THE 4D EXPERIENCE

DRAFTING
DEFENDING
DIVIDING
TRUSTS IN DIVORCE

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Lora has been practicing exclusively in the trusts and estates area since 1991. She began her law career at the former Seattle firm Bogle & Gates, and then at Stokes Lawrence in Seattle (1993-2006), where she was a partner in the estate planning group. In 2006 she opened her solo law firm and after more than a decade of a distinguished solo law practice, she joined KHBB Law in 2017.

Lora advises individuals and families in estate planning matters, assists in the drafting and negotiation of cohabitation, premarital and postmarital agreements, and represents fiduciaries in the administration of trusts and estates. In her work with estate planning clients, Lora focuses on purposeful planning, with a close eye on tax advantageous options for wealth transfers, and works closely with clients to develop succession plans for closely-held businesses.

Lora studied law at the University of Puget Sound (now Seattle University School of Law), graduating in 1991, and earned her Bachelor's degree from the University of Washington in 1985 (Communications/Editorial Journalism major).

Recognized as a leader in the estate planning community, Lora was elected to the American College of Trust and Estate Counsel ("ACTEC") in 2002. She served as Washington State Chair of ACTEC from 2012-2017, and as Western Region Chair (2016-2018). She was appointed to the Board of Regents of ACTEC in 2018 and is also the current Chair of the Practice Committee and a member of the New Fellows Steering Committee.

Lora was Chair of the Washington State Bar Association's Real Property, Probate & Trust Section, and has served as Emeritus Chair. She is a Past Chair of the WSBA Taxation Section's Estate and Gift Tax Committee. Lora has been recognized as a "Super Lawyer" (Washington Law and Politics) every year since 2002 (including through 2019), was honored as a "Top 100 Washington Lawyer" in years 2011, 2013, 2015 and 2016, and as a "Top 50 Washington Women Lawyer" in eleven consecutive years (2006-2017). She has been chosen by her peers as a "Best Lawyers in America in Trusts and Estates Law" by American Lawyer Magazine since 2007 (including and through 2019).

Katarinna McBride is a Partner in the private client group and advises business owners, families, family offices and charitable organizations on the formation and operation of their enterprises, including the creation and administration of private trust companies and the modernization and migration of trusts.

Katarinna renders strategic and holistic advice on domestic and international tax strategies and tax compliance requirements. She also advises executives and entrepreneurs on tax-savvy ways to own, transfer and protect their assets.

Katarinna serves as outside general counsel to closely held companies and acts as expert witness guiding clients and their counsel through complex litigation surrounding domestic and international assets and entities.

Katarinna is an ACTEC Fellow and serves on the Program Committee, International Estate Planning Committee and Practice Committee. She has been published in Trusts & Estates Magazine, BNA, CCH, BusinessWeek, Forbes, Bloomberg, Leimberg and other technical and legal publications.

Katarinna is a featured tax expert for Fox News, ABC News, NBC News and CBS News and is a frequent content provider and speaker at ACTEC, the American Bar Association, the Notre Dame Tax & Estate Planning Institute, Hawaii Tax Institute, Seattle Estate Planning Seminar, STEP, Chicago Estate Planning Council, Chicago Bar Association and for family office panels and symposia.

I. INTRODUCTION AND ATTRIBUTION

Divorce is rarely a full separation and division of a couple's lives. Clients often share children, grandchildren, pets, philanthropic efforts, friends, academia, community ties and business interests. For better or worse, even if divorced, spouses often continue to be intertwined. They need to continue to share in the management of their finances, family, health and philanthropy. Particularly when there are children and descendants, and alimony or support, there is a great deal of practicality in collaborating. It may be desirable or necessary to keep a former spouse involved -- to continue to be a guardian, trustee or financial decision maker for descendants, having a power to redirect assets to support their evolving needs and life-facts.

Planning and drafting for the modern family has become an indispensable chapter of every planner's playbook. In order to plan thoughtfully, planner should have sufficient knowledge to help clients identify the issues aforehand, and thereby be able to implement solutions in the midst of a crisis. Many planners and speakers on this topic have come to preach that it is imperative to partner with family law attorneys, advisers, accountants and other professionals on the client advisory team, to provide a uniform and tactical strategy, and seek opportunities to keep the peace and prevent the unraveling of tax and trust strategies, that result in, at minimum, lost tax opportunities, and at their worst, lost opportunities for children and grandchildren to benefit and for a spouse to be comfortably supported.

In arriving at the intersection of divorce and estate tax planning, being mindful of (i) the trust language, (ii) the applicable case law, (iii) and application of the Restatement of Trusts and the Uniform Trust Code, and (iii) having an understanding of creative but sound ways of dividing trusts between spouses and beneficiaries, planners and advisers will be better able to help themselves and their clients avoid accidents and acrimony.

In preparing these materials, we collaborated with many of the best planners and advisers in the country, including, Jonathan Blattmachr (spendthrift trust and drafting), George Karibjanian (application of 682 and Alimony Trusts) Justin Miller (tax issues in divorce after tax reform), Sharon Klein (case law updates and plan review), Michael Stegman (UTC, Restatement 3rd and case law) and James Spratt ('Coding' to divide trusts – creative solutions). We are so thankful for their input, shared materials and feedback. Without this type of collaboration in our planning communities, we would have less opportunity to create and test mindful solutions that have the potential of making difficult life events, such as death and divorce, financially and emotionally less painful.

II. DRAFTING FOR 4D PLANNING

A. Trust Planning for Spouses – Perpetuity may Exist in Trusts but Not in Marriage. Please note that practical drafting tips is being presented, with supporting written materials and samples, in another segment entitled "Estate Planning for the Evolving Modern Family: Flexibility and Other Considerations for the 21st Century." Therefore, these materials focus on drafting from a conceptual and best practices perspective and spend more time discussing defending trusts and dividing trusts in divorce.

1. Defining moments.

    a. Defining moments; my spouse?

    b. Timing is critical.

        i. Rethink "living apart."

        ii. Upon divorce, entry of a decree, or dissolution of marriage (a problem). *Petelle* case (Division One, Washington).

        iii. Upon filing for dissolution of marriage, legal separation or any equivalent action in any jurisdiction and worldwide.

    c. Kill the spouse! Kill the spouse?

        i. Treat the spouse as having predeceased you on the date of such filing or action

        ii. Treat the spouse's heirs at law as having predeceased you on the date of such filing or action

        iii. Should the spouse remain as a power holder?

            - For the benefit of descendant's trusts

            - Limited power of appointment

            - Power to appoint trust protectors, investment advisers, successor trustees, determine if grantor-spouse is disabled, make distributions upon spouse's disability, and other powers.

        iv. What is the nature of the property? See *Appendix A* for a guide to identifying property in divorce.

- Marital
- Separate
- Community
- Quasi / Hotchpot

v. Estate planning Memorandum. To do or not to do?

- The transferred property is transferred to the Trust, but…
  1. Does not convert such property from separate property
  2. Does not convert such property to separate property
- Formalities – written recommendation and right to obtain separate counsel
- State law
- May still be considered for alimony and child support, but may block or deter the division of living trust property in a divorce

2. Joint Trusts and drafting considerations – Will divorce unravel both spouse's interests?

   a. Split interest trusts

   b. Reciprocal or parallel trusts

   c. Community property and limits on amendments to a trust holding community property by one spouse upon separation

   d. Jonathan Blattmachr adds provisions to joint trusts when grantors divorce – malpractice or negligence if you don't discuss such provisions

   e. Community property trusts and double-step up in basis

3. LLC and partnership interests.

   a. Removal of spouse as a member upon filing for divorce; include provisions for discount of LLC interest to be acquired from a former spouse

b. Spousal waivers when creating an LLC

c. Watch out for community property interest in a business where one spouse is an employee if no premarital agreement severed the community's interest in the spouse's contributed labor to the business.

4. Irrevocable Trusts.

    a. Intentionally Defective Grantor Trusts

    b. Grantor Trusts with Crummey Powers (5% or $5,000 withdrawal rights); right to add, remove or limit withdrawal rights

    c. Lifetime QTIP Trusts.

        i. With many married couples, "marital trusts" exist within their respective estate plans.

        ii. In advanced estate plans, spouses may use irrevocable trusts created for the benefit of the other spouse, with the trust qualifying for the gift tax marital deduction as "qualified terminable interest property" (QTIP). These trusts, called "inter-vivos QTIP trusts."

    d. Death on Divorce Clauses Don't Always Work.

        i. A fairly common boilerplate clause invokes death on divorce (at least on paper). Such a clause -- referred to as "death on divorce" clause -- is a legal fiction providing that, in the event of a divorce and for all purposes of the trust, the donee spouse will be "deemed" to have then died and all of the donee spouse's interests in the trust will then terminate.

        ii. The only spousal trust where a "death on divorce" is not possible is in an inter-vivos QTIP trust because, in order to qualify for the gift tax marital deduction, the trust must continue unimpeded for the spouse's lifetime, and a "death on divorce" clause prevents this from occurring.

        iii. If any other form of spousal trust contains a "death on divorce" clause, upon the divorce the spouse's income interest ends, which thereby terminates the applicability of §677(a)(1) and, with it, "grantor trust" status based on the spouse's interest in the trust. Of course, the trust could still be a "grantor trust" based on other provisions, such as the Substitution Power, but, even in those situations, the grantor is not being taxed on income payable to the done-spouse.

f. What if a trust does not contain a "death on divorce" clause; can it be added? If the trust is not an inter-vivos QTIP trust, there are several potential ways to add the clause, such as a trust modification proceeding, decanting (if permissible within the particular jurisdiction) or modification by a trust adviser (if authorized in the trust and/or under the governing law). Of course, at the time of a divorce, the parties could agree upon the termination of the spousal interest in the trust.

5. Spousal Lifetime Access Trusts –SLATS the G2 of the Intentionally Defective Grantor Trust.

   a. Another type of spousal trust became overly popular in 2012 when individuals were seeking ways to use their available estate and gift tax exemption before the end of the year for fear of a "sunset" of the then newly-increased exemption amount (which was $5.12 million at the time) and a reversion back to the 2001 exclusion threshold of $1 million (the "use it or lose it" paradigm).

   b. In order to utilize the exemption without sacrificing assets within the marital relationship, many clients created a trust called a "spousal lifetime access trust," or SLAT.

   c. The typical SLAT would be a taxable gift by one spouse (the "grantor") to the SLAT that would provide the other spouse (the "donee spouse") with discretionary distributions of trust income and principal.

   d. The SLAT may also be a "sprinkle" trust by including the descendants into the class of individuals who could receive discretionary distributions of trust income and principal, with a direction that the needs of the spouse are to be considered before any distributions are to be made to the descendants (referred to as a "Preference Clause").

   e. The effect of a SLAT is to utilize gift tax exemption while allowing the assets to technically remain within the "marital unit."

