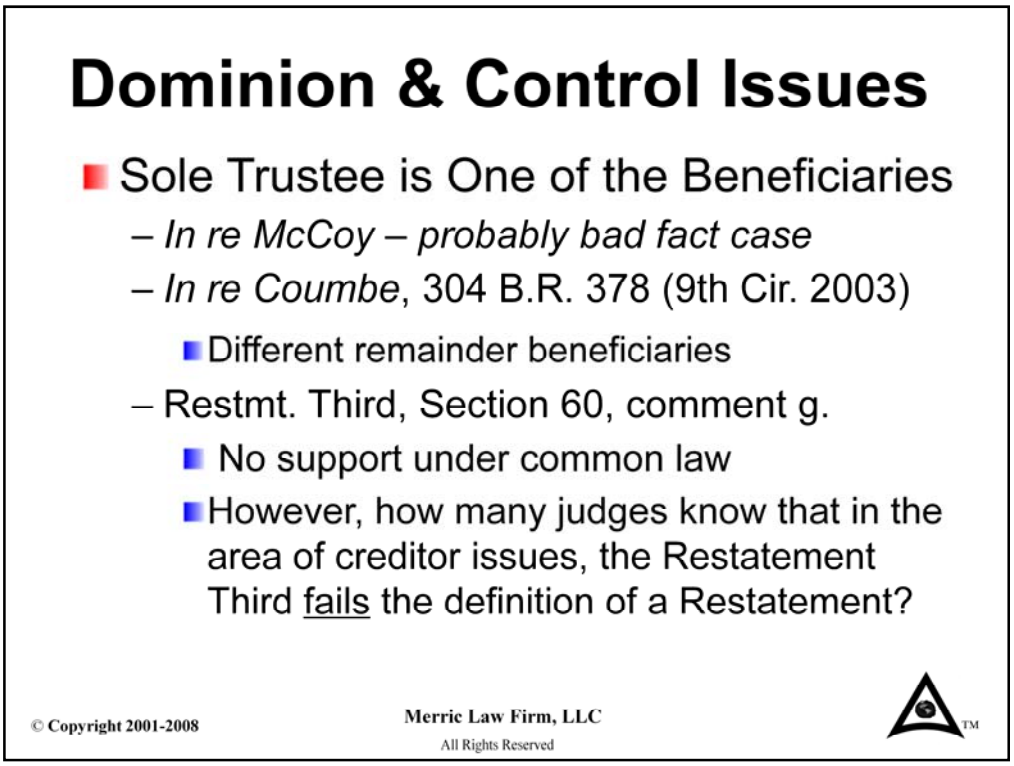
1. Regarding the children, the Trustee/Spouse could make distributions to them in his discretion for their health, education, maintenance, and support. He could also make unequal distributions between them.

2. However, in making distributions to himself as a trustee, he could distribute whatever was "required" or "desirable" for his own health, maintenance, and support. The trustee/spouse also "need not consider the interests of any other beneficiary in making distributions to my spouse or for his benefit.

The court concluded that the word "desirable" placed no ceiling on distributions, and that since he did not need to consider the interests of other beneficiaries he could distribute everything to himself. Therefore, he had control and dominion over the trust and the spendthrift provision provides no asset protection.

ii. Will Courts Cite McCoy Broadly to Conclude That a Sole Trustee/Beneficiary's Creditors May Reach the Sole/Trustee's Interest in the Trust?

As discussed in the following pages, the *Restatement (Third)* has little, if any authority for taking this creditor friendly legal position. However, if a court broadly cites the unreported case of *McCoy* and ignores the determining drafting language that was unique to *McCoy* in 2. above, *McCoy* may well begin a line of cases that a sole trustee/beneficiary has no asset protection for his or her beneficial interest in trust.



ii. In Re Schwen - Dicta

In re Schwen, the court mentioned that if one of the beneficiaries was the sole trustee, the trustee/beneficiary's control regarding making distributions was still limited by a fiduciary duty to other beneficiaries. Therefore, the trustee/beneficiary would not have control.[i] It should be noted that in *Schwen*, there were actually two trustees and the court mentioned the sole trustee situation purely as dicta.

iii. In Re Coumbe

The 9th Circuit in a review of a bankruptcy case has provided further guidance in this area when it held that a sole beneficiary could serve as the sole trustee for so long as there were different remainder beneficiaries.[ii]

iv. Section 60 comment g.

Also, without any reported case law supporting its position, the Restatement (Third) of Trusts takes the position that the trustee/beneficiary interest may be reached as if the trustee/beneficiary were the settlor of a self-settled trust. Restatement (Third) of Trusts, Section 60, comment g. It is true that many states are passing laws, and even the UTC, reversed this unsupported position of law. However, in states that do not affirmatively fix this issue by statute, many judges will simply error by following the Restatement position that they would assume was based on common law.

