Focus
LOS ANGELES DAILY JOURNAL • WEDNESDAY, APRIL 12, 2006 • PAGE 9

Poorly Drafted Trust Could Become Subject to IRS Lien

By Bruce Givner

A parent may want to give assets to a child in connection with the parent's own estate tax planning. For example, a parent may be giving limited partnership interests in a family limited partnership or non-voting stock in a family "S" corporation to a child. The gift may be direct, or through a sophisticated gifting technique, e.g., a grantor retained annuity trust.

An interest in the family residence may be transferred through a qualified personal residence trust. As an alternative to, and sometimes in addition to, such "inter vivos" transfers, the parent may leave interests in property to a child at the parent's death. In either case, the parent may consider the benefit of asset protection planning for the child.

Tax Law

In other words, the parent may not wish to transfer assets to the child simply to have the assets satisfy the claims of the child's own creditors. Claims against the child's gift or inheritance might arise from the child's future ex-spouse, the child's own hazardous occupation and even a traffic accident causing liability in excess of the relevant insurance policy.

A parent with that concern should not give or leave property outright to a child. Once the child owns the property, it is available to the child's creditors. Instead, the parent should transfer the property to a trust for the child's benefit. However, not just any trust will do.

First, the trust must contain a spendthrift provision — for example: "No interest of any beneficiary shall be subject to sale, assignment, hypothecation or transfer by any beneficiary, other than in the exercise of an appointment power given to the beneficiary, nor shall the principal of any Trust, or its income, be liable for any beneficiary's debt, or to the process of any court in aid of execution of any judgment so rendered."

Second, the trust's spendthrift provision must not be circumvented. *In re Moses*, 167 F.3d 470 (9th Cir. 1999): "The critical inquiry in determining whether a spendthrift trust is valid under California law is whether the trust's beneficiaries exercise excessive control over the trust .... [A] participant cannot exercise excessive control over a trust thereby shielding the trust with an anti-alienation provision lacking true substance."

Third, the trust must give the trustee complete discretion as to the distribution of principal and income. And fourth, the trustee must be someone other than the child. (Or, at a minimum, the child should not be the sole trustee.)

With this structure, the child will be protected by two California Probate Code sections. Although the two sections' inter-relationship is unclear, both from the legislative history and case law, the following suggests one approach. The beneficiary's first protection is Probate Code Section 15307, entitled Income in Excess of Amount For Education and Support Subject To Creditors' Claims. It provides that, except for amounts needed to maintain the beneficiary's education and standard of living, "any amount to which the beneficiary is entitled ... or that the trustee [has discretionarily determined to] pay to the beneficiary ... may be applied to [satisfy the creditor's] money judgment ... . [T]he court may ... order ... the trustee to satisfy ... the judgment out of the beneficiary's interest."

In other words, a creditor can get only a portion of what is in fact distributed and a judge cannot force the trustee to make distributions. Presumably the trustee, carefully chosen by the beneficiary's parent, will determine that the beneficiary needs all distributions to maintain the beneficiary's standard of living (and the creditor will get nothing under this Probate Code section).

What if the trustee — even one predisposed to favor the beneficiary — is uncomfortable concluding that the beneficiary needs all trust distributions to maintain the beneficiary's standard of living? Assume the trust has $10 million of corporate bonds paying $800,000 per year. The trustee might distribute merely the amount needed to maintain the beneficiary's standard of living, e.g., $200,000. However, the trustee would be hard-pressed to conclude the beneficiary needs all the income or all of the principal (especially as principal increases by that amount of undistributed income each year).

The trustee might petition the court for instructions under Probate Code Section 17200. If the court agrees with the trustee's proposed action, the trustee is insulated from liability to an unhappy beneficiary (or creditor).