6. Alimony Trusts or IRS Section 682 Trusts.

a. When it comes to divorce, trusts may play an important role. Sometimes, instead of having alimony paid directly to the recipient, the payor may be required to establish a trust for the benefit of the recipient that would provide the recipient with trust income in lieu of requiring the payor to pay recurring alimony payments. These trusts are often referred to as "alimony trusts."

b. Interestingly, alimony trusts are not always created as a result of the divorce -- if, for example, the donor had previously created an inter-vivos QTIP Trust, the court decree may reduce or eliminate the alimony requirement on account of the income that the recipient receives from the trust.

c. Shifting of Taxability and Section 682 (before and after 2018)

    i. As stated above, a trust created by a grantor that requires the income to be distributed to, or gives the trustee the discretion to pay the income to, the donee spouse would be a "grantor trust" as to the grantor under §677(a)(1) because the income was, or could be, paid to the donee spouse. The income taxation was not an issue because the spouses were part of the "marital unit.

    ii. However, upon a divorce, because §677(a)(1) only looks to the marital status at the time of the "creation" of the power or interest, the "grantor trust" provisions remain applicable.

    iii. As a result of the divorce, because the parties are no longer part of a "marital unit," not only does the grantor lose the benefit from the trust income, but the grantor is also taxed on such trust income. Under these circumstances, not only does the donee spouse receive the trust income, but the donee spouse would not be required to report any trust taxable income or expenses on her/his income tax return because the trust is a "grantor trust" as to the grantor. The end result is that the donee spouse receives the trust income free of income tax

    iv. To avoid this seemingly harsh result, Congress enacted §682 to shift the taxability away from the grantor. Generally, if trust income is distributed to a married person from a trust created by her/his spouse, then, upon a divorce and irrespective of any other income tax provision, §682(a) taxes the income to the recipient (except as to any income specifically determined to be allocated for child support).

- *Example*: Suppose that A is married to B. During the marriage, for estate planning purposes, A irrevocably transfers property to a trust that A created for B. Under the trust, B is to receive all of the income for her/his lifetime. Some years later, B obtains a divorce from A under a court decree. Acknowledging that B receives sufficient income from the trust, the court does not award any alimony to B. Because A and B were married at the time that A created the trust, A would be taxed on the trust income under §677(a)(1) notwithstanding the fact the income is paid to B.

- This would seem logical and non-controversial because, as a married couple, A and B are the equivalent of one "marital unit," so together, they receive and are taxed together on the income. However, upon divorce, even though A and B cease to be one "marital unit," the "grantor trust" rules of §677(a)(1) still apply to tax all trust income to A even though B receives such trust income.

- *Result*: For this reason, until the beginning of next year, §682 comes to A's rescue and taxes the trust income to B.[367] By its design, §682 is designed to match tax implications to economic reality.

7. 2017 Tax Act and §682 Repeal – Re-Shifting of Taxability.

8. Unfortunately, §682 is repealed as of January 1, 2019.
    a. Starting on January 1, 2019, the income taxability of certain alimony trusts is determined under *other* Code provisions, such as the "grantor trust" rules.

    b. However, the Grandfathering Exception described above should be applicable in that it applies to all of the §11051 provisions of the 2017 tax act and not just to the provisions affecting §71 and §215. Although it is not clearly stated in the 2017 tax act, presumably, if a trust is referenced in a pre-January 1, 2019, divorce decree as paying its income in lieu of alimony, the income tax treatment under §682 should continue to apply.

    c. Recall that in the above example, if A and B's divorce occurs prior to 2019, §682 taxes the trust income to B. Based on the wording of the Grandfathering Exception, §11051 of the 2017 tax act applies to any divorce or separation instrument executed after December 31, 2018. If the divorce decree references that the trust income is in lieu of a higher alimony (or any alimony) payment, then, because the decree was issued prior to 2019, §682 should still apply even after December 31, 2018.

i. *Example*: Suppose in the prior example that the divorce decree is executed after December 31, 2018; §682 would not be applicable and other income tax provisions would determine the trust's income taxability.

ii. *Example*: What if, in December 2018, in an effort to resolve the open issues between the parties and expedite the issuance of a final divorce decree, A creates and funds a trust that pays all of the income to B? The parties agree that the divorce decree should reference the trust and state that the income paid to B is in lieu of alimony. The divorce decree, however, is not issued until January 4, 2019. Under these facts, because it was created during the marriage, the trust would be a "grantor trust" as to A pursuant to §677(a)(1) and, upon the issuance of the divorce decree, the trust remains a "grantor trust" because after January 1, 2019, §682 would not then exist.

d. Can §682 Apply Even if the Divorce Decree is Silent?

i. An interesting anomaly concerning §682 is the fact that §682(a) applies even if a trust was not specifically created pursuant to a property settlement agreement or a decree of divorce or separate maintenance. To invoke §682(a), the divorce decree is not required to reference the trust -- the only requirement is that income be paid, or used for the benefit of, the donee spouse.

9. Recall that the Grandfathering Exception only applies to any divorce or separation instrument executed after December 31, 2018, which means that §682 should still apply to any divorce or separation instrument executed prior to January 1, 2019. Although the Congressional Conference Report did not give a specific reason for the grandfathering, it is likely that the exception is provided because the alimony payments were a factor in the particular settlement.

10. What happens, though, when the decree fails to mention the source of payments in lieu of alimony, i.e., payments already coming to a spouse under an existing trust?

a. *Example*: Suppose that, in the above example, the alimony trust created by A is not referenced in the 2018 divorce decree. Should the Grandfathering Exception apply?

b. Technically, there was a divorce decree and the decree was entered prior to January 1, 2019; however, the decree appears to be mutually exclusive from the trust because there is no reference whatsoever to the trust in the decree.

c. Given that §682 governs the taxability of the trust in 2018, should this trust fall within the Grandfathering Exception, or does the lack of a specific reference to the trust in the divorce decree now subject A to the "grantor trust" rules under §677(a)(1) even though it was obvious to the parties, but not stated in any manner in the decree, that the trust income was in lieu of alimony? The answer to this is unclear, and, technically, guidance is needed on this issue as well as to provide clarification as the applicability of the Grandfathering Exception to all trusts subject to§ 682.

11. SLATs and §682.

a. What about SLATs – does §682 apply to them?

b. Applicability of §677(a)(1)

c. As stated above, the typical SLAT is not an income trust but is a discretionary trust. In other words, all distributions to the donee spouse are at the discretion of the trustee and the donee spouse has no entitlement to any distributions.

d. Pursuant to §677(a)(1), §677(a) applies to trusts where income *may (as opposed to shall)* be distributable to a spouse ("… whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, *may be* … distributed to the grantor or the grantor's spouse").

e. Since a SLAT is a discretionary trust in which the income *may* be paid to the spouse, §677(a)(1) applies to a SLAT.

12. IRC §682 and the Regulations.

a. §682(a) provides, in part, as follows: "There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife *is entitled to receive* …" What, exactly, is entitled to receive?

b. In a discretionary trust, such as a SLAT, the donee spouse has no entitlement to receive any distributions -- all distributions are at the Trustee's discretion. So while the SLAT is a "grantor trust", it would seemingly not fall within §682 because the spouse can only receive discretionary distributions and is not entitled to receive anything from the trust.

c. The Regulations, however, clarify this issue – under Treas. Reg.

> §1.682(a)-1(a)(1), §1.682(a) applies where the income,
>
> "(i) Which *is paid, credited, or required to be distributed* to the wife in a taxable year of the wife, and
>
> (ii) Which, except for the provisions of section 682, would be includible in the gross income of her husband, is includible in her gross income and is not includible in his gross income."

d. Does "entitled" really mean the same as "paid"? Who cares! Treasury expanded the meaning of "entitled" and, as a result, SLATs are covered under §682.

Section 682 applies to certain trusts regardless if they are referenced in the divorce decree. If a trust is not so referenced, as of January 1, 2019, such trusts are governed under other provisions of the Code, which, because spouses are involved, reverts to the "grantor trust" provisions.

13. Ordinarily, when an individual creates a "grantor trust," it is possible to "toggle" the taxability on-and-off by relinquishing a power. For example, if a trust is a "grantor trust" on account of the inclusion of the Substitution Power, the grantor can "turn off" the "grantor trust" provisions by renouncing the Substitution Power. However, from the above analysis, §677(a)(1) cannot be "turned off" -- it remains in effect for as long as the grantor remains alive during the trust term. Similar to the news of the tax treatment of SLATs, this too would appear to be surprising news for any grantor who created an income trust for donee spouse and then became divorced from the donee spouse after December 31, 2018.

14. Unfortunately, courtesy of the power of §677(a)(1), if a divorce occurs after 2018 there may be few options, if any, to switch the income taxability to the donee spouse (to reflect economic reality).

15. Disabling. One way to disable §677(a)(1) is to modify the trust so that the income provisions are outside the scope of §677(a)(1). For example, if the

trust provides for a "trust adviser," the adviser could amend the income distribution provision so as to negate the applicability of §677(a)(1) by requiring income distributions to the spouse to be approved by an adverse party. If the trust does not provide for a trust adviser, the trust could possibly be judicially or non-judicially reformed or could be "decanted" to provide for one.[1] However, the question arises as to whether such a change by the trust adviser, if the law provides that the trust adviser is a fiduciary, would be a breach of fiduciary duty as to the donee spouse in her/his capacity as the income beneficiary of the trust. These suggested strategies are probably not possible with an inter-vivos QTIP because these changes could be considered to be a restriction on the donee spouse's income interest. Such a restriction could thereby disqualify the trust for the gift tax marital deduction under §2523(f). Alternatively, if the QTIP election is not invalidated, upon implementation of such a strategy, it may cause the entire trust to be immediately subject to transfer taxation pursuant to §2519.

16. Taking another approach, for those decrees that are issued before January 1, 2019, but fail to reference the particular trust, would it be possible for the decree to be amended after December 31, 2018, and have the amendment act to bring the trust within the Grandfathering Exception? There is no current answer to this question – the next likely step would be to request guidance from the Internal Revenue Service in the form of a private letter ruling request.

17. If the trust is a discretionary trust, such as a SLAT, whereby distributions can be made for any one or more of the spouse or the grantor's descendants, it may be possible for the trustee to effect distributions only to the descendants. This way, even though the trust would remain a "grantor trust" under §677(a)(1), the income would benefit the descendants and not the ex-spouse. However, this might not be feasible if the trust contains a Preference Clause, as the ex-spouse could object that her/his needs must be considered before any distributions can be made to the descendants.

III. DEFENDING TRUSTS – Restatement, UTC and Winners and Losers

A. Beneficial Interests in the Context of the Divorcing Spouse

1. In the context of divorce, the Ex may be successful in counting the partner's beneficial trust interest as property for purposes of determining either the amount of spousal support (maintenance or alimony) or the overall marital property award. In this context, the Ex does not reach the trust estate (except in the limited case of delinquent support), but he or she nevertheless benefits by successfully counting assets or income of the trust into the overall pool for purposes of division of property or for determining support.

2. When analyzing beneficial interests in trusts, courts sometimes use property law concepts from the law of present and future interests as applied to trusts. Such application has led to inconsistent and sometimes inaccurate characterizations. A brief review of such concepts is in order.

B. A General Review of the Law of Present and Future Interests

1. The Restatement (Third) Property – Wills and Other Donative Transfers (2010) ("Restatement of Property" or "Restatement Third") introduces the classification of present and future interests as follows:

> "The system of classification developed over the centuries in English land law to serve a variety of purposes, originating in feudal, military, and fiscal arraignments that have long since become archaic [citation omitted]. Today, present and future interests are predominantly created as equitable interests in trust, not as legal interests in land. For modern purposes, the system of classification based on English land law is unnecessarily complex. Restatement Third, Division VII – Present and Future Interests, Scope of Division VII."

