



WRMarketplace

An AALU Washington Report



The *WRMarketplace* is created exclusively for Pat McNamara, FINANCIAL CONCEPTS INC. by experts at Greenberg Traurig and the AALU staff, led **by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirius, and Rebecca Manicone.** *WRMarketplace #17-14* was written by Greenberg Traurig Shareholder Jonathan M. Forster.

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TOPIC: Sometimes Love Knows No Boundaries: Protecting Your Family Legacy from In-Laws.

MARKET TREND: Interest in the family creditor protection offered by irrevocable trusts is on the rise.

SYNOPSIS: When creating legacy plans for their families, parents often are as concerned about creditor protection as they are about transfer taxes, especially as to how that protection relates to marital claims against their legacy. Leaving a child’s inheritance in an irrevocable trust can act as a substitute to a premarital plan, avoiding many of the difficulties associated with using and enforcing prenuptial agreements. To be effective, however, the trust agreement should not: (1) rely solely on a spendthrift clause, (2) provide the beneficiary with too much access or control, or (3) mandate trust distributions.

TAKE AWAYS: While parents generally want to protect their family legacy from in-laws, premarital planning is often difficult to discuss and implement. A fully discretionary trust properly administered by an independent trustee should offer enhanced creditor protection and may serve as an effective substitute for a child’s premarital plan. Parents should pay close attention to the trust’s jurisdiction, however, as the protections afforded to trust assets with regard to marital claims are highly dependent on applicable state law.

When leaving a legacy for children, parents are often concerned about creditor protection, especially as it relates to marital claims against that legacy should a child's marriage end in divorce. Leaving a child's inheritance in an irrevocable trust can act as a substitute to a premarital plan; however, parents should review the following "dos and don'ts" to enhance their trust's overall creditor and family legacy protection.

PREMARITAL PLANNING TRUST SOLUTIONS

Spendthrift Clauses

DON'T: Assume Spendthrift Clauses Cover Marital Claims. Spendthrift clauses prohibit a beneficiary from voluntarily or involuntarily assigning his or her right to current or future trust distributions, including to creditors. State laws, however, vary on the actual protection afforded by spendthrift clauses and may provide exceptions for payment of spousal support claims and alimony. The protections also may be undermined if a beneficiary retains too much control over the trust.

Trust Distributions

DON'T: Require Mandatory Distributions. While mandatory trust distributions of income and/or principal ensure that a beneficiary will receive certain amounts at set times, those assets may be deemed marital assets in divorce proceedings. Further, depending on state law, creditors may even be able to attach distributions that are due but not yet paid from the trust, as well as levy future distributions for judgments and debts that remain unpaid.¹

DON'T: Give Beneficiary Sole Authority Over Distributions. For premarital planning purposes, a beneficiary who has the power to authorize distributions to himself, even if limited by an "ascertainable standard" restricting distributions to specific needs, such as for the beneficiary's health, education, maintenance, or support ("**HEMS**"), may still subject the trust assets to marital property claims in the event of a divorce or disinheritance of a surviving spouse.²

Completely prohibiting a beneficiary from having any distribution authority over his or her trust likely provides the greatest protection. If beneficiary participation is desired, subjecting the beneficiary's power to the consent of other beneficiaries or the approval/veto of an independent trustee may offer a compromise.

DO: Use Fully Discretionary Trusts. The trust agreement should authorize, but not require, the trustees to make distributions to trust beneficiaries. For the greatest protection, the discretion should allow distributions to any beneficiary for any purpose. This discretion, along with the next two provisions, may make the beneficial interest of any one beneficiary negligible for purposes of a judgment or creditor claim.

If desired, ascertainable standards can be used to restrict trust distributions to HEMS, but only if applicable state law interprets the standard as a limit on the trustee's discretion, not a

mandate requiring HEMS distributions. To further clarify, the trust agreement should say that the trustee “may” (and not “shall”) make distributions for HEMS.³

DO: Authorize (and Make) Variable and Unequal Distributions. The trust agreement should provide that the trustee: (1) has discretion to make distributions in favor of any one, all, or none of the beneficiaries, in equal or unequal shares, (2) need not treat the beneficiaries equally or proportionally with regard to trust distributions, and (3) need not follow any pattern set in prior distributions for later distributions. The trustee also should not actually make standardized or regularly-scheduled distributions to avoid the claim that certain beneficiaries had an implicit understanding regarding the timing and amount of their distributions.

DO: Allow for Changes to Beneficiary Class. The trust agreement can allow future persons to be added to the class of beneficiaries and/or allow removal of existing beneficiaries. For example, the trust can benefit multiple generations of descendants. Alternatively, the trust agreement can authorize someone else, like a trust protector, to remove existing beneficiaries or add other persons, such as additional family members or charities, to the beneficiary class.

