Matrimonial Strategist[1]

Tannen – Recent NJ Case Upholds Protection of Trust

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Introduction

When trusts are involved between divorcing spouses, matrimonial practitioners are faced with a number of issues concerning the assets of the trust. Among these issues, important to the matrimonial practitioner is whether the wealth held in the trust is part of the marital estate subject to distribution, or if not whether the assets are available to provide support to a former spouse and the children born of the marriage. While the laws differ from state to state, and the law continues to evolve, there are valuable general lessons for the matrimonial lawyer and other matrimonial practitioners. This article, and the conclusion appearing next issue, will discuss a recent landmark New Jersey case that addressed whether, for purposes of determining alimony, it was appropriate to impute income to a party based on her beneficial interest in a discretionary support trust, Tannen v. Tannen, 416 N.J. Super. 248 (App. Div. 2010), aff'd, --- N.J. ---, --- A.3d ----, 2011 WL 6090130 (2011)("Tannen"). The key terms, "discretionary" and "support," will be discussed below. This case is likely to be cited in future cases when other state courts have to address this issue.

The Tannen case involved a less than optimal trust for a host of reasons, such as the fact that the grantor/parents remained trustees. It is unusual for the person forming and funding an irrevocable trust, the grantor, to serve as a trustee (other than in a revocable living trust). This and other provisions raise other tax concerns that were not addressed by the case . Further, the court did not have to address a range of ancillary issues that may prove critical to the resolution of how trusts should be treated in other matrimonial cases. These matters will be discussed below, and in the second part of this article.

Overview of Tannen and its Implications

For matrimonial practitioners to understand the essence of the Tannen decisions and similar cases they may confront, the distinction between a "support" and a "discretionary" trust needs to be clarified. A "support" trust is a trust which directs the trustee to make distributions to support the beneficiary. A common support standard is Health Education Maintenance and Support, referred to by the acronym "HEMS." A "discretionary" trust is one that grants the trustee the discretion to determine if, when and how much to distribute from the trust. As a generalization, if a trust were characterized as a pure support trust the court might be inclined to enforce the beneficiary's interests in

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the trust in a matrimonial action. If the trust is a pure discretionary trust, the courts would be hard pressed to find an interest to enforce and the trust should not be reachable. In reality, many trusts are combinations of the two standards, and that makes the decision process murkier.

The significance of the Tannen decision is the rejection of the Restatement Third of Trusts that a discretionary trust can be enforced as a support trust (based on the notion that the trustee must act in the best interests of the beneficiary). Instead, the decision reaffirmed that New Jersey will follow the Restatement Second of Trusts position that a purely discretionary trust will be honored as giving the trustee unfettered discretion to distribute or not distribute, regardless of the support needs of the beneficiary. This is important in areas far beyond matrimonial disputes. It is important in debtor/creditor situations as well. It is also very important in the area of asset protection for trust beneficiaries who may otherwise qualify for governmental benefits such as Medicaid.

There is a distinction between third party funded discretionary trusts (which should be effective against creditors) and self funded (or self settled) discretionary trusts (which should not be effective against creditors unless the trust was formed in Delaware, Nevada, South Dakota, Alaska or a limited number of other states that have enacted asset protection trust legislation.

In Tannen, there was an aspect of self funding in that the ex-spouse/beneficiary conveyed the marital home (which had been titled to her) to the trust. The decision does not address that fact. While effective with regard to the assets that were funded by the ex-spouse/beneficiary's parents, the spouse/beneficiary conveyed the marital home to the trust. As such, the court should have considered whether the trust should not have been effective with regard to the marital home and the consequences thereof. Also, is there a quantum of self-funding that might warrant treating the trust as entirely ineffective, not only as to the assets funded, but as to all assets.

Situs – Which Jurisdiction is Used and Which Should Govern

Another lesson from Tannen is that greater care should be exercised to proactively plan to use a purely discretionary trust in a jurisdiction which has adopted the Restatement Second of Trusts view. Ideally, the client should have the situs of the trust planned from inception to be in a jurisdiction with more favorable laws.

The choice of jurisdiction raises a host of issues. What if the trust was formed in New York and the parties at the time of divorce reside in New Jersey? Which state law governs? Depending on the facts involved, the intentions of the grantor may not be honored and may be subject to the forum state's choice of law provisions and the discretion of the court subjecting the trust to unpredictable results.

Many sophisticated trusts are intentionally designed to have a situs and governing law in Delaware, Nevada, Alaska, or South Dakota, which states have tax, property, trust and other laws that were enacted to be very favorable to trusts. In most instances this will

include the designation of an institutional trustee in the desired state. But even with this and other precautions, will the Full Faith and Credit clause of the Constitution apply to prevent application of these more favorable laws to a grantor domiciled in another state?