For the benefit of judges and lawyers (and perhaps for the good of humanity), the Restatement Third adopts simplified terminology for classification that is descriptive of the interests themselves. Under its terminology, there are present interests and future interests, and within the ambit of future interests, there are only contingent and vested future interests.

2. Present Interests. Present interests are those that give a present benefit to the beneficiary that entitles the beneficiary to possession or enjoyment. Restatement Third § 24.1 and cmt. d. Examples are as follows: (1) an income interest for life or a term of years; (2) a power to appoint trust assets to himself or herself (a general power of appointment); (3) an overdue distribution that is mandated by the trust, such as a distribution or all or part of the trust estate upon the beneficiary reaching a certain age. As a property right, a present interest is enforceable by the beneficiary.

3. Future Interests.

   a. In contrast, future interests involve postponed enjoyment. Restatement Third § 25.1, cmt. c. A future interest may be contingent or vested.

   b. Contingent Future Interests. A future interest is contingent if, for any reason, it might not take effect in enjoyment. Restatement Third § 25.3 and cmt. f. Prior to the issuance of this Restatement in 2010, the terminology was overly complicated. What is now classified as "contingent" had been previously subdivided into three categories, namely, "vested subject to complete defeasance"; "vested subject to open" (or "vested subject to partial defeasance"); and "contingent". All are now simply contingent. Restatement Third § 25.3, cmt. a. The distinctions among the three categories were subtle and in some instances contrary to reason. It is no wonder that courts confused and misconstrued these classifications when consulting earlier versions of the Restatement or the jurisdiction's particular common law.

In the context of beneficial interests in trusts, contingent future interests include interests that take effect in enjoyment depending on surviving another person or living until a certain age. Such is true even if premature expiry would vest the enjoyment in that person's descendants pursuant to the terms of the trust. See Restatement Third § 25.3, cmt. g, illustrations 12 and 16. Under prior classification, such would have been "vested subject to complete defeasance".

c. Vested Future Interests.

A future interest is vested if it is certain to take effect in enjoyment. Under prior classifications, this interest was known as "indefeasibly vested". Restatement Third § 25.3 and cmt. a. In the context of trusts, there is no future interest that is vested, save in the case of a corporate taker such as a charitable organization or the estate of a named or ascertained beneficiary who does not survive the life estate of another. In such cases, there is a successor in interest to the named taker, specifically the charitable corporation or the estate of the named or ascertained beneficiary. See Restatement Third § 25.3, cmt. f, cmt. g, illustration 8. Few trusts, however, fail to provide that the premature expiry of a remainderperson results in a taking by other contingent beneficiaries who are alive at that time, most commonly the decedent's issue.

In the context of common split-interest trusts, the interest of a charitable organization of a charitable remainder trust is a vested future interest. In contrast, the interests of individuals at the back end of a charitable lead trust are contingent future interests if failure to survive would result in the taking by another under the terms of the trust, such as the decedent's issue.

With these classifications in mind, we may now turn to the diverse case law on property division and spousal support that considers whether or not a beneficial interest in a trust is considered to be "property".

C. Case Law Alert: Including or Considering a Beneficiary's Interest when Determining Property Division or Spousal Support.

In divorce cases, a spendthrift clause is often meaningless, because the court is not typically ordering a third-party trustee to distribute property; instead, the court is considering that property in making an overall property division or determining support.

1. Future Interest Cases.

    a. Contingent Future Interests.

    Remainders are an example of contingent future interests, but courts have been fairly liberal in counting them as marital property. E.g. *Buxbaum v. Buxbaum*, 692 P.2d 411 (Mont. 1984); *Zuger v. Zuger*, 563 N.W.2d 804 (N.D. 1997); *In re Balanson*, 25 P.3d 28 (Colo. 2001); *In re Marriage of Dale*, 87 P.3d 219 (Colo. Ct. App. 2003); *Trowbridge v. Trowbridge*, 114 N.W.2d 129 (Wis. 1962).

    In a Massachusetts Supreme Judicial Court case, the husband was a beneficiary of a spendthrift trust established by his father that had real estate as its sole asset and that was to end 21 years after his father's death. The father had died a few years before filing of the son's divorce action, so the 21-year period had begun to run. The court held that the son enjoyed a "vested right" to take his share of the real estate upon termination of the trust according to its terms, because at the son's current age of 26, "the likelihood is that he will survive to receive his share of the title". The opinion did not say how the son's interest would devolve if he died before the stated term of the trust. The court held that the son's interest was divisible marital property. *Lauricella v. Lauricella*, 565 N.E.2d 436 (Mass. 1991). This case is an example of a court that likely mischaracterized the remainder interest under property law. Unless the trust instrument did not name the husband's issue as a contingent remainder beneficiary (which would be unusual) and it was clear that the gift did not lapse, the remainder interest was in fact a contingent future interest.

    The most extreme example of such jurisprudence occurred in another Massachusetts case. In *Davidson v. Davidson*, 474 N.E.2d 1137 (Mass. Ct. App. 1985), the husband held a contingent future interest in his father's testamentary trust. If he survived his mother and lived to age 35, he would receive his share of the trust outright. The trustees had "uncontrolled discretion" to invade principal for his mother. Although the husband's remainder interest was "at the outer limits" of a property interest and was inalienable, the court classified it as marital property to be considered in making an overall division.

    The Supreme Judicial Court of Massachusetts reached a contrary result in the later case of *Williams v. Massa,* 431 Mass. 619, 728 N.E.2d 932 (2000).

In *Williams*, the husband was the contingent remainder beneficiary of trusts established by his father. The court upheld a finding that the assets were not part of the husband's estate and therefore not subject to division. In its reasoning, the court distinguished a vested remainder interest from a contingent one. It found that the "husband's contingent remainder interests in the two trusts were not clearly fixed and enforceable property rights…These interests were mere expectancies…" *Accord*, *Fernandes-Huff v. Huff*, 60 N.E.3d 1198 (Mass. Ct. App. 2016). The *Williams* court did not attempt to distinguish its opinion in *Lauricella*.

Other Massachusetts appellate decisions have determined that, where the spouse's remainder interest in a trust is subject to complete divestment by the possible exercise of a power of appointment held by another, the interest is not to be included as marital property. *S.L. v. R.L.*, 774 N.E.2d 1179 (Mass. App. Ct. 2002); *D.L. v. G.L.*, 811 N.E.2d 1013 (Mass. App. Ct. 2004).

Courts in some other states have not allowed a remainder interest to be considered. *Loeb v. Loeb*, 301 N.E.2d 349 (Ind. 1973); *Solomon v. Solomon,* 611 A.2d 686 (Pa. 1992); *Rubin v. Rubin*, 204 Conn. 224 (1987) (referring to the interest as an "expectancy").

b. Vested Future Interests.

The case of *Flaherty v. Flaherty*, 138 N.H. 337 (1994) is an example of a court that correctly discerned a rare vested future interest. In that case, the Supreme Court of New Hampshire upheld an award to the Ex of one-half of the beneficiary's remainder interest in a trust created by his parents. The parents, who retained an income interest, were alive at the time of their son's divorce, and he would not take unless he survived them. The court determined that his interest was "vested" because "the interest was certain to reach him upon the specified event of the death of the last surviving parent". The trust apparently provided that the premature death of the son would cause his interest to pass to his estate, as opposed to an alternate take such as his own issue. The court said, "If the [son] should die before the last surviving parent, then his interest would pass through his estate as an owned asset."

The *Flaherty* court omitted any quote of the trust language pertaining to the effect of the son not surviving his parents. It is noteworthy that some states have trust anti-lapse statutes that provide a rule of construction in favor of the heirs of a deceased taker. To overcome the presumption in favor of a *per stirpes* succession of an interest, the trust instrument must manifest the settlor's intent in that regard. *E.g*. Ohio Rev. Code § 5808.19.

2. Present Interest Cases.

A mandatory income interest is an example of a present interest because the beneficiary has current enjoyment and an enforceable right. Because the trust is generating current income and this income stream is capable of valuation, a mandatory income interest makes for an easy target when a court makes an award of property. *E.g. Fox v. Fox*, 592 N.W.2d 541 (N.D. 1999). Some courts have reached a different conclusion. *E.g. Sayer v. Sayer*, 492 A.2d 238 (Del. 1985); *In re Marriage of Guinn*, 93 P.2d 568 (Colo. Ct. App. 2004).

The same result would occur if the beneficiary had a power of withdrawal, a general power of appointment, or an interest in an overdue distribution, as discussed above in Section III. For an example of the latter, *see Burrell v. Burrell*, 537 P.2d 1 (Alaska 1975).

3. Discretionary Interests in Income or Principal (Expectancies).

Current interests in discretionary spendthrift trusts are not categorized by property law as present or future, but are generally known as expectancies.

a. Discretionary Trusts Subject to a Standard.

In the recent case of *Pfannenstiehl v Pfannenstiehl*, 475 Mass. 105, 55 N.E.3d 933 (2016), the Massachusetts Supreme Judicial Court took a well-grounded view of discretionary interests. In this case, the husband was a beneficiary of a discretionary spendthrift trust established by his father that had an open class of current beneficiaries, namely, the descendants of the settlor living from time to time. The trust was apparently dynastic, or at least it was not scheduled to terminate during the husband's lifetime. The trust instrument provided that the trustees "shall pay to, or apply for the benefit of, a class composed of any one or more of the Donor's then living issue such amounts of income and principal as the Trustee, in its sole discretion, may deem advisable from time to time, whether in equal or unequal shares, to provide for the comfortable support, health, maintenance, welfare and education of each or all members of such class." The husband and other beneficiaries had received substantial distributions from the trust, but the distributions to the husband ceased upon his filing for divorce.

The Supreme Court held that the husband's interest in the trust was so "speculative" that it created "nothing more than an expectancy" and, as a result, could not be considered property assignable to the marital estate. "A divorcing spouse's enforceable right to an asset generally permits that asset to be included in the marital estate," it wrote, but "when interests are properly characterized as mere expectancies, …they may not be included in the divisible estate of the divorcing parties."

In so ruling, the Supreme Judicial Court reversed the decision of the Appeals Court written by Associate Justice Berry. Judge Berry's opinion would make any lawyer with a sophisticated understanding of trust and property law cringe, and it marked a deviation from centuries of settled law. In that opinion, the judge referred to the spendthrift clause as a "subterfuge", dismissed the "unusual" testimony of a co-trustee (who was the settlor's lawyer) that the discontinuation of the distributions to the husband "was out of a concern that the intent of the donor (the husband's father) to keep funds within the family might be violated if distributions continued", referred to husband's present interest as "vested in possession" and, despite the dynastic nature of the trust and its inclusion of currently living grandchildren of the settlor in its open class, stated that "upon termination of the distributions from the trust, the husband will receive a share equal to his siblings" and that the "husband therefore has a vested beneficial interest". 88 Mass. App. 121 (2015).

A result consistent with the Massachusetts Supreme Judicial Court in *Pfannenstiehl* was reached in the case of *In re Goodlander & Tamposi*, 161 N.H. 490 (2011).