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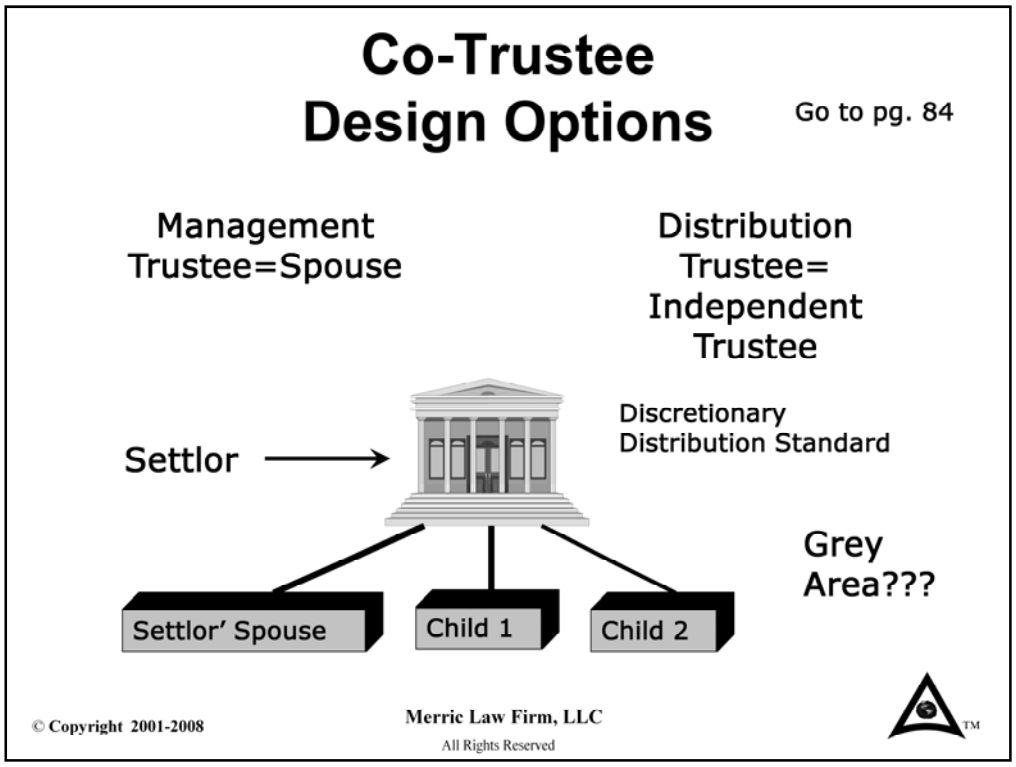
[i] David B. Young, *The Pro Tanto Invalidity of Protective Trusts: Partial Self-Settlement and Beneficiary Control*, 78 MARG.L.REV, 807, 855 (1955).

[ii] *In re Coumbe*, 304 B.R. 378 (9th Cir. 2003).



d. Co-Trustee Design Options

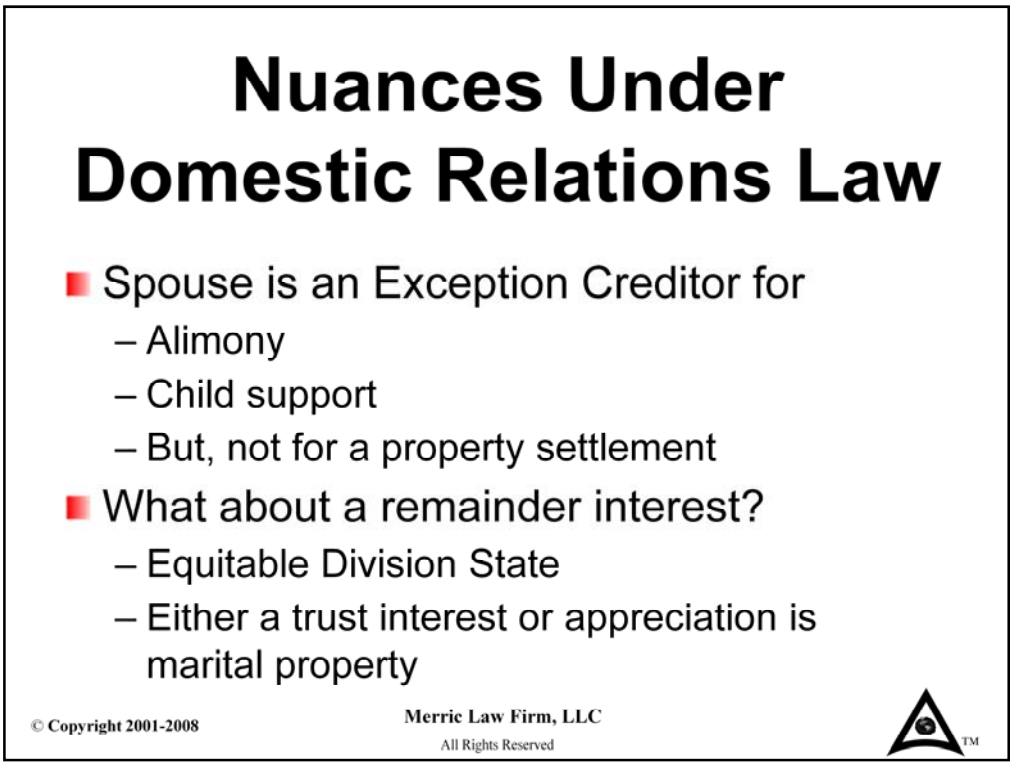
i. Independent Distribution Trustee

With a co-trustee option, the distribution should be independent within the meaning of IRC §672(c). This structure is theoretically sound from an estate planning perspective. Even when the beneficiary managing trustee holds a removal/replacement power over the distribution trustee, this structure is theoretically sound from an estate planning perspective.

ii. Grey Area

Unfortunately, it is uncertain whether this structure is completely sound from an asset protection planning perspective. When a single trustee may serve as trustee for multiple beneficiaries, we have already discussed the possible problems with such a planning structure. The above structure, is one more step removed from those issues.