Trustee Selection

DON'T: Name Beneficiary as Sole Trustee. As individuals often struggle with who to name as trustees of family trusts, they frequently appoint children or other descendants as trustees, especially when children have attained a certain age or if they have proven their responsibility. As noted, however, marital and creditor claims likely will be an issue if a beneficiary is the sole trustee of his or her trust, even if distributions are limited by an ascertainable standard. If a beneficiary will act as a trustee of his or her trust, make sure to name a co-trustee and to not give the beneficiary-trustee sole power to make distributions to him or herself.

DO: Consider Independent Trustees. To further enhance protections, the trust should appoint one or more “independent” trustees who hold sole distribution authority over discretionary distributions or share such authority over distributions (and cannot be out-voted or overruled by any non-independent trustee(s)). Ideally the independent trustee would be a financial institution or other professional co-trustee, as they have the infrastructure and experience for trust administration and may be more able to demonstrate independence.

If desired, a beneficiary can have the power to remove and replace the independent trustee. To preserve independence and limit the beneficiary’s power over the trust, however, it is important that the beneficiary be limited to appointing trustees who are not related or subordinate to him or her. Otherwise, the beneficiary arguably retains indirect control over his or her trust.

Trust Administration

DO: Consider Consolidating Trust Assets in Entities. To increase protection in the event that a trust becomes subject to creditor or marital claims, “back-up” protection may be achieved by having the trust assets consolidated in underlying family entities, like family limited

partnerships or limited liability companies, which can impose restrictions on the transfer/alienation of entity interests or on the ability to receive entity distributions (the level of protection provided by the entities will vary by state law).

DO: Follow Administrative Formalities. The administration and circumstances of the trust should support the true independence of the trustees from the trust beneficiaries, since lack of independence may evidence that a beneficiary retained indirect control over the trust. The trustee, and not the beneficiary, should be solely responsible for handling trust accounts, issuing payments, selecting service providers, etc. Further, the trustee should not simply “rubber stamp” beneficiary requests for trust payments but should exercise true discretion when making distributions and document the deliberations related to those distribution decisions. Using an unrelated or professional trustee may help as friends or family members serving as trustees may find it difficult to maintain separation from beneficiaries.

Trust Intentions

DO: Clearly State Trust Exclusions and Intentions. The trust agreement should clearly state that trust assets are not intended as part of the marital estate of any beneficiary, and ex-spouses are not intended to be direct or indirect beneficiaries of the trust, whether through divorce or other legal proceedings.

State Law

DO: Consider State Law Impact. The extent of marital asset inclusion for, or creditor access to, trust assets is very fact specific and will depend on applicable state law, including whether the state trust, marital, and/or creditor laws have specific statutes related to the impact of creditor and marital claims on spendthrift clauses and/or discretionary trusts, and how state courts interpret those laws. Certain states, like Delaware, offer specific protection from creditor claims for funds distributed from discretionary and spendthrift trusts. Thus, jurisdiction selection is critical for a trust that is intended as a substitute for a beneficiary’s premarital plan.

TAKE AWAYS

While parents generally want to protect their family legacy from in-laws, premarital planning is often difficult to discuss and implement. A fully discretionary trust properly administered by an independent trustee should offer enhanced creditor protection and may serve as an effective substitute for a child’s premarital plan. Parents should pay close attention to the trust’s jurisdiction, however, as the protections afforded to trust assets with regard to marital claims are highly dependent on applicable state law.

**Irrevocable Trust as Substitute for Beneficiary’s Premarital Plan:
Summary of Do’s & Don’ts**

DO	DON’T
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<ul style="list-style-type: none"> • Use fully discretionary trusts where an independent trustee has absolute distribution discretion • Authorize and make variable and unequal trust distributions (no set distribution schedules) • Allow for changes to the trust's beneficiary class (e.g., allow later-born beneficiaries or give a person the discretion to add beneficiaries) • Allow a beneficiary to appoint only trustees who are not related or subordinate to the beneficiary • Consider consolidating trust assets in underlying entities as back-up protection should trust assets be distributed to satisfy marital or creditor claims • Comply with all trust administrative formalities and document deliberations in discretionary distributions • Clearly state intentions in the trust that ex-spouses should never be direct or indirect trust beneficiaries • Consider state law impact on available trust protections from creditor and marital claims 	<ul style="list-style-type: none"> • Assume spendthrift clauses provide protection from marital claims • Mandate trust distributions to beneficiaries, even if only for health, education, maintenance, or support • Name beneficiaries as sole trustee of their own trusts or give them sole authority over distributions from their trusts
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NOTES

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¹ See e.g., *Carmack et al. v. Reynolds*, (Ca. Sup. Ct.), 2017 WL 1090497, discussed in *WRNewswire #17.03.29*.

² See e.g., *Pfannenstiehl vs. Pfannenstiehl*, 88 Mass. App. Ct. 121, 37 N.E.3d 15 (2015), rev'd 2016 Mass. LEXIS 591 (Mass. Aug. 4, 2016).

³ See e.g., Lisa M. Rico and Judith A. Saxe, "The Planning Implications of 'Pfannenstiehl'," *The Daily Record Newswire*, as posted in *Detroit Legal News*, Feb. 4, 2016.

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