In the context of an award of spousal support, a New Jersey appellate court in *Tannen v. Tannen*, 416 N.J.Super. 248 (2010), *aff'd* 208 N.J. 409 (2011) ruled that the wife's current interest in a discretionary trust subject to a standard could not be taken into account in determining spousal support owed to her by her husband. The wife was the sole trust beneficiary but had never received a direct monetary distribution. The trial court, which ordered the joinder of the trustees of the trust (the wife and her parents), had ruled that the trust assets and their income should be taken into account in determining the husband's alimony obligations and ordered the trustees to distribute $4,000 per month to the wife. Such an order served to substantially reduce what the husband would otherwise have owed her as spousal support. The appellate court reversed (and the Supreme Court of New Jersey affirmed the appellate decision). It held as follows: "defendant's [wife's] beneficial interest in the [trust] was not an asset held by her. It was, therefore, improper to impute income from the [trust] to defendant in determining plaintiff's alimony obligation." In arriving at this conclusion, the court gave weight to the settlor's intent. The trust instrument provided that "it was the express intention of the Grantors…that [wife] shall not be permitted, under any circumstances, to compel distributions of income and/or principal prior to the time of final distribution." The court further held that the trial court had no power to order the trustees to make a distribution and that the trustees were not proper parties to the litigation.

It is important to distinguish *Tannen's* decision as to whether to include trust assets and income in determining an award of spousal support from the power of an Ex who has a judgment for support and who seeks to enforce it against the beneficiary's interest in the trust, as an exception to the spendthrift clause under common law and the UTC.

b. Purely Discretionary Trusts.

If the spouse is one of several beneficiaries and the trustee has complete discretion in distributing principal and income among them, courts have generally not considered such beneficial interests to be marital property.

In the Illinois case of *In re Marriage of Eddy*, 210 Ill.App.3d 450, 569 N.E.2d 174, 181 (1991), the trust in question was for the primary benefit of the wife's mother, who was still alive, and was for the further benefit of the wife and her descendants (the children of her marriage to husband). Other than the mandate to consider the wife's mother first, the trustee had complete discretion as to distributions. It also appears that the wife's father, who was also living, had a testamentary power of appointment over the trust assets that could have left the wife with no remainder upon her mother's death. The appellate court held that although the trial court could consider wife's "present interest" in making a property division, the trial court had erred in determining that a fixed percentage of the trust estate was marital property. "Potential inheritances … are not property which can be valued and awarded to a spouse, although they can be given some consideration in determining property distribution."

A still better result was reached in the Colorado case of *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991). The trust in this case was for the benefit of wife, wife's father, and wife's descendants. The trustee had complete discretion to distribute income and principal to any one or more of the beneficiaries. Upon the death of wife's father, wife did not take; instead, the trust would continue for the remainder of her life for the benefit of her descendants and her. At her death (or the later of the death of her father and her), her descendants took outright. The court concluded that the wife's interest was a "mere expectancy" and its appreciation in value during the marriage could not be considered as part of a marital property division, as would otherwise be the case under Colorado law for the appreciation in value of separate property. The court said that the wife had no "vested 'property' right to receive payment from the trust".

4. Decant and Swirl.

Estate planning and family law attorneys alike have been watching the unfolding of *Powell-Ferri v. Ferri* in Connecticut. In August 2014, the trial court dissolved the 19 year marriage of Nancy Powell-Ferri ("wife") and Paul John Ferri, Jr. ("husband"). At the time of trial there were three minor children, and wife had been a homemaker throughout the marriage. Husband's income had come from his involvement in numerous Valvoline franchises. Husband was the beneficiary of an irrevocable trust created by his father under Massachusetts law for his benefit in 1983 when he was 18 years old (the "1983 Trust"). The value of the 1983 Trust was between $69-98 million, and there were two independent individual co-trustees. The parties did not rely on the trust for their day-to-day expenses, although they received $300,000 for home improvements and regularly paid their taxes from the trust. Husband primarily used the 1983 Trust for franchise investment purposes, and under the 1983 Trust's terms, husband had a right to access 75% of the trust assets at the time the divorce action was filed, with a full right of access at his 47th birthday. Husband turned 47 during the course of the case.

While the parties' dissolution of marriage action was pending, the trustees of the 1983 Trust created a second trust whose sole beneficiary was husband, and relying on language in the 1983 Trust, independently decanted about 75% of the 1983 Trust assets into the new trust (the "2011 Trust"). Whereas the 1983 Trust gave husband the right to trust corpus at the attainment of certain ages, the 2011 Trust was a purely discretionary spendthrift trust, and the trustees exercised complete authority over whether and when to make distributions to husband. Husband had no present or future entitlement to the 2011 Trust funds. The trial court recognized that the assets in the 2011 Trust were not marital assets because husband had no present or future entitlement to those funds. In distinguishing the case from an earlier Connecticut Supreme Court case dealing with unvested pension benefits, the court stated, "The evolution of the doctrine of includable property in *Mickey* cannot be construed to extend to property of a trust that a beneficiary has no present or future legal entitlement to absent the approval of the trustee, where said approvals are solely in the trustee's discretion and control, as it is here with the 2011 Trust…The defendant's expectant interest in the 2011 Trust is not in any way vested… This expectancy is entirely conjectural and lacks any of the indicia of property contemplated to be included in the marital estate by the Supreme Court in *Mickey*." *Powell-Ferri v. Ferri*, 2014 Conn. Super. LEXIS 1993, 2014 WL 4638030 (Superior Court, 2014). However, the trial court also found that the 75% of the assets of the 1983 Trust to which husband had a full right of withdrawal were marital property subject to division, and so its analysis was limited to the 25% of the trust estate to which the husband did not enjoy the right of withdrawal at the time the divorce action was filed. The parties appealed.

Meanwhile, the trustees instituted their own declaratory judgment that they had properly exercised their trustee powers under the 1983 Trust when they distributed the property to themselves as trustees of the 2011 Trust and that wife had no interest in the 2011 Trust. *See Ferri v. Powell-Ferri*, (Conn. Super. Ct., June 5, 2014). The trial judge here found the decanting improper and ordered restoration of the 75% of funds that had been transferred from the 1983 Trust to the 2011 Trust. On appeal from this decision, the Supreme Court of Connecticut certified specific questions of law to the Massachusetts Supreme Judicial Court (regarding decanting and this Massachusetts trust). The Massachusetts Court in *Ferri v. Powell-Ferri*, 72 N.E.3d 541 (2017) looked to the language of the 1983 Trust. It found that, although a beneficiary has a fully vested interest in trust assets, it does not follow that such assets are now out of the fiduciary's control, and that "full legal title to all property of a trust and the rights of possession that go along with it" still belong to the Trustee. Since the 1983 Trust terms provided for the idea of decanting, the Massachusetts Supreme Judicial Court determined that the decanting to the 2011 Trust was proper. The Supreme Court of Connecticut in *Powell-Ferri v. Ferri*, 326 Conn. 438 (Conn. 2017) then adopted the Massachusetts Supreme Judicial Court's decision in full, stating that the "trial court incorrectly determined that the [trustees] did not have authority to decant the 1983 Trust and, accordingly, [we] reverse the judgment of the trial court on that issue."

In further addressing the appeal from the lower court's decision dividing marital property in the divorce action, the Supreme Court of Connecticut in *Powell-Ferri v. Ferri*, 326 Conn. 457 (Conn.2017) also discussed its full adoption of the Massachusetts decision regarding the proper decanting of the 1983 Trust, stating that "the 2011 Trust is a spendthrift trust and, thus, is not considered an asset of the marital estate that the court may divide" under applicable state law. The Court further stated that "although the court could divide those assets while they were held in the 1983 Trust, it could not reach them once they were moved into the 2011 Trust." Thus, the decanting stands, and the majority of the $69-98 million dollars was effectively removed from the reach of wife.

However, it is worth noting that the Supreme Court of Connecticut also upheld the trial court's finding that although it could not consider the assets of the 2011 Trust for equitable distribution in the divorce, "it could, and did, consider [husband's] ability to earn additional income when creating alimony orders" (326 Conn. 466). It ordered husband to pay to wife $300,000 in annual alimony, even though at the time of the action, husband had been earning $200,000 annually. Husband was further ordered to pay to wife 20% of his yearly earnings over $500,000. Thus, although trust assets were not considered a divisible marital asset, husband's access to income was considered in calculating support payable to wife.

5. Pure Discretion as a Sword.

Similarly, in a recent Ohio case, the bifurcated distribution standards of a trust further illustrate the points made above. In *Guagenti v. Guagenti*, 2017-Ohio-2706, husband's father established an irrevocable trust into which the father put his shares of the family business. Husband was named to serve as the trustee, and the beneficiaries of the trust were husband and husband's descendants. The Third District Court of Appeals affirmed the trial court decision holding that although husband's income interest in the trust could be taken into consideration when devising support awards, husband's beneficial interest in trust principal was purely discretionary and not subject to equitable division in the parties' divorce under R.C. 3105.171. Although husband was the trustee, an independent "protector committee" had complete discretion in distributing principal. The court determined that trust corpus was neither marital property nor separate property, but property of a third party and not subject to division in the parties' divorce. However, it is worth noting that although the trust corpus was not subject to division, the appeals court also upheld the earlier finding that trust income received by husband from the trust was a property interest he presently enjoyed and includable in determining husband's income. Whereas in *Tannen*, the wife's beneficial interest in trust income was not considered an asset held by her because she had never received a monetary distribution, in *Guagenti*, the husband had received many liberal distributions of income. And while in *Tannen*, the trust instrument explicitly stated that distributions could not be compelled until the final distribution, here the husband was the trustee of the trust in question and could make distributions of income to himself and his descendants for their support, and did so with some regularity. "Therefore, the trial court properly included the $330,000 of annual income distributions to [husband] from the [trust] in its calculation of [husband's] child support and spousal support obligations."

6. *Appendix B*, Case law update.

IV. DIVIDING TRUSTS

A. Master Plan Under Review.

1. All of the client's important planning documents, account titles and beneficiary designations will need to be updated to be certain chosen heirs are still appropriate, as well as designees for healthcare and power of attorney documents. Documents to consider include:

    a. Will and Trusts.

        i. These documents must be reviewed immediately.

        ii. Consider that not all states provide for revocation on divorce of bequests in wills or other estate planning documents. Even if revocation on divorce does apply, the statute will be inapplicable during the pendency of the divorce, until the final divorce decree is entered.

        iii. For example, in *Acosta-Santana v. Santana,* a husband was in the process of getting divorced, but died before a final decree was entered. His will divided his assets among his three children and his wife. If the divorce had been finalized, the wife would likely have received less than half of the amount she received under the will because the husband's premarital assets would not have been considered for equitable distribution purposes. The court denied the executor's motion to continue the divorce proceeding in the husband's place and instead dismissed the complaint with prejudice because divorce proceedings abate with the death of one of the parties prior to the entry of the final order of divorce. The New Jersey appellate court affirmed.

iv. *In re Matter of Leyton*, the decedent's mother and sister sought to disqualify the decedent's former same-sex partner as executor and a beneficiary under the decedent's will. They argued that he was the equivalent of a former spouse, disqualified from inheriting pursuant to EPTL §5-.

v. *In re Matter of Lewis*, EPTL § 5-1.4 disqualified the decedent's ex-husband from inheriting under her will or acting as executor. However, the ex-husband's father (the decedent's ex-father-in-law), was the successor beneficiary and executor and he was not disqualified under the terms of the statute. Presumably the ex-husband would inherit or obtain the property from his father, causing an end-run around the statute. While the court acknowledged this, it opined that the statute was clear and unambiguous in omitting the relatives of ex-spouses from disinheritance.

