

# Drafting Trusts for Asset Protection

by Robert J. Kolasa

*The following is an outline summary of materials presented at the Wills, Trusts & Probate Committee's estate planning seminar held on November 18, 2005.*



## I. CONSIDER ASSET PROTECTION IMPLICATIONS FOR "ROUTINE" TRUSTS

### A. Initial Client Interview—Educate the Client about Asset Protection.

1. Inquire about asset protection concerns.
2. Explain benefits of holding in trust for children (versus outright distribution).
  - a. Protection from creditors;
  - b. Beneficiary enjoyment of assets in trust;
  - c. Potentially superior tax results.

### B. Trust "Funding"—Are we improperly "shifting" assets to a spouse with creditor problems?

1. Splitting Assets between husband and wife in order to fully fund Credit Shelter Trust.
2. Severing Tenants by the Entirety Real Estate.

### C. Marital Trust Estate Tax Planning.

1. *Outright transfer* to surviving spouse offers no creditor protection;
2. *Testamentary QTIP Marital Trust* offers significantly better creditor protection.
  - a. If clients consider a Qualified Terminable Interest Property or "QTIP" Trust as "too restrictive," counter that the surviving spouse effectively may have more money, as trust has better asset protection.
  - b. For optimal protection, spouse should not be sole trustee (have a "friendly" party as trustee, with the power to remove and replace the trustee).
  - c. If spouse is not acting as sole trustee, consider a discretionary QTIP Trust (no need for spouse to "justify" distributions based on "ascertainable" standards).
3. *Inter Vivos QTIP Marital Trust*
  - a. Fabulous funding technique—set up by "monied" spouse transferring assets to a QTIP trust for the "non-monied"

spouse during lifetimes of both.

- b. For estate tax purposes, trust assets are included in the non-monied spouse's taxable estate (estate tax "funding" is accomplished with an outright transfer to the non-monied spouse).
- c. Non-monied spouse is only required to get income from trust. Principal distributions can be discretionary or subject to a standard.
- d. May provide asset protection for both spouses (if asset protection for the monied spouse is a concern, he or she should not retain an interest in the QTIP Trust upon the death of the non-monied spouse).

### D. Dynasty and Generation Skipping Trusts.

1. Illinois Repeal of Rule Against Perpetuities. Illinois has repealed the rule against perpetuities 765 ILCS 305/4. Thus, an Illinois trust can continue for multiple generations until the trust assets are extinguished.
2. Typical Trust Structures.
  - a. Terminates upon the death of the last child to die, with outright distribution to grandchildren at that time.
  - b. "Pot" Trust—children, grandchildren and all generations are beneficiaries (fights among siblings?).
  - c. Splits into multiple trusts when parents pass away, i.e., pot trust for 2 children and descendants; upon parents' deaths, trust splits into two separate dynasty trusts for each child; upon child's death, trust splits into separate dynasty trusts for each grandchild and so on until trust assets are exhausted.
  - d. Can be structured as a *Discretionary Trust* (independent trustee to avoid estate tax inclusion and provide for discretionary distributions; power of trust-

