Expert Analysis Trusts and Estates Law
By Judge C. Raymond Radigan

The uncertainty that has emerged with the 2010 federal estate tax repeal and the current state of the economy has reconfirmed the importance of estate planning to preserve family wealth from taxes and creditors. A comprehensive plan must extend beyond the circumstances of the immediate client. This requires planners to utilize wealth transfer strategies that preserve assets throughout future generations. Without properly protecting beneficiaries from estate taxes, as well as their potential creditors and current and/or future spouses, a family's wealth preservation efforts can be severely hindered.

Despite our ever expanding litigious society and the upward trend in divorce rates, many clients fail to incorporate protective measures in their planning. The primary failure is the underutilization of lifetime trusts as a means to pass wealth to future generations. When properly drafted, a lifetime trust can be considered to: (i) provide a high level of beneficial enjoyment that is flexible and accessible, (ii) shield assets from a beneficiary's creditors, equitable distribution in the event of a divorce and the elective share upon death, and (iii) effectively keep trust assets from a beneficiary's taxable estate.

This article discusses the benefits and key components of lifetime trusts in New York and options in the absence of lifetime trust planning. It concludes with a 'friendly' lifetime trust approach applying the concepts presented herein. For purposes of this article, a parent or grandparent is referred to as 'client,' and a child or grandchild is referred to as 'beneficiary.'

Distribution vs. Lifetime Trust

Distributions made outright or through a trust that terminates upon some triggering event (e.g., a child reaching 30 years of age) should be the exception and not the rule. Clients are uniquely positioned because they can create lifetime trusts to provide substantial estate tax, generation skipping tax and creditor protection benefits that their beneficiaries would be unable to duplicate if those same distributions were outright. The vast majority of the benefits inherent in a lifetime trust are only attainable because someone other than the trust's primary beneficiary creates the trust and trust funds remain segregated from the beneficiary's other assets.

The fact is that clients generally are not capable of knowing whether their beneficiaries will have a taxable estate of their own, be a spendthrift, be faced with heightened creditor risk or simply be involved in a divorce. If any of these scenarios come to fruition, accumulated family wealth becomes unnecessarily exposed and planning efforts severely compromised. For these reasons, lifetime trusts should be utilized whether planning for inter-vivos transfers, testamentary distributions or remainder interests in more sophisticated planning devices such as a Grantor Retained Annuity Trust, sale to an Intentionally Defective Grantor Trust or a Qualified Personal Residence Trust. [FN1]

While assets held in trust are not outright by definition, trust assets can be effectively used to purchase and own assets whose utilization to the beneficiary is not significantly different than if the beneficiary purchased that item with an outright distribution. For example, if a second home is desired, the lifetime trust can make the purchase for the beneficiary. This way, the trust is the deeded owner and the beneficiary enjoys the estate tax and asset protection benefits of a lifetime trust, which are unavailable if the home was owned directly by the beneficiary.

Spendthrift Clause

An essential provision of a lifetime trust is a spendthrift clause expressly prohibiting trust beneficiaries from transferring, encumbering or pledging their beneficial interests in the trust assets. Subject to certain exceptions, EPTL §7-1.5(a)(1) provides that the beneficiary cannot voluntarily alienate the income interest. Conversely, unless otherwise provided in the trust, a beneficiary's interest in trust principal may be freely assigned or transferred pursuant to EPTL §7-1.5(a). Accordingly, it is critical to ensure that a spendthrift clause in the planning document covers both the principal and income interests of the beneficiary. [FN2]

Distribution Standard

A lifetime trust can be drafted as a discretionary trust, a support trust or a hybrid of both. A purely discretionary trust provides the best asset protection for the beneficiary in that the trustees have absolute and unfettered discretion to distribute trust income and/or principal to or for the benefit of the trust's beneficiaries. If the beneficiary is also a trustee, a provision prohibiting the beneficiary/ trustee from making distributions to himself or herself, for his or her benefit, or to persons he or she has an obligation to support, can be included to avoid adverse estate tax consequences to the beneficiary/trustee.