2. The Uniform Probate Code (UPC), in effect in Alaska, Arizona, Colorado, Idaho, Massachusetts, Michigan, Montana, New Jersey, New Mexico, North Dakota, South Dakota and Utah, revokes dispositions to and fiduciary nominations of the former spouse, as well relatives of the former spouse. This approach would have prevented the outcome in the *Lewis* case, but might not effectuate the decedent's intent in those cases where bequests to relatives of an ex-spouse (for example, step-children of the decedent) are still intended despite a divorce. Hawaii, Minnesota, Nebraska and South Carolina, which have also adopted the UPC, have modified the language to revoke testamentary bequests to the decedent's former spouse only, and not to the former spouse's relatives. Maine revised its statute, which previously revoked testamentary bequests to the decedent's former spouse only, and now also revokes bequests and fiduciary nominations of a former spouse and the former spouse's relatives.

3. Don't default. The most prudent course of action is not to rely on state default law at all. Divorced spouses, spouses in the process of getting a divorce and unmarried couples who are separated should give immediate attention to their planning documents, to ensure they reflect their intent (subject to elective share statutes and other legal restrictions). Importantly, there is generally no revocation on divorce regarding an ex-spouse's interest in an irrevocable trust. Some practitioners use the concept of a "floating spouse," defined as the spouse to whom the trust creator or beneficiary is married from time to time. If an ex-spouse actually is named as a trust beneficiary, other techniques may have to be considered to restructure the trust, including decanting, discussed below.

4. Powers of attorney and healthcare directives. It is obviously important to carefully review powers of attorney, which allow a designated person to conduct financial transactions, and health care directives, which allow a designated person to make important health care and potentially end-of-life decisions, to ensure that an estranged spouse is removed from those roles. In Michigan, if a patient advocate designation is executed during a patient's marriage naming the patient's spouse as the patient advocate, the designation is suspended during the pendency of an action for separate maintenance, annulment, or divorce and is revoked upon the entry of a judgment of separate maintenance, annulment, or divorce. If a successor patient advocate is named, that individual can act as the patient advocate.

5. Retirement accounts and plans, other beneficiary designations, such as life insurance. State laws that do provide for revocation on divorce may not apply to retirement plan beneficiary designations, which should be reviewed promptly. Spousal rights in retirement plans governed by the Employee Retirement Income Security Act of 1974 (ERISA) are subject to special rules. Life insurance is discussed later in this outline.

6. Authorizations to access digital accounts, including financial accounts, email accounts, social media accounts, etc. Note that authorizations to access online financial accounts, social media accounts and other sensitive information are generally not revoked on divorce and must be changed as soon as possible. In the context of an account owner dying, a uniform law (Revised Uniform Fiduciary Access to Digital Assets Act [RUFADAA]) provides guidance regarding an executor's and trustee's access to electronic records after the death of the account owner. RUFADAA has been introduced or enacted in at least 49 jurisdictions. RUFADAA takes a three-tiered approach:

    a. Directions given via a provider's online tool that can be modified or deleted at all times (for example, Google's "Inactive Account Manager," or Facebook's "legacy contacts") prevail over any other direction in a will, trust, power of attorney or other record;

    b. If the user has not utilized an online tool, or if the custodian has not provided one, a user's direction in a will, trust, power of attorney or other record prevails; and

    c. In the absence of any direction, the generic terms of service agreement (TOS) controls, which might provide that the account is terminated at death, and all data is deleted.

7. Accordingly, in order to avoid a provider's generic TOS Agreement potentially controlling, it is important to use a provider's online tool, if one is provided, to keep that designation updated during lifetime, particularly in the event of

separation or divorce, and to address these issues in estate planning documents, which are also appropriately updated.

B. The Long Pour - Trust Decanting for Revising an Otherwise Irrevocable Trust.

There's been continued state-level activity regarding "decanting," which allows the trustee of an otherwise irrevocable trust to transfer the trust assets into a new trust with different terms. The rationale behind decanting is that, if a trustee has the ability to make discretionary distributions to or for the benefit of a beneficiary, the trustee should also be permitted to exercise that discretion to distribute trust assets into another trust for that beneficiary. Decanting can be a tremendous tool for dealing with changed circumstances, correcting mistakes, facilitating tax benefits or optimizing a trust's administration. Decanting is not to be taken lightly. As the trend from Settlor's intent moves to focusing on the beneficiary's rights and interests, consider the following cases that lay some ground rules.

1. *Ferri v. Powell-Ferri,* also discussed earlier, is a recent example of the power of decanting in the divorce context. Trust assets were successfully moved out of reach of a divorcing wife, although they were considered for alimony purposes. Husband was the beneficiary of a trust (the 1983 Trust) created by his father under which he had the right to receive the trust assets at certain ages. The trust was valued between $69 – $98 million. The trustees, who were concerned divorcing Wife would reach trust assets, transferred the assets to a new trust (the 2011 Trust) without the knowledge or consent of Husband. At the time of the creation of the 2011 Trust, Husband had a right to request outright 75% of the 1983 Trust assets, and during the course of the legal proceedings, his right matured to 100%. The new 2011 Trust extinguished Husband's power to request trust assets at stated ages, making distributions solely discretionary with the trustees. Wife had filed to dissolve the marriage in Connecticut. The trusts were settled in Massachusetts. The Connecticut Supreme Court asked the Supreme Judicial Court of Massachusetts to determine whether the trustees, one of whom was Husband's Brother, validly exercised their powers under the 1983 Trust to distribute the trust property to the 2011 Trust. The Massachusetts Court determined that since Father, who created the 1983 Trust, intended to convey to the trustees almost unlimited discretion to act, the decanting was authorized. The Massachusetts Court did not rule on whether the trust assets must be considered in the divorce, including for alimony purposes. The Connecticut Supreme Court issued two opinions in the *Ferri* matters, one related to the decanting, the other related to the divorce action.

    a. Decanting was authorized. The trustees sought a judgment declaring that they were authorized to decant assets to the new trust, and that Wife had no right or interest in those assets. The Connecticut Supreme Court adopted the opinion of the Massachusetts Supreme Judicial Court and held that the decanting was proper.

b. The Connecticut Supreme Court did affirm the determination of the Connecticut trial court that Wife had standing to challenge the trustees' actions because their actions regarding the original trust directly affected the dissolution court's ability to make equitable financial orders in the underlying dissolution action. Under Connecticut law, the 1983 Trust was a marital asset because Husband had an absolute right to withdraw up to 75%, and later 100% of the principal.

c. Trust is not a Marital Asset; Considered in Alimony Determination. The court noted that the Massachusetts Supreme Judicial Court determined that the decanting was appropriate: "Consequently, the assets from the 1983 Trust cannot be considered as part of the dissolution judgment..." With regard to the 2011 trust, because that was a so-called "spendthrift trust" (protected from creditors), it was not considered an asset of the marital estate that the court could divide under Connecticut law. Wife's status was that of a creditor and the court held that, although the court could divide the assets while they were held in the 1983 Trust, it could not reach them once they were moved into the 2011 Trust – the decanting was successful in removing the assets from division. However, the court noted that, although the trial court could not consider the assets decanted to the 2011 trust for equitable distribution purposes, it could and did consider Husband's ability to earn additional income when creating its alimony orders. The trial court found that the trust funds had routinely supported Husband's investments. Notably, the trial court ordered Husband to pay Wife $300,000 in alimony annually, despite the fact that, when the action was commenced, he had been earning only $200,000 annually.

2. Refill. Note that about half the states, including Indiana and New York, provide statutory authority to decant. Michigan has two decanting statutes, one dealing with administrative decanting, and the other with dispositive decanting. Most states, including Indiana, Michigan and New York, require that notice be given to beneficiaries. It was important in the *Ferri* case that the decanting occurred without Husband's permission, knowledge or consent. Query if the same result would follow if a beneficiary was given notice of the decanting, or whether notice alone would not detract from the Connecticut Supreme Court's holding that Husband took "no active role in planning, funding or creating the 2011 Trust"

3. Including decanting provisions in trust instruments may maximize flexibility without resort to state default law. Indeed, in a recent New

York case, *In re Hoppenstein,* the trustees successfully relied on their powers under a trust document to distribute a life insurance policy on the settlor's life to a new trust that excluded an estranged daughter of the settlor and her issue. Dismissing an objection that the transfer did not satisfy the requirements of the New York decanting statute, the court held that the New York decanting statute had no bearing on the case since the trustees relied on their powers under the document to effectuate the transfer.

4. In *Hodges v. Johnson,* however, a New Hampshire court found that trustees had violated their duty of impartiality because they didn't consider the interests of beneficiaries who were removed in decantings. The court found that the decantings were void and ordered the removal of the trustees. Although the court's decision rested on broader grounds, the facts of the case may have influenced the holding: The trial judge found that the trustees decanted the trusts to remove beneficiaries in three separate decantings at the request of the settlor and commented on the "deeply personal and harsh nature of the decantings." The beneficiaries who were removed were the grantor's second spouse, his stepchildren and one biological child, leaving his other two children as beneficiaries. In each of the three decantings, one of the two individual co-trustees resigned, he was replaced by the settlor's estate attorney, the other co-trustee delegated his decanting power to the attorney/trustee who executed the decanting documents and once the decanting documents were executed, the attorney/trustee resigned as co-trustee, and the individual trustee who had resigned was re-appointed. Including specific guidance in trust agreements as to why the settlor may wish the trustee to exercise discretion unevenly may be helpful.

C. Unitrusts to Modify Trust Distributions.

1. A trustee must invest assets pursuant to the so-called Prudent Investor Rule. Under that rule, a trustee is required to invest for "total return." That is, a trustee must invest in a way that benefits both income and principal beneficiaries. However, when beneficial interests clash, as they typically do in a divorce scenario, the source of return becomes critical, and the tension between investing for income and investing for growth can become more pronounced. More specifically, how does a trustee invest without considering whether return is produced from income or from capital appreciation when the income beneficiary (perhaps a second spouse) is pressuring the trustee for more income and the remainder persons (perhaps children from a prior marriage) are pressuring the trustee for more growth?

2. Fortunately, there are two regimes that provide trustees with the means to implement the mandate of total return investing - the power to adjust and unitrust regimes. Under a power to adjust regime, the trustee is permitted to make adjustments between income and principal to be fair and reasonable to all beneficiaries. In other words, even if a principal distribution is not permitted under a trust document or is permissible pursuant only to a very limited standard (like health or education), the trustee can "redefine" a portion of the principal as income, and pay that to the income beneficiary. Under the unitrust regime, the trustee can convert an income beneficiary's interest into a unitrust payout of a fixed percentage of the trust's principal. Most states allow a trustee to determine the appropriate unitrust payout within a band of 3-5%.