- tee removal and replacement limited to unrelated and non-subordinate person—See paragraph IV.C.5. below).
- e. Can be structured as a Support Trust (beneficiary can be trustee without estate tax inclusion, as long as distributions are limited to an ascertainable standard).
  - f. Allocate Generation Skipping Tax Exemption in order to Mitigate GST Tax (Code Section 2631).
- E. **Special Powers of Appointment** (i.e., a power to appoint to anyone except the powerholder, the powerholder's creditors or his estate).
1. Creditors cannot reach property.
  2. Provides beneficiary with flexibility to transfer assets to family members during the beneficiary's lifetime.
  3. Contrast to General Powers of Appointment (power for holder to vest assets in himself). Trustee in bankruptcy can reach assets subject to a presently exercisable general power of appointment. 11 U.S.C.A. 541. See also Matter of Rolfe, 34 B.R. 159 (Bankr. N.D. Ill. 1983) (absolute right to withdraw trust principal nullifies spendthrift protection).
- II. **ASSET PROTECTION DRAFTING RECOMMENDATIONS**
- A. **Utilize a Discretionary Trust** (see below).
  - B. **Include a Spendthrift Clause**.
    1. General Protection.
      - a. Spendthrift Clause generally prohibits trust beneficiaries from assigning trust property and creditors from attaching undistributed trust property.
      - b. Beneficial interests in a spendthrift trust are generally not considered part of the bankruptcy estate 11 U.S.C. 541 (c)(2).
      - c. 735 ILCS 5/2-1403 generally provides Spendthrift Clause protection even if there is no express Spendthrift Clause in trust (but statute excepts from protection certain types of child support and self-settled trusts).
      - d. 760 ILCS 5/15.1 generally provides that a discretionary trust ("Special Needs Trust") established by a third party for a disabled beneficiary should not be subject to reimbursement for public aid or other assistance the beneficiary might receive.
    2. "Exception Creditors" may Defeat Spendthrift Clause protection.
      - a. Certain "Exception Creditors" may override Spendthrift Clause protection (e.g., such as alimony or tax claims).
      - b. Absolute right to withdraw trust principal nullifies spendthrift protection. Matter of Rolfe, 34 B.R. 159 (Bankr. N.D. Ill. 1983); 58, comment (d) Restatement (Third) Trusts.
      - c. Once property has been distributed to trust beneficiary, spendthrift protection is lost, 152, comment (j) Restatement (Second) of Trusts.
      - d. "Too much" beneficiary control may void spendthrift protection (See paragraph VI. below).
  - C. **Consider Independent Third Parties as Trustees**.
    1. More protection than beneficiaries acting as trustee; or
    2. Consider implementing a distribution committee to approve distributions.
  - D. **Trust with Multiple Beneficiaries Offers More Protection than Single-Beneficiary Trusts**.
  - E. **Be Judicious in Severing Tenant by Entireties Property**.
  - F. **Consider Trusts Lasting as Long as Possible (i.e., Dynasty Trusts) under State Law**.
  - G. **Grant Trustee Power to Suspend Distributions to Beneficiaries**.
    1. Financial Hardship;
    2. Alcohol or drug abuse;
  - H. **"Shifting" Trusts upon Triggering Event**.
    1. Triggering Event:
      - a. Insolvency of beneficiary;
      - b. Bankruptcy by beneficiary;
      - c. Creditor attempt to collect against trust.
    2. Types of Shifts:
      - a. Interest of beneficiary terminates;
      - b. Interest of beneficiary changes to:
        - i. Discretionary Trust (best protection);
        - ii. "Pot" Trust;
        - iii. Support Trust.
      - c. Third-party controlled Discretionary Trust becomes a beneficiary-controlled Support Trust upon the beneficiary reaching a specified age.
  - I. **Impose a Condition Precedent for Distributions to Beneficiaries**.
    1. For example, before distributions are made, beneficiary must be solvent or married (or

any other "worthy" condition).

J. **No Beneficiary Should Be Given a General Power of Appointment or Power of Withdrawal.**

1. If trust does permit beneficiary to withdraw assets, consider requiring a third party to consent to withdrawals.

K. **Include a "Facility of Payment" Clause**—allows trustee to apply any distributions for the beneficiary's benefit, instead of payments directly to beneficiary.

L. **QTIP Marital Trust Preferable over Outright Spousal Gift or Power of Appointment Marital Trust.**

III. **SELF-SETTLED TRUSTS (Grantor is also Trust Beneficiary)—NO ASSET PROTECTION**

A. **General Rule: a Creditor of a Self-settled Trust May Reach the Maximum Amount That the Trustee Could Distribute to the Grantor.**

156 Restatement (Second) of Trusts; *In re Simon*, 170 B.R. 999 (1994); *In re Marriage of Chapman*, 294 Ill.App.3d 611, 697 N.E.2d 365 (1st Dist. 1998).

B. **Examples of Self-Settled Trusts.**

1. Living Trusts;
2. Charitable Remainder Trusts (CRTs);
3. Grantor Retained Annuity Trusts (GRATs);
4. Qualified Personal Residence Trusts (QPRTs);
5. Crummey Trusts

C. **Exception to Self-Settled Trust Rule (i.e., asset protection even though Grantor is beneficiary).**

1. Foreign Asset Protection Trusts;
2. Domestic Asset Protection Trusts (Do these trusts really "work?")
3. "OBRA Pay Back Trust" and the "OBRA Pooled Trust." A disabled person, in order to qualify for Medicaid or to preserve eligibility, may create two types of self-settled Medicaid trusts. These two trusts (the "OBRA Pay Back Trust" and the "OBRA Pooled Trust") are described in 89 Ill. Admin. Code 120.347(d). In general, such self-settled trusts will not disqualify a beneficiary from Medicaid benefits if it is agreed that upon the death of the beneficiary the trust reimburses the Department of Public Aid for medical and nursing home expenses incurred for the beneficiary.