Tannen Does Not Mean a Slam Dunk that Every Trust is Protected

Some matrimonial attorneys will be lulled into concluding that any trust should provide protection in the event of a divorce, certainly one that appears to be discretionary in nature. However, the analysis is much more complex than that. Practitioners who merely assume a discretionary trust cannot be pierced may well miss a significant opportunity for their client if their analysis of the trust and surrounding circumstances is too superficial. Tannen, while an important case, addresses only a small part of the issue when dealing with trusts.

What Rights does the Ex-Spouse/Beneficiary have Under the Trust Instrument

Practitioners should begin the trust review process by evaluating the ex-spouse/beneficiaries rights and powers under the trust instrument. If they significantly exceed the control and access which the spouse/beneficiary had in Tannen there may well be a basis to distinguish Tannen (or whatever cases are applicable in your jurisdiction).

The analysis of the ex-spouse/beneficiary rights should not be limited to only what distributions he or she actually received. The Appellate Division, in Tannen, at 263, quoted , Aronson v. Aronson, 245 N.J. Super. 354 (App. Div. 1991), as follows: "The issue is not actual receipt of funds but access to them. So long as the spouse has the ability to tap the income source…whether he or she actually obtains the cash in hand is inconsequential."

The trust document that was addressed in Tannen included a restriction preventing the beneficiary from forcing a distribution that was influential in the court reaching its decision: "(C) Notwithstanding any other provision in this Trust Agreement to the contrary, it is the express intention of the Grantors in creating this Trust that the beneficiary shall not be permitted, under any circumstances, to compel distributions of income and/or principal prior to the time of final distribution." Tannen, at 256,

Other factors which might be relevant to consider:

- Crummey or annual demand powers (see also below) provide the ex-spouse beneficiary the right to withdraw gifts made to the trust. Crummey v. Comm'r, 397 F2d 82 (9th Cir. 1968). If the beneficiary had the unfettered right during the marriage to withdraw 100% of the gift transfers made to the trust, should that affect the shield afforded by the trust? While most or perhaps all estate planners might argue no, this issue was not addressed in Tannen. What if the Crummey power existed for ten years prior to the marriage and only one year during the

marriage? There is a more complex structure for many Crummey powers that is intended to avoid the release of a general power, called a "hanging power." This technique results in a potentially significant portion of the annual gifts remaining in limbo ("hanging") and hence reachable during such period by the beneficiary holding the power. Example: In year one Mom makes a gift of $13,000 to the trust and the ex-spouse/beneficiary is given the right to withdraw up to $13,000 (the annual gift exclusion). However, nothing is withdrawn. At the end of year one $5,000 of the $13,000 gift lapses but the remaining $8,000 hangs until it can lapse at the rate of the greater of $5,000 or 5% of the trust corpus. For trusts that have received annual gifts over many years, the amount "hanging" that the ex-spouse can reach could be significant.

- If the trust holds stock in an S corporation the trust may be characterized as a Qualified Subchapter S Trust ("QSST") to preserve the corporation's tax favored status. A QSST must currently distribute (or be required to distribute) all of its trust accounting income to the income beneficiary. This means that any income, as determined under the trust instrument and local law, received by the trust, must be actually distributed (or be required to be distributed) at least annually. Such a trust may afford no protection over income, but perhaps might afford some protection over corpus. In contrast, a grantor trust, or an Electing Small Business Trust ("ESBT") which too can hold S corporation stock are not required to make distributions. Query, would the results be different?

- A Florida court evaluated the consequences of a trustee abdicating certain fiduciary responsibilities, the beneficiary serving as trustee, and other powers, on the ability of creditors to reach a third party settled trust and upheld the trust. While favorable to trusts, the holding does not rule out such challenges from succeeding with different facts. Miller v. Kresser, 2010 Fla. App Lexis 6152 (Fla. 4th DCA 2010).

There are a host of other factors that may arise depending on the structure of the trust.

Might Rights Be Inferred under the Reciprocal Trust Doctrine

In some instances parents will establish trusts for their children and name sister as sole trustee of brother's trust, and brother as sole trustee of sister's trust. Clearly brother has no rights as trustee over his trust. But might there be another line of attack? The reciprocal trust doctrine is a legal doctrine recognized in the tax law for more than four decades. It addresses the establishment of similar trust and unwinding or uncrossing them. U.S. v. Grace, 395 316 (1969); PLR 9643013; PLR 200426008. Might there be merit to an argument that if brother has sole discretion over an identical trust for sister,

that he could force her to distribute what he wishes to him by refusing to distribute to her? Might a matrimonial court be persuaded by the similar concepts that have convinced courts to unravel mirror-image trusts for tax purposes?

This article will be concluded in the next issue.

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This article concludes the article from the last issue

How Was the Trust Operated and Maintained

Practitioners must analyze the operations of the trust. Advice of estate planning counsel and a CPA specializing in trust income tax planning and compliance are essential to carry out this task properly. Consider whether the trust has historically been operated and maintained in accordance with its terms? If the trustee did not bother with the most basic indicia of an independent and valid trust, e.g., the establishment of a trust bank account, perhaps the Court can be convinced that the ex-spouse/beneficiary should not be permitted to hide behind the shield of a trust he himself disregarded, in an effort to prevent his wife and children from having benefit of the assets of that trust considered in determining support and maintenance.