3. These two regimes are intended to ease the tension between competing income and remainder beneficiaries and align interests, so that all beneficiaries benefit from the trust's growth, wherever that growth may emanate. Every state in the country has enacted one or both of these regimes, and every trustee or advisor should be aware of these powerful tools. In particular, consider whether existing trust terms should be evaluated in the event of divorce to potentially adjust beneficial interests. Consider the chart illustrating a few select state statutes on Unitrusts:

State	Power to Adjust	Power to Adjust Guidelines	Unitrust Regime	Unitrust Regime Guidelines
Delaware	Yes 12 Del. C. § 61-104	No guidelines	Yes 12 Del. C. §61-106	3% - 5% Unitrust
Florida	Yes Fla. Stat. § 738.104	No guidelines	Yes Fla. Stat. §738.1041	3%-5% Unitrust or 50% of AFR
Illinois	No	N/A	Yes 760 Ill. Co. Stat. 5/5.3	3-5% Unitrust
Indiana	Yes Ind. Code § 30-2-14-15	Trustee must first consider power to invade principal or income	Yes Ind. Code §§ 30-2-15-1-30-2-15-26	4% Default or 3%-5% by Agreement
Kentucky	Yes Ky. Rev. Stat. Ann. § 386.454(1)	No guidelines	Yes Ky. Rev. Stat. Ann. § 386.454(2)	3%-5% Unitrust or 4% if fiduciary makes no determination
Michigan	Yes Mich. Comp. Laws § 555.504	No guidelines	No	N/A
New York	Yes N.Y. Est. Powers & Trusts Law § 11-2.3(b)(5)	No guidelines	Yes N.Y. Est. Powers & Trusts Law §11-2.4	4% Unitrust
Ohio	Yes Ohio Rev. Code Ann. § 5812.03	Safe harbor for adjustments up to and including 4%	No	N/A

4. Note that even if a divorce action is taking place in one state, a spouse may be a beneficiary of a trust governed by the laws of another jurisdiction, so familiarity with the operation of that other state's power to adjust or unitrust laws may be important. Typically, the state statutes provide a number of factors for a trustee to consider in determining whether or not to make an adjustment or opt into the unitrust regime.

5. See, for example, the use of the unitrust regime in *Matter of Jacob Heller*. The trustees defended a challenge to their determination to opt into the unitrust regime. Jacob Heller created a trust under his will for the benefit of his second wife, who was to receive income for her life. Decedent's children from a prior marriage were named as remainder beneficiaries, and two of those step-children, the decedent's sons, became trustees. When Mrs. Heller's two step-sons became trustees of the trust, Mrs. Heller's annual trust payment was $190,000, far above a 4% payout. In 2003, the co-trustees opted into the unitrust regime pursuant to New York law to reduce the payment to their stepmother to 4% *and* opted to make their election retroactive to January 1, 2002 (the date the unitrust regime became effective in New York). As a result of the unitrust election, Mrs. Heller's annual income from the trust was reduced from $190,000 to $70,000. As result of making the election retroactive, Mrs. Heller would have owed the trust $360,000 ($120,000 a year from the date of the 2005 decision, back to each of the three preceding years).

   Mrs. Heller commenced a proceeding seeking to annul the unitrust election on the grounds that the co-trustees were also remainder beneficiaries of the trust and conflicted from making that decision, and a determination that the unitrust election could not be made retroactive to January 1, 2002. The court reasoned that the co-trustees owed fiduciary duties to Mrs. Heller as an income beneficiary, but also to all remainder beneficiaries, including the trustees' siblings. The fact that the remainder beneficiaries' interests aligned with the interests of the co-trustees did not disqualify them from opting into the unitrust regime. As such, a question of fact remained as to whether the co-trustees were reasonable in their unitrust election, precluding summary judgment on that issue.

   In addition, the Court of Appeals held that, since the New York statute allowed a trustee to specify the effective date of a unitrust election, the co-trustees' retroactive application of the unitrust election was proper. Note that in some jurisdictions the unitrust election can only be made prospectively. Since the decision in the *Heller* case, New York law was revised and a retroactive unitrust election is still possible, but only with court approval.

D. Life Insurance Review, Considerations and Cases

1. Life insurance is often as part of the ultimate resolution/settlement in a divorce, whether it is an asset to be allocated between the parties, or a requirement placed upon parties to maintain for some period of time. In *Woytas v. Greenwood Tree Experts, Inc.*, a Marital Settlement Agreement (MSA) required an ex-husband to maintain life insurance policies to secure his child support and alimony obligations. The MSA provided that, if either party failed to maintain the life insurance policy requirements, that party's estate would be liable for any outstanding obligations owned under the agreement. The policy included a "suicide exclusion" barring recovery of benefits if the insured were to commit suicide within two years of purchase, which he did. The New Jersey Supreme Court affirmed that the ex-husband failed to "maintain" life insurance, and therefore breached the MSA, entitling the beneficiaries to payment from the ex-husband's estate for the amount of the unrecoverable proceeds. Since the estate was less than the value of the claim, the court ordered that the entire balance of the estate be paid to the ex-wife.

2. It is critical to review life insurance policies periodically to ensure they are performing as intended at the best cost, and that the premiums are being paid by the responsible party. Other important issues may be uncovered by having a disciplined policy review procedure in place include (consider engaging the help of an insurance professional):

   - The interest rate environment could have affected the policy performance, particularly if initial illustrations were run in a different interest rate environment
   - Market returns may have underachieved expectations
   - Policies issued prior to 2009 are based on 1980 mortality tables
   - Life expectancies have increased over time which may generate lower premium rates in newerpolicies
   - Newer policies have guaranteed and/or extended Death Benefit Guarantees that may not have been available with the original policy
   - Are premium notices being sent to the correct address and are premiums being paid on time? This verification is often required, annually, or as demanded, in an MSA.

3. In *Orchin v. Great-West Life & Annuity Insurance Company* the insured's friend and fellow dentist Orchin served as trustee of a trust holding a life insurance policy. He did not miss a single premium payment from 1993 (when the policy was assigned to the trust) through January 2009. In April 2009, Orchin moved homes. Though he claimed to have told the post office his forwarding address, the insurance company was never notified of this change. It continued to send payment notifications to Orchin's old address, and as a result, Orchin never received them, nor the notices that the policy was in default or that it eventually lapsed. On January 15, 2010, the insured died suddenly. At this point, Orchin realized he failed to pay the previous premium payments. Omitting to mention that the insured had died, Orchin convinced a supervisor to exercise her authority to make aone-time exception and reinstate the policy. When Great-West discovered that the insured had died before the insurance was reinstated, they denied the claim. The insured's wife and Orchin brought suit against Great-West for improper termination of the policy and breach of contract, and the insured's wife also brought suit against Orchin for breach of fiduciary duty.

   The court held that Great-West's decision to reinstate the coverage was unenforceable. Although "a close question," the court denied Orchin's summary judgment motion because issues of fact remained. Specifically, there were questions regarding whether it was reasonable for Orchin to expect the insurance notices to reach his new address and whether he exercised ordinary diligence.

4. As well as emphasizing the importance of having a reliable policy review mechanism in place to prevent a policy lapse, this case also highlights the issue that, when friends or family members are appointed as trustees, oftentimes they are simply unaware of the myriad of duties to which they are subject. One important step a trustee can take to minimize fiduciary risk is to hire trusted professional advisors who are cognizant of the responsibilities imposed on fiduciaries and have expertise in fulfilling those responsibilities.

5. Does the policy have the correct beneficiary designation and are taxes apportioned as intended? A case decided in Georgia underscores the importance of having both the correct beneficiary designation and the tax apportionment result that was intended. In *Smoot v. Smoot,* decedent's ex-wife, Dianne Smoot, was the named beneficiary of life insurance and retirement assets that were included in the taxable estate. The decedent and Dianne had divorced in 2006, but the decedent had not changed any of his beneficiary designations. Having lost a previous action in which the decedent's son from a prior marriage claimed that Dianne was not entitled to the decedent's

retirement benefits, the son argued in this action that Dianne was responsible for paying her pro-rata share of the federal estate taxes. The tax apportionment clause in the decedent's will provided for taxes to be pro-rated against those who received property included in his taxable estate. The court held that federal law governed the tax apportionment concerning the life insurance proceeds. However, with regard to the retirement benefits, the court noted that, under Georgia law, "[a]ll provisions of a will made prior to a testator's final divorce…in which no provision is made in contemplation of such event shall take effect as if the former spouse had predeceased the testator..." According to the court, because the will made no provision in contemplation of divorce, the tax apportionment clause had to be construed as if Dianne had predeceased the decedent. Accordingly, the tax apportionment clause did not apply to her, with the harsh result that not only did the ex-wife receive the retirement benefits, but she received them tax-free.

6. Although states may have default laws that would have prevented this result (because designations are revoked in the event of divorce or because of default pro-rata tax apportionment provisions), this case is a stark reminder not to rely on state law but to carefully update beneficiary designations.

E. Dividing Trusts. Fun with Bob and Jane!

1. Hypothetical One: Trusts for the Benefit of Descendants

In 2012, Bob created two generation-skipping trusts, one for the benefit of Bobby and his descendants and one for the benefit of Janie and her descendants ("Bob's 2012 Trusts"). Jane is the trustee of both trusts. If Jane ceases to serve as trustee, then Bob's brother is her successor. He has the power to name his successors.

The trustee has broad distribution discretion with respect to both trusts. Bob retained the power in a nonfiduciary capacity to reacquire the trust property of each trust by substituting property of equivalent value.

Bobby's trust provides that in the event his family line dies out, the trust property passes to Janie's trust. Janie's trust has a reciprocal provision. If both Bobby and Janie's family lines die out, the remote takers are Wendy and their community foundation in equal shares.

Bob's 2012 Trusts are grantor trusts with respect to Bob. As a part of the divorce settlement, Bob wants to terminate the grantor trust status of both trusts.

Solving the problem:

To determine the steps necessary to "toggle out" of grantor trust status, Bob's 2012 Trusts must be analyzed to determine which powers or beneficial interests are causing them to be grantor trusts. Bob retained a corpus substitution power over each trust. A corpus substitution power is an administrative power under IRC § 675(4)(C), which causes each trust to be a wholly grantor trust with respect to Bob. Fortunately for Bob, he can relinquish the corpus substitution powers, and the trusts will no longer be grantor trusts with respect to him because of this administrative power. So, Bob is in the driver's seat with respect to this attribute of grantor trust status. The corpus substitution powers, however, are not the only trust attributes that cause the trusts to be grantor trusts. Jane is the trustee of each trust. Her distribution authority is not limited by a reasonably definite standard such as a HEMS standard. Consequently, the trusts are wholly grantor trusts with respect to Bob under IRC § 674. Jane has the power to control beneficial enjoyment under IRC § 674(a), and none of the exceptions of IRC § 674(b) or 674(d) apply.

One might think that upon divorce the exception under IRC § 674(c) would apply because Jane would no longer be related or subordinate to Bob, so she would be an independent trustee who could hold broad distribution powers without causing the trusts to be grantor trusts with respect to Bob. IRC § 672(e), however, provides that a grantor is treated as holding any power or interest held by any individual who was the spouse of the grantor *at the time of the creation of the power or interest*. Because Bob and Jane were married when Bob's 2012 Trusts were created, Jane's power to control beneficial enjoyment will be attributed to Bob even after their divorce. He will be deemed to have the power to control beneficial enjoyment under IRC § 674(a) and none of the exceptions of IRC § 674(b), 674(c), or 674(d) would apply. Bob is not in the driver's seat with respect to this attribute of grantor trust status; he needs Jane's cooperation. She needs to resign.