IV. **DIFFERENT TRUST DISTRIBUTION STANDARDS**

A. **Mandatory Distribution Standard.**

1. "LEAST" ASSET PROTECTION

2. For example—"income to wife for life" or "upon my death distribution of trust estate to X."

B. **Support Trust.**

1. "HIGH" ASSET PROTECTION

2. A support Trust directs the trustee to apply the trust's income and/or principal as is necessary for the beneficiary pursuant to a standard:

a. Example—The trustee shall make distributions for the health, education, support, or maintenance of the beneficiary.

b. In order to avoid bad tax results, the "standard" should generally be consistent with the health, education, maintenance and support "Ascertainable Standards" of Code Section 2041. See paragraph V.A.2. below.

3. Beneficiary's Rights—beneficiary of a Support Trust can compel the trustee to make a distribution consistent with the stated standard.

4. Creditor's Rights—Creditor's remedy to compel distributions—generally NONE if Valid Spendthrift Clause.

C. **Discretionary Trusts.**

1. "GREATEST" ASSET PROTECTION

2. Trustee has uncontrolled discretion to pay income and principal for beneficiaries without regard to any ascertainable standard;
- a. Undistributed income added to principal;

b. Can exclude a beneficiary from receiving any distribution;

c. Protection derived from tenuous nature of beneficiary's interest.

i. Example—The trustee may make distributions in the trustee's sole and absolute discretion to the current beneficiaries. In determining whether a distribution shall be made and the amount of any distribution, the trustee may exclude any beneficiary from a distribution.

3. Beneficiary's Rights—Abuse of Discretion. Beneficiary of a Discretionary Trust can compel Trustee to make a Distribution if it can be shown that Trustee has abused his discretion (generally trustee acted improperly, dishonestly, or arbitrarily). 187 Restatement (Second) of Trusts.

4. Creditor's Rights—Generally NONE. Gen-

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erally, as the beneficiary's interest is so indefinite or contingent, it cannot be reached by creditors. Protection does not depend on spendthrift provisions—hence even "Exception Creditor's cannot reach trust interests."

5. Tax Trap—If beneficiary has right to remove and appoint trustee in a discretionary trust, in order to avoid beneficiary from having a general power of appointment (triggering estate tax inclusion—usually a bad estate tax result) the appointed trustee must not be related or subordinate to the beneficiary within the meaning of Code Section 672(c) (i.e., generally can't be a spouse; child; grandchild; parent, or sibling of the beneficiary). Rev. Rul. 95-58. This is typically not a concern for a Marital Trust (as the assets will be counted in the surviving spouse's estate anyway), unless a "partial" QTIP election is contemplated.

D. **The Hybrid "Discretionary Support" Trust.** Grantor combines Discretionary Trust language with language that, by itself, would create a Support Trust.

1. Example: The trustee may in its discretion pay to my spouse, or for his benefit, so much or all of the principal of the Family Trust as the trustee from time to time determines to be re-

quired or desirable for his health, maintenance and support. The trustee need not consider the interest of any other beneficiary in making distributions to my spouse or for his benefit ... the trustee may in its discretion ... pay to ... one or more of my descendants to the exclusion of one or more of them so much of the principal ... for their health, education, maintenance and support. Is this a discretionary or a support trust?

2. Bad asset protection results?
  - a. In re George McCoy, 274 B.R. 751 (N.D. Ill. 2002), aff'd 2002 U.S. Dist. LEXIS 13239 (2002), the debtor in bankruptcy was the surviving spouse and primary beneficiary and trustee of a testamentary trust. The trust provided language similar to that provided in paragraph

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above.

- i. The Court ruled that the trust was not a spendthrift trust (i.e., therefore, trust is includible in bankrupt estate and subject to creditor claims) and reasoned that: "By vesting control of the trust in its primary lifetime beneficiary and granting him complete discretion to make payments to himself, the Trust reveals that settlor's primary dispositive intention was the preservation of her residuary estate for the benefit of her husband, rather than an intent to grant identical beneficial interests to other beneficiaries. The upshot here is that Debtor, as a primary life beneficiary with discretion to invade the corpus of a spendthrift trust for any purpose and to any extent and at any time he deems desirable, invalidates the alleged spendthrift character of the trust." *Id.* At 765.