Of growing importance among estate planners is the flexibility to decant the trust pursuant to EPTL §10-6.6(b). If this flexibility is desired, the trust must be a purely discretionary trust giving the trustee absolute discretion over principal. Finally, in drafting a trust with absolute discretion, the planner should phrase the trustee's discretion to make distributions using the term 'may' rather than 'shall' to avoid a court's interpretation that the trustee's power is something other than absolute. [FN3]

Alternatively, a support trust distributes income and/or principal according to the standard(s) set forth in the document. If the client's intent is to avoid includability of trust assets in the estate of a beneficiary who is also a trustee that can distribute to himself or herself, an ascertainable standard such as health, education, maintenance and support (HEMS) is commonly used and recognized by statute and the courts. [FN4] Unlike a completely discretionary trust, a support trust provides that the trustee 'shall' distribute according to the standard(s) set forth in the trust agreement and, thus, enables the beneficiary to compel distributions necessary to satisfy such standard.

While this does not completely expose the trust assets to the beneficiary's creditors, the beneficiary retains an element of control that may enhance a creditor's ability to reach the trust assets. Moreover, because the standard is 'ascertainable,' some planners fear that although a trustee may want to make a distribution, the trustee may be limited when such need falls outside the standard, thereby hindering the beneficiary in meeting his or her needs.

Given these two distribution standards and their unique benefits, a hybrid approach has emerged. This approach provides the trustee with absolute discretion to make distributions within the limitations of an ascertainable standard. As discussed above, the full discretion component prevents creditors from forcing distributions and the ascertainable standard component helps avoid adverse tax consequences for the beneficiary/ trustee. Moreover, while an ascertainable standard may generally be vulnerable to creditors, a hybrid approach alleviates creditor risk because before the ascertainable standard is even considered, the trustee has the absolute discretion as to whether or not any distribution will be made. [FN5] Thus, a hybrid approach should provide as much creditor protection as a purely discretionary trust even though it contains an ascertainable standard. However, the hybrid approach will not enable decanting pursuant to EPTL §10-6.6(b), and distributions are limited to HEMS. Accordingly, a planner should consider all of the above factors when designing the distribution standard.

Control by Beneficiary

A common misconception is that trusts are primarily designed to allow the trust's creator (the grantor) to 'rule from the grave.' Although that is often the grantor's intent, a trust can also be designed to become 'friendly' by making the beneficiary a co-trustee at an age that the grantor feels such beneficiary does not need protection from himself/herself. By being a cotrustee, the beneficiary can control all aspects of the trust except for distributions. To expand the beneficiary's control, the trust can also provide the beneficiary with the ability to remove and replace the co-trustee. Importantly, the successor co-trustee does not have to be adverse to the beneficiary and can be the beneficiary's friend, close adviser, etc.

Another key characteristic of a 'friendly' trust is that the beneficiary can be given the power to control how the trust assets will pass upon his/her death. This power (referred to as a 'special' or 'limited' power of appointment) is estate tax neutral, as long it does not create a general power of appointment by allowing the beneficiary to exercise the power in favor of himself/herself, his/her estate or the creditors of either. Given the unique control retained by the beneficiary, passing assets in a lifetime trust designed to be 'friendly' is as close to outright ownership as possible, while the beneficiary retains important estate tax and asset protection benefits available under the law.

Holdback Option

In most cases the benefits of a lifetime trust will outweigh the negatives. However, for various reasons, some clients will nevertheless favor outright distributions. A viable alternative to consider is a terminating trust coupled with a holdback provision if, at the date of termination, the beneficiary is a defendant in serious litigation, or is involved in matrimonial difficulties or some other condition making it highly likely that the assets to be distributed would be subject to confiscation.

The effect of a holdback provision enables the trustee to extend the duration of a terminating trust by taking into account the beneficiary's circumstances. While this may appear to be a more flexible alternative to a lifetime trust, it provides the non-beneficiary/ trustee with a substantial amount of power and control, which may conflict with the client's objectives. Additionally, if the holdback is not exercised, trust assets are distributed and the estate tax benefits, as well as creditor and spousal protections are lost.

Disclaimer Option

In our experience, for some clients, outright distributions to beneficiaries are desired over lifetime trusts, despite the obvious benefits set forth above. This is often the case when clients want to ensure that their beneficiaries have complete and unfettered control over their inheritance. In this situation, a disclaimer or renunciation, pursuant to EPTL §2-1.11, can be a post-mortem option to achieve two goals of lifetime trusts--estate tax avoidance and asset protection. Of course, if a disclaimer is utilized, the intended beneficiary must give up all rights and benefit to the asset(s) disclaimed. Accordingly, this strategy is one of last resort and not a substitute to proper planning utilizing lifetime trusts.