If Jane resigns, then Bob's brother succeeds her as trustee of both trusts. Because his distribution discretion is not limited by a reasonably definite standard and he is related to Bob, none of the exceptions under IRC § 674(b), 674(c) or 674(d) would apply, so the trusts would remain grantor trusts with respect to Bob. So now Bob needs his brother's cooperation. His brother could resign and appoint successor trustees who are not related or subordinate to Bob. This would disengage grantor trust status because the exception under IRC§ 674(c)

2. Hypothetical Two: Life Insurance Trust

In 1998, Jane created a life insurance trust to address liquidity issues that might arise upon her death with respect to her business (the "1998 Trust"). Bob is the trustee of the trust. The beneficiaries of the trust are Bob, Bobby, Janie, and their descendants. Bob's discretion with respect to distributions to Bobby and Janie and their descendants is not limited by a HEMS standard.

The 1998 Trust was not intended to be a generation-skipping trust. At Bob's death, the trust would divide into separate trusts for Bobby and Janie and each trust would end when the beneficiary reaches age 40. If Bobby or Janie were to die before reaching age 40, his or her trust would divide into trusts for his or her descendants until they reached age 40.

The 1998 Trust is subject to the common law rule against perpetuities with the measuring lives being Bob and Jane's descendants. All of the grandchildren have been born since 1998, so Bobby, Janie, and Wendy are the only measuring lives. Jane has funded the 1998 Trust each year using her annual gift tax exclusion. Bob and the children have withdrawal rights with respect to additions to the trust. The cash value of the life insurance policy in the trust is $450,000. The income tax basis of the policy is less than $450,000.

When IRC § 2632(c) was enacted providing for the automatic allocation of GST exemption with respect to certain GST trusts, Jane elected out of these rules for the 1988 Trust. Jane used all of her GSTT exemption when she created Jane's 2012 Trust. On the advice of her CPA, she has topped that trust off each year as her exemption has increased, so her currently available GSTT exemption amount is the 2017 increase only—$40,000.

As a part of the divorce settlement, Bob has agreed to give up his interest in 1998 Trust. In connection with any process that would terminate Bob's beneficial interest in the trust, Bob and Jane would like to see the policy end up in a generation-skipping trust. The 1998 Trust is a grantor trust with respect to Jane.

Solving the Problem:

With respect to the termination of Bob's beneficial interest in Jane's 2012 Trust, the conclusion was that the best option was for Bob to exercise his decanting power over the trust. Because the plan is for his beneficial interest in the 1998 Trust to terminate as well, decanting might the best option here. Bob has expanded distributive discretion under the UTDA, so he could exercise his decanting power to distribute the assets of the 1998 Trust to another trust or trusts— "second trusts" to use the terminology of the UTDA. It would be convenient if the second trusts were the second trusts created in connection with the exercise of his decanting power over Jane's 2012 Trust. Using those trusts would avoid a proliferation of trusts, and those trusts would have income producing assets that could pay the premiums on the life insurance policy, so Jane would no longer need to fund the premiums from her resources. There are two problems, however:

First, because the 1998 Trust is subject to the common law rule against perpetuities, any second trust resulting from a decanting of the 1998 Trust must provide that interests in the property distributed to the second trust must vest 21 years after the death of the survivor of Bobby, Janie, and Wendy otherwise the decanting would reduce or eliminate a vested interest. The second trusts resulting from the decanting of Jane's 2012 Trust have a 360 year vesting period. Distributing interests in the life insurance policy to these trusts would complicate the administration of the trusts because they would hold assets subject to two different vesting periods.

Second, the life insurance trust is not exempt from the GSTT. Although the gifts to the 1998 Trust were not subject to gift tax because they qualified for the gift tax annual exclusion, they did not qualify for the nontaxable gift exception to the GSTT. So the 1998 Trust would have an inclusion ratio of one for GSTT purposes. Jane would need to file a late allocation of $450,000 of GSTT exemption to cause the 1998 Trust to have an inclusion ratio of zero. Jane has only $40,000 of GSTT exemption, so a late allocation would not have much effect on the inclusion ratio of the 1998 Trust. If Bob were to exercise his decanting power to distribute interests in the life insurance policy to the second trusts created in exercising his decanting power with respect to Jane's 2012 Trust, those trusts would no longer have inclusion ratios of zero for GSTT purposes. Because of the differing vesting periods and inclusion ratios, decanting is not an ideal process for migrating the insurance policy held by the 1998 Trust to the second trusts created in the decanting of the assets of Jane's 2012 Trust.

A sale of the policy would be a better option, but there are income tax considerations with a sale. The 1998 Trust and Jane's 2012 Trust are both grantor trusts with respect to Jane. The 1998 Trust should be able to sell the policy to Jane's 2012 Trust without gain recognition because for income tax purposes the sale would be disregarded. The sale would need to take place before Bob exercises his decanting power with respect to Jane's 2012 Trust because one of the purposes of that exercise is to create second trusts that are not grantor trusts with respect to Jane. Gain recognition on the sale of the policy is not the only income tax concern in transferring the life insurance policy from the 1998 Trust. Bob and Jane would not want the sale of the policy to be a "transfer for value."

As a general rule, gross income does not include amounts received under a life insurance policy if the amounts are paid by reason of the death of the insured. There is an exception, however, in the case of a transfer for valuable consideration, and there are exceptions to this exception. If Jane's 2012 Trust purchased the life insurance policy from the 1998 Trust would there be a transfer for value? In Rev. Rul. 2007-13, the Service concluded that the sale of a life insurance policy from one trust to another trust for cash was, in one situation, not a transfer for a valuable consideration within the meaning of IRC § 101(a)(2) and in another situation, a transfer to the insured within the meaning of IRC § 101(a)(2)(B). In the first situation, both trusts were wholly grantor trusts with respect to the insured under the life insurance policy. In the second situation, the selling trust was not a grantor trust, but the purchasing trust was a wholly grantor trust with respect to the insured. Citing Rev. Rul. 85-13, with respect to the first situation, the Service held that because the grantor was treated as the owner of both trusts for federal income tax purposes, the grantor was treated as the owner of all the assets of both trusts, including both the life insurance policy and the cash received for it, both before and after the exchange.

Accordingly, the Service held that there was no transfer of the policy within the meaning of IRC § 101(a)(2).

In the second situation, the Service held that because the grantor was treated as the owner of all the assets of the purchasing trust, but not of the selling trust for on a promise or agreement. Such claims must be bona fide and for adequate and full consideration in money or money's worth. Under IRC § 2516, the transfer to Bob would meet this requirement.

In summary, regardless of the trust strategy, Bob and Jane have a number of tools at their disposal to accomplish their objectives. They could relinquish powers, exercise powers of appointment, change trustees, purchase trust assets, modify trusts under UTC § 411, divide trusts under UTC § 417, and exercise decanting powers under the UTDA. A number of factors determine which tool is best suited for the specific objective. Some could be used by Bob or Jane alone; others would require cooperation. Some tools would involve the exercise of fiduciary duties; others would not. Some would raise income, gift, and generation-skipping transfer tax issues that others would not. For each objective, Bob and Jane would want to select the tool that is the safest—the one with the fewest tax and fiduciary issues.

V. IN CONCLUSION

What have we created? A Frankenstein? Trusts are now drafted to evolve to suit the needs of generations of beneficiaries. And there are so many mad scientists and surgeons operating on theses trusts, including, trust amenders, protectors, special trustees, appointers, and parties that grant and remove powers, and approve decisions, that it is unclear what remains in the four corners of a trust document. Will this new flexibility limit or improve spendthrift provisions, asset protection strategies, and diminish a settlor's intent in the event of a divorce? Defending and dividing trusts in a divorce may yield disparate results as courts adjust to the new paradigm. The grantors and their spouses may have died, but the trust, "It's Alive!"

APPENDIX A

4D PLANNING

I. New Case Law – A Win for the Beneficiary-Spouse
Levitan v. Rosen

Massachusetts Appeals Court, May 6, 2019

A recent Massachusetts Appeals Court case has revisited the question of whether a spouse's beneficial interest in a discretionary trust should be included in the marital estate and thus subject to equitable division upon a divorce. In Massachusetts, upon a divorce, the court (guided by state statute) will determine which of the couple's assets are 'marital' assets comprising the marital estate. The court then divides the marital estate 'equitably' (meaning fairly, but not necessarily equally) between the husband and wife.

Background
In *Levitan v. Rosen (Levitan v Rosen*, Mass. Appeals Court No 18-P-847, May 6, 2019 *"Levitan")*, the wife was a beneficiary of an irrevocable trust (the "Trust"), created by her father. The wife served as co-Trustee along with an independent, unrelated Trustee. The terms of the Trust gave the independent Trustee discretion to distribute as much of the income and principal to the wife as he deemed advisable (this type of trust is often referred to as a discretionary trust). Additionally, the wife had the ability to withdraw up to 5% of the principal annually.

In 2013, after 16 years of marriage, the wife filed a complaint for divorce. The Probate and Family Court issued a judgment of divorce nisi, ruling that the 5% of the Trust the wife was able to withdraw annually constituted a marital asset subject to equitable division, but excluding the remainder of the wife's Trust interest from the marital estate because it was subject to the Trust's spendthrift provisions (discussed below). The wife appealed the ruling.

Appeals Court Findings

The Appeals Court disagreed with portions of the Probate Court's judgment. The Appeals Court concluded that the wife's <u>entire</u> interest (including the 5% withdrawal right) was governed by the Trust's spendthrift clause. A spendthrift clause is a provision included in a trust that is meant to prevent creditors, including divorcing spouses, from attaching the beneficiary's interest. However, the Court also found that the wife's entire interest in the Trust <u>was</u> part of the marital estate. The effect of this decision is that while the spendthrift clause prevented the Trust assets from being paid over to the husband in the divorce, the Trust assets were considered part of the greater marital estate for calculation purposes, and in determining what an equitable division of the marital assets would be, the Trust assets were 'allocated' to the wife's share.

The Appeals Court in *Levitan* interpreted the 2016 *Pfannenstiehl* Supreme Judicial Court Case, which established guidelines for determining what type of trust interest would be included in the marital estate in a divorce. The court in *Pfannenstiehl* held that for a trust interest to be included in the marital estate, the interest should be a "fixed and enforceable" property right, not so "remote or speculative" that the interest is better characterized as a "mere expectancy." The Appeals Court's interpretation of the *Pfannenstiehl* ruling led them to conclude that because (1) the wife was the sole beneficiary of her share, (2) no additional beneficiaries (such as children) could ever be added to her share, and (3) the primary intent of the Trust was to provide for the wife (as opposed to further generations), the Trust interest <u>was</u> a fixed and enforceable property right, not a mere expectancy, and thus considered a marital asset.

Comments

The Appeals Court's finding that the entire Trust interest was subject to the spendthrift clause is consistent with the purpose of the clause; indeed, its why practitioners include spendthrift provisions. However, the finding that the Trust assets were includable in the marital estate is concerning for many estate planners. Using fully discretionary trusts with independent Trustees is a long-standing planning technique, and this decision prompts questions from practitioners about protecting certain discretionary trust assets in the event of a divorce and also how best to structure trusts for children and future generations in order to protect the assets from a divorcing spouse.