Some planners will consider this structure, even though one step removed, is also a little too much in the grey area. Particularly if the fact pattern is that the managing trustee has a removal power over the distribution trustee and the distribution trustee is the managing trustee's best friend.

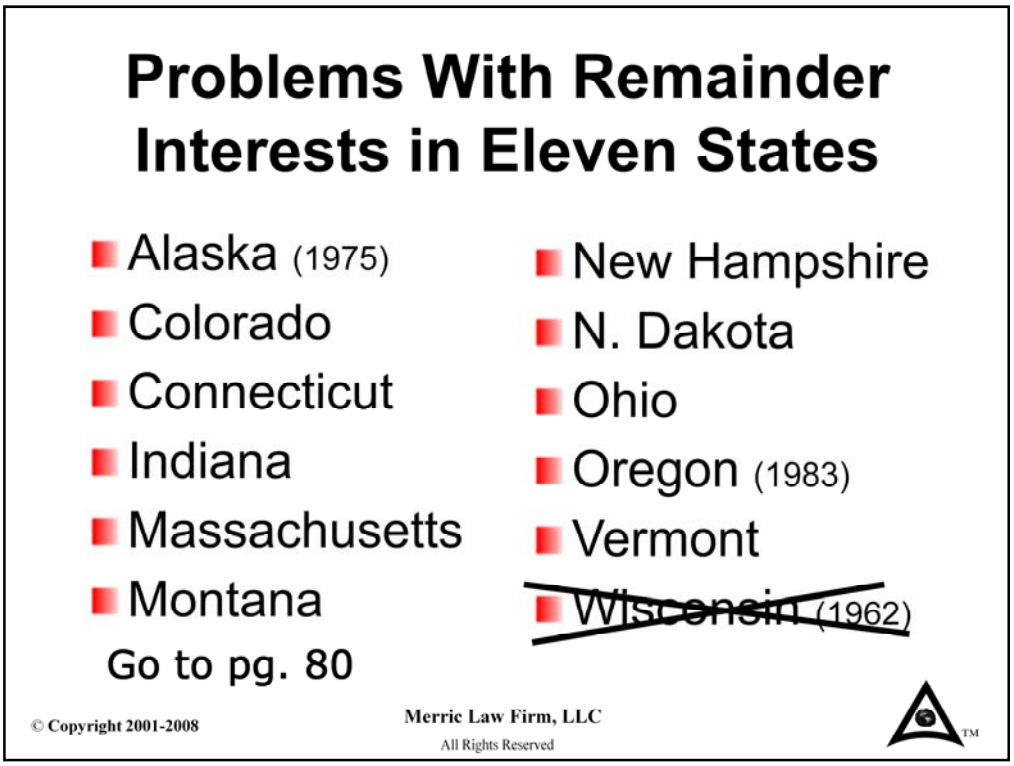


M. Nuances Under Domestic Relations Law

1. Current Distribution Interest

The first nuance, was already discussed in detail under Spendthrift Provisions – Support Trust. In this section, the exception creditor status of an estranged spouse for child support or alimony was discussed. However, if the trust was drafted as a discretionary trust, the beneficiary did not hold a property interest or an enforceable right, and the spouse could not proceed against the assets of the trust.

Please note, while the exception creditor status allowed a spouse to proceed against the assets of a support trust for child support or maintenance, it does not allow an ex-spouse to force a distribution of trust assets as a property settlement in the dissolution of the marriage.



2. Problems With Remainder Interests in Eleven States

Until recently, in the event of a divorce, almost all asset protection planners thought that a remainder interest was free from division of marital property. First, most states provide that a gift (including the gift of a beneficial interest in trust) is separate property. Second, many courts in the domestic relations context have found that a remainder interest in trust is indivisible.[i] Third, some courts have characterized a remainder interest in trust as to remote to be classified as marital property.[ii] Finally, at least one court found that that a remainder interest in trust is an inchoate right and is nothing more than a mere expectancy.[iii] However, eleven states have to one degree or another treated a remainder interest as marital property for division in a divorce.

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[i] *Hussey v. Hussey,* 312 S.E. 2d 267 (1984); *Frank G.W. v. carol M.W.,* 457 A.2d 715 (Del. 1983); *Khroha v Khroha*, 578 S.W.2d 10 (1979); *Bacher v. Bacher*, 520 So. 2d 299 (Fla. Dist. Ct. App. 1988); *In re Marriage of Rosenblum*, 602 P.2d 892 (1979).

[ii] *Loeb v. Loeb*, 301 N.E. 2d 349 (Ind. 1973).