3. Conclusion—do not use permissive language indicating "unfettered discretion" in a support trust.

**V. BENEFICIARY AS TRUSTEE—TAX ISSUES****A. Tax Trap #1—Beneficiary Acting as Sole Trustee—"Ascertainable Standard."**

1. Distribution should be limited to an "ascertainable" standard necessary in order to avoid (i) a taxable gift under Regulation Section 25.2511-1(g)(2); or (ii) the creation of a general power of appointment triggering estate tax inclusion under Code Section 2041(b)(1).
2. The Code and regulations (2041(b)(a)(A); 20.2041.1(c)(2); 25.2514-1(c)(2)) provide a number of examples of ascertainable standards:
  - a. health, education, support, or maintenance;
  - b. support;
  - c. maintenance;
  - d. maintenance in health and reasonable comfort;
  - e. support in his accustomed manner of living;
  - f. education, including college and professional education;
  - g. health;
  - h. medical, dental, hospital and nursing expenses and expenses of invalidism.
3. **Caution:** Do not vary from above ascertainable standards. Even a slight variance can cause the standard to become "unascertainable" and trigger bad tax results.

**B. Tax Trap #2—Beneficiary Acting as Sole Trustee—Discharge of Legal Obligations.**

1. Even if existence of "ascertainable stan-

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dard," the trustee who can distribute property in order to discharge a legal obligation is treated as possessing a general power of appointment to the extent of that obligation. Regulation Section 20.2041-1(c)(1).

2. Solution—Draft to avoid this by including a so-called Upjohn clause in the trust agreement that limits the exercise of a trustee's powers so that distribution powers will not be treated as a general power of appointment.

Sample "Upjohn" Language: No individual successor trustee may participate in the exercise of any discretion to distribute principal to himself or herself other than for his or her health, education, support and maintenance, nor may any individual successor trustee participate in the exercise of any discretion to distribute or expend principal or income in a manner that would discharge such trustee's personal obligation to support the beneficiary. If this paragraph precludes the exercise of a discretion otherwise provided, an independent per-

son may be named by the individual successor trustee as an additional trustee, with the sole authority to exercise these discretions.

**C. Tax Trap #3 (or Opportunity?)—Beneficiary Acting as Sole Trustee—Is Trust a Grantor Trust for Income Tax Purposes?**

1. Code Section 678(a)(1) provides that an individual will be treated as the owner of any portion of a trust with respect to which the individual has a power, exercisable solely by himself, to vest the corpus or income from the trust in himself.
2. *Ergo*, a trustee's power to distribute trust income or principal to himself (whether or not limited to an ascertainable power) causes the trustee to be taxed as the owner of the trust.
  - a. Example—Mom is trustee of deceased husband's credit shelter trust, providing for distributions of principal and income (pursuant to an ascertainable standard) to herself.
    - i. Arguably, under Code Section 678(a)(1), entire trust is a "grantor"



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trust and all income and capital gains will be taxed to Mom, whether or not amounts are distributed.

- ii. Is this "good" tax planning—disguised gift by Mom paying income taxes on property which will ultimately be distributed to children? Also, Mom's tax bracket may be lower than the highly compressed trust income tax brackets.
- iii. Note: Some tax attorneys disagree with this interpretation.

3. "Opt-out" of possible Code Section 678(a) (1) grantor trust treatment by requiring that distribution power be exercised in conjunction with a co-trustee or other third party.

### VI. BENEFICIARY AS TRUSTEE—CREDITOR PROTECTION ISSUES

A. **In General—"Too Much" Beneficiary Control may Nullify Spendthrift Protection.** If the beneficiary holds too much control over the trust, the creditor may be able to attach the beneficiary's interest and reach trust assets, irrespective of spendthrift provisions.

