



# Drafting a Trust for Maximum Creditor and Divorce Protection

By Steven J. Oshins and Catherine M. Colombo

**A**n irrevocable trust set up by someone other than one of the beneficiaries provides the ultimate in creditor protection. With a divorce rate of over fifty percent, as well as an increasing number of lawsuits, creditor protection is often the most important objective of our clients. Historically, the general rule has been that the creator of the trust can dictate who may receive the beneficial enjoyment of the property and the extent and circumstances under which this enjoyment may be obtained. As a result, unless trust property is distributed outright to a beneficiary, it will generally be protected from the beneficiary's creditors.

The general rule is that through accepted legal remedies, a creditor of a debtor stands in the shoes of the debtor and may exercise any property or other right that the debtor may exercise. So does this mean that a creditor may attach a beneficiary's trust interest or force the trustee to make a

distribution to the creditor in satisfaction of a beneficiary's debt? If this is the general rule, does an estranged spouse have more rights to attach a beneficial interest under domestic relations law than an ordinary creditor? Does a discretionary trust provide stronger creditor protection than a support trust? This article will answer these questions.

For mature, competent family members who would receive the property outright, were it not for the benefits that can be derived through the receipt of property in a trust, the trust should be designed to give the beneficiary of a trust the functional equivalent of outright ownership, including undisturbed control over the property. Indeed, many candidates for this type of planning would be unwilling to create such a structure unless the trust benefits are coupled with the ability of the beneficiary to obtain control over the trust property that is virtually tantamount to outright ownership.

A surprisingly large number of wealthy estate owners and persons who are otherwise astute in business and finance neither recognize the wealth planning and creditor protection opportunities available to them, nor realize the potential diminution of family assets that can be unnecessarily and irretrievably lost through exposure to both the wealth transfer system and the failure to use creditor protection strategies. A properly structured irrevocable trust can avoid this exposure.

## Staggered distribution trusts

Staggered distribution trusts should never be used. A "staggered distribution trust" is a trust which makes mandatory distributions to the beneficiaries at staggered ages. For example, the trust may distribute one-third of the trust assets to the beneficiary upon reaching age 25, one-half of the balance upon reaching age 30 and the balance upon reaching age 35.

This distribution philosophy does not consider that many of our clients' beneficiaries will have taxable estates and many, if not most, will either be sued or go through at least one divorce. Forcing the assets out of the trust because of a deficient trust-drafting philosophy exposes the assets to estate taxes, creditors and divorcing spouses. Perhaps the primary reason that these types of trusts are so widely used is because the formbooks are generally insufficient.

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## Dynasty trusts

In order to achieve the maximum transfer tax savings, the trust should be wholly exempt from the generation-skipping transfer tax. This will avoid the imposition of transfer taxes for successive generations. The trust should be drafted as a dynasty trust which is an irrevocable trust that is protected from estate taxes for as long as applicable state law allows. Effective October 1, 2005, Nevada law allows a dynasty trust to continue for up to 365 years. With proper drafting, a Nevada dynasty trust can also be designed to protect the trust assets from the creditors and divorcing spouses of the trust beneficiaries for up to 365 years.

## Support trusts vs. discretionary trusts

Trusts are generally drafted as either: (1) mandatory distribution trusts, (2) support trusts, or (3) discretionary trusts.

A "mandatory distribution trust" is a trust which requires the trustee to make distributions mandated by the terms of the trust agreement. The trustee may not withhold or accumulate a mandatory distribution. Unless there is a tax reason to do so, this makes some or all of the trust assets available to the beneficiary's creditors and divorcing spouses for no reason but that the trust scrivener was using a trust "form" which was inadequate for planning purposes.

A "support trust" is created by the grantor 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 of a beneficiary. 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 the beneficiary's support, maintenance, education, or welfare, or whatever other standard is contained in the trust. The standard for distributions often contains words such as "health, education, maintenance and support" since that language keeps the trust assets outside of the trustee/beneficiary's estate even though that person is both a beneficiary and is the sole trustee.

A "discretionary trust" allows the trustee complete and uncontrolled discretion to make allocations of income or principal if and when the trustee deems appropriate. Because the trustee is given such broad powers, the beneficiary can only compel the trustee to distribute funds if it can be shown that the trustee is abusing its discretion by failing to act, acting dishonestly, or acting with an improper purpose in regard to the motive in denying the beneficiary the funds sought. A discretionary trust generally uses permissive language such as the word "may" instead of the word

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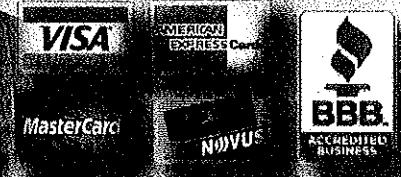
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“shall.” The permissive word “may” is still generally further qualified by granting the trustee unfettered discretion using words such as “sole and absolute discretion,” “absolute and uncontrolled discretion” or “unfettered discretion.”

### **Beneficiary controlled discretionary trusts**

Since the terms of a discretionary trust exceed the ascertainable standard permitted by Section 2041 of the Internal Revenue Code, a beneficiary cannot serve as distribution trustee without causing the trust assets to be included in that beneficiary's estate for estate tax purposes. Therefore, in order to draft the trust as a Beneficiary Controlled Discretionary Trust, the trusteeship should be bifurcated into two separate roles. Upon reaching a selected age, the beneficiary becomes the investment trustee and has the power to fire and hire trustees. The other trustee, often the beneficiary's closest friend, acts as the distribution trustee since the beneficiary cannot have that power.

### **Spendthrift provisions**

A spendthrift provision is a provision in a trust agreement that provides that the beneficiary cannot sell, pledge or encumber his beneficial interest, and provides that a credi-

tor cannot attach a beneficiary's interest. At common law, the purpose of a spendthrift trust was to protect a beneficiary from his own spending habits. The idea was to provide for someone who could not provide for himself, and to keep such beneficiary from becoming dependent on public assistance. Therefore, if a spendthrift clause was added to a trust, the common law developed a legal principle that a creditor could not recover from the beneficiary's interest.

A beneficiary of a discretionary trust does not need to rely on a spendthrift provision because neither the current distribution interest nor any subsequent interest is a property interest under state law. Therefore, neither the beneficiary nor the creditors of the beneficiary have any right to force a distribution from the trust. However, as a matter of course, trust scrivener's should nearly always include spendthrift provisions even when using a discretionary trust.

The rule is different for support trusts. The Restatement Second of the Book of Trusts, Section 157, carves out four key exceptions to spendthrift protection, where a creditor may attach the assets of a support trust. Those exception creditors are: (1) alimony or child support, (2) creditors for necessary services or supplies rendered to the beneficiary, such as medical services, (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, such as a tax lien.

Applicable state law will determine which exceptions, if any, apply. Nevada law is very protective for support trusts. However, our clients' descendants often live in other states, so unless the trust is drafted to continue with at least one Nevada trustee at all times in order to maintain Nevada jurisdiction, it is generally prudent to draft trusts for Nevada residents as discretionary trusts.

### **Conclusion**

It is generally insufficient to draft a trust with mandatory staggered distributions for the beneficiaries upon reaching certain ages. Rather, the trust should be drafted to continue in trust for the beneficiary. For those beneficiaries who are financially astute, the trust should be drafted to give the beneficiary control as trustee. For maximum creditor and divorce protection, the trust should be designed as a discretionary trust rather than a mandatory distribution or support trust. **©**

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