[iii] *Storm v. Storm*, 470 P.2d 367 (Wyo 1970) [Note that since Wyoming has adopted the Uniform Trust Code, it is most likely that *Storm v. Storm* has been over turned by statute, under Section 501 of the Uniform Trust Code.]

a. States With Remainder Issues to Date

The following courts listed alphabetically by state detail where courts have found a remainder interest to be a marital asset eligible for division in a divorce:

(1) Alaska - *Burrell v. Burrell*[i] - In 1975, the Alaska Supreme Court found a vested remainder interest is subject to division.

(2) Colorado - *Balanson v. Balanson*[ii], 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* [iii] - In 1994, the Superior Court of Connecticut found remainder interests in a credit shelter trust, marital trust, and an irrevocable trust that were found to be marital property.

(4) Indiana – *Moyars v. Moyars*[iv] - In 1999, the Court of Appeals of Indiana distinguished the *Loeb v. Loeb*, 301 N.E. 2d 349 (Ind. 1973). *Loeb* 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 *Moyar*, 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 of Appeals held that a vested remainder interest was marital property.

(5) Massachusetts - *Davidson v. Davidson*[v] - In 1985, the Massachusetts Supreme Court held that neither uncertainty of value nor inalienability of husband's vested remainder interest in a discretionary trust found sufficient to preclude division.

(6) Montana - *Buxbaum v. Buxbaum*[vi], In 1984 the Montana Supreme Court held that 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 as dissolution.

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i 537 P.2d 1, (Alaska 1975).

ii 25 P.3d 28 (Colo. 2001)

iii 1994 WL 592243 (Superior Ct. of Conn. 1994).

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

v 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 subject to division of marital property.

vi 692 P.2d 411 (Mont. 1984).

(7) New Hampshire - *Flaherty v. Flaherty*[i]- In 1994, the New Hampshire Supreme Court held that anti-alienation clause and circumstance that the defendant's contingent remainder interest will not have value until his last parent dies does not preclude the treatment of the interest as marital property.

[4]

(8) North Dakota - *van Ossting v. van Ossting*[ii] - In 1994, the North Dakota Superior Court held that when where the present value of the husband's vested credit trust was subject to contingencies and was too speculative to calculate, the court found the proper method of distribution was awarding the wife a percentage of future payments.

(9) Ohio - *Martin v. Martin*,[iii] - In 1978, the Ohio Supreme Court found a future interest whether contingent or executory is alienable.

(10) Oregon - *Benston v. Benston*[iv] - In 1983, the Oregan Appeal court found vested as well as a contingent remainder interest is subject to division.

(11) Vermont - *Chikott v. Chilkott*[v] - In 1992, the Vermont Supreme Court held techniques of actuarial valuation of pension interests held applicable to determining present value of husband's vested, defeasible trust interest for the purposes of property division at dissolution.

(12) Wisconsin - *Trowbridge v. Trowbridge*[vi], – In 1962, as dictum the Wisconsin Supreme Court held remainder interests in trust subject to conditions of survivorship, depletion of corpus, and spendthrift clause, are part of marital estate subject to division at divorce. However, this case law has been reversed by Wisconsin becoming a community property state effective 1986.

To date, twelve states have held that a vested remainder interest is property that is eligible for division in a divorce (Wisconsin case law was reversed when it became a community property state). Some states require the property to be vested, but most states hold that a vested remainder interest, even if subject to complete divestment is a marital asset. In this respect, the *Balanson* case is not the shock that many people first suspected. Rather, it appears to be a common finding in many courts when all or part of a remainder interest is considered marital property.

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i 638 A.2d 1254 (N.H. 1994).

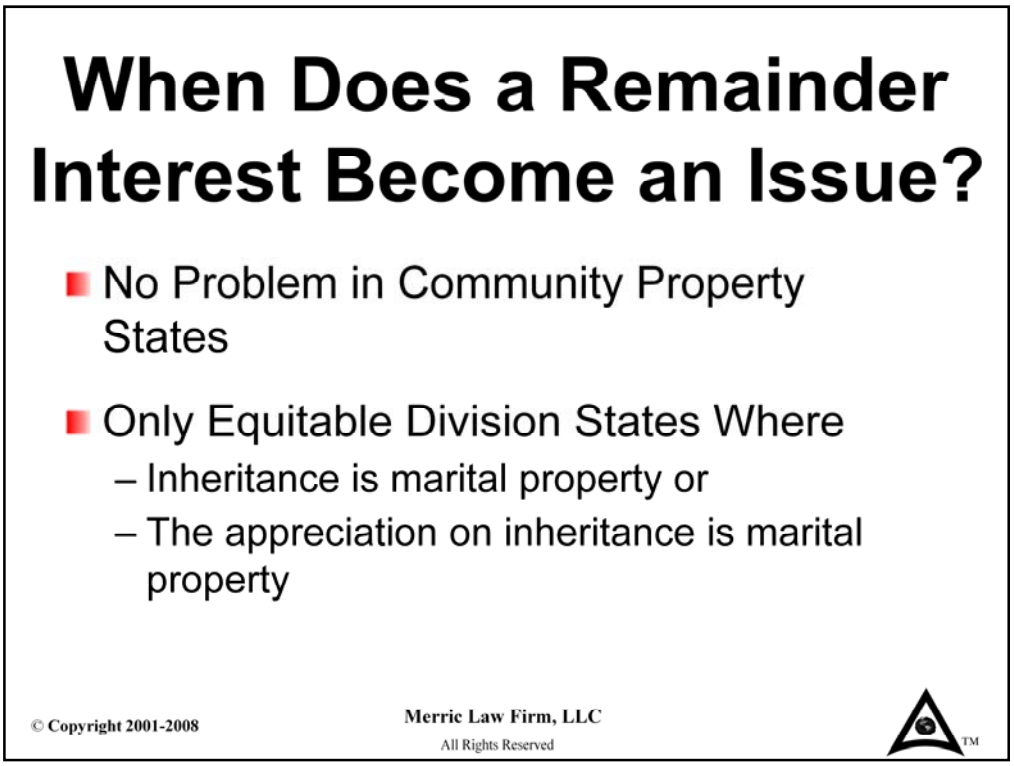
ii ND Sup Ct., No 940003 (1994).

