

**Steve Leimberg's Estate Planning Email Newsletter - Archive
Message #733**

Date: 13-Oct-04
From: Steve Leimberg's Estate Planning Newsletter
Subject: [The Uniform Trust Code's Effect on ILITs](#)

Listserves have been buzzing as attorneys in national publications and via the internet and in speeches have expressed a growing concern regarding the Uniform Trust Code's ("UTC") decrease in asset protection for spendthrift trusts. These articles have analyzed the UTC's dramatic departures from common law regarding the protection of a beneficial interest in a trust.

Other articles and comments by highly respected practitioners have praised the UTC changes and have addressed and explained why and how the UTC changes are positive. Folks, there's lots of heat that goes along with the light here!

What is certain is that all planners must know more about the UTC changes and how their areas of estate and financial planning are affected and their clients impacted.

Although the commentary that follows briefly touches upon some of these concerns, its primary focus is on how Irrevocable Life Insurance Trusts (ILITs) might be impacted, the possible migration of some ILITs out of UTC states, and the possible changing of insurance policies from policies issued in UTC states to non-UTC states.

Estate and asset protection planning authorities **Mark Merric**, **Douglas Stein**, and **Robert Gillen** provide Leimberg Information Services members with a summary of the many areas where they believe the UTC decreases asset protection for non-self settled trusts.

Mark Merric is a national speaker on estate and asset protection planning. Mark is also a co-author of CCH's treatise on asset protection, *The Asset Protection Planning Guide*, and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*.

Douglas Stein has lectured nationally and locally on Medicaid planning, guardianship issues, charitable giving, qualified plans, asset protection

and estate planning. Doug is also nationally published in Probate & Property and Exempt Organizations review.

Robert Gillen is a national speaker on estate and asset protection planning. Bob is also a co-author on the ABA's treatise on asset protection, Asset Protection Strategies Volume II.

I. ASSET PROTECTION CONCERNS

The following list details some of the major asset protection concerns under the UTC:

Abolition of the common law distinction between a discretionary and a support trust.

Discretionary trusts have been an integral part of estate planning for wealth preservation, special needs trusts, planning for beneficiaries with a drug dependency or emotional problems, planning for beneficiaries with poor marital relations as well as for a host of other beneficiaries for whom no creditor issues are apparent.

- Ø Under the UTC, discretionary trusts must now rely solely on spendthrift language for their protection and can no longer rely upon hundreds of years of well articulated common law precedents and holdings that a discretionary income interest (i.e., current discretionary interest) is not a property interest.
- Ø Creation of new remedies for creditors that prevent the trustee from directly paying the expenses of the beneficiary. These remedies, combined with the UTC permitting an exception creditor and POSSIBLY ANY CREDITOR to attach present and ALL FUTURE distributions at the trust level, significantly reduces the protection formerly provided by spendthrift trusts. It is most noteworthy that this is a significant departure from common law and not a restatement of existing established law.
- Ø Permitting judicial foreclosure sale of ALL beneficial interests in a trust. Very few states authorize the judicial foreclosure sale of a remainder interest in trust. The UTC and Restatement Third not only ignores this foundation of American law but extend this aberrational concept to permit judicial foreclosure of income interests as well as

remainder interests in trusts by exception creditors.

- Ø Implementation of an untested continuum of discretionary trust theory which is highly creditor favorable. This may well include imputing income from discretionary trusts to an income beneficiary which may render an otherwise qualified person unqualified for Medicaid. It is also unclear whether income will also be imputed for purposes of computing alimony or child support of a discretionary trust beneficiary.
- Ø Creation of a property interest in most, if not all, current beneficial interests in a trust. Consequentially in many states, current beneficial interests being a property interest, will be classified as marital property or a factor to determine the disproportionate distribution of marital property in favor of the beneficiary's estranged spouse.
- Ø The ability of an estranged spouse to force a distribution from a trust to satisfy a claim for alimony from trusts. This includes any discretionary or support trust as they were previously classified under common law. Furthermore, to add fuel to spur even more litigation in this area, the spouse may seek the payment of legal fees directly from the trust.
- Ø Treating inter vivos general powers of appointment as the equivalent of ownership, thereby permitting ANY creditor to attach and exercise the general power of appointment. This is particularly troublesome with the classic Crummey withdrawal powers included in virtually all ILITs.

With all but the inter vivos general power of appointment issue, other articles, cited below, have addressed many aspects of the decrease in asset protection afforded spendthrift trusts.

This commentary discusses the creditor protection issues associated with a general power of appointment applicable to ILITs and the possible conversion of insurance contracts from companies located in UTC jurisdictions to non-UTC jurisdictions.

II. INTER VIVOS GENERAL POWER OF APPOINTMENT

In another great departure from common law, the UTC authorizes any judgment creditor to attach and exercise any unexercised general power of appointment. Pursuant to UTC §103(10), an inter vivos general power of appointment is classified as a "power of withdrawal." To the extent that

a person holds a general power of appointment, even a lapsing 5/5 power, he or she is classified as the settlor. UTC § 603(a). A settlor has no spendthrift protection.

