ESTATE PLANNING

Asset Protection and the Spendthrift Trust

CCH: Could you provide our readers with some background on what a spendthrift trust accomplishes and why it may be important to establish one?

The estate planning community is still trying to come to grips with the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) (2001 Act). The 2001 Act contains a number of far reaching provisions dealing with transfer tax issues, including the scheduled repeal of the estate tax in 2010 (but only for one year), the retention of the gift tax, and the sunset of the 2001 Act in 2011. Although it is not certain that any of these provisions will ever actually take effect, estate planners are faced with the task of justifying the importance of estate planning above and beyond the need to save on transfer taxes. Asset protection is just one of the many non-tax reasons for estate planning. In the following interview, attorney Steven J. Oshins provides us with his thoughts on at least one popular asset protection strategy—the spendthrift trust. Mr. Oshins is a shareholder with the Law Offices of Oshins & Associates, Las Vegas, Nevada (www.oshins.com), a nationally recognized firm specializing in estate planning, business planning, and probate.

Mr. Oshins: The primary purpose of a spendthrift trust is to protect the trust's income and principal from the beneficiaries' creditors. Since the beneficiaries of a properly established spendthrift trust are prohibited from assigning their interests in the income or principal of the trust, the trust assets are generally protected from their creditors.

CCH: Is the level of creditor protection variable?

Mr. Oshins: The level of protection generally varies depending on the amount of discretion given to the trustee. Basically, the greater the level of discretion given to the trustee the greater the creditor protection provided by the trust.

CCH: Are spendthrift trusts always "bulletproof" for asset protection purposes?

Mr. Oshins: Not necessarily. The statutory and case law of many states may limit the amount of creditor protection afforded by such trusts. For example, persons who provide certain necessities for the health, education, and welfare of the beneficiary may be able to reach the assets of spendthrift trusts. Child support obligations of the beneficiary may provide another potential reason for reaching trust assets. In addition, it may be possible for certain state or federal agencies to attach trust assets (e.g., tax liens) or to force trust assets to be used for the benefit of the beneficiary.

CCH: Is it necessary that the beneficiary and the settlor of a spendthrift trust be separate persons?

Mr. Oshins: Ordinarily, yes. However, the laws of certain jurisdictions, including Alaska, Delaware, Nevada, and Rhode Island, allow for the creation of so-called self-settled spendthrift trusts.

CCH: A recent decision by the New Hampshire Supreme Court (*Scheffel v. Krueger*, 2001 WL 839850, N.H. 2001) presents a fairly egregious set of facts, but also a rather stunning example of how hard it can be for a creditor to overcome the protection of a properly created spendthrift trust. Could you elaborate on the facts of this case?

Basically, the greater the level of discretion given to the trustee the greater the creditor protection provided by the trust.

Mr. Oshins: *Sheffel* involved a trust beneficiary (Kyle Krueger) who was accused of sexually molesting a minor. The minor's mother won a civil tort judgment in excess of $500,000 against the beneficiary. She attempted to attach the beneficiary's interest in the trust to satisfy the judgment. The attempt was thwarted by a dismissal of the action at the lower court level. After an appeal, the Supreme Court of New Hampshire ruled that the spendthrift provision in the trust barred the tort creditor's claim and, regardless of the fact that the beneficiary exerted a certain degree of control over the trust, the trust did constitute a spendthrift trust.

The trust was created by Krueger's grandmother in 1985 with a bank as trustee. Under the terms of the trust, Krueger is to receive all of the net income, at least quarterly, and more frequently if he so requests. The trustee also has the discretion to pay any of the principal to Krueger if the trustee determines this is necessary for Krueger's support, maintenance, and education. Krueger, who is currently 35 years of age, is prohibited from invading the principal of the trust until he reaches age 50.

The specific language of the trust instrument governing the prohibition of the beneficiary from making voluntary or involuntary transfers of his interest in the trust provides that:

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"No principal or income payable or to become payable under any of the trusts created by this instrument shall be subject to anticipation or assignment by any beneficiary thereof, or to the interference or control of any creditors of such beneficiary or to be taken or reached by any legal or equitable process in satisfaction of any debt or liability of such beneficiary prior to its receipt by the beneficiary."

CCH: Isn't there a public policy argument for not allowing such a result?

Mr. Oshins: The plaintiff in *Sheffel* made such an argument, but to no avail. The state supreme court examined the language of the New Hampshire statute and noted that the relevant portion stated that "... a creditor of a beneficiary shall not be able to subject the beneficiary's interest to the payment of its claim." Accordingly, the conclusion of the court was that by writing the statute as it did, the legislature had negated the public policy exception claimed by the plaintiff.

CCH: What about the fact that the beneficiary could request payments from trust income more frequently than quarterly and could invade the principal after age 50?

Mr. Oshins: This issue was also disposed of in favor of the beneficiary. Although the court did not elaborate on its reasoning, it did state that, because the settlor of the trust was not the beneficiary, the spendthrift provision was enforceable. It also stressed that the state spendthrift statute does not place any limitation on the rights a beneficiary is granted under the trust instrument in applying the spendthrift protection.

CCH: Are there any other recent cases illustrating the asset protection potential of spendthrift trusts?

Mr. Oshins: In a Nebraska case (*Dokansky v. Norwest Bank, N.A.*, 615 NW2d 104 (Neb. 2000)), the former spouse of a spendthrift trust's beneficiary attempted to reach the trust's assets for payment of past due child support. The trust, which had been established by the beneficiary's father, gave discretion to the trustees to make distributions in the best interest of the beneficiary and his children. The Nebraska court held that the beneficiary's interest in the trust could not be reached by the spouse because the beneficiary did not have the power to require the trustees to satisfy his debts.