iii 374 N.E. 2d 1384 (Ohio 1978).

iv 656 P.2d 395 (Or. App. 1983).

v 607 A.2d 883 (Vt. 1992).

vi 114 N.W. 2d 129 (Wis. 1962).



b. When is Division of a Remainder Interest An Issue For Marital Purposes?

One might ask why more states have not found a contingent remainder interest as property eligible for division. First as noted above, a hand full of states still follow the theories that a contingent remainder interest is not divisible, it is a mere expectancy, or it is to remote to be classified as marital property. Moreover, the primary reason why more states have not found that a remainder interest is marital property is because in most states inheritance, including any appreciation on inheritance, is separate property. Many of the aforementioned states which have concluded that a remainder interest is marital property have state statutes that in general are based on one of the following types:

(1) Inheritance is classified as a marital asset.

(2) Inheritance is classified as separate property. However, the appreciation on inheritance is considered a marital asset.

(3) The statute provides a factor test for dividing all property owned by either spouse at the time of dissolution. In other words, based on the state statute, the judge has complete authority to give the separate property of one spouse to the other spouse for reasons such as the length of the marriage, the contributions to the marriage of the receiving spouse, the needs of the spouse who has custody of the children, the lower income level of the receiving spouse, etc.

On the other hand, a few states have found the opposite in an equitable division state:

(1) Some states have found that a remainder interest in trust is indivisible.[i]

(2) At least one state court has characterized a remainder interest in trust as to remote to be classified as marital property.[ii]

(3) At least one court found that that a remainder interest in trust is an inchoate right and is nothing more than a mere expectancy.[iii]

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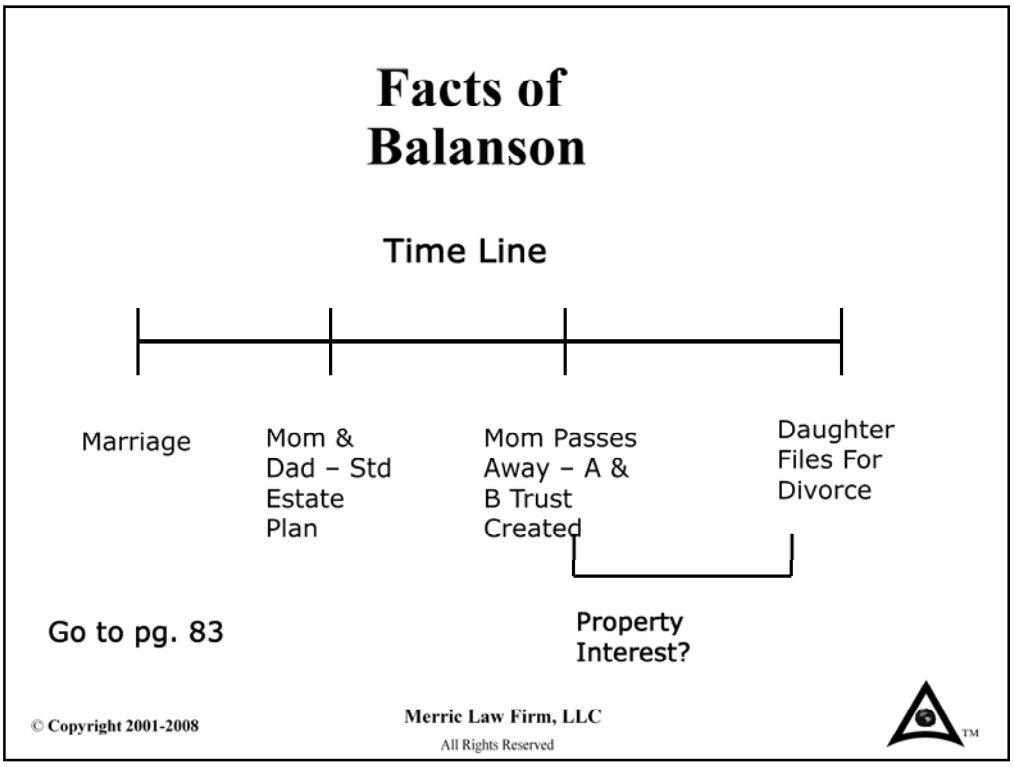
[i] *Hussey v. Hussey*, 312 S.E. 2d 267 (1984); *Frank G.W. v. carol M.W.*, 457 A.2d 715 (Del. 1983); *Khroha v Khroha*, 578 S.W.2d 10 (1979); *Bacher v. Bacher*, 520 So. 2d 299 (Fla. Dist. Ct. App. 1988)

[ii] *Loeb v. Loeb*, 301 N.E. 2d 349 (Ind. 1973).