### B. **"Grey Area"—Will Spendthrift Provisions be Upheld if Sole Beneficiary is Sole Trustee?**

1. Some commentators contend that the creditor of a sole beneficiary-trustee should be able to reach whatever assets the beneficiary-trustee can properly distribute to himself under the terms of the agreement.
2. Lack of cases on this subject.
  - a. In re Bottom, 1716 B.R. 950 (ND. Fla. 1994) (creditor protection disallowed).
  - b. In re Coumbe, 304 B.R. 378 (9th Cir. 2003) (creditor protection allowed—debtor's children as contingent beneficiaries "counted" as additional beneficiaries).
  - c. Under some state statutes, a valid spendthrift trust will not exist when the sole beneficiary also serves as the sole trustee (Arizona R.S. 14-7706).
3. **Trust controlled by beneficiary-trustee invites scrutiny regarding the conduct of the beneficiary-trustee—if the beneficiary-trustee ignores the ascertainable standard (i.e., numerous, unauthorized distributions are made, or the trust acts as the beneficiary's "pocketbook"), the court may void creditor protection.**

"The Chapter 7 Trustee focuses his argument on the issue of dominion and control by the Debtor, while the Defendants argue that the Court should end its inquiry with the spendthrift provision in the original trust ... I agree with the Chapter 7 Trustee that the original trust should not be examined in a vacuum, but must be looked at together with the Addendum and the conduct of the Debtor, which disclosed blatant and unfettered dominion and control over the assets." In re McCullough, 259 B.R. 509,

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2001 Bankr. LEXIS 264 (D. R.I. 2001).

4. Example—Parent sets up trust for Child, wherein child is sole trustee and distributions are limited to health, education, maintenance and support, with child's grandchildren as remainder beneficiaries. Will this provide sufficient asset protection for Child? PROBABLY, as long as trust is properly administered by Child, *i.e.*, ascertainable standards are respected and trust is not used as Child's pocketbook with little regard for trust provisions.
5. Many commentators suggest that for "maximum" asset protection:
  - a. It's better to have an independent co-trustee (Code Section 674(c)), rather than a beneficiary act as trustee.
  - b. Consider "Distribution Committee" relating to distributions which beneficiary does not control (but may benefi-

ary be a member of such committee?).

- c. Consider having sole beneficiary trustee resign in the event of creditor attack.
- d. It's better to have multiple current beneficiaries.
- e. The beneficiary should be able to remove trustee only "for cause," or with the consent of a third-party "trust protector."
- f. Note that for Discretionary Trusts, beneficiary cannot be trustee and achieve asset protection or estate tax exclusion.

**C. What if Beneficiary is Co-Trustee?**

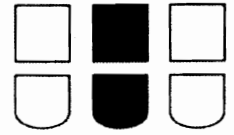
1. In re Hersloff, 147 B.R. 262 (M.D. Fla 1992); In re Schwen, 43 Collier Bankr. Cas. 2d 255 (D. Minn 1999, creditor protection allowed because debtor's control over the trust was limited by a co-trustee and fiduciary duties

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- to the other beneficiary).
2. However, trustee cannot be a "dummy" trustee, blindly following the settlor's instructions regarding investments and signing checks for distribution. In re McCullough, supra.
  3. What if beneficiary trustee has right to remove other co-trustee?
    - a. Does this signify "too much" control?
      - i. Perhaps limit removal rights "for cause" or in conjunction with a third-party "trust protector."
  4. "Investment Trustee" and "Distribution Trustee" combination.
    - a. Independent trustee named as "Distribution Trustee" subject to pure discretionary distribution standard.
    - b. Primary beneficiary is "Investment Trustee."
      - i. Makes investment decisions;
      - ii. Has power to remove and replace Distribution Trustee only in conjunction with the vote of another independent party.

#### VII. GOOD ASSET PROTECTION RESOURCES

- A. Spero, Peter, *Asset Protection: Legal Planning, Strategies and Forms*, published by Warren, Gorham & LaMont.
- B. Osborne, Duncan, *Asset Protection, Domestic and International Law and Tactics*, published by Thompson West.
- C. Bove, Alexander A., *Asset Protection Strategies*, Volumes I and II, published by the American Bar Association.
- D. Rosen and Rothschild, 810-2nd T.M., *Asset Protection Planning*, published by Tax Management, Inc., a subsidiary of the Bureau of National Affairs, Inc.

*Robert J. Kolasa is an attorney-C.P.A. practicing estate planning, probate and asset protection law in Lake Forest, Illinois. He also holds a Master of Laws in Taxation degree from Georgetown University Law Center and once was an attorney for the IRS National Office, Office of Chief Counsel, in Washington, D.C.*