In *Sligh v. First National Bank of Holmes County* (704 So.2d 1020 (Miss. 1997)), the Supreme Court of Mississippi invoked a public policy exception to judicially created spendthrift trust law. That case involved the enforcement of a tort judgment stemming from an auto accident. Based on its interpretation of the relevant portions of the Restatement (Second) of Trusts and Scott on Trusts, the court determined that, even though ordinary creditors are charged with the responsibility of being aware of the law concerning spendthrift trusts, this responsibility should not be imposed on tort creditors. However, the court's decision in *Sligh* has effectively been overturned by the Mississippi legislature, which enacted a statute dealing with spendthrift trusts subsequent to the court's decision.

CCH: Despite the obvious protection provided by a spendthrift trust, why do so many people choose to pass their assets outright rather than in trust?

Mr. Oshins: Unfortunately for the public, many estate planners advise their clients to make outright gifts and bequests, or to keep the transferred assets in trust only until the beneficiary attains a selected age. This is probably the biggest mistake made by advisors. This single mistake can cost the client's family millions of dollars. Unless the client can absolutely guarantee that his or her children will never get divorced or sued, or unless the transferred assets are so small in value that the cost of an annual income tax return is prohibitive, there is rarely ever any reason not to pass assets in trust. Often, the client is not even aware of the trust option.

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CCH: Do you find that the trust option is often not selected because of the perception that the trust will cause a loss of control?

Mr. Oshins: Yes, I do. However, the skilled draftsperson can draft the trust to give the primary beneficiary the functional equivalent of outright ownership, but without the assets being subject to attachment by creditors

and without the trust estate being subject to estate taxes. This is the beneficiary controlled trust concept.

CCH: Can you describe the beneficiary controlled trust concept?

Mr. Oshins: A beneficiary controlled trust is a trust in which the primary beneficiary is either the sole trustee or a co-trustee and who, in either case, has the ability to remove and replace the trustees. The trust agreement also includes provisions opting out of the prudent person or prudent man standard so that the primary beneficiary, as trustee, can invest in anything he or she desires just as such individual would be able to do with outright ownership. The primary beneficiary is also given a broad non-general power of appointment that can eliminate any potential interference by remote beneficiaries since a complaining remote beneficiary can be cut out by the primary beneficiary entirely.

CCH: Do you recommend a beneficiary controlled trust with the primary beneficiary as sole trustee, or does inclusion of a co-trustee enhance the benefits and protections?

Mr. Oshins: Although the sole trustee version is much simpler, it provides significantly less flexibility and asset protection than a co-trusteeship arrangement. If the beneficiary is the sole trustee, then in order to avoid estate taxes at the beneficiary's death, the beneficiary would generally be limited to distributions for his or her health, education, support and maintenance. For asset protection purposes, a creditor may have a stronger argument that the amount that the beneficiary, as trustee, can distribute to himself or herself should be available to satisfy the creditor's claim. The Restatement (Third) of Trusts, Tentative Draft No. 2, takes the position that a creditor of a trustee-beneficiary can reach as much as the trustee-beneficiary could properly distribute to himself under the terms of the trust instrument.

Therefore, an even more effective asset protection strategy is to design the beneficiary controlled trust with two trustees – the primary beneficiary as the investment trustee and an independent trustee as the distribution trustee. The primary beneficiary can be given the power to remove and replace the independent trustee, thereby maintaining the beneficiary controlled feature of this trust design. In addition, with this trust design, there is no requirement for generation-skipping transfer tax purposes that distributions be limited under an ascertainable standard such as health, education, support and maintenance. ✦

RETIREMENT PLANNING

IRS Provides Guidance on Qualified Plan Changes

In Rev. Rul. 2001-51, the IRS has provided guidance on various law changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) (2001 Act). The ruling, which is set forth in a question and answer format, considers: (1) benefit increases that may be provided as a result of the increased Code Sec. 415 limitations; (2) plan amendments that may be adopted to take into account the increased limitations; (3) the effect of the increased Code Sec. 415 limitations on other qualification requirements; and (4) the impact of the "sunset" provision with respect to Code Secs. 404 and 412.

Among the changes made to the rules governing qualified plans by the 2001 Act is the increase in the defined benefit dollar limitation of Code Sec. 415(b) to $160,000, effective for limitation years ending after December 31, 2001. The defined contribution dollar limitation of Code Sec. 415(c)(1)(A) was increased to $40,000, effective for limitation years beginning after December 31, 2001. In addition, the 25-percent of compensation limit (Code Sec. 415(c)(1)(B)) for defined contribution plans was increased to 100 percent, effective for years beginning after December 31, 2001.

Besides dealing with the basic contribution and benefit limitation changes, the ruling includes a question on the impact of *not* amending a plan to take into account the increased limitations (Q&A 2). If a defined benefit plan is not amended to take into account the increased Code Sec. 415 limitations, the effect on the benefits of plan participants will depend on the plan's existing provisions for applying the limitations and any other relevant plan provisions. In some circumstances, a plan's existing provisions could result in automatic benefit increases for participants as of the effective date of the increased limitations for the plan. For example, the increased limitations could result in automatic benefit increases for participants in defined benefit plans that incorporate by reference the limitations of Code Sec. 415.

Also addressed is the question of what special considerations must be taken for a defined benefit plan that has a normal retirement age of less than 65? In such a case, the requirements for nonforfeitability of benefits and actuarial increase for delayed retirement of Code Sec. 411 must be coordinated with the requirements of Code Sec. 415 (Q&A 4). Under Code Sec. 411, if benefits are not paid to a participant after the participant attains the plan's normal retirement age, and the plan's terms do

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