[iii] *Storm v. Storm*, 470 P.2d 367 (Wyo 1970)



c. The Shock Wave in Colorado

Most Colorado estate planners went into shock when the Colorado Supreme Court handed down the *Balanson v. Balanson* decision. *In re Balanson*, 25 P.3d 28 (Colo. 2001). The Colorado Supreme Court ruled that the appreciation on a vested remainder interest subject to complete divestment was marital property eligible for equitable division. Please note, while Colorado law ruled that inheritance is exempt from the definition of marital property, any appreciation on inherited property is considered marital property. Prior to this, Colorado had held that remainder trust interests were indivisible. *In re Marriage of Rosenblum*, 602 P.2d 892 (1979).

i. Facts

Balanson begin when the daughter marries. A few years later, Mom and Dad create the standard estate plan in their wills or revocable trusts that creates the marital trust and the credit shelter trust (i.e., family, bypass, or exemption trust) upon the death of the first spouse. Several years later, mom dies and the first $1 million of her assets fund the credit shelter trust, the remainder fund 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 is based on ascertainable standards. Dad is in good health and may easily live another 15 years. Further, Dad has a testamentary general power of appointment over the marital share that allows him to completely extinguish the daughter's interest should he desire by appointing all of 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.

ii. Holding

The daughter's remainder interest is contingent since she must outlive her father. Also, the daughter's interest is subject to complete divestment, because her dad may exercise his special power of appointment solely in favor of his son. However, 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.[i] The logic behind the decision is that the Court values interests that are hard to value all the time, such as retirement plans or business valuations.

d. A National Trend?

In *Balanson*, the Colorado case cited two other cases – *Davidson v. Davidson* (a Massachusetts case) and *Trowbridge v. Trowbridge* (a Wisconsin case)[ii] when it held that a contingent remainder interest subject to complete divestment was eligible for marital property division. Therefore, at first glance, following in Massachusetts footsteps, the Colorado Supreme Court appears to be crossing new legal ground. However, this does not quite appear to be the case. Rather, as noted by the cases previously cited, it appears that this is a national trend, rather than a few states with isolated occurrences. In fact, the author believes that this issue will be similar to retirement plans. Approximately forty years ago, most courts held that retirement plans were not divisible and therefore not subject to division in the domestic relations context. However, now all states value retirement plan interests, and readily divide them in divorce settlements.

e. What About Spendthrift Provisions?

In the states that hold that a remainder interest is property eligible for division on the dissolution of a marriage, does an estranged spouse have greater rights than an ordinary creditor? Under the Restatement Second, an ordinary creditor cannot generally attach the remainder interest (until it is distributed), because the interest is either contingent or subject to spendthrift provision.[iii] However, as noted above, a spouse is an exception creditor for purposes of child support and alimony- but in most states this only applies in the situation of child support or alimony, not the division of marital property.[iv]

Furthermore, older cases, follow the general rule that a spouse attempting to receive a property settlement stands no better than any other creditor.[v] Unfortunately, the court cases cited in the twelve states above did not discuss the spendthrift issue. In one case, the Supreme Court of Massachusetts mentioned the spendthrift provisions in the facts of the case. Later in the opinion, without discussing the spendthrift provisions, the Court stated that it rejected the contention that "the content of estates of divorcing parties ought to be determined by the wooded application of the technical rules of the law of property. We [the Supreme Court of Massachusetts] think an expansive approach, within the marital partnership concept, is appropriate."[vi] Therefore, as applied to remainder interests, a former spouse in many states has greater rights to a remainder interest than an ordinary creditor.

f. What is the Solution to the Remainder Interest Problem?

Once one of the aforementioned courts decided that a remainder interest was property, the only issue left was valuation. Therefore, the solution to the *Balanson*, *Davidson*, and other remainder interest problems is relatively straight forward –create an interest after the event

(1) Inheritance is classified as a marital asset.

(2) Inheritance is classified as separate property. However, the appreciation on inheritance is considered a marital asset.

(3) The statute provides a factor test for dividing all property owned by either spouse at the time of dissolution. In other words, based on the state statute, the judge has complete authority to give the separate property of one spouse to the other spouse for reasons such as the length of the marriage, the contributions to the marriage of the receiving spouse, the needs of the spouse who has custody of the children, the lower income level of the receiving spouse, etc.