The beneficiary's second protection is Probate Code Section 15306.5, entitled Rights of General Creditors. This section gives the creditor an alternative if the trustee — under the previous section — determines the beneficiary needs all trust distributions to maintain the beneficiary's standard of living. The judgment creditor asks the court to determine the beneficiary's standard of living. Assume the judge determines the beneficiary needs less for "standard of living" than what the trustee decided. The judge can order the trustee to satisfy the judgment out of "payments to which the beneficiary is entitled under the trust instrument or that the trustee, in the exercise of the trustee's discretion, has determined or determines in the future to pay to the beneficiary." Probate Code Section 15306.5(a) However, the beneficiary has significant protection because that order "may not require that the trustee pay in satisfaction of the judgment an amount exceeding 25 percent of the payment that otherwise would be made to, or for the benefit of, the

beneficiary." Probate Code Section 15306.5(b).

Again, assume the trust has $10 million that generates $800,000 per year, and the trustee decides to distribute all income to the beneficiary. The judgment creditor who was victorious under Section 15306.5 cannot receive more than $200,000. If, instead, the trustee decides to accumulate $400,000 and only distribute $400,000, the creditor will get $100,000.

The theme of Chapter 2, "Restrictions On Voluntary And Involuntary Transfers," Part 2, of Division 9 (Trust Law) of the Probate Code is that judges and creditors cannot force distributions from discretionary spendthrift trusts to satisfy a beneficiary's obligations. That even applies to much-favored claims, those for child or spousal support. Probate Code Section 15305. The exception is when the beneficiary creates the trust for his or her own benefit. See Probate Code Section 15304, entitled Invalidity of Restraint on Transferee.

With this background, IRS Private Letter Ruling 200614006 (April 12, 2006) is unsurprising, but a useful reminder. The IRS chief counsel addressed two issues: "[w]hether the IRS may levy against a spendthrift trust under which the taxpayer is a current income beneficiary and is a vested beneficiary of a future interest in established portions of the trust principal"; and "[i]f the trustee knowingly distributes funds encumbered with the federal tax lien and the funds disappear into the stream of commerce, under state law may the government sue the trustee for the tortious conversion of the federal tax lien?"

A California resident created a trust for the benefit of his or her heirs. One heir, who had outstanding federal tax liabilities, was named the trustee. Income distributions were mandatory. Principal distributions were required on certain anniversaries of the trustor's death.

Under Internal Revenue Code Section 6321, entitled Lien For Taxes, the federal tax lien attaches to all of a delinquent taxpayer's property. The question of whether a state law right constitutes property is a matter of federal law. After the tax lien attaches, the IRS gives notice and demand for payment. If the taxpayer neglects or refuses to pay, the IRS may levy upon the taxpayer's property. Internal Revenue Code Section 6331, entitled Notice And Distraint.

The levy seizes the taxpayer's property as of the time of the levy, but — consistent with the Probate Code's theme — it does not accelerate a right to future payment. If a taxpayer has a fixed and determinable right to a stream of payments, the levy will seize not only the payments currently due but also payments to be made in the future.

Accordingly, the ruling concludes that the mandatory distribution of current income is a property right that may be levied by the IRS and collected as payable. Also, the levy will seize all future income payments. In other words, the federal tax levy seizes the taxpayer's present right to future payments, although it cannot accelerate the right to payment.

The ruling then concludes that the federal government may sue the trustee for tortious conversion of the tax lien. It notes that under California law, a lien holder may sue a defendant who intentionally impairs a lienor's security. *Nomellini Construction Co. v. U.S.*, 328 F. Supp. 1281 (E.D. Cal. 1971) (imposing liability for the tortious conversion of the federal tax lien under California law).

In this situation, if the trustee-beneficiary-taxpayer draws a check payable to herself as a trust distribution, then she will have impaired the federal tax lien if the government cannot recover the distributed funds.

Multi-generation asset protection planning should be considered in connection with estate planning (providing who gets what upon someone's death) and estate tax planning (reducing the estate tax due upon someone's death). Careful drafting of trust instruments can accomplish the parent's goal of providing income and assets to the child, and/or later generations, while giving a significant degree of protection to those assets from the heirs' own missteps.

Bruce Givner, of the Law Office of Bruce Givner, is a tax attorney in Los Angeles.