Finally, UTC § 505(b)(1) provides that any creditor of a person who has a power of withdrawal may reach any property subject to an inter vivos power of withdrawal.

The Third Restatement reiterates and expands this point. Section 58 comment b(1). The commentary to the Third Restatement uses an example of a Crummey beneficiary who holds a 5/5 power as an example of an interest that can be attached. Interestingly, both the UTC and Third Restatement adopt a distinctly minority position which has been adopted by only two (2) states, Illinois and California.

In following this distinctly minority position, the Restatement Third takes the position that the taint of holding a general power of appointment never disappears. For example, assume a settlor creates an ILIT with two beneficiaries, each beneficiary has a withdrawal power, and each year the settlor transfers \$22,000 to the ILIT.

Since a Crummey power is a general power of appointment, under the Restatement Third, each beneficiary holds a general power of appointment over one-half of the ILIT's trust property. As such, any creditor, not just estranged spouses, may force the exercise of the general power of appointment. Furthermore, the creditor can attach the debtor's full one half interest in the trust since that half of the trust is a self-settled trust.

Unfortunately, several questions regarding how a creditor attaches the insurance policy within an ILIT remain unresolved:

Example: May a creditor of the beneficiary force the trustee to borrow against the cash surrender value of the policy and distribute one-half of the value of the policy?

Example: Can a creditor force the trustee to liquidate the life insurance policy and force a distribution of one-half of the proceeds?

Example: Is there any creditor protection if the "hanging" amount of a 5/5 power can only be exercised with the consent of the Trustee? .

Fortunately, the UTC does not appear to be as draconian as the Restatement Third. UTC § 505(b)(2) provides that upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust ONLY to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or Section 2503(b)”

In the event such language cuts back the Restatement Third’s position on lapsed 5/5 powers, a result which is not entirely clear, that should mean that only the unlapsed portion of a Crummey power remains subject to creditor attack. This is because a hanging Crummey power is an unexpired inter vivos general power of appointment.

Unfortunately, numerous ILITs (as well as many other irrevocable trusts) utilize hanging Crummey powers. To demonstrate how much any creditor may attach with a hanging Crummey, the following simplified example is provided.

As with the last example, assume that the settlor contributes \$22,000 a year to an irrevocable trust with two beneficiaries. Further, assume a 0% growth rate. In the tenth year of the trust the beneficiary has a hanging withdrawal power of approximately \$46,500 that may be attached by ANY creditor of either beneficiary.

Unfortunately, the hanging Crummey power does not disappear until the twentieth year. In the event that there was only one beneficiary of the ILIT, in the twenty-first year of trust, the beneficiary would have a hanging Crummey power of approximately \$93,000. The beneficiary must wait until the thirty-ninth year for the hanging Crummey power to completely disappear.

This generates a number of difficult questions:

Example: From a planning perspective, does an estate planner now have an affirmative obligation to notify the client as well as the beneficiaries of the availability of the ILIT’s assets to the beneficiary’s creditors?

Example: Must a planner offer the client the choice of creating an ILIT in another jurisdiction?

Example: Is the discussion of forum shopping now mandatory?

III. DO WE WALK, RUN, OR FLY AWAY FROM A UTC JURISDICTION?

Many practitioners are asking whether a trust should flee a UTC jurisdiction. Perhaps the question should be whether a trust should flee a UTC or Restatement Third jurisdiction.

Obviously, trusts which do not contain change of situs and change of law provisions (i.e., flight provisions) are severely limited in their choices. However, for those trusts which contain a choice of law provision (i.e., flight provisions) the option to change situs may be available.

On a grander scale the question should be whether a Trustee has a fiduciary obligation to consider changing the situs of a trust since creditor protection is often in the beneficiaries' best interest and consistent with the Settlor's intent.

In many cases the decision to move the trust depends on a cost/benefit analysis, which in turn depends on whether family members or a trust department are serving as trustees. In addition, the cost of changing situs will depend on whether the trustee is managing a passive interest such as a partnership interest, limited liability company, S corporate stock, life insurance policy, or an active asset such as an operating business.

CONFLICT OF LAWS ISSUES

After consultation, should the client determine that the cost/benefit analysis weighs in favor of fleeing a UTC or Restatement Third jurisdiction, the tactic of merely changing the applicable law of a trust to a non-UTC jurisdiction and changing the trustee to a non-UTC state may be insufficient.

This is because a judge in a UTC state where the beneficiary resides or the settlor resides is not required to follow the choice of law provision in the trust. Rather, under the "most significant relationship" and "strong public policy" test, UTC § 107 permits a judge to apply the law of any relevant state. The vague "strong public policy" test and significant relationship tests make it virtually impossible to achieve any certainty.

Furthermore, the difference between strong public policy and just ordinary public policy is hard to determine. Presumably, all public policy is strong.