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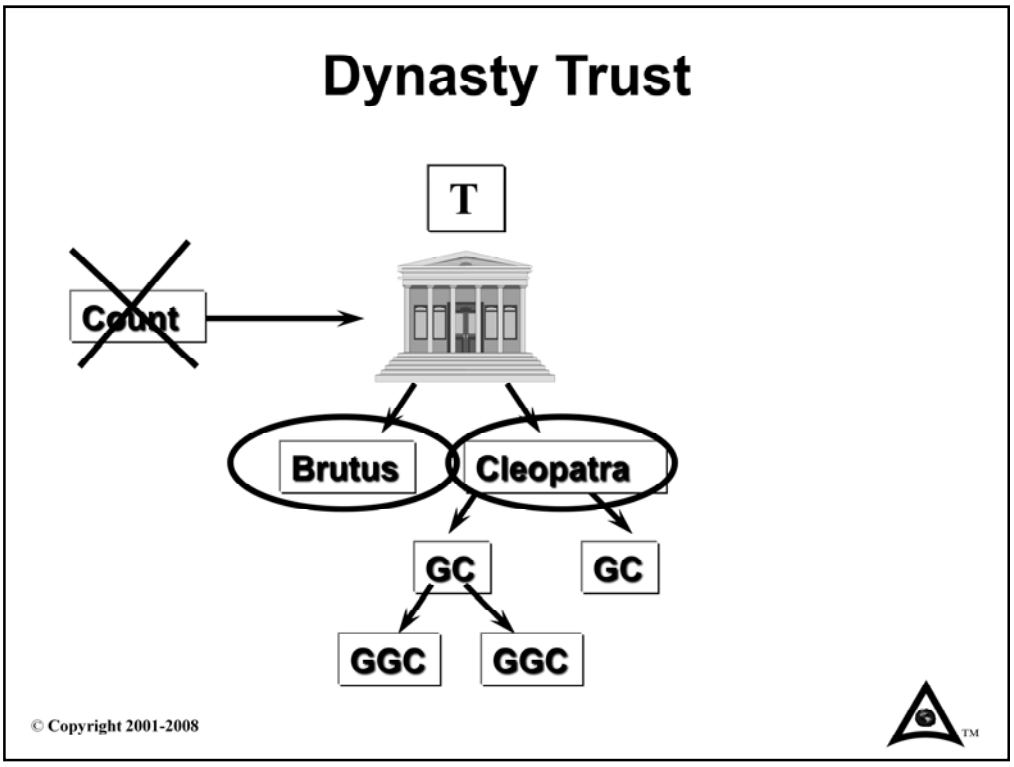
i *Restatement (Second of Trusts),* Section 162 (1959); *Henderson v. Collins*, 267 S.E. 2d 202 (Ga. 1980) [noting that a remainder interest was future property].

ii The author is aware that in some states statutes on domestic relations issues do not separate alimony and property settlements. Rather, these states view the two as integrated in a divorce settlement. In these states, the spouse would be an exception creditor.

iii *Loeb v. Loeb,* 301 N.E. 2d 349 (Ind. 1973), ("where a wife's interest under a trust where she is not a beneficiary can never be greater than her beneficiary-husband's interest"); *Buckman v. Buckman,* 200 N.E. 918 (Mass. 1936) – where a former spouse attempting to enforce alimony stood "no better than any other creditor." Please note that *Buckman* appears to have been reversed by the holding in *Davidson v. Davidson¸* 474 N.E. 2d 1137 (Mass. 1985). However, while the *Davidson* court cited *Buckman*, it did not specifically state that such holding was reversed.



N. What's the Solution to the Remainder Interest and Other Creditor Problems

1. What is the Solution to the Remainder Interest Problem?

Once one of the aforementioned courts decided that a remainder interest was property, the only issue left was valuation. Therefore, the solution to the *Balanson*, *Davidson,* and other remainder interest problems is relatively straight forward –create an interest after the event date that is not a property interest for state law. In other words, create a dynasty trust[i] for each child and his or her descendants.

2. Definition of a Dynasty Trust

A dynasty trust is a trust where a remainder interest never vests in any beneficiary. Rather, 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 a multiple beneficiary trust, or the dynasty trust may split into separate dynasty trusts at each generation level. In a multiple generation beneficiary (sometimes referred to as "pot trust"), when the children, grandchildren, and great grandchildren are born, they all become beneficiaries of the same dynasty trust.