Courts have disregarded corporations when shareholders have used the corporation as a personal pocket book or disregarded the corporate form. Courts have extended the corporate veil-piercing to limited partnerships under certain conditions, and there has been discussion of extension of the concept to limited liability companies. Perhaps it can be argued that similar veil-piercing principles can be applied to trusts. Canter v. Lakewood of Voorhees, A-1795-10, New Jersey Law Journal, 205 N.J.L.J. 117, July 4, 2011. According to the Court in Canter, "[v]eil-piercing may apply when a partner's actions exceed the bounds of N.J.S.A. 42:2A-27b, which creates a "safe harbor" for activities such as being a shareholder or general partner, consulting with a general partner, or being the partnership's contractor, agent or employee. . . . It may also apply where the limited partner dominates the partnership and uses it to perpetuate fraud or injustice." If a ex-spouse/beneficiary serves as a co-trustee and completely disregards the formalities of a trust, but foists it as a barrier in the divorce, might that be a comparable to the Canter arguments?

Some factors which practitioners might consider in the analysis, and which many trusts inadequately address, might include:

- Does the trust have its own bank account? Are funds commingled?
- Has the trust made disbursements that were not legitimate trust expenditures.

- If the trust holds assets, such as insurance, are the correct persons listed as trustees on the insurance company records. In some instances insurance companies might not update their records from the initial trustees.

- Have appropriate gift tax returns been filed?

- Have assets been properly transferred to the trust? Too often tax returns may reflect that a trust owns an interest n a business entity but the requisite entity documents (e.g., assignments, operating agreements) have never been completed.

- Have appropriate Form 1041 income tax returns been filed? Were the Forms K-1s properly issued? Were the appropriate or required schedules attached (e.g., a split-dollar loan statement).

- Annual demand or "Crummey" powers are rights included in many trusts that afford the beneficiary the opportunity to withdraw gifts made to the trust each year up to the amount of the annual gift exclusion (see above). The purpose of this is to qualify gifts to the trust for the annual gift exclusion. Practitioners should ascertain whether the trustees issue these notices in conformity with the requirements of the trust.

- Have distributions from the trust followed the mandates contained in the trust instrument? For example, if a trust mandates that only income can be paid out to the ex-spouse/beneficiary, were distributions limited to that criteria? What if the trust provides that a particular beneficiary has an income (or other) interest but distributions are not made consistent with that right.

What quantum of disregard of trust formalities is tolerable before a court should prevent the ex-spouse/beneficiary from using the trust as a shield? While it seems clear that the more trust formalities that are respected the more likely it should be that a court would respect the trust, there are no bright line rules. Another issue that will undoubtedly arise, is what happens when the bank account was formed and Crummey powers issued the week after the Complaint was filed?

<u>Spendthrift Trusts are Not Always Bullet Proof</u>

A spendthrift clause is an almost ubiquitous trust provision that seeks to prevent the trust beneficiary from alienating, pledging or assigning the assets or income of the trust. It is an important component of the asset protection benefits many trusts endeavor to provide.

Exceptions to spendthrift trusts are recognized for specific types of claims in some states. For instance, if the state in which a particular case is heard has adopted the Restatement (Third) on Trusts, a different result may be reached than by the Tannen Court. The Restatement Third states that "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 . . ." Ch. 12, Section 59, Page 395

A spendthrift trust can protect the income and principal interests of its beneficiaries from claims of their creditors, but that principal or income must be properly [emphasis added] held in trust. Restatement (Third) on Trusts, Ch. 12, Section 58, Page 361. If the trust formalities have not been properly adhered to, perhaps it can be argued that the assets the ex-spouse/beneficiary is trying to protect with the trust should not shielded by the Trust.

Conclusion

The Tannen case was a victory for the estate planning bar in that a trust, which was not the poster-child for ideal planning, was upheld as protecting gifted assets from a former spouses claim for support. All practitioners, when counseling clients about prenuptial agreements should learn lessons from Tannen and guide their client to inform any potential benefactors to gift or bequeath wealth in the form of an appropriate crafted trust so that a challenge like Tannen, or worse, can be avoided. Most importantly, practitioners should exercise caution. The intersection of matrimonial law and sophisticated estate planning is extraordinarily complex, the dollars are large, emotions are high, and malpractice risks significant. Matrimonial lawyers are likely to face these issues in the future as the current $5 million gift exemption has motivated substantial numbers of wealthy taxpayers to shift wealth now, before Congress acts to limit the $5 million exemption. This has accelerated the trend of wealth transfers. The result will be an increasing number of cases requiring the analysis of trust owned wealth to resolve divorce matters. With the growing wealth concentration in trusts, Courts will be pressed to find other ways to reach trust assets if the results of not doing so will create a hardship on the ex-spouse and certainly on minor children. Practitioners confronted by a trust that seems impenetrable might consider some of the possible alternative lines of attack suggested in this article.