The Appeals Court focused on the fact that the wife was the sole beneficiary of the Trust and the primary intent of the Trust was to benefit the wife, which led the Court to conclude that her interest was sufficiently distinguishable from a "mere expectancy." Depending on the given circumstances, it may be appropriate to include trust language that clarifies the Donor's intention to benefit multiple generations, and/or to establish a trust for a group of beneficiaries as opposed to establishing separate trusts or trust shares for each beneficiary.

APPENDIX B

4D PLANNING

I. A General Review of the Law of Property Division and Spousal Support

A. *Property Division*

State law on property division at divorce is essentially a recharacterization of the property held separately or jointly by the couple using community property concepts. As such, regardless of how property is titled, property earned during the marriage is considered to be "marital property"; and property that a spouse held at the time of marriage or acquired during marriage by gift or inheritance is that spouse's "separate property". States differ on whether the income from or the appreciation of separate property during the marriage is marital property.

In general, absent equities to the contrary, (1) marital property is divided equally between the parties, and (2) separate property is not subject to division. In a small minority of states, such as Indiana and Massachusetts, all property of either spouse is subject to division. Ind. Code § 31-15-7-4; Mass. G. L. c. 208, § 34. In the majority of states that respect the distinction between marital and separate property, the court is generally free to apply equitable principles in considering separate property when dividing up marital property or even awarding part of a spouse's separate property to the other spouse. The factors that a court will often consider are: "(1) The duration of the marriage; (2) The assets and liabilities of the spouses; (3) The desirability of awarding the family home, or the right to reside in the family home for reasonable periods of time, to the spouse with custody of the children of the marriage; (4) The liquidity of the property to be distributed; (5) The economic desirability of retaining intact an asset or an interest in an asset; (6) The tax consequences of the property division upon the respective awards to be made to each spouse; (7) The costs of sale, if it is necessary that an asset be sold to effectuate an equitable distribution of property; (8) Any division or disbursement of property made in a separation agreement that was voluntarily entered into by the spouses; (9) Any retirement benefits of the spouses, excluding the social security benefits of a spouse except as may be relevant for purposes of dividing a public pension; (10) Any other factor that the court expressly finds to be relevant and equitable..

B. *Spousal Support*

An award of support to one spouse (also known as maintenance or alimony) is a different issue than property division. A support award will be determined after the division of marital and separate property has been made. The court will award support to a spouse, payable from the income or property of the other spouse, if justice so requires. In determining the need for and the amount of support, the court is typically instructed by statute to consider a variety of factors. These often include the standard of living established during the marriage, the income of the parties <u>from all sources</u>, the present and future earnings capacity of each party, the education of the parties, and the duration of the marriage.

States differ on the validity and effect of pre- and post-nuptial agreements as affecting property division and support. A discussion of such is beyond the scope of this presentation. Illinois regards post-nuptial agreements under general contract principles, with consideration being a necessary factor and the agreement being subject to review by the court of equity both at the time it was entered into by the parties and at the time of its enforcement.

From the above discussion, we can appreciate that what is considered "property" is important in the context of property division. Furthermore, states vary as to whether income from all sources is considered when an award of support is made. These concepts lead us to a discussion of beneficial interests in trusts as property and the income derived from such interests. But first, a primer on the law of spendthrift and discretionary trusts is in order.

II. Law of Spendthrift & Discretionary Trusts

Most every trust contains a traditional spendthrift clause. These are widely held to be enforceable to protect the interests of beneficiaries (other than the beneficiary-settlor) against creditors of the beneficiary. But there are exceptions for the claims of certain parties and for any claim if the beneficiary's interest is one that mandates distributions. In the context of beneficial interests that are purely discretionary, the protection is significantly greater. Regardless of the level of protection, however, a divorcing spouse of a beneficiary (the "ex-to-be" or simply "<u>Ex</u>" hereafter) may be effective in counting all or part of the trust estate as either marital property or as part of the equation in determining a division of pure marital property, which in the latter case would result in one party being awarded more of the marital property than the other party. The Ex may also attempt to take beneficial trust interests into account in determining the spousal support (also known as maintenance or alimony) due to one or the other of the parties.

The spendthrift and discretionary trust provisions of the Restatement (Third) Trusts and the Uniform Trust Code will be examined next. The spendthrift and discretionary trust law of each state may deviate from it in significant ways.

A. *Restatement (Third) Trusts*

The Restatement (Third) Trusts provides the following on the general validity of spendthrift clauses:

> § 58. Spendthrift Trusts: Validity and General Effect
>
> (1) Except as stated in Subsection (2)…, if the terms of a trust provide that a beneficial interest shall not be transferable by the beneficiary or subject to

claims of the beneficiary's creditor, the restraint on voluntary and involuntary alienation of the interest is valid.

> (2) A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the settlor of a trust is invalid.

Spendthrift clauses do not prevent attachment by a general creditor, however, where the beneficiary has the "equivalence of ownership" [such as a presently-exercisable general power of appointment – see comment b(1)] or an enforceable right to a distribution. Regarding enforceable rights to a distribution, comment d(2) to Section 58 provides:

> In addition, property that has become distributable to the beneficiary but is retained by the trustee beyond a time reasonably necessary to make distribution to the beneficiary, and thus to which the beneficiary has a right to demand immediate distribution, is then subject to attachment by creditors of the beneficiary.

Examples of such enforceable rights are powers of withdrawal (*cf.* comment b to Section 58) and distributions upon the occurrence of an event (the attainment of a certain age or the death of a life income beneficiary). In the event of an attempt to attach an enforceable interest, however, a trust instrument may validly provide that the interest may be forfeited or become discretionary. The relevant section is as follows:

> § 57. Forfeiture for Voluntary or Involuntary Alienation
>
> Except with respect to an interest retained by the settlor, the terms of a trust may validly provide that an interest shall terminate or become discretionary upon an attempt by the beneficiary to transfer it or by the beneficiary's creditors to reach it, or upon the bankruptcy of the beneficiary.

The Restatement further provides for certain exception creditors who can reach the trust estate despite a spendthrift provision:

> § 59. Spendthrift Trusts: Exceptions for Particular Types of Claims
>
> The interest of a beneficiary in a valid spendthrift trust can be reached in satisfaction of an enforceable claim against the beneficiary for
>
> (a) support of a child, spouse, or former spouse; or
>
> (b) services or supplies provided for necessities or for the protection of the beneficiary's interest in the trust.

B. *Uniform Trust Code*

The Uniform Trust Code (2000) (as last revised or amended in 2010) provides for the general validity of spendthrift clauses:

SECTION 502. SPENDTHRIFT PROVISION

(a) A spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest.

(b) A term of a trust providing that the interest of a beneficiary is held subject to a "spendthrift trust," or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.

(c) A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision and, except as otherwise provided in this [article], a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.

The UTC allows any creditor to compel or attach a mandatory distribution. This provision parallels the Restatement concept of a creditor coming through an enforceable right of a beneficiary to a distribution. The relevant UTC section is as follows:

SECTION 506. OVERDUE DISTRIBUTION

(a) In this section, "mandatory distribution" means a distribution of income or principal which the trustee is required to make to a beneficiary under the terms of the trust, including a distribution upon termination of the trust. The term does not include a distribution subject to the exercise of the trustee's discretion even if (1) the discretion is expressed in the form of a standard of distribution, or (2) the terms of the trust authorizing a distribution couple language of discretion with language of direction.

(b) Whether or not a trust contains a spendthrift provision, a creditor or assignee of a beneficiary may reach a mandatory distribution of income or principal, including a distribution upon termination of the trust, if the trustee has not made the distribution to the beneficiary within a reasonable time after the designated distribution date.

Like the Restatement, the UTC provides for certain exception creditors:

SECTION 503. EXCEPTIONS TO SPENDTHRIFT PROVISION

(a) In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another State.

(b) A spendthrift provision is unenforceable against:

(1) a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance;

(2) a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust; and

(3) a claim of this State or the United States to the extent a statute of this State or federal law so provides.

As is apparent from Section 503, the UTC expands on the Restatement's list of exception creditors by adding the state itself and the federal government. In subsection (c) of § 503, the UTC further provides that the remedy of attachment is available to exception creditors:

> (c) A claimant against which a spendthrift provision cannot be enforced may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary. The court may limit the award to such relief as is appropriate under the circumstances.

The UTC specifically frustrates a creditor's ability to *compel* a distribution (as opposed to attach a current or future distribution) from a discretionary trust, unless the creditor is seeking child or spousal support, and even then under limited circumstances. UTC § 504 provides:

> SECTION 504. DISCRETIONARY TRUSTS; EFFECT OF STANDARD
>
> (a) In this section, "child" includes any person for whom an order or judgment for child support has been entered in this or another State.
>
> (b) Except as otherwise provided in subsection (c), whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if:
>
> (1) the discretion is expressed in the form of a standard of distribution; or
>
> (2) the trustee has abused the discretion.
>
> (c) To the extent a trustee has not complied with a standard of distribution or has abused a discretion:
>
> (1) a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse; and
>
> (2) the court shall direct the trustee to pay to the child, spouse, or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion.
>
> (d) This section does not limit the right of a beneficiary to maintain a judicial proceeding against a trustee for an abuse of discretion or failure to comply with a standard for distribution.

> (e) If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee.

In the context of discretionary trusts, UTC Sections 503 and 504, taken together, mean that no creditor may *compel* a distribution from a discretionary trust, except that an exception creditor for support may compel a distribution to the extent that the trustee has abused its discretion or has failed to abide by a standard of distribution. Any exception creditor may attach a distribution that is to be made currently under the terms of the trust or that is to be made in the future under such terms but may not otherwise compel a distribution.

APPENDIX C

MISCELLANEOUS CITATIONS

4D PLANNING

1. *Acosta-Santana v. Santana,* No. A-5646-16T4, 2018 WL 6332211 (NJ App. Div. Dec. 5, 2018)
2. *In re Matter of Leyton,* 135 A.D.3d 418, 22 N.Y.S.3d 422, 2016 N.Y. Slip Op. 00020 (1st Dept. 2016)
3. *In re Estate of Lewis,* In re Estate of Lewis, 25 N.Y.3d 456, 34 N.E.3d 833 (2015)
4. *In re Hoppenstein,* 2015-2918/ANYLJ 1202784244139 (Sur. Ct. N.Y. Co, March 31, 2017)
5. *Hodges v. Johnson,* 170 N.H. 470, 177 A.3d 86 (2017)
6. *Matter of Jacob Heller,* 800 N.Y.S. 2d 207 (App. Div. 2005), aff'd, 849 N.E.2d 262 (Ct. App. 2006)
7. *Woytas v. Greenwood Tree Experts, Inc.,* 237 N.J. 501, 206 A.3d 386 (2019)
8. *Orchin v. Great-West Life & Annuity Insurance Company,* 2015 WL 5726334, 133 F.Supp.3d 138 (2015)
9. *Smoot v. Smoot,* 2015 TNT 69-13, No. 2:13-cv00040 (U.S.D.C. S.D. Ga. March 31, 2015)