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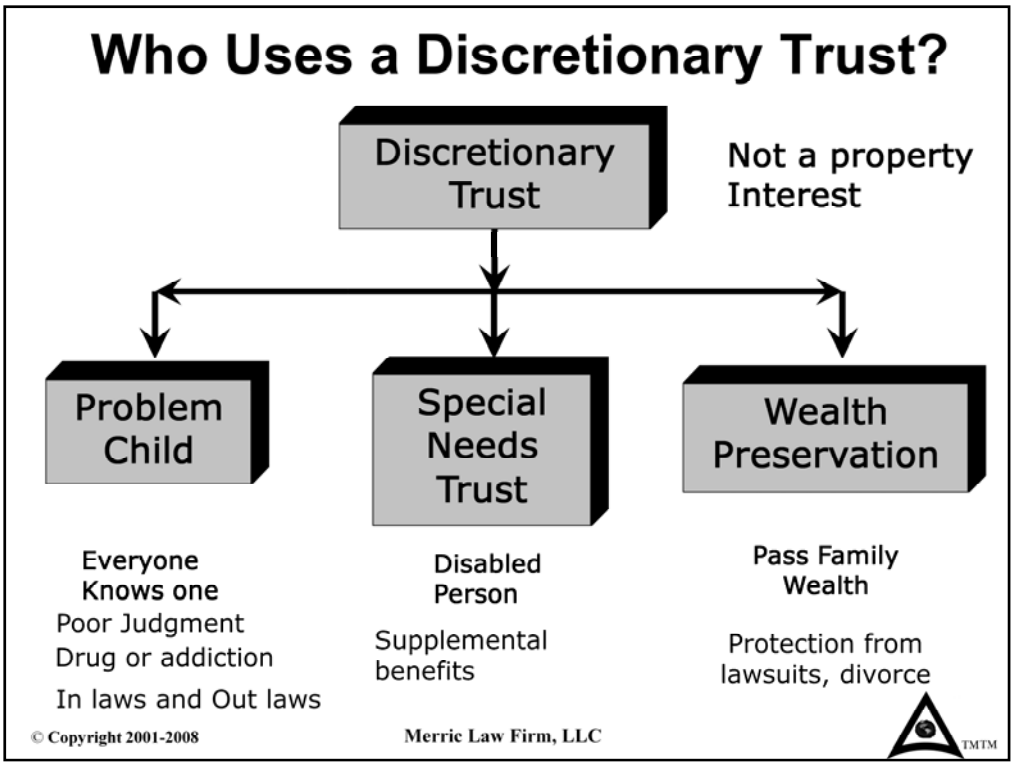
[i] *Restatement (Second) of Trusts,* Section 161 (1959); *Henderson v. Collins*, 267 S.E. 2d 202 (Ga. 1980) [noting that a remainder interest was future property].



2. Who Uses a Discretionary Trust

Discretionary trusts are primarily used for the following three purposes:

a. Problem Child or Child With a Problematic Spouse

Unfortunately, many families (maybe every other family) has a child where the parent does not trust the child's decisions. This is true even though the child in many cases has grown to be an adult. In these cases, the parent typically will transfer this child's inheritance in trust. The trustee will be a close friend or relative that the settlor (i.e., parent) has the utmost confidence to make the "hard" decisions. The client's trusted friend, financial advisor, or relative is willing to accept the thankless trustee position and make the hard decisions, because the beneficiary has few rights to sue the trustee in court. (If the client [i.e., trust makor] had wanted the trust makor to have greater rights to sue the trustee, the client would have created a support trust.) Sometimes, it is not the child with the problem, rather the child's spouse is considered an "outlaw" instead of an "in law" by the family. In this case, a discretionary trust may again be used as part of the planning process.

b. Special Needs Trust

A special needs trust is generally created by a parent for a person who is incapacitated: either physically or mentally. The parent wishes to restrict the gift to provide for benefits that are not covered by a governmental agency. Since a discretionary trust is not a "property interest," a governmental agency cannot reach the assets in the trust. These trusts are generally not large trusts.

c. Wealth Preservation

These trusts tend to be the larger dollar trusts (usually greater than $1 million in assets). For families of wealth, these trusts are the preferred option of choice.

3. Discretionary/Dynasty Trust For Most Clients

Some estate planners are now advocating that almost all clients that do any planning should use discretionary/dynasty trusts. Therefore, these estate planners are ironically suggesting the opposite of what most estate planning practitioners currently do. Most practitioners tend to use ascertainable standards as the distribution standard and an age vesting as the remainder interest. Why do these planners think that the discretionary/dynasty trust should be the rule, rather than the exception?

As previously noted, the discretionary/dynasty trust is the vehicle of choice for high net worth individuals. So this concept is not new for these clients. How about a discretionary/dynasty trust when the client is an astute business client? If his or her parents could create a trust for the astute business client, the trustee could close future business opportunities of the clients. All of these future business opportunities would now be protected without going offshore or to a domestic asset protection trust state.

What about the standard marital and family trust client? If the husband passed away first, his assets are held in trust for the surviving spouse. What if the surviving spouse becomes eligible for governmental care? If the standard support trust had been drafted, the result is that governmental agency may reach the beneficial interest. On the other hand, if a discretionary/dynasty trust been used, the trust would function as a third party special needs trust. The result is that the government would not be able to attach the wife's beneficial interest in trust.

P. Key Issues to a Discretionary Dynasty Trust

1. No Property Interest or Enforceable Right

The asset protection behind a common law discretionary trust is not related to spendthrift protection. Rather, it is the fact that a beneficiary does not have a right to force a distribution, which result in the beneficiary not have a property interest that may be attached. The Restatement Third's (and most likely the Uniform Trust Code) rewrite of almost all common law regarding discretionary trusts and creditor rights is most troubling.

2. All of the Assets May Be Distributed to the Primary Beneficiary

The marketing concept of these discretionary trusts is that a beneficiary wishes to receive his or her property in trust, rather than outright. However, if the beneficiary's children also have rights to distributions or a remainder interest, then not all of the property may be distributed to the primary beneficiary.

3. Control is Not Attributed to the Primary Beneficiary

Three different models of discretionary dynasty trusts were presented in this outline. Absent a statute specifically addressing the dominion and control issues, the author has strong concerns regarding the sole trustee/beneficiary model. The author also finds the independent trustee model to be the strongest of the three. The second model that has a management and a distribution trustee should work under the limited existing case law. However, the author could see problems with this model with a judicial activist judge.