This point is also discussed by **Richard Covey** and **Dan Hastings**, in *Practical Drafting* (October 2003) as well as Professor **Begleiter**, the principal architect of the Iowa Trust Code, in his law review article, *In the Code We Trust - Some Trust Law For Iowa*, 49 Drake L. Rev. 165 (2001) at footnote 113. .

Under the most significant relationship test, a judge may determine the outcome of a case based solely on which law the judge decides to apply. In this respect, it is possible that a result oriented judge may apply the law most consistent with their personal bias under the guise of strong public policy. In a less egregious situation a judge may decide to apply the law of the jurisdiction they sit in because it most familiar to them.

Presumably, but no means a certainty, a judge may consider the following factors when determining which law to apply:

- (1) the choice of law designated in the trust;
- (2) the situs of the trustee;
- (3) the situs of the trust property;
- (4) the place the trust was initially created;
- (5) the residence of the settlor;
- (6) the residence of the beneficiary;
- (6) the law governing the trust;
- (7) the presence or absence of a statute in both jurisdictions on the issue;
- (8) the state the trust is taxable in; and
- (9) any other factor.

However, it is generally believed that the fewer contacts a trust has with a UTC jurisdiction, the harder it is for a judge to apply the law of a UTC jurisdiction. In fact, this is a common conflict of laws discussion with estate planners who work with multi-jurisdictional clients and offshore trusts.

For this reason as well as others, some of the noted international

commentators, such as **Duncan Osborne** and **Peter Spero**, recommend that all offshore trust assets should be held offshore, rather than in the U.S. If this theory is correct, the planning should not be any different in avoiding the application of the UTC if underlying trust assets should be held outside of UTC states.

POSSIBLE CONVERSION OF SOME LIFE INSURANCE POLICIES OUT OF UTC JURISDICTIONS

One of the key factors in determining which law may apply in a conflict of laws situation is where the underlying assets are located.

With regard to insurance products, the situs of the insurance policy is the state in which it was issued. For example, assume that the client creates an ILIT in Michigan. The Michigan trustee applies and receives an insurance policy on the life of the client and the policy is a Michigan policy. The Michigan legislature subsequently passes the UTC.

Before enactment, the trustee decides to change the situs of the trust to the non-UTC state of South Dakota. The settlor changes the Trustee to a South Dakota trustee pursuant to a power they retain.

Does the South Dakota trustee now have an affirmative obligation to change the situs of the insurance policy from Michigan to South Dakota?

What if the cost of insurance has significantly increased? The answers to these questions are unclear.

When moving brokerage accounts out of UTC states, usually the cost to the client is minimal. In the event a Trustee makes the decision to move a trust out of a UTC state, the cost to move securities is usually not a significant factor.

However, this is not true for insurance policies. Typically, insurance products are front loaded with commissions and selling costs. These fees are generally paid in the early years of the product. Therefore, with many insurance policies, a client, or the trustee in the case of an ILIT, will incur a second load by liquidating an existing life insurance policy and purchasing a new life insurance policy.

In the alternative, even if the insurance company will exchange the policy to a non-UTC state, there is no guaranty that the settlor will be insurable at

such time. Further, if the Settlor is uninsurable, this may act as a strong deterrent to changing the situs of the trust's assets to a non-UTC jurisdiction.

IV. CONCLUSION

As with all legal matters the ultimate decision lies with the client. Estate planners can only discuss alternatives and the possible consequences of the client's decisions or inactions.

Unfortunately, due to the UTC's significant changes to common law, attorneys must now seriously consider the jurisdiction of their trusts and determine how strongly a client desires creditor protection for beneficiaries.

Due to the UTC's new remedies, spendthrift protection on all trusts will most likely be greatly reduced in most of the states that adopt the UTC. Further, in many areas the UTC has created a mountain of uncertainty regarding the protection of beneficial interests.

One possible solution is to move the ILIT to a non-UTC state. However, merely changing the choice of law to a non-UTC state is likely to be an insufficient remedy. The drafting attorney and/or trustee should not only consider changing the trustee to a non-UTC jurisdiction but also moving the underlying trust assets to non-UTC jurisdictions.

Prior to moving the trust's assets the client must engage in a cost/benefit analysis which must include the certainty, or lack thereof, of the application of more favorable laws, duplicative commissions and selling costs of liquidating life insurance policies, and the insurability of the Settlor.

Failure to undertake this type of analysis and action could result in the loss of significant trust assets and potential liability for the trustee who had the ability to protect the assets under the management but chose not to or negligently failed to consider the consequences of legislative changes on its fiduciary duties.

In sum, the UTC has added a whole new meaning to forum shopping. Now, the failure to consider forum shopping may result malpractice for the drafting attorney or a negligence suit for the trustee or perhaps both.

HOPE THIS HELPS YOU HELP OTHERS!

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CITES:

Merric & Oshins, The Effect of the UTC on Spendthrift Trusts, Estate Planning Magazine, August, September, and October 2004; Merric, Stein, and Freeman, The Uniform Trust Code and Asset Protection in Non-Self Settled Trusts, Steve Leimberg's Asset Protection Planning E-mail Newsletter #53, September 14, 2004.