For example, if an inheritance would adversely affect an already large taxable estate, the inheritance can be disclaimed causing it to be distributed as if the person disclaiming predeceased the testator. Just as the assets in a lifetime trust can be kept outside the taxable estate of the beneficiary, the assets disclaimed bypass the beneficiary's estate because ownership never vests due to the disclaimer.

Regarding creditor protection, planners should consider a disclaimer if circumstances exist where an inheritance may be subject to attack by a creditor's claim. It is well-settled law in New York that a post-mortem disclaimer will be honored even if the sole purpose is to avoid creditors. [FN6] The courts' reasoning is based on the belief that no one is required to accept a gift because such a mandate would frustrate the decedent's intent to benefit the distributee and not a creditor. Subject to a few exceptions,7 the post-mortem disclaimer can be a powerful asset protection technique saving assets that would have otherwise been preserved if initially transferred in a lifetime trust.

Conclusion

In considering the above concepts, if the client's family consists of mature and responsible children and/or grandchildren, employing a 'friendly' lifetime trust to preserve and enhance the utility of family wealth throughout the generations may prove especially beneficial. This type of trust can provide a client's beneficiaries with significant control during their lifetime, while containing a spendthrift clause and a hybrid power to make distributions that are fully discretionary within the limits of an ascertainable standard.

A 'friendly' lifetime trust can be drafted to maximize beneficial enjoyment while maintaining significant tax benefits and creditor/spousal protection. First, the beneficiary retains a significant level of control by: (i) becoming a co-trustee at a specified age with no right to make distributions for himself/herself or for his/her benefit, (ii) retaining a power to remove and replace the co-trustee at a specified age, and (iii) possessing a special power of appointment to direct the disposition of trust assets among his/her issue and/or spouse (if desired) at death. Next, the spendthrift provision combined with the trustee maintaining absolute discretion for distributions prevents the beneficiary's creditors from having enforceable rights to trust assets. As with most trusts, additional provisions such as a situs, supplement needs and EPTL §7-1.6 clause should be included to complement the concepts discussed above.

In summary, the benefits of planning with lifetime trusts will often outweigh the detriments and will provide much needed protection and flexibility in a well-crafted wealth preservation plan.

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FN1. A unique issue that can arise with a Qualified Personal Residence Trust is that a primary residence is frequently the residence transferred to the trust and the grantor often desires to rent the residence once their interest terminates and it is transferred to the beneficiaries. Without passing the residence to a lifetime trust as discussed herein, the beneficiary's creditors may be able to attach the residence and frustrate the grantor's intent to remain in his/her home.

FN2. See Matter of Vought, 303 N.Y.S.2d 61 (1969) (holding that a testamentary settlor's spendthrift clause prohibiting assignment of trust principal was valid).

FN3. See e.g. Magavern v. United States, 415 F.Supp. 217, 220 (W.D.N.Y. 1976); United States v. Taylor, 254 F.Supp. 752, 755 (N.D. Cal 1966).

FN4. The ascertainable standard prevents the trustee/beneficiary from having a general power of appointment over the trust and the trust assets are not includable in the gross estate pursuant to IRC §2041(b) (1)(A). See also Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947) (recognizing the tax protective features of an ascertainable standard). Planners intending to utilize an ascertainable standard must not deviate from HEMS (i.e., welfare, comfort, well being) because courts have consistently held that such standards are not ascertainable.

FN5. See Hamiltonv. Drogo, 241N.Y. 401(1926).

FN6. See In re Schiffman, 430 N.Y.S.2d 229 (Sur. Ct. New York County 1980).

FN7. First, a debtor cannot defeat a creditor by disclaiming joint property that the debtor contributed. See In re Lastella, 448 N.Y.S.2d 1017 (Sur. Ct. Nassau County 1982). Second, a debtor cannot disclaim to defeat a federal tax lien. See In re Adler, 869 F.Supp. 1021 (E.D.N.Y. 1994). Finally, property disclaimed will nevertheless be considered as an available resource for purposes of Medicaid eligibility. See In re Molloy, 631 N.Y.S.2d 910 (2